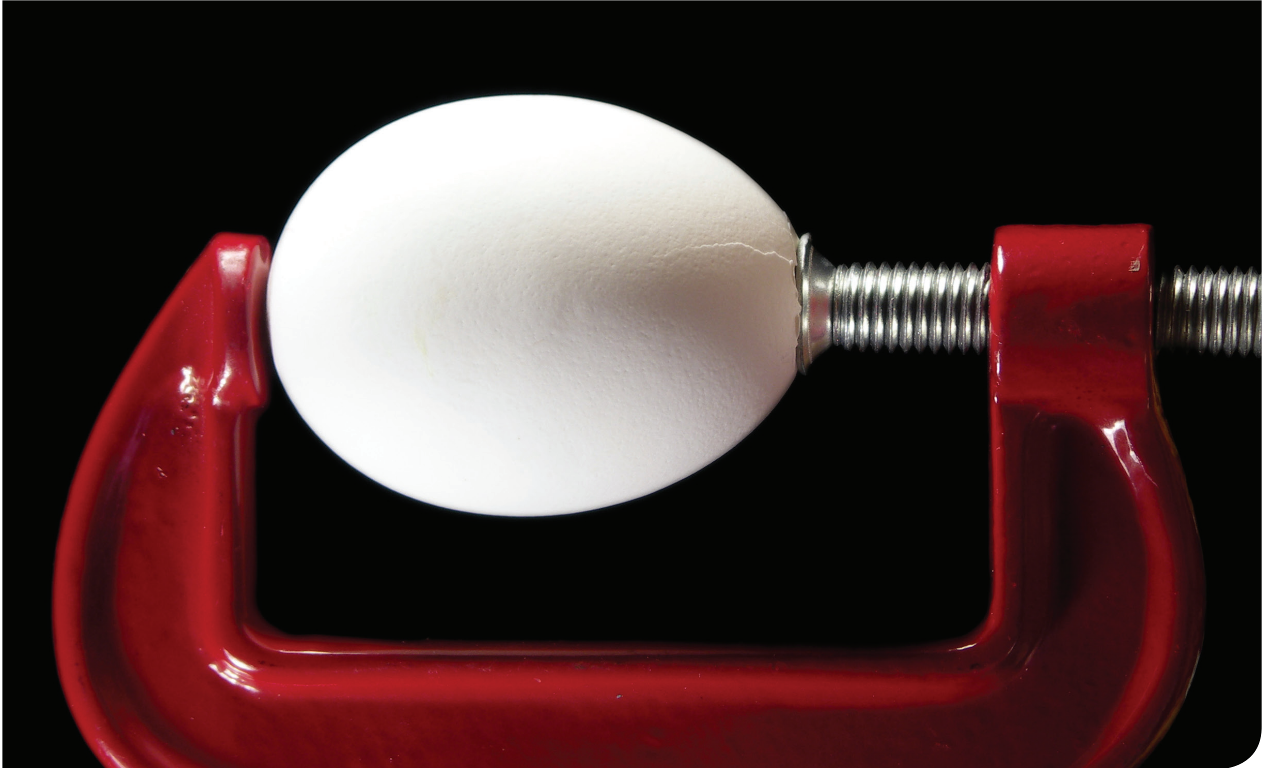

Portfolio Management

By Marty Mosby, guest columnist

Pressure's on

Marty Mosby of Vining Sparks explains how community banks can navigate the new rising-interest-rate environment.

As the Federal Reserve began to normalize interest rates, the typical U.S. bank has been able to expand net interest margins by about 10 basis points on average by simply lagging interest-bearing deposit rates. Historically, U.S. banks have typically passed along 30 to 40 percent of the rise in the fed funds rate to their customers. However, this period of rising interest rates has been meaningfully different.

The pace of increases in the fed funds rate has been significantly slower than past periods when the Federal Reserve has increased short-term rates. In the past three periods of rising interest rates, for example, it took the Federal Reserve only six months to increase the fed funds rate by 100 basis points. This cycle, a 100-basis-point rise in the fed funds rate has taken the Federal Reserve 24 months.

As a result of this slower pace, we estimate that bank managements have been able to pass along only 20 percent of the rise in the fed funds rate to their customers. This ensures that the U.S. banks would be able to achieve a much-needed 100-basis-point spread between interest-bearing deposit rates and the fed funds rate, even if the Federal Reserve's anticipated rate hikes became more limited.

We also believe that U.S. banks were able to

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push deposit rates up much less than in previous periods. This is because the competition from money market mutual funds has been minimal, as the assets that these funds could invest in had become much more constrained since the last financial crisis.

Further hikes in the fed funds rate will likely create increasing pressure on raising deposit rates. In the fourth quarter of 2017, U.S. banks passed along 40 percent of the hike in the fed funds rate. Since the U.S. corporate tax rate was lowered earlier this year, banks have likely begun to pass along somewhere between 60 percent and 80 percent of the most recent 25-basis-point hike in the fed funds rate to their customers. Once the fed funds rate eventually surpasses 2 percent, any incremental rise will likely be passed along to customers in full.

We are approaching an inflection point, when lagging deposit rates is no longer reasonable and rounding up asset yields is becoming critical.

How phase II benefits can help

In order to offset rising deposit costs, banks can take advantage of what we call "phase II benefits" from this rising-interest-rate environment, rolling securities and longer-term loan yields higher while the cost of net free funds remains zero. In order to mitigate the natural increase in deposit rates at this point in the rate cycle, it has become more critical to manage loan origination pricing higher and look for higher-yielding securities to replace the lower-yielding existing portfolios.

For the first time in a decade, it will become important to manage asset yields higher to offset the incremental cost of higher rate funding. Currently, bank securities portfolios average about a 2.5 percent yield, while current market security yields range from 3 to 4 percent, depending on the needed duration of the incremental securities purchased. This gap will naturally close as maturities in the securities portfolio are reinvested.

Moreover, banks can choose to recognize losses and restructure their portfolios to higher yields instantly if a bank has the incremental capital to deploy. This strategy can improve returns by deploying excess capital that can enhance securities portfolio yields, generating higher returns on tangible common equity.

Additionally, many community banks have high loan-to-deposit ratios, which place a higher premium on growing deposits to fund the upcoming incremental loan growth. For these banks, loan officers should be conditioned to raise loan origination pricing equivalent to the rise in the market rate for securities and wholesale borrowing sources. This will naturally lessen loan growth and ease the pressure on creating deposit growth in this tough environment.

Quick stat

24 months

The time it took the Fed this cycle to make a 100-basis-point rise in the fed funds rate

Focus on deposit pricing

We are approaching an inflection point for community banks, when lagging deposit rates is no longer reasonable and rounding up asset yields is becoming critical.

To make the most of this new environment, community bank managements should develop a deposit pricing plan that enables their banks to get something in return for the higher rates offered to their customers.

Two options are to offer higher CD rates with three- to five-year maturities to get longer duration funding, or to make sure higher money market rates are offered to customers who are expanding their relationship with the bank.

On the asset side of the balance sheet, community bank managements should refine their loan pricing skills to ensure they continue to receive compensation for assuming this credit risk, and to maximize the opportunity to restructure securities portfolios to the current higher-yielding market rates.

By preparing for this shift in the market, we believe community banks can continue to expand net interest margins and net interest income. ■