ROCKVILLE FINANCIAL
"Fourth Quarter 2012 Earnings Conference Call"

January 31, 2013, 10:00 AM ET
Marliese L. Shaw, Senior Vice President Investor Relations
William H.W. Crawford, Chief Executive Officer and President
John Lund, Chief Financial Officer
Scott Bechtle, Chief Risk Officer
Mark Kucia, Head of Commercial Banking
Eric Newell, Director of Treasury
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OPERATOR: Good morning, and welcome to the Rockville Financial fourth quarter 2012 earnings conference call. All participants will be in listen-only mode. Should you need assistance, please signal a conference specialist by pressing the star key followed by zero. After today's presentation, there will be an opportunity to ask questions. To ask a question, you may press star, then 1 on your touchtone phone. To withdraw your question, please press star, then 2. Please note this event is being recorded.

I would now like to turn the conference over to Marliese Shaw, Senior Vice President Investor Relations. Please go ahead.

MARLIESE SHAW: Thank you, Laura, and good morning, everyone. Thank you for joining us. Welcome to our fourth quarter conference call.

Before we begin, we would like to remind you to read our safe harbor advisement on forward-looking statements on our earnings announcement. Forward-looking statements by their nature are subject to risks and uncertainties. Certain factors could cause actual results to differ materially from expected results. Our comments today are intended to qualify for the safe harbor afforded by that advisement.

And now I would like to introduce Bill Crawford, our Chief Executive Officer and President.

BILL CRAWFORD: Thanks, Marliese. Good morning and thank you for joining us on today's call and for your continued interest in our company. Yesterday afternoon we released fourth quarter earnings. This morning I'll review some of the highlights of the strategies resonating in the fourth quarter results, and then my team will provide a more detailed overview of the quarter.

With me this morning is John Lund, our Chief Financial Officer; Scott Bechtle, our Chief Risk Officer; Mark Kucia, Head of Commercial Banking; Eric Newell, Director of Treasury; and Marino Santarelli, Chief Operating Officer.

I'm very pleased to announce that Rockville reported record fourth quarter earnings of 16 cents per share. The return on average assets for the quarter was 88 basis points. Rockville continues to be focused on organic growth, as reflected in both the substantial increase in loans and deposits in both the linked quarter and for the year.

Profits continued to be driven by earning asset growth, mortgage banking originations, and sales in the secondary market. The company's been working hard to transform the mortgage line of business, and it continues to develop and achieve process improvements. Mortgage production increased to a record $87 million in the fourth quarter, and the company recognized $1.3 million of gains on loan sales in the quarter, contributing to a 20 percent increase in annual core operating revenue year over year. The company achieved record quarterly earnings despite a 20 percent increase in year-over-year fourth quarter core operating expenses. Expense growth has been primarily driven by increases in salary and benefits costs as the company built out its support team and revenue-producing areas. Going forward, the company will primarily focus hiring in revenue-producing areas such as commercial banking, mortgage banking, retail, and financial advisory services.

Of note, our West Hartford Banking Center opened last week and represents an exciting business model for the company. In addition to the retail team, the composition also includes mortgage professionals, commercial bankers, a private banker, and a financial advisor, all from large competitors in the West Hartford market. All of our customers' financial needs will be met in one location, and this model will enhance our ongoing focus on organic business growth.

At Rockville, we remain committed to shareholder return and executing on sound capital management principles. The company paid both a regular quarterly dividend and a special cash dividend in the fourth quarter. We also executed 61 percent of the stock buyback program as of December 31, 2012. All in, the company returned 231 percent of its 2012 net income to shareholders during the year.

We recognize that 2013 will be a difficult operating year for banks, with asset yields continuing to decline and pressuring margins. At Rockville, we will always work thoughtfully in the best interest of shareholders to carefully navigate through these challenges without compromising our core values.

At this time, I'd like to personally thank our employees for their continued focus on delivering superior customer service, which is the driver of our success every day.

Now I'd like to turn the call over to John Lund, our CFO to provide some further detail on the quarter's results.

