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Down We Go

A guide to profiting from the flattening interest-rate curve

By Jim Reber

Many are the bank analysts who have decided that falling, or low, interest rates are bad for net interest margins, and that may be true for a given community bank. However, given the many variables at play here, and their importance ultimately to an institution's franchise value, this topic deserves more inspection.

For one thing (2016 is a handy example), rates do not change in a parallel fashion. For another, a com-

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The solution is to invest in securities that will either reprice in the near future or will produce substantial cash flow soon. Obviously floating-rate securities can help, as can amortizing instruments such as seasoned fixed-rate mortgage-backed securities. Above-market coupons on callable agencies and municipal bonds also can ensure that you get reasonable return on short duration assets.

aforementioned flattening of the yield curve. Although the market for swaps changes constantly, as of this writing a 10-year amortizing loan with a note rate of 3.50 percent can be converted into a quarterly resetting asset with a start rate of about 2.75 percent.

Lower your deposit costs

Another way to address asset-liability mismatches is to extend the maturities of your community bank's deposits. Most find it difficult to accumulate worthwhile volumes of time deposits with maturities greater than a couple of years. Two strategies have emerged that accomplish the desired effect of making the balance sheet more asset-sensitive.

First, wholesale deposits are available. It's clear that many community banks have not tapped the wholesale market for the simple reason that they didn't need to. However, as loan demand is on the rise, and as the all-in costs of a four- to six-year deposit have fallen, more community banks have adopted this tactic.

Second, just as interest-rate swaps can convert fixed-rate assets to floating rates, so too can they make floating-rate deposits fixed.

munity bank's ability to control the rate of change of its various balance-sheet components is unique to that institution. For another, products that create fee income can potentially offset shrinkage in margins.

Since the yield curve has flattened, and seems poised to move in that direction for a while longer, it's time for a column that will make some suggestions help your community bank profit from such a condition.

Mend the gap

Mathematically, a flattening curve shrinks the benefit of an asset-liability mismatch. Banks that have longer assets than liabilities are the first to see their net interest margin shrink. From a risk standpoint, it's a left jab and a right hook: declining income

and greater exposure to interest-rate metrics such as economic value of equity and capital at risk. It is just as simple for a community bank to turn fixed-rate loans into floaters, whether we're talking about a segment of the loan portfolio, a fixed block of credits or even a single commercial loan.

Several variables have been acting simultaneously that have created this opportunity. One has been the shift downward in the swaps curve (which itself is the residue of multiple factors). Another is the

Loan portfolio strategies

Rarely, if ever, has it been more beneficial to convert fixed-rate assets to a floating rate via interest-rate swaps. This column in the recent past has explored the "DIY



Jim Reber (jreber@icbasecurities.com) is president and CEO of ICBA Securities, ICBA's institutional fixed-income broker-dealer for community banks.

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Community banks are almost always looking for “longer” liabilities. As with the previous strategies, a confluence of events has pushed down the all-in cost of swapping floating deposits to fixed at rates that are just nominally above the Treasury curve.

Regardless of which of the above strategies can be employed, the starting point is the measurement of interest-rate risk by your community bank. I recommend that this be quantified soon and often. As the curve flattens, you may be able to actually improve your bank’s risk profile and net interest margins. ¹²

Webinar with Free CPE in October

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