Asset Liability Management: Get Flexible, Play Defense, and Be Opportunistic

“There are three types of baseball players: Those who make it happen, those who watch it happen and those who wonder what happens.” – Tommy Lasorda. Mixed messages by the Fed have arguably increased interest rate volatility and definitely complicated bankers’ investment and funding strategies. As we go to press, longer-term interest rates are lower than they were this time, last year; the yield curve is flattish; and the market is questioning if a more dovish Fed portends slower economic growth than previously expected. There is also growing conviction that the Fed will not raise rates as Fed funds futures indicate that central bankers will finish 2019 with interest rates at or below their current level. According to CME Group, about half of all investors expect at least one rate cut in 2019. This is a dramatic swing from last year when the Fed contemplated there could be three interest rate increases in 2019, with more hikes possible in 2020.

Appropriate action can be taken to alleviate the net interest margin pressure likely to occur if the yield curve stays flat or inverts for a lengthy period. As discussed below, we continue to recommend prudent and customized approaches regarding the blend of investment securities (to supplement loan portfolios) and funding instruments, designed to enhance profitability while effectively managing interest rate risk and liquidity considerations. We also consider derivative instruments – interest rate swaps, caps and floors – as effective asset/liability (“A/L”) tools to manage interest rate risk. Core deposits are always prized, but because you can’t always get what you want, other funding sources, such as time deposits (including brokered CDs), FHLB advances, and other debt, are important. In addition to providing funds to support growth, subordinated debt can satisfy Tier 2 capital objectives.

- The yield curve is flat. As of April 22, 2019, the spread between 2-year and 10 year Treasury notes was merely 21 basis points, compared with 50 basis points a year ago and 102 basis points two years ago. (There is currently a one basis point spread between 2-year and 5-year Treasury notes on the yield curve.)

- Invest opportunistically. Banks with outsized investment portfolios are typically not accorded higher trading multiples, but tangible capital (particularly retained earnings) matters and A/L officers should review portfolios for opportunities to eke out more earnings without exposing the bank to undue credit or interest rate risk.

- Short-term wholesale funding sources can be hedged with an interest rate swap and lower the cost of hedging or provide a wider net interest spread on the hedged earning assets. This takes advantage of currently attractive short term brokered CD pricing and most-efficient pricing achieved from the interest rate swaps curve.

- Consider the efficient frontier. The efficient frontier maps all investments at our disposal to find the options with the most yield for a stated level of risk. There are multiple considerations here as risk can be defined by both interest rate risk and credit risk. However, when possible, we favor rebalancing the portfolio to remain on the efficient frontier.
• **Get your board onboard.** Developing an effective A/L strategy is company-specific and should include board policies regarding liquidity and capital.

We expect that investors and analysts will take a harder look at community banks’ funding sources as first quarter, 2019 results are reported due to the flat yield curve and likelihood of net interest margin pressure going forward. The franchise value of community banks often rests in deposits that are classified as liabilities (counter-intuitively) on financial statements. **Core deposits, which we define as all deposits other than certificates of deposit and other time deposits, are especially prized due to their greater stability and relatively lower cost of funds.** Core deposits also imply customer relationships that can be used to cross-sell other products and services and reduce interest rate risk.

Balance sheet hedging has many purposes including modifying interest-bearing liabilities to help manage earnings and interest rate/extension risk. Appropriate hedging, including forward starting swaps, can be used to reduce the cost of wholesale funds, change the duration of deposit funding, and lock in current funding rates, versus waiting for the wholesale funding to mature.

**Financial institutions that are “liability sensitive” or seek to match interest-earning asset durations should consider the Rolling Short-Term Brokered CD Strategy, which reduces hedging costs and results in a wider net interest spread.** The strategy simply involves rolling three month brokered CDs (or the desired short-term maturity) and entering into a pay-fixed/receive Libor swap to the desired term. Term funding costs are reduced from the combination of savings from: (a) the “Basis” – the fact that the 3 month Libor-receive rate on the swap is higher than the 3 month pay-rate on the brokered CD and (b) the Term Premium – the excess of the long-term FHLBank or brokered rate over the same-term swap rate. The lowest wholesale funding source today (brokered CD) is combined with the lowest interest rate hedging vehicle (the swap).

With rising funding costs and a flat yield curve, bank margins are coming under pressure. Coupled with the shareholder demand for a higher return on equity, banks must look to the portfolio for opportunities to help supplement earnings. The current economic expansion is on pace to be the longest economic recovery (post WWII) in U.S. history. Given we are much closer to the end of the cycle than the beginning, our recommendation is to remain underweight credit, with some exceptions. For banks struggling with loan growth, it may be prudent to take on additional credit risk in the investment portfolio by adding loan surrogate-type investments. **We continue to like community bank debt as it is one of the most attractive subsets of the credit space.** Specifically, this asset class allows management teams to invest in what they know while also earning very attractive yields on favorable fixed to floating rate structures.

Over the past 30 years, when the Fed is lowering Fed funds, the curve generally steepens, and when the Fed raises rates, the curve generally flattens. Once a FOMC tightening campaign ends, long rates often begin to fall in anticipation of the next Fed easing cycle which provides significant price appreciation potential. For these reasons, we continue to recommend adding duration when Treasury sell-offs provide attractive entry points. It is important to purchase longer duration issues with positive convexity. **We recommend buying bullets or issues where the optionality is far out of the money, such as discounted callable agencies, or munis with lengthy call protection.** If rates continue to move lower, these types of structures should offer the greatest opportunity for price appreciation.
Opportunities remain available to reposition the portfolio on the efficient frontier. Generally, we remain sellers of municipal bonds on the short end of the curve where the spread to Treasuries is negligible and in some cases even negative. A similar dynamic is occurring in corporate spreads, and there are opportunities to increase yield with Agency MBS while taking credit risk off the table. Other banks are using the portfolio to help reposition the entire balance sheet by selling low yielding securities and paying off FHLB borrowings.

Many banks are saddled with underwater/low yielding securities. This is often a function of the interest rate environment when those securities were purchased. **Banks that are willing and able to absorb an immediate loss can deliver higher future earnings (assuming all other things equal), as those proceeds are reinvested at higher yields, thus improving net interest margins.** Similar to M&A transactions, we analyze a payback model to determine when the higher earnings will recapture the recognized loss on the sale of securities.

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