JOHN LUND: Thank you, Bill, and good morning, everyone. Thank you for joining us on our call today. I will review our fourth quarter operating results and financial position as described in our earnings release yesterday afternoon.

As Bill indicated, the company reported record fourth quarter earnings. Net income for the quarter ended December 31, 2012, of $4.3 million, or 16 cents per share, is largely reflective of the company's commercial banking expansion and mortgage banking business development.

Net gains from sale of loans were $1.3 million in the fourth quarter of 2012 and $4.4 million for the year. This is a $2.7 million, or 158 percent increase in net gains from sales of loans over the prior year. I caution, however, that while the 2012 results were substantially driven by volume increases that earnings also benefited from market spreads, which were exceptionally wide. We experienced narrowing of spreads in the fourth quarter to some extent and are currently observing much narrower spreads.

Net interest income benefited from the $42 million linked quarter increase in earning assets. Total loans increased $57 million, or 4 percent, during the linked quarter, comprised largely of commercial loan growth, which Mark Kucia will discuss in more detail shortly.

The net interest margin was influenced by the decline in loan yields and decreased to 3.74 percent on a tax equivalent basis for the fourth quarter from 3.8 percent in the prior quarter. The company has largely realized the benefits of deposit pricing, and any incremental benefit in the cost of funds will be achieved through continued migration to core deposits from time deposits and from composition changes as the company focuses on increasing non-interest bearing deposits.

We are certainly mindful that this artificially low rate environment presents significant challenges to maintaining margins. In this environment, we will seek to continue to mitigate interest rate risk though continued proactive asset liability management and continually assess our interest rate sensitivity position.

Regarding non-interest expenses, on a year-over-year basis, the $3.3 million, or 28 percent increase, was primarily concentrated in salaries and benefits expense. The salaries and benefits expense increase of $3.3 million, or 56 percent, is reflective of higher staffing levels. Fifty full-time equivalent employees were hired through the 12 month period ending December 31, 2012, comprised of about 10 in the commercial banking department, 30 in the mortgage banking business line, and 10 in support of the West Hartford Banking Center.

Additionally included is the impact of the June 2012 stock awards to officers, which reflects a $328,000 increase in fourth quarter benefits expense. Annual salaries and benefits expense also included the impact of higher pension expense in 2012, which was increased by $864,000, or 112 percent, over the 2011 expense.

The company announced last quarter that it would be hard freezing the plan as of December 31, 2012. For 2013, it is expected that the incremental decrease in pension expense will approximate $1.1 million and continue to diminish over time based on current modeling.

The company did contract with an efficiency consultant in the fourth quarter, with the goal to benchmark itself against other high performers in order to fine tune processes and position the company for success in the future.

To conclude, we are pleased with the strong operating results for the quarter and the continued organic growth the company is experiencing. We were also delighted to share those strong results with our shareholders by way of dividends representing 94 percent of the company's earnings for the year. Going forward, we continue to focus on capital management, prudent growth, maintaining asset quality, and on seeking opportunities to mitigate interest rate risk.

Eric Newell, our Director of Treasury, will now provide further detail on the company's interest rate risk management strategy.

ERIC NEWELL: Thank you, John, and good morning. Management has been very focused on interest rate risk throughout 2012 and will remain so in 2013. The company is taking incremental steps to alter the balance sheet to position it for a rising rate environment, including a modest extension of the duration of liabilities by opportunistically using wholesale funding and incenting retail customers to go out on the curve.

Additionally, the company has been reducing the duration of the asset side of the balance sheet through several steps. First, a secondary mortgage strategy whereby the company is selling most 15-, 20-, and 30-year fixed rate loans where spreads are favorable; second, we're adding more shorter-duration and adjustable-rate earning assets, such as quarterly adjustable guaranteed SBA and USDA loans; and, finally, we are implementing a barbell approach in the investment portfolio to improve on a relative basis the price impact of rising rates versus a ladder approach.

Importantly, the company is now using and has the ability to offer both macro and loan level hedging as interest rate risk management tools.

