Through the second quarter of 2018, the banking industry at large, and community banks in particular, have been posting very impressive results. For the six months ending June 30, the FDIC reported industry earnings of $116 billion. For perspective, this beat the entire 12-month results of each year between 2008 and 2011, and is about 25 percent ahead of last year's pace.

There are several components to these results. One, of course, is continued growth in loan demand, which is running about 7 percent ahead of 2017. Another is the stellar credit quality metrics, which are so good as to cause concern among your regulators. Yet another is the improvement in net interest margins. As the Federal Reserve has now raised rates eight times, banks have been able to push their asset yields up faster than they've had to pull up their costs of funds.

Can it last?
Your community bank's management team is probably in deep discussion about how to finance itself. It’s clear that liquidity in the industry is tight and will likely get worse before it gets better. So far, total cost of funds has remained low on an historical basis, with the average bank still paying less than 75 basis points (0.75 percent), all-in. That will soon be changing.

With overnight rates now around 2.00 percent, and banks and non-banks offering short-term deposit products higher than that, your next
round of liquidity will cost more than you’re used to paying. (This subject was addressed in June’s Portfolio Management column.) Fortunately, with the yield curve continuing to flatten, community banks can, for the moment, avail themselves of longer-term deposits at attractive levels.

**Borrow and swap**
The strategy is a two-step approach. First, the bank taps a wholesale liquidity source that has a very short-term duration but a longer-term maturity.

Two examples of this are floating-rate FHLB advances (typically based on 30-day LIBOR) and insured money-market deposits that will float based on LIBOR or prime. As of this writing, the starting rate for such products with a five-year term is around 2.1 percent.

Next, the borrower will turn the floaters into fixed rates by executing an interest rate swap with a third party. Thanks to the aforementioned flatness, it only costs about an additional 60 basis points, today, to lock in the rate for five years and to hedge away the risk of further increases. This is a very nominal additional cost for the significant increase in duration.

**Long-term benefits**
To the community banker who says, “I’d rather have 2.1 percent versus 2.6 percent as my cost of borrowing today” (which would earn him/her a Master of the Obvious diploma), I would reply that this advantage is only sustainable if the Fed isn’t actively trying to snuff out inflation, which it clearly is.

Remember also that locking in your cost of funds on this batch of liquidity frees your community bank to loan or invest out on the curve. While much has been made of the flatness of the Treasury curve, all other sectors still have some degree of steepness. This is especially true of “off the run” mortgage securities and bank-qualified munis.

So 2018 is the year when it’s cool (and beneficial) to take a hard look at your funding options. With many community banks ahead of their earnings projections, perhaps it is timely to lock in some costs that appear to be poised to rise. Here’s to the bottom-up approach to financial management. Cheers!

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**Webinar series continues**
ICBA Securities and its exclusive broker, Vining Sparks, present the next segment of their 2018 webinar series on Oct. 16. Tom Mecredy of Vining Sparks Community Bank Advisory Group will present “M&A and Community Bank Valuation Update.” One hour of CPE is available. To register, visit www.viningsparks.com

**Economic outlook webinar**
Vining Sparks strategists Craig Dismuke and Dudley Carter have scheduled their third-quarter “Economic Outlook” webinar for Oct. 9. They will discuss and analyze the most recent Fed statements and actions, and will comment on the macroeconomic trends that determine GDP.

To register, contact your Vining Sparks sales rep or visit www.viningsparks.com

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