Tug of war

Rate volatility can work to your community bank’s advantage.

Whew. In just the nine months between November 2018 and July 2019, the bond market witnessed these events:

- Both a hike (Dec. 19) and a cut (July 31) to overnight benchmark rates
- An inversion of the yield curve between one and 10 years
- A dramatic drop in expectations via the Fed funds futures market
- Fast wordsmithing from the Federal Reserve about its posture and strategies.

The net result: rates down, prices up, durations down and cash flows up. The average community bank’s bond portfolio now has an unrealized gain for the first time in four years. Attendant to that is a drop in duration, which should please no one but your regulators, unless you include your community bank’s treasury function, which may be hustling to match still-robust loan demand with the ever-dwindling stock of core deposits.
The liability side of a community bank has slowly and quietly changed its tenor over the past decade. For some years now, deposit growth has been left in the dust by loan growth. While that in a vacuum is good news for net margins, it has created some issues. One example is that only about one-quarter of total liabilities are time deposits, a record low. The corollary to that is large amounts of funding could walk at any time.

Not surprisingly for community banks, most of the liability picture shows some discipline. The amount of brokered CDs on hand has shrunk in the last decade. Public funds, which some contend are reliable wholesale sources, have consistently been the largest non-retail segment of liabilities. And let’s not forget the still-attractive funding costs, which all-in remain well under 1%.

Welcome additions
Into this melee of deposit-gathering steps the bond portfolio. As rates have fallen, community banks’ cash flows have increased, in some cases dramatically. This has helped finance loan demand in a real-life example of just-in-time production.

As an indicator, in the month of June, total dollars of bonds called by all the government agencies were $21.8 billion. That is more than double the amount called in February. Also, prepayments on simple mortgage-backed securities (MBS), including community bank staples like 15-year pass-throughs, have likewise more than doubled in the last year.

This prepayment and call activity has caused effective durations in investment portfolios to hit multi-year lows. As of June, the average duration in community bank portfolios was down to 2.7 years. For comparison, it was 3.4 years as recently as 2016. To the uninitiated it may not seem like much of a difference, but the risk analyst knows that represents a 20% drop in price volatility.

Fair and balanced
As mentioned before in this space, community banks have pretty much eradicated rate risk from their balance sheets. This is the result of a number of factors working in concert, such as clarity of expectations by examiners, a historically low rate environment from 2008 through 2015, and commitment to a robust asset-liability committee (ALCO) by community banks in general.

On top of this is the increased use of off balance sheet tools that quickly and efficiently customize asset and liability risk profiles to fit an institution’s needs. Interest rate swaps can now be executed on certain loan segments, a defined portfolio of credits, or even an individual loan. The same is true for the liability side of the ledger, and certain capital components.

In fact, what remains seems to be exposure to falling rates, which is a departure from historical norms. This “asset-sensitive” posture means that community banks can purchase or offer certain amounts of fixed-rate products or take on some shorter-term liabilities and actually improve their earnings at risk (EAR) and economic value of equity (EVE) ratings.

And who’s to argue with success? According to the FDIC, community banks reported an estimated $13.4 billion in earnings in the first six months of 2019, which is well ahead of the record set last year. The tug-of-war by management teams for the proper mix of cost-effective deposits, quality assets and complementary cash flow appears to show advantage: community banks.