At this time, Mark will provide some further detail on the company's commercial banking business.

MARK KUCIA: Thank you, Eric, and good morning, everyone. Despite significant payoffs, total commercial loans grew by approximately $130 million, or nearly 17 percent, for the year, boosted by a strong fourth quarter. Of that growth, commercial real estate loans grew by $102 million or approximately 17 percent for the year; and C&I loans grew by $28 million, or nearly 20 percent for the year. The pipeline is solid, and we expect the historical trend of strong commercial loan growth to continue.

To support this effort, we continue to recruit top commercial bankers to expand our production capacity statewide. I would note, however, that currently the commercial loan environment is extremely competitive, which will impact production opportunities as we go forward. Rockville will continue to maintain the credit disciplines and principles which have provided strong loan growth and excellent asset quality over the years.

At this time, Scott will provide some further detail on the company's asset quality.

SCOTT BECHTLE: Thank you, Mark, and good morning, everyone. Rockville's asset quality remains strong and continues to be top amongst its peer group by nearly every performance metric. Net charge-offs to average loans outstanding at December 31, 3012 was 0.04 percent and is nominal at 0.07 percent for the year 2012.

Total non-performing assets to total assets was 0.95 percent. Note that the net credit losses and non-performing loan ratios have crept up slightly over the year and continue to reflect Rockville's proactive approach to early identification of potential problem loans, aggressive remediation efforts, and the continued hurdles faced in a highly competitive market and challenging economic environment. The allowance for loan losses was increased accordingly during the fourth quarter to $18.5 million. At December 31, 2012, the ratio of allowance for loan losses to non-performing loans was a comfortable 114.88 percent, and the allowance for loan losses to total loans was 1.15 percent.

Thank you all for your time this morning, and now Bill, John, Mark, Eric, Marino, and I would be happy to answer any questions you may have.

OPERATOR: We will now begin the question-and-answer session. To ask a question, you may press star, then 1 on your touchtone phone. If you are using a speaker phone, please pick up your handset before pressing the keys. To withdraw your question, please press star, then 2. At this time we will pause momentarily to assemble our roster.

And our first question is from Mark Fitzgibbon of Sandler O'Neill & Partners.

MARK FITZGIBBON: Good morning and thank you for taking my question.

BILL CRAWFORD: Hey, Mark.

MARK FITZGIBBON: Hey, Bill. Bill, I wondered — your head count, I think, at the end of the year was around 331 people. What do you think that's going to look like sort of midyear of 2013?

BILL CRAWFORD: Mark, it's, like I said, we've sloped off hiring a lot of the infrastructure folks in terms of risk and finance and operations, areas like that, but opportunistically we would look at additional mortgage bankers, we would look at additional financial advisors, and we would look at additional commercial lenders, but that depends on our ability to identify those salespeople — very high quality salespeople — so it's difficult for me to put a number out there, but we're trying to, obviously, balance reinvestment in the business with current period earnings.

MARK FITZGIBBON: Okay. And then it sounded like from your comments earlier, excluding some of the efficiency benefits that you're working on, a good starting point for, you know, run rate operating expense is around $13.9 million. Am I thinking about that the right way?

BILL CRAWFORD: John, I'll let you sort of chime in on where you see that.

JOHN LUND: Yeah, I think that's a reasonable barometer. You know, we did have a lot of noise, as you know, in the quarter in the year-end, and clearly we've been able to back off a lot of those one-time and non-recurring items. Certainly the Hurricane Sandy event added a lot of noise, but I think that's probably a good — a good jumping point for us.

MARK FITZGIBBON: Okay.

BILL CRAWFORD: Yeah, I wanted to add some additional color around that. You know, we're obviously a thrift — a mutual thrift that's converted, coming up on two years, to a commercial bank model, and so there's a lot of projects that we do inside the company that generate professional expenses in terms of consulting, in terms of project management, and so that influences that number. We've gotten through a good deal of that, so I wanted to give that additional color there.

MARK FITZGIBBON: Okay. And I wonder if Mark might be able to give us the size of the loan pipeline and also, you know the mortgage pipeline?

