ACBB
ATLANTIC COMMUNITY BANKERS BANK

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MONETARY TOOLS

BY JON EVANS

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One of the Federal Reserve Bank's major goals is 'long term stable economic growth'. This goal has always been a top priority in monetary policy and has, over time, resulted in the expanded use of monetary tools. This was especially true after the quantitative easing programs that the Fed enacted during the financial crisis. The Fed now pays interest on excess reserves, utilizes reverse repurchase agreements on a much larger scale, and continues to peg the federal funds rate as a key metric in carrying out monetary policy.

Reverse repurchase agreements (I sell you a security today and agree to repurchase it in the near future at a higher rate) have become a key monetary tool. The primary reason for this is that GSEs and money market funds are prohibited from investing in excess reserves. These reverse repurchase agreements take the place of investing in excess reserves at the Fed. Two of these GSEs: Freddie Mac and Fannie Mae have combined assets in excess of $5 trillion. These entities combined with money market funds (a $2.9 trillion industry) are significant and crucial players in the financial markets and as we found out during the financial crises are not without potential risks.

Reserves are another monetary tool of the Fed and they have two elements associated with it.

The first are reserve requirements. The Fed has the ability to change reserve requirements though this is rarely done due to the potential shock effects. Our reserve requirements on transaction accounts are for the most part 10% in the U.S., versus China who recently lowered its reserve requirement for banks to 17%. Theoretically, the less banks have to maintain in reserves, the more they can lend out.

> **The Fed has the ability to change reserve requirements though this is rarely done due to the potential shock effects.**

The second aspect of reserves is the interest paid on reserves. Before the financial crisis, the Fed paid interest on required reserves and furthermore kept this rate under the market fed funds rate, discouraging bankers from reallocating money out of the private sector. Fed funds, which we'll discuss in more detail, were borrowed to meet reserve requirements on a daily basis.

After the financial crisis began, Congress authorized the Fed in October 2008 to pay interest on excess balances or excess reserves. This was an important

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WELCOME NEWEST CUSTOMERS

National Grand Bank of Marblehead
Marblehead, MA

DID YOU KNOW?

In the MLB, there are currently five stadiums sponsored by financial institutions. Chase (Arizona Diamondbacks), Comerica (Detroit Tigers), Citizens Bank (Philadelphia Phillies), PNC (Pittsburgh Pirates), and Safeco (Seattle Mariners).
http://www.bargaineering.com/articles/50-fun-facts-about-banks.html

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FINANCIAL HIGHLIGHTS (consolidated)

BALANCE SHEET (in thousands)

	Unaudited	Unaudited
ASSETS	**3/31/16**	**3/31/15**
Cash and Due from Banks	$173,835	$248,485
Investment Securities	77,356	71,687
Federal Funds Sold	52,190	35,000
Loans, net	217,426	198,237
Other Assets	30,778	29,975
Total Assets	**$551,585**	**$583,384**
LIABILITIES AND CAPITAL		
Deposits	$362,027	$398,822
Federal Funds Purchased	69,912	76,031
Other Borrowed Money	37,831	29,522
Other Liabilities	6,162	6,171
Total Liabilities	475,932	510,546
Equity Capital	75,653	72,838
Total Liabilities and Capital	**$551,585**	**$583,384**

INCOME STATEMENT (in thousands)

Interest Income	$3,367	$2,854
Interest Expense	595	474
Net Interest Income	2,772	2,380
Provision for Loan Losses	0	(410)
Realized Gains (Losses) on Securities	0	0
Non-interest Income	3,431	3,191
Operating Expenses	4,565	4,562
Taxes	508	437
Net Income	**$1,130**	**$982**

COMPLIANCE ANCHOR – YOUR EDUCATION LIFELINE TO STORIES LIKE "THE PANAMA PAPERS"

By now you have probably seen our postcards and our new theme "Compliance Anchor – Your Education Lifeline". Our community banks are struggling to keep the balance between staying in compliance and still servicing the customers effectively. Of course the bottom line is that profits of these banks are shrinking as compliance seems to demand more resources.

So what exactly does Compliance Anchor do to help your bank meet these compliance challenges in an economical fashion besides bringing quality webinars on a monthly basis? We provide an overview all of applicable compliance news to your Compliance/BSA team every month that includes stories like "The Panama Papers". If you haven't seen it yet in the news, The Panama Papers are the biggest data leak in history involving 11.5 million files from the world's fourth biggest offshore law firm, Mossack Fonseca. (To give you perspective 250,000 files were released by WikiLeaks in 2010). The records were obtained from an anonymous source by a German newspaper that shared them with the International Consortium of Investigative Journalists who in turn shared them with international partners.[1]

The documents revealed the multitude of ways the rich can exploit secretive offshore tax havens. Twelve current and former world leaders were among those utilizing these havens including Vladimir Putin who moved as much as $2 billion

(Continued on next page)

SUMMARY OF FINANCIAL HIGHLIGHTS

YTD Net income of $1,130,000, was $148,000 above last year to date, and exceeded the March 2016 YTD budget by $438,000. In the first quarter of 2016, several "one-time" income events helped drive non-recurring profits, including additional interest income and expense reimbursements relating to the resolution of several problem loans.

