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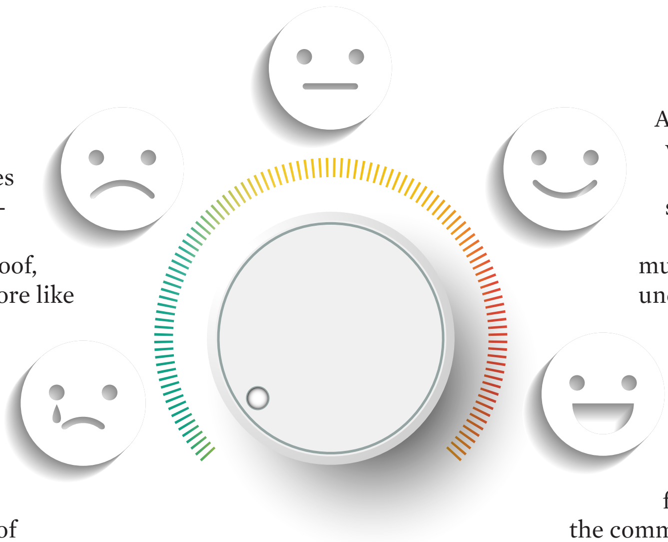
Cap and Trade

Rate caps on your ARMs can affect performance

By Jim Reber



Community bank portfolio managers can sometimes behave like sixth-graders. I'm not suggesting that they can be aloof, petulant or whiny. They're more like a 12-year-old who has a crush on a classmate, but either can't or won't admit it: Many community bankers find adjustable-rate securities alluring. It goes back to DNA.

There is an unwritten bias of portfolio management when it comes to community banks that short is better. This results in many portfolios being heavily weighted with bonds that have near-term maturities, call dates, step dates or reset dates, even when it's not necessary, profitable or even advisable. A reason that net interest margins have declined over the last five years is that banks have had to reinvest, or have had to reset, too much of their investment portfolios.

In this period of still-low interest rates, several strategies have emerged to ensure that the floating-rate portions of the balance sheet are properly designed to benefit from a true rising rate environment, whenever that may occur. These strategies should mesh well with the sensibilities of the community banker, who is ever risk-averse.

Looking good

As proof that community banks in aggregate try to keep their investments on the short side, even back before the financial crisis erupted in 2008 around 14 percent of their bonds were of the floating rate variety. Since then, floaters have grown to represent about 18 percent of the total.

That may not sound like a big adjustment, but there are back stories that bear mentioning. Only about 3 percent of all new home loans are adjustable-rate mortgages (ARMs), so it is a bit of a scramble to find the ones that fit a community bank's risk/reward profile. Small Business Administration (SBA) pools, which also float, account for a large part of the increased sector-weighting.

Also, more and more community banks, some of them under $100 million in assets, use interest rate swaps to fix asset-liability mismatches on their balance sheets. The vast majority of these swaps are of the "pay fixed" variety, which means the community bank is lowering its exposure to rising rates.

Beat the clock

Many community bank portfolios bought securities two, three or even five years ago that had fixed rates for a while, but are very close to having their first reset, or "roll" date. Since this column is about bonds, which we have seen is a good news/bad news proposition, here is another example.

These near-reset ARMs will probably be resetting to a lower rate soon, which is the "bad." However, since market yields on the short end are so low, you may be able to sell your way out of these bonds at little or no loss, even though their yields are not ambitious. That is the "good."

What then, to reinvest into? Perhaps more ARMs, with longer roll dates. Your community bank will almost certainly be economically better off, regardless of the gain or loss. However, if your bank's interest rate risk will allow, you can pick a future roll date that you feel is a good bet to have your new ARMs reset higher. Which is why you bought them in the first place.

Webinar Series Announced

The 2015 Community Bank Matters webinar series will present five different topics and five speakers throughout the year. The first event will be in April. Registration information will be emailed to all Vining Sparks customers and prospects around April 1.

Raise the roof

Another inconvenience of many ARMs is their restrictive caps. Ginnie Maes, in particular, don't have a lot of room to stay on market because of their 1 percent annual caps. This is good news (that theme again) if rates are falling, but not if rates do what the Federal Reserve itself is predicting. At the most recent release, on Dec. 17, the Fed's forecast for end-of-year 2016 is for Fed Funds to be at 2.50 percent.

Two strategies can be used to increase "cap space." One is to more heavily weight the ARMs toward conventional loans, backed by Fannie Mae and Freddie Mac. These will have 2 percent annual caps, and more liberal life caps as well. The other is to buy truly floating-rate bonds, such as the SBAs mentioned earlier. SBAs have no caps at all, and will therefore stay on market. Be aware that SBAs carry some very large premium prices, but diversification can help limit the attendant prepayment risk.

If you're like many angst-riddled portfolio managers (pre-teens) who just can't get ARMs (cute classmates) off their minds and (dreamily) see only the most appealing features, my advice is to pay attention to the undercurrent as well. Rate caps and roll dates play a large part in how your community bank's floating rate investments will perform. IB

Track Your Roll Dates

ICBA Securities' exclusive broker, Vining Sparks, has developed a report to help community banks monitor the reset dates of their adjustable-rate investments. To view your community bank's ARM Position Report, contact your Vining Sparks sales rep or visit ***www.viningsparks.com.***