BILL CRAWFORD: Sure. Mark, I'll let you talk about the pipeline.

MARK KUCIA: Sure. How are you, Mark?

MARK FITZGIBBON: Good. How are you?

MARK KUCIA: Good — very well. Not — without going into specific numbers, I would say that the pipeline is in our view sufficient to continue with the goals that we have, which are continued double-digit growth going forward. We expect that we'll be able to continue the historical trends, but the pipeline — the pipeline is solid. We have brought on our lead — identified and hired our lead for our Western initiative, and we believe that's going to create additional opportunities for us as well.

BILL CRAWFORD: And, Marino, I'll let you talk about the current state of the mortgage pipeline.

MARINO SANTARELLI: Okay. Well, the mortgage pipeline right now looks pretty average, like it was looking towards the end of the last year. A lot will depend on what happens in February. January is typically not a big month for mortgages. We'll see what happens in February, but so far we're encouraged.

MARK FITZGIBBON: Okay. And then with respect to the buyback, you were fairly active in the fourth quarter, bought back 450,000 shares, a little over an average price of 13 bucks a share. And in the third quarter, you guys only bought back like 28,000 shares when the stock was sort of around 12 bucks. I'm just curious why so much less activity in the third quarter versus fourth quarter?

BILL CRAWFORD: Right. As you'll recall, in the third quarter, the price of the stock really started to run up on us, and in the fourth quarter, you know, we obviously reacted to that. The way we think about the buybacks is it's really a — it's a risk-free transaction for us to buy back our stock, so we're thinking about that in terms of, you know, pennies accretion, pennies dilution, let's see what's the payback or the earnback of the tangible book dilutions. That's why we're buying it, you know, over tangible book.

MARK FITZGIBBON: Okay. And the last question I had for you is on the margin. You know, it looks like you still have a little bit of room to take down your cost of funds. Should we anticipate sort of a — maybe a similar decline in the NIM in 1Q to what we saw in the fourth Q?

BILL CRAWFORD: Eric, do you want to comment on the NIM?

ERIC NEWELL: Yeah. Hey, Mark, it's Eric.

MARK FITZGIBBON: Hi, Eric.

ERIC NEWELL: I think that the — you know, the NIM, in the first quarter, obviously you're going to see some compression based on some of the growth that came in at the end of the fourth quarter on the earning asset side. You know, we definitely work really hard analyzing opportunities to reduce funding on the — on our cost of funds on the deposit piece. You know, we try to balance that between, you know, meeting our internal goals for deposit growth to fund, you know, expected growth this year and also make sure that, you know, we try to get as much of the excess costs that we can out of that. So you'll see some compression. You know, I don't want to necessarily, you know, give you some guidance on how it will compare to the fourth quarter.

BILL CRAWFORD: And obviously, Mark, what we're working on to fight the NIM is to grow earning assets, you know, principally in the commercial area, some in the investment portfolio, and then as we continue to reinvest in our mortgage banking, we expect to continue to take more share there. And then with our financial advisors, that's really a new line of business for us that's fee-based, and we're excited about our prospects there.

MARK FITZGIBBON: Thank you.

BILL CRAWFORD: Thanks, Mark.

OPERATOR: And our next question is from Damon Delmonte of KBW.

BILL CRAWFORD: Hi, Damon.

DAMON DELMONTE: Hi. Good morning. How are you guys?

BILL CRAWFORD: Good.

DAMON DELMONTE: Just a question for you to start off with on the provision outlook. You know, with the expectation of solid loan growth coming here in 2013, can we look to see a higher level of provision as you — you know, as you try to keep reserve levels consistent with the growth?

BILL CRAWFORD: Damon, I'll let Scott Bechtle, our Chief Risk Officer, take that question. Scott?

SCOTT BECHTLE: Good morning, Damon.

DAMON DELMONTE: Hi, Scott. How are you?

SCOTT BECHTLE: Thanks for the question. It's — in our view, we feel that we're going to continue to carry appropriate levels of reserves based on the composition of the portfolio, and at this time, we don't see any large deviations from where we're carrying now to move out through the year.