A $410,000 credit was made to the loan loss provision in the first quarter of 2015.

Operating expenses have been contolled in 2016 at 2015 levels.

STRONG CAPITAL LEVELS:

Total Risk-Based Capital ratio = 25.76%
Tier 1 Risk-Based capital Ratio = 24.46%
Leverage Capital Ratio = 12.95%

FUNDING DIVERSIFICATION AND BALANCE SHEET RESTRUCTURING:

$19.2 million increase in net loans, or a 9.77% increase over the past 12 months.

Investment securities increased $5.67 million year over year, as new mortgage-backed securities were purchased.

The net $8.3 million increase in other borrowings was due to additional FHLB advances to support loan growth.

CREDIT QUALITY:

2016 YTD charge-offs were $0, while recoveries totaled $24,000.

Past due loans still accruing were only .2% of total loans as of March 31, 2016

Robust loan loss allowance as illustrated below:

- ALLL to Total Non-Current Loans of 329.2%
- ALLL to Total Loans of 3.83%
- Texas ratio of only 4.37%

OTHER RATIOS

Return on Average Assets	0.78%
Return on Average Equity	6.03%
ALLL to Non-performing Loans*	241.3%
Non-performing Assets to Total Assets	0.75%

* Includes performing TDRs

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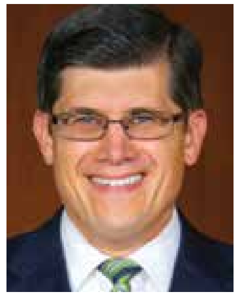
through banks and shadow companies. Others mentioned include drug dealers, politicians, billionaires, and fraudsters, celebrities, and sports stars. It also included at least 33 people and companies blacklisted by the U.S. because of evidence that they were tied to illegal activity such as doing business with terrorists or Mexican drug lords.[2] Numerous countries have launched investigations into their citizens mentioned in the leaked documents, of course, not everyone mentioned in the documents is tied to illegal activity.

Many feel stories like this are interesting, but they are not really applicable to our community banks here in the U.S. However, with the U.S. being one of the top money laundering countries in the world (second only to Kenya) due to the ease of establishing shell companies here, the release of the Panama Papers will only serve to increase the regulatory pressure on banks of all sizes to comply with anti-money laundering regulations. With tax evasion, data breaches and innovative technology exploding, knowing exactly with whom we are doing business and identifying beneficial owners is and will continue to be a constant struggle. Compliance Anchor is here to help keep your Compliance/BSA Officers up to date on news and regulatory expectations on a monthly basis.

1 http://www.theguardian.com/news/2016/apr/03/what-you-need-to-know-about-the-panama-papers
2 https://panamapapers.icij.org/20160403-panama-papers-global-overview.html

MEET OUR NEW BOARD MEMBER



David J. Hanrahan
President and CEO
Capital Bank of New Jersey

David J. Hanrahan is the founding President and CEO of Capital Bank of New Jersey, a commercial bank headquartered in Vineland, New Jersey which opened for business in 2007. Capital Bank has had an extremely successful history, has paid an annual cash dividend to stockholders since 2012, and reported record earnings in 2015. As of December 31, 2015 Capital Bank's assets totaled nearly $380 million.

Hanrahan is a member and past Chairman of the ABA's Community and Economic Development Committee, a member of ABA's Community Engagement Council and a member of ABA's Community Bankers Council. He currently serves as a member of the Rutgers University - Camden School of Business Dean's Leadership Council and on the Investment Committee of the Garden State Council – Boy Scouts of America. From 2008 to 2015 he was a Director and past Board President of Cumberland County Habitat for Humanity. He is also a member of the Vineland Rotary Club and Tenth Presbyterian Church in Philadelphia, Pennsylvania.

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step, as the Fed was able to establish a floor in the federal funds market. If banks wanted to purchase federal funds in the market, they would have to compete with the Fed's excess reserve rate. The rate the Fed paid on excess reserves was in fact higher than the market federal funds rate. While federal funds traded 8 to 12 bspts lower, a floor had been established. In addition, when the federal funds market tightened up in 2008, banks were reluctant to trade with one another, so the Fed became a safe haven for banks' excess liquidity. It was during this time that I and other bankers' banks' CEOs visited the Board of Governors to lobby for aggregators like ourselves to become agents for excess balance accounts, even for non Fed member banks. While bankers were seeking a safe place for their excess funds, the Fed needed funding for their quantitative easing programs of purchasing securities. This was adopted by the Fed shortly thereafter. While this is a tool the Fed should always have in its monetary tool box, the hope would be we can someday lower the rate back below the market federal funds rate and let the private sector operate in the free market.

