Slow Burn

Excess cash continues to be a drag on profits

By Jim Reber

Stop me if you’ve heard this before: Community banks collectively are exposed to rising rates. The regulators have warned us on multiple occasions that the Economic Value of Equity (EVE) exposure has grown. Risk models portend that community banks are reaching for yield and are throwing caution and good sense to the wind.

However, it seems we’ve not let the facts get in the way of a good story. Year-over-year, the 500-plus community banks that use Vining Sparks for their bond accounting service have seen a dramatic drop in average durations, even in rising-rate scenarios. And we can’t attribute the drop to a general decline in interest rates, because we have basically run in place for a year.

I’m not just picking on the lowly investment portfolio. As of the end of 2014, community banks have much average Earnings at Risk (EAR) in a +200 basis point scenario is actually positive, at +2.14 percent, and it has increased in each of the last five quarters. Another important risk measure, EVE, projects an improvement in value in the same +200 basis point shock for 72 percent of these banks, which is up from just 30 percent a year ago.

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Hurts to wait ...

Let’s stick with the numbers a bit longer. If in fact your community bank is fairly balanced from an interest rate risk standpoint, it is pretty hard to benefit from a strategy of waiting on higher rates before investing. It would take very aggressive action by the Fed, and almost a knee-jerk response by the bond market, for
the wait-and-see approach to pay off. A way to quantify this gambit is to simply compare interest earnings on both options. Vining Sparks, like most full-service brokers, can produce a schedule that shows aggregate earnings and break-even yields between two options, with you, the banker, being in charge. You can choose the bond in which your community bank invests, and your projection of the future path of Fed Funds.

Using a recently issued bond, I compared the cash flows from these instruments:

» Fed Funds yields determined by the futures contracts in May 2015; and

» Freddie Mac bond of 1.30 percent bond maturing June 29, 2018, callable one time on Dec. 29, 2015.

The results are compelling. The Freddie Mac bond, per $1 million invested, earned more than $7,000 in additional income for the three years. A delayed-start strategy, staying in Fed Funds for one year and then buying a two-year bond, would have to be able to yield 1.79 percent in a year just to break even. Right now, they yield about 1 percent less than that.

...While options are available
Still don’t like this option? One way to employ dollars today, and not impact your community bank’s EAR or EVE negatively, is to purchase true floating-rate securities. The two securities most popular with community banks are Collateralized Mortgage Obligation floaters and Small Business Administration 7(a) pools.

CMOs float each quarter, usually, and are indexed to money-market yields. They have no periodic (i.e., quarterly or annual) caps, but they do have life caps. The SBAs are based on Prime and have no caps whatsoever. Both securities will enjoy higher yields as soon as the Fed starts to raise the target rate of Fed Funds.

Today, CMO floaters yield about 40 basis points (0.40 percent), depending on their structure. They are priced very near 100.00. SBAs yield anywhere from 75 to 125 basis points. The main risk of SBAs is premium risk; these pools can have prices that are well over 110 cents on the dollar. Either of them should outperform Fed Funds while providing monthly cash flow as well as collateral for pledging.

Know your risks
While the improvements in EAR and EVE mentioned above are good news, it must be noted that they were derived from user (banker) opinions. I would encourage all members of your community bank’s asset-liability committee to place under scrutiny the assumptions for cost of funds and availability of liquidity in the long-anticipated rising rate environment.

My summation is multifaceted. Given that community banks appear to have prepped their balance sheets for a higher-rate environment, plus the fact that loan demand is less than robust and the Fed really isn’t expecting overnight rates to be appreciably higher soon, cash may remain expensive to hold.

Many hundreds of community banks have adopted the strategy of simple redeployment of excess funds into short-term options. The math from both asset-liability risk and interest-income standpoints arrives at the same conclusion: You may be doing your community bank multiple favors by dousing the slow burn from excess cash.