As we enter the holiday season, let’s recall the adage “Be careful what you wish for.” I bring this up not in reference to the exchanging of gifts but to the two rate cuts the Federal Reserve’s Federal Open Market Committee approved in September and October, which may have helped or hindered your community bank’s annual earnings.

Most bankers had been begging for some relief from the Fed for months. Net interest margins generally narrowed during the first nine months of 2007, which begat tepid earnings, which begat flat (or falling) bank stock values. A rate cut, the theory went, would produce some room for improved margins as deposit costs dropped.

Even before the buzz of the autumn rate cuts could wear off, a sobering thought occurred to many net creditors: The immediate impact of a drop in Fed Funds, and therefore in Prime, will be to further cut net interest margins.

It has been ICBA Securities’ experience that most community banks are positively gapped, or asset sensitive, to a one-year horizon. So, for the time being, decreases in Fed Funds are a negative for most community banks.

In the hopes of spreading some holiday cheer, I have a grab bag of options that are available to most bankers, which, when properly applied, can speed up the process of getting your margins back to normal. I use the phrase “speed up” here because over time it’s expected that most banks will benefit from a rate-cut cycle, as the interest rate curve assumes some normal steepness.

**Bond Swaps**

This is a timely topic for two reasons. First, the fourth quarter and the first quarter are the two most popular times to execute these strategies. By late in the year, a bank knows if it needs to create income or defer income.

### Historical Yield Curve

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<th>2</th>
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<tr>
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Source: Bloomberg
Sales of securities at gains can help an institution reach its annual goals, while sales at losses usually put a bank in position to improve its future earnings. First-quarter swaps usually consist of selling bonds at a loss with the intent of recouping most or all of the loss within the calendar year. Reason number two is that, whenever or however a bond swap is built, the steepness of the Treasury curve has a lot to do with its effectiveness. This is contingent upon some extension risk being built into the swap model.

A benchmark for defining the curve’s steepness is to compare the two-year and the 10-year Treasuries’ yields. On March 31 of this year, the curve was sloped 7 basis points. By Sept. 30, it had steepened to 66. This does not reach historical norms, as the 15-year average is closer to 100 basis points. Still, it’s the best we’ve had in three years.

**Leverages**

Leveraging activity has basically taken the last three years off. Now, with some slope to the curve, and even more slope to the curves that matter to a portfolio manager, this strategy has also resumed some attractiveness.

Leveraging consists of buying securities with borrowed money. The securities that are appropriate will vary from bank to bank, but they can include tax-free munis, long resetting hybrid adjustable-rate mortgages or fixed rate mortgage backed securities or collateralized mortgage obligations. Callable securities with little or no lockout are not good fits for leverages and should be avoided regardless of their enticing coupons.

Leveraging usually requires some mismatch between the durations of the liability and the asset. This generally isn’t a problem for a bank that is positively gapped. In fact, it’s the mismatch that takes advantage of the curve’s slope. And remember that anything you’d buy has a slope that’s steeper than the Treasury curve. Munis, in particular, are typically quite steep.
Pre-funding Future Purchases

Pre-funding future purchases is another technique to take advantage of the curve. This practice is really a modified form of leverage, and usually consists of borrowing via Federal Home Loan Bank advances whose maturities coincide with near-term cash flow from the investment portfolio. Many, many community banks are still owners of securities purchased in 2003-2004 with yields that are far below market. Such institutions probably didn’t have the stomach (or earnings) to sell them at a loss.

These “dogs” are finally getting near their maturity date. As an example, let’s use a bond with a 3 percent coupon that will mercifully roll off on Feb. 1. A portfolio manager could take down an advance that will mature on that date and purchase a security that fits the bank’s long-term needs. Once again, the slope to the curve will allow for at least some positive carry during this pre-funding period, and even more spread once the old bond and the advance roll off.

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Learn More

ICBA Securities can help your community bank identify which investment strategies are appropriate by providing a Performance Profile report and a number of its planning models on a complimentary basis. For more details, contact your sales rep or Jim Reber at (800) 422-6442.