DAMON DELMONTE: Okay. So, you know, your current reserve level of 115, call it, is probably a good — a good target to keep in the coming quarters?

SCOTT BECHTLE: At this point, based on the composition of the portfolio, we feel that's an adequate level.

DAMON DELMONTE: Okay. And you guys are expecting, you know, C&I and CRE growth to dominate the portfolio this year. Is that correct?

BILL CRAWFORD: That is correct. Yeah.

DAMON DELMONTE: Okay. And then just kind of circling back on the mortgage banking operations, how are gain-on-sale margins looking so far in the first quarter versus what you saw in the fourth?

BILL CRAWFORD: Well, if you look — if you look at the market, I mean, obviously, third quarter, the market had really wide spreads in them; the fourth quarter it tightened up a little bit, but that market right now, those spreads are very tight, have come in considerably, and there's a lot of volatility in mortgage spreads currently.

DAMON DELMONTE: Okay. But directionally they're getting thinner then?

BILL CRAWFORD: Yes.

DAMON DELMONTE: Okay. Okay, that's all that I had. Thank you very much.

BILL CRAWFORD: Okay.

OPERATOR: And next, our question is from Travis Lan of Stifel Nicolaus.

TRAVIS LAN: Thanks. Good morning.

BILL CRAWFORD: Hey, Travis.

TRAVIS LAN: Hey. In terms of mortgage banking, I know sales volumes were down this quarter despite the fact that your gross originations were higher. I know that in the prior quarter you mentioned there may have been some timing issues, but can you just explain to us maybe how you determine what portion of your originations each quarter will be sold versus portfolioed?

BILL CRAWFORD: Sure. Eric, would you go through our process there?

ERIC NEWELL: Hi, Travis, this is Eric.

TRAVIS LAN: How you doing, Eric?

ERIC NEWELL: Good. What we decide to do — I mean, you know, we have a strategy in pricing for a secondary committee that is basically a subset of our asset liability group here, and we basically make a decision to pretty much sell the majority of our 15-, 20-, and 30-year production. However, we also are cognizant about where the spreads are coming in on that, so there is, you know, some opportunities for us to sell in the market. If the spreads are acceptable, we'll do that, and in other instances, we may choose to delay the purchase or sale. So it largely depends on what we're kind of seeing in the market and what it's giving us. But, you know, we, you know, have a strategy on how we want to price our mortgages relative to our competitors, and, you know, we want to make sure we're always in the market.

TRAVIS LAN: So the volume that you would portfolio seems to be more a product of the way pricing is in the secondary market as opposed to any strategy in terms of the way you want residential mortgage to trend in your portfolio. Does that make sense?

BILL CRAWFORD: Yes, within limits. As you can — as you can notice, our mortgage portfolio has grown very, very modestly over the last several quarters, and so our strong bias is to sell, you know, everything we can. There is an inflection point where we'd hold some, but, clearly, we don't want to materially move the size of that portfolio, because we're always managing for interest rate risk, and we think long-term, you know, you've just got to be careful of putting too much mortgage product on your balance sheet in this environment.

TRAVIS LAN: Sure. Okay. And then on expenses, over the last six quarters, obviously, it kind of looks like core operating efficiency's trending continually higher, and I guess, you know, we — people have asked questions about what the expense base would be, but my question would be more geared towards how do you quantify the success of these infrastructure investments in either talent or branches or support — you know, support functions? Is there kind of a breakeven timeline that you look at or a corresponding growth or revenue projection that would kind of help you measure success in these investments? Or, you know, maybe you can just help us understand how we can measure outside of the bank, you know, how these are paying off in the future?

