An indication of Americans’ devotion (or obsession) toward tackling small projects on their own is the fact that home improvement stores continue to perform very well. Lowe’s, Home Depot and the like have posted record profits, and their stock prices have followed suit. Further expansion is predicted by analysts covering the industry.

The rewards are obvious. Curb appeal, more efficient heating/cooling systems, lower utility bills or attractive landscaping all create a sense of gratification. And, the homeowner’s value can also benefit as a result.

Community banks can now do the same thing, only with securities in their investment portfolio. It is a perpetual source of unease for investment managers that rising interest rates will hammer their investments’ market values, and the shape of the yield curve has been predicting exactly that for the last eight years. As it may be that a true bear market for bonds is in the offing, perhaps it’s time to take matters into your own hands.

**Spread analysis**
Before we create our very own floating-rate security, we must first review interest rate fundamentals. Community banks buy investments whose yields are directly affected by U.S. Treasury securities. Since Treasuries are viewed as the globe’s collateral, their yields are usually the lowest anywhere, so community banks don’t buy them in large volumes.

What community banks do purchase are safe, liquid investments that yield a bit more than Treasuries. The yield differential is known as spread, and usually the longer the term of the bond, the greater the spread. Take high-quality, tax-free municipals for example. Currently, the difference in yield between a 10-year, AA-rated muni and the 10-year Treasury note is about 143 basis points (BPs), or 1.43 percent.

While that may have a good ring to it today, what investment managers are increasingly not liking are the long maturities necessary to attain that spread. I am pleased to report to you that by employing a certain strategy using interest rate products, a community bank can have very short effective durations, and attractive yields.

**Moving parts**
First, we take a municipal bond with a longer state maturity of 15 to 20 years. This muni should have two other quantitative features: a high-stated coupon payment of about 4 percent or greater, and a call date of around 10 years. This will make it more likely that the bond will be called away in 10 years, which is the desired outcome.

Next, the bank will execute a generic interest rate swap, effectively turning the muni into a floating-rate asset. The bank will be receiving two interest payments: the 4 percent coupon payment on the bond, and a floating rate interest payment on the bond swap. It will also pay right back out to the swap counterparty the fixed-rate interest rate payment of 4 percent. That leaves the 90-day LIBOR-based income stream, and voila! Floating rate security.

What the bank has done is reduce the maturity of the bond from about 10 years down to an effective duration of three months. And, the answer to the big question of “how much does this cause my yield to drop?” is relatively painless. That’s due to...
the impact of retaining the attractive spread originally purchased in the municipal bond.

**Live example**
Recently a Mineola, Texas, tax-free issue came to market that had these desirable features: maturity in 18 years, call date in eight years and a stated coupon of 4.00 percent. It came to market priced to yield 3.55 to the call date, and when the tax-equivalent yield is calculated, the yield rises to 5.19 percent.

After an interest rate swap is executed, the bond’s effective duration is 90 days due to its floating-rate profile, and the yield is about 2.54 percent. This is possible because of two factors:
  1. the “pay fixed” part of the swap at 4.00 percent produces a “receive floating” payment of 90-day LIBOR plus 1.12 basis points, and
  2. the tax-equivalent benefit adds another 1.19 percent. At this writing, LIBOR yields about 23 basis points, and the sum of the three arrives at 2.54 percent.

There are a number of additional points that need to be made about this trade. One is to remind you that this new yield is only locked in for 90 days. Potentially, its yield could begin rising in three months, and there are no caps. Another is that there are some variables in this or any rate swap that could cause the outcome to be less than expected; an example of this is basis risk, in which the spreads between the muni curve and the swap curve do not stay consistent. A third is that efficiencies in the interest rate swap market have improved to the point that very small block sizes can be swapped. Somewhere around $250,000 and up is where the fun begins.

As always, be sure you understand the risks and the range of outcomes when entering into interest rate contracts. Your counterparty should produce for you in writing the possible scenarios that could occur.

Included is documentation of the hedge accounting. Of course, common sense tells us that your examiners and auditors will expect plenty of backup.

Do-it-yourself floaters using municipal bonds or other non-amortizing bonds are very much in play for community banks. Self-gratification, the kind that comes from knowing you’ve improved your community bank’s profile, but without the need for a paintbrush or a weed eater, is just an inquiry away.

**Fast Fact**
Effective Sept. 1, 2014, Vining Sparks, the exclusive broker for ICBA Securities, participates in all trades with ICBA members as principal. Other community bank safeguards remain in place, and ICBA Securities now maintains a marketing and education platform. For more information contact Jim Reber.