

ALCO Beat: Devising a rationale for current portfolio structure

You could go two different right ways, today. So, which way? And why?

Looking forward at interest rate risk and other factors raises many questions. While puzzles like this can be solved one way, generally, author Darnell Canada says the current investment policy puzzle has multiple answers. But how well your bank does hinges on understanding and execution.

By Darnell Canada, managing director, Darling Consulting Group, Inc. For more about the author, see the end of this article.

How optimistic are you concerning the outlook for your net interest margin?

The credit-related effects of the financial crisis of 2007-2009 are fading, as indicated by lower loan loss provisions and reduced problem asset levels. However, another threat to bank earnings is gaining rapid momentum: margin compression. Ironically, the culprit is the quantitative easing tactic taken by the Federal Open Markets Committee (FOMC) to stimulate economic growth and bank lending. The FOMC's plan to push medium- and long-term rates lower has produced unintended consequences that are actually creating great challenges for community banks, and possibly prompting some to take on unforeseen or underestimated risks.

Darling Consulting Group recently examined the risk patterns for hundreds of banks across a broad range in asset size, and concluded that over 60% of community bankers can expect to experience meaningful margin compression in 2012 and 2013. The outlook for margin compression varied between 2%-5%, depending in many cases on bond cashflow and related re-investment tactics.

Why is this happening?

In most economic downturns, when lending activity slows and credit losses threaten profitability, banks often find success in protecting earnings by lowering deposit rates more aggressively with market rates. Also, banks are normally able to take advantage of slope in the yield curve by executing carry trades that strengthen investment income. These strategies worked very well for banks for much of the past three years.

However, things began to change in 2011.

We've seen bank deposit rates reach near-zero levels. Hence, the ability to offset the negative influence of declining asset yields through funding cost reductions has become increasingly limited. Meanwhile, slope in the yield curve has all but disappeared since the FOMC began its quantitative easing tactics.

Currently, banks can only expect to earn 80-100 basis points on incremental yield for taking five years of interest rate risk in U.S. Treasury bonds. This is considerably lower than the nearly 200 basis points of slope opportunity observed in 2010, which compares consistently with historical trends. Five-year t-bonds yielded over 225 to 250 bps more than 3-month t-bills during the trough periods of the last two meaningful economic downturns in 2003 and 1992 as well.

With justification, some bankers have become more reluctant to invest in the bond market. Cash balances on community bank balance sheets have increased noticeably as interest rates have fallen and the yield curve has flattened.

And, as a community banker recently quipped at a conference, "Cash is a nonperforming asset."

Rates have to move up...right?

It is no surprise that many bank treasurers worry about performance in the bond portfolio under rising rate conditions.

Interest rates are at historically low levels. Some economists believe recent data indicate a stable recovery is unfolding and will influence the FOMC to change the course of monetary policy earlier than planned. If not, all the action taken by the FOMC will only stimulate inflationary pressures.

Further, a precarious fiscal situation caused the rating agencies to downgrade the credit status of the US government. Eventually, the broader marketplace will begin to price higher risk premiums into the US bond market, forcing bond yields higher.

But when?

What happens if rates don't rise ... soon?

It is silly to contemplate the question of whether interest rates will rise--of course they will. The more appropriate question for ALCO is:

How well positioned is the balance sheet for a variety of rising rate scenarios versus flat or falling rate scenarios?

For many of the balance sheets that we examine, the greatest risk to margin is a scenario where medium- and long-term interest rates remain flat or fall from current low levels, before beginning to rise. In other words, unless the FOMC begins to raise rates in the near future (and/or the yield curve steepens meaningfully), margin levels will narrow and, in the absence of meaningful loan growth or capital leverage, net interest income will suffer.

In short, ALCO planning might be exacerbating core earnings exposure in your worst-case interest rate risk scenario by deciding to accumulate cash or invest in overly short duration assets. To best illustrate the near and longer-term tradeoffs for your institution, consider interest- rate-risk modeling that includes scenarios that