



Bottoms Up

Manage your community bank's deposits for better margins

By Jim Reber

In the last year, this column has covered several investment topics in as much detail as they deserved, and possibly more so. We've talked about mortgage-backed security prepayments, callable agencies, municipals, SBA's, interest rate risk and premium risk. Generally, I've recycled themes based on the "buy securities that will do well when rates begin to rise" proposition.

What I've ignored lately are opportunities on other parts of your community bank's balance sheet. Since there are some really good reasons to look at your deposit liabilities, let's take a bottom-up approach to possible bank investment strategies.

Of course, it's completely understandable if a community banker has put the liability side of the balance sheet on autopilot. Banks remain stuffed with cash, and depositors for the moment have very low expectations for yields on their FDIC-insured balances. Ironically, now may be an ideal time to pay some attention to your deposits. Your bank's net interest margin, and shareholders, may thank you.

employ a range of techniques to keep interest rates low, net interest margins have shrunk. This includes both components of the calculation: yields on earning assets and cost of funds.

Funding costs, in fact, have never been lower. A bank with a 1.00 percent cost of carry is paying far higher than its peers. As of December 2012, the average bank was paying just 60 basis points to finance its deposits. Large portions of deposit liabilities have no cost at all.

Many community bankers are trying to shrink their deposits, as they feel there's limited ability to redeploy them into a meaningful arbitrage. There may be better alternatives to the conscious surrender of low-cost financing.

Duration play

Most community banks have some exposure to rising rates, whether or not their interest rate risk profile reflects this. Adjustable-rate loans that are floored out or floating-rate bonds with small periodic caps are examples of assets that could create a temporary squeeze in earnings when rates begin heading north.

A large and growing number of community banks have employed brokered CDs in a fashion that will serve their asset/liability needs well now, and *very* well in the future. Long-duration deposits can help fix an asset/liability mismatch, and often at rates below what can be raised from a given bank's footprint.

For example, 10-year CDs are now available at an all-in cost to the issuer of about 35 basis points over the U.S. Treasury curve. That is a narrow spread from an historical perspective, and an absolute cost of about 2.30 percent. The issuer can further add flexibility by making them callable—meaning you

Rate Indicator


ICBA Securities publishes a weekly Brokered Deposit Rate Indications spreadsheet that displays all-in costs to issue CDs and convert them to floating rates. Contact your ICBA Securities sales rep or Jim Reber to receive the document.

have the hammer—for only another five basis points. With all rates compressed, the value of the call option is very low. The banker in turn can invest in longer-duration assets like fixed-rate loans or municipal bonds, and earn a respectable spread.

Fixed to float

A variation on the brokered CD story is for a bank to execute a simultaneous interest rate swap to create a floating-rate deposit. This would not fix an interest rate mismatch, but it would create a very low current cost at present rates. It's common for the net cost to a bank to be in the LIBOR minus 15 basis points range, which today is about 10 basis points (0.10 percent).

In this strategy, whatever a bank chooses to invest in would create a spread. Of course, the cost would begin to ratchet higher whenever general rates rise, so some type of short-duration or floating-rate asset would be most appropriate as a match. Your broker should be able to quantify the incremental earnings and interest-rate-risk outcomes for the pairing.

As you search through your community bank's balance sheet for parts that can be made more productive, think about these deposit strategies. The planets are aligned to lock in historically low cost of funds. So here's to improved net interest margins! Bottoms up. 

ICBA Securities Factoid

ICBA Securities has rebranded its popular investment school. The Community Bank Investment Institute has become the ICBA Bond Academy. Details and registration information for the 2013 academy will be available soon.

Cost of funds falls

As we wrap up the bean counting for 2012, we see several emerging trends. The industry overall continues to post decent results, with earnings higher than at any time in the last six years. As the Federal Reserve has continued to