BILL CRAWFORD: Absolutely. You know, I think if you look at, you know, commercial bankers, for example, when you hire very, very talented ones who can move a book of business, you're looking at a payback on that type of investment probably about 18 months, and, you know, so maybe the range on that is 12 to 24 months. Clearly, you go build a new branch, the real return on that, payback on that is probably more in the four or four-and-a-half year range, somewhere in there at that point. Mortgage bankers, because they're commissioned — paid by commission, have a very quick payback. What's a little harder to measure is, you know, you have to put in an infrastructure to support those mortgage bankers, but we do have, for example, profitability reporting on our entire mortgage unit, and we can know what the efficiency ratio of that business is. You know, at any point in time, if we don't like the trends in that business, we have the ability to scale that business back, you know, if revenue or sales were to come down very significantly. So that's how we think about, you know, really the commercial business and the mortgage business. Some of the areas we invest in — risk management, that's just a function of the regulatory environment. That's a function of being a couple-billion-dollar bank. When I think about our finance area, you know, we've invested in some expertise there that allows us to do things like loan-level hedging, which we haven't really profited from that yet, but we're developing that. It's also helped us to do some things in our investment portfolio, so that's what — you know, how we think about investments in the company, but it's really those investments in the company that are critical to our organic strategy, and so we'll continue to look for those opportunities.

TRAVIS LAN: Sure. And just back on the commercial bankers, do you think that the timeline for payback — I mean, can you quantify kind of the extension? You know, you mentioned 12 to 24 months, but with, you know, the current environment, both on the interest rate side and the way that's impacted yields and the potential for growth, I mean, do you think that's extended beyond maybe 24 months now, or do you still think that's a good, you know, barometer?

BILL CRAWFORD: It puts more pressure on you to really hire talented people, because your average commercial banker, you know, would have a hard time really moving business and generating profits. If you hire somebody very experienced with a very significant book, and they can move that book over, you know, the payback is shorter. We spend a lot of time on recruiting, and the people that we hire are absolutely best in the business, with very large books of business, so we still feel very comfortable investing there, but we're investing in 'A' players. I think it would be very dangerous to invest in, you know, 'B' or 'C' players in this environment, because your payback would be very extended for the reasons you identified.

TRAVIS LAN: Okay. That's helpful. And I guess maybe more specifically, I think in the past you've mentioned getting at some point to an incremental 50 percent efficiency ratio, where every dollar of spend would generate two dollars of revenue. You know, have — I guess, kind of building on my previous question, but broadening it across the bank, you know, do you think that the environmental pressures have kind of changed the way you think about that, or do you still think that 50 percent of incremental efficiency is an achievable target at some point down the road — not to put a timeline on it?

BILL CRAWFORD: Yeah. I mean, ultimately I think what you — you know, what you do is you sort of reach your investment in your core business. You've added these salespeople. These salespeople stay with you, and, you know, revenue continues to grow, and your expense base slows down, so you get to a very favorable operating leverage. I will say this, though, this is a very difficult environment right now to grow revenue, because you have volatility on mortgage spreads, you have asset yields coming down. These actions by the Federal Reserve certainly make it very difficult for anybody in the spread business, and so, you know, the weather is what it is. We just have to manage through that, but, you know, in the end, I don't think it changes anything about where we want to go, where we want to be. You know, the environment just makes it a little tougher to get there.

TRAVIS LAN: Got it. Thank you very much.

BIL CRAWFORD: Okay.

OPERATOR: And the next question is from Brad Rinschler of FIG Partners.

BRAD RINSCHLER Hey, guys.

BILL CRAWFORD: Hey, Brad.

BRAD RINSCHLER: Just one quick one on the slight tick up in NPLs. Can you elaborate on that just a little bit? It looks like it was across the residential and the commercial book, and was it a bunch of loans or just one commercial loan? You know, and also, is it a cause for concern, you know, for 2013?

BILL CRAWFORD: Sure. Scott, I'll let you take that one.

SCOTT BECHTLE: Good morning, Brad. It's kind of spread across residential and commercial as you note. It's about two-thirds commercial, one-third residential, and on the commercial side, it was a handful of loans, no one large loan that's a concern.

BRAD RINSCHLER: Okay. And also on the buyback — I think someone else already elaborated on it a little bit — obviously a tick up in shares this quarter versus last. Do you guys see that continuing for 2013 or kind of somewhere in between? And obviously it's market conditions, but, you know, I'm just trying to gauge that a little bit.