These federal funds and the liquidity market they established are crucial to ensuring the private sector plays a key role in the liquidity markets. The private sector is truly the only sector whereby the forces of supply and demand can determine an appropriate market rate. It also provides the Fed a key metric in the federal funds rate which should reflect the effects of supply and demand. As mentioned, these same federal funds were the 'canary in the coal mines' in 2008 as banks no longer trusted each other with their excess funds. Having an early warning signal is another factor in encouraging a strong private liquidity market as the Fed would have a built in 'warning' signal.

An additional challenge in returning to a pre-crisis environment was brought about by unintended consequences resulting from the Liquidity Coverage Ratio ("LCR") established during the implementation of BASEL III – Liquidity.

Under the LCR, large banks (starting at $50 billion in assets for modified treatment and $250 billion in assets for full treatment) have additional imbedded costs or are now penalized for purchasing federal funds. Many larger banks we used to sell federal funds to are no longer in the market because of the limitations and added costs.

Federal funds purchased fell over 200% between 12/31/07 and 12/31/12. While federal funds is only one component of the overnight liquidity markets, it is still a key overnight instrument for banks and the Fed. It is also interesting to note

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YOUR BULLETIN BOARD

August 24 - ACBB Annual Golf Outing with business session, Hershey Country Club

Compliance Anchor 2016 Upcoming Events

Speaking Engagements:

May 25-26 Nancy Lake will be speaking at NH and VT 29th Annual Compliance Conference at Grappone Conference Center, Concord, NH

June 14-15 Gary Iorfido and Nancy Lake will be teaching Compliance and BSA/AML Overview for PA Bankers 2016 School of Banking at the Penn Stater Conference Center, State College, PA

June 24 Nancy Lake will be giving BSA updates to the Compliance Group in Harleysville, PA.

July 11-13 Nancy Lake will be speaking at the Anti-Fraud and Financial Crimes Conference in Antigua

Webinars

May 17 – Fair Lending

June 9 – AML Model Validation

June 21 – FinTech

July 19 – Vendor Management

Aug 11 – Body Language: What Your Banking Customers Are Really Trying to Tell You

Veterans' Venues:

BSA	Compliance
June 7	June 23
July 6	July 28
Aug 2	Aug 25
Sept 7	Sept 22

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that total reserves at the Fed as of February 2016 were approximately $2.5 trillion, up 260% over a ten year period. As mentioned previously, these reserves have been a significant funding source for the Fed's $4.5 trillion balance sheet.

If we want to reestablish the federal funds market as a key market in the private sector as well as having the Fed affect rates utilizing the federal funds rate, we'll need to get the large players back in the market. This will be a challenge unless we can get a change in the treatment of federal funds within the Liquidity Coverage Ratio.

In summary, the Fed has expanded its use of monetary tools beyond the traditional buying and selling of securities, and it has been wise to do so. It must deal with new players in GSEs and money market funds, in addition to much larger numbers or balances under its management. Reverse Repurchase agreements and paying interest on excess reserve are two tools the Fed is increasingly utilizing.

The Fed still has many challenges with one of them being to shrink its balance sheet under the current $4.5 trillion asset level. I also believe a strong private federal funds market is in everyone's best interest. This will require us to reexamine the rate paid on excess reserves once the economy strengthens, in addition to assessing the consequences of the unfavorable treatment on federal funds established under BASEL III Liquidity Coverage ratio.

Finally, what is still needed is a long term game plan. This plan should allow for the winding down of assets (predominately securities), while on the liability side of their balance sheet the excess reserves should also wind down. This could be accomplished by lowering the rate on excess reserves below the fed funds rate, thereby encouraging excess funds back into the private sector's federal funds market.

Finally, what is still needed is a long term game plan.

Please note: these opinions are that of my own and not that of ACBB or the Federal Reserve Bank of Philadelphia where I serve as a Board Director.

DID YOU KNOW?

A Federal Reserve Note has a life expectancy of: $1 bill, 22 months; $5 bill, two years: $10 bill, three years; $20 bill, four years; $50 bill, nine years; and the $100 bill, nine years. Coins usually circulate for 30 years.

http://www.bankrate.com/finance/federal-reserve/fun-federal-reserve-facts-1.aspx#ixzz44rvDLpSR

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