You may have heard a nasty rumor concerning community banks’ profit margins. It began with the Federal Open Market Committee’s raising of Fed funds at 17 consecutive meetings over the course of two-plus years, for a sum of 425 basis points. Some rumor-mongers, masquerading as bank analysts, swore that margin compression was going to take root in 2006. Even with efficiencies borne of scale, net profits and bank valuations were in for a beating, or so the story went.

The chart below, however, says it isn’t so, at least for banks between $100 million and $1 billion in assets. It indicates that net interest margins actually widened between 2004 and 2006. Now that several quarters have passed since the last tightening, could it be that these soothsayers were really Chicken Littles?

Today’s Issues

The current relationship between Prime and bank cost of funds is a product of recent interest rate history, and it poses potential risk to net interest income. Consider that Prime was 8.25 percent in February 2007, and as of September 2006 the cost of funds for community banks was 2.74 percent, a spread of 551 basis points.

Before raising a cheer for the magnitude of the spread and the implications toward profitability, consider that interest income is 180 basis points below Prime, a spread that compares unfavorably to past interest rate cycles. As cost of funding lags Prime, so does interest income. Stated another way, if this is as high as Prime will go in this rate cycle, this is a very low high.

The key issue to address is banks’ ability to reduce funding costs if Prime begins approaching a cut. Should Prime fall by 100 basis points, savings accounts that...
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are currently paying only 0.50 percent have little room to fall. Money market account volume has suffered via funds moving to mutual funds because the money market rates in banks are comparatively low.

So, now is the time for banks to look at their asset management and funding considerations with a cold realism concerning the responsiveness to funding costs when rates fall. How far can you drop rates and still maintain deposit volume?

Historical Viewpoint

We are bouncing off a period of more than five years of Prime being 8.25 percent or lower and banks accumulating assets at low rates. In prior cycles, as Prime got to 9.00 percent or higher, banks had some time to accumulate higher-yielding assets that stayed in place when rates fell. Recall that many higher-yielding bonds matured, were called or prepaid during the 2002 thru 2004 period, and investment portfolios had to replace them with lower rates.

The same applies to the loan portfolio. Net interest margins have a downward trend over the past 10 years (but not the last two), and that trend could have been even more severe if banks had not restrained funding costs. Again, the ability to manage those liability costs may be constrained going forward due to the relatively low level of funding costs today.

More to the point, does your bank have an asset-liability analysis capability that will predict with reasonable accuracy the results of its assumptions? Banks can only drop their deposit rates so far from where they are today, and whatever action is needed to protect their margin must be provided for on the asset side of the balance sheet or via derivative transactions (caps, floors, interest rate swaps).

For most banks, asset duration must extend to be prepared for a falling interest rate cycle. On the loan side, your borrowers are generally not interested in your asset-liability welfare and want loan terms that are the opposite of what you need. Floors are certainly appropriate to help your cause in a falling interest rate scenario, but you may have to give them a cap to make the floor palatable.

Portfolios Can Help

To begin, bond swaps can be executed to liquidate your “losers” and replace them with higher-yielding, longer-duration securities. Overcoming the loss on sale in this transaction typically requires adding high-yielding, bank-qualified municipal bonds, and the current interest rate environment offers substantial yield pickup in this sector. Bank-qualified munis with maturities in the 15- to 25-year range typically offer 10 years of call protection as well as high yield—a dynamic duo should rates fall.

Investments in mortgage-related securities should concentrate on discount-priced, lower-coupon issues that would be the last to prepay in a declining rate environment, thus preserving today’s yields. Callable agencies should have extended call protection out to two or three years, and a one-time call feature is highly desirable as well. All of these strategies and features could help to add duration to the investment portfolio and keep today’s relatively high yields in place should rates fall.

Giving up some liquidity could be wise (not to mention profitable) in a declining rate scenario. Adequate borrowing capacity from the Federal Home Loan Banks or others could supplant short-term liquidity needs, and extended durations will undoubtedly impinge on liquidity. Generally speaking, rates are falling because loan demand has decreased and the Federal Reserve is trying to stimulate a weak economy. In that scenario, excess liquidity is an asset of diminishing value.

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