BILL CRAWFORD: Absolutely. Yeah, again, we sort of — I look —I think about the buyback as a risk-free transaction, so what's the tangible book value payback period that will be acceptable to most investors when you think about pennies accretion, pennies dilution? And so we're really solving for that. You know, we think the terminal value of the stock, obviously, is significantly higher than where we trade now, and that's why we like buybacks, but, you know, that said, we want to also be mindful of the dilution we create by buying above tangible book, so it's sort of a balancing act. I think if you think about it in terms of a risk-free transaction, you know, what would that — what would be acceptable to investors? That's sort of the view we take.

BRAD RINSCHLER: Okay. All right. That's helpful. Thanks, guys.

OPERATOR: The next question is from Matthew Kelley of Sterne Agee.

MATTHEW KELLEY: Yeah. Hi. I was curious on the mortgage banking operation. Are the current gain on sale margins you're seeing holding the 2 percent level?

BILL CRAWFORD: Matt, I'm sorry. Could you repeat that question?

MATTHEW KELLEY: Yeah. I know that's in the text of your press release. You had mentioned that the third quarter, the average spread was 3.95%, fourth quarter was 2.73%, and then if you just look at the, you know, primary and secondary spreads, I know they've compressed quite a bit since year-end, and I was wondering, are you seeing gain on sale margins or spreads holding at 2 percent currently?

BILL CRAWFORD: Eric, I'll let you take that question.

ERIC NEWELL: Hey, Matt. Yeah, we've seen significant compression in the first quarter from the average that we reported on in the fourth quarter —

MATTHEW KELLEY: Okay.

ERIC NEWELL: — which is largely driven by, you know, what's been happening in the markets in terms of the ten-year and whatnot.

MATTHEW KELLEY: Yeah. And then, you know, you mentioned earlier that you do track, you know, the profitability of the operation. Maybe just give us a sense of what you're seeing for, you know, pre-tax profitability in the mortgage business in isolation or the expenses associated with that business?

BILL CRAWFORD: Eric, I'll let you take that one too.

ERIC NEWELL: One of the things that we looked at — you know, obviously there's the fixed costs, you know, a lot of the folks that support our production unit, and then we also have some of our variable costs, so the actual producers. So when we're looking at the profitability there, you know, we largely kind of hone in on efficiency, and we look at, you know, our existing portfolio, you know, so the all-in kind of efficiency of what the portfolio is benefiting us as well as kind of taking that and separating it from, you know, the actual kind of secondary — you know, residential secondary marketing aspect of it. So, you know, we evaluate that efficiency periodically, very frequently, every month, to make sure that, you know, we're happy with what we're seeing. And, as Bill had earlier noted, you know, we would make adjustments to our cost structure if we needed to if we didn't like what we were seeing.

BILL CRAWFORD: Now, a little more color there. We just — you know, one of the projects we completed was the implementation of a FiServ earnings model that gives us the ability to drive down into every cost center we have and evaluate profitability, efficiency, resource allocation, so that's one of those projects that's been helpful for us.

MATTHEW KELLEY: Okay. Gotcha. And then a question on commercial real estate loan pricing, can you give us a sense of what the origination yields were in the third quarter compared to the fourth quarter and just any trends you're seeing there on competition?

BILL CRAWFORD: Sure. Mark, I'll let you take that one.

MARK KUCIA: Yeah. I would say that, you know, clearly the market is still what I would consider hypercompetitive. Third quarter to fourth quarter probably saw some yield compression, not, you know — I would probably put it in the — maybe somewhere in the 20 to 30 bps type category, but clearly it's hypercompetitive, and I think, you know, as we move forward, there's still going to be significant pressure on yields.

MATTHEW KELLEY: Okay. And maybe give us a sense of the nature of the competition. Is it bigger banks trying to, you know, come down the food chain and re-establish or regain relationships?

MARK KUCIA: I think it's a whole — it runs the whole gamut, Matt. It's from banks that — you know, community banks that we compete with, insurance companies competing on commercial real estate deals, larger banks, so we — you know, in the — in kind of the space we're in, we do kind of run the entire gamut. I would say the bigger banks are probably, you know, less involved in that marketplace than some of the — you know, what I call the bigger, the super regional type banks.

MATTHEW KELLEY: Okay.

BILL CRAWFORD: And a little more color around that. We do use a risk-adjusted return on capital, or RAROC, model at the loan level and the relationship level, and so we're, you know, always trying to make very rational decisions there, and, you know, we're not going to — we're going to have discipline around that going forward, as we have in the past.

MATTHEW KELLEY: All right. Thank you.

BILL CRAWFORD: Okay.

OPERATOR: Again, if you would like to ask a question, please press star, then 1 at this time. And our next question is from Eric Grubelich of Highlander Bank Holdings.

BILL CRAWFORD: Hi, Eric.

ERIC GRUBELICH: Yeah. Hi. Good morning. Just a couple of questions, and I think Eric Newell talked about, you know, trying to extend your investment portfolio and talked about, you know, trying to offload more fixed rate loans and add adjustable rate. I was just curious, you know, your securities portfolio is all not that big. Is there something else where you're envisioning building on more securities at the longer end of the curve, or is it just managing what you have a little differently?

BILL CRAWFORD: We are looking to expand it probably on the shorter end of the curve, and I'll let Eric talk about that.

ERIC NEWELL: Good morning, Eric. We — in terms of how we're looking at the portfolio, we always analyze how it, you know, represents the investment portfolio as a percentage of total assets, and, you know, we're willing to grow that modestly throughout 2013. You know, we kind of are cognizant of where we stand relative to our peers in terms of that growth. We've been looking at using a barbell approach, so it's not necessarily just focusing on the long end of the curve or long end but also, you know, looking at adjustable rate opportunities. And, you know, there has been some opportunity, you know, that we've seen recently to, you know, execute that successfully, but I think, you know, the long end of the curve was something that we focused in on in 2012, illustrated by the addition of the municipal portfolio, where most of that has an average, you know, expected life of seven to ten years based on call dates.

ERIC GRUBELICH: Okay. And then — so if you're going to do that, though, barring any huge growth on the deposit side, are you going to try and do a matched book then, with something similar on the liability side, like an advance to grow it?

ERIC NEWELL: We — you know, obviously looked to organic deposit growth first, but, you know, definitely if growth is expected to exceed that deposit growth, you know, we'll look opportunistically to make sure that, you know, in the wholesale funding providers, whether it be the Federal Home Loan Bank, you know, using fed funds, or looking at brokered deposits — you know, and we'll use that to fund some of the growth.

BILL CRAWFORD: This is Bill Crawford. With the way deposits work right now, if we really wanted to move those up, I mean, we could move pricing, and, you know, they would go up pretty significantly, so we're always looking for the most opportunistic, you know, low-cost way to do it that leaves us with the most favorable interest rate risk positions.

ERIC GRUBELICH: Okay. And then maybe just one related item, just on the CD side. You know, any near-term relief on better pricing there? I think you were at 127%. That was the average cost on the CD book. Is there anything coming up that's going to drive that down much lower?

BILL CRAWFORD: John, do you want to take that one?

JOHN LUND: Sure. Thank you. Yeah, we have brought our CD rates down commensurately over the last quarter. There's probably a little more relief there, but I think all in, we've started to see a floor. I think where we're going to pick up the benefit is where we continue to see migration out of time deposits into more liquid money market and savings.

ERIC GRUBELICH: Okay. Okay. Great. Thanks a lot.

OPERATOR: This concludes our question-and-answer session. I would like to turn the conference back over to management for any closing remarks.

BILL CRAWFORD: Okay. Well, again, thank you for being on the call today. Thank you for your interest in our company, and we're always glad to take any questions, or give us a call if we can be helpful. Thanks again.

OPERATOR: The conference is now concluded. Thank you for attending today's presentation. You may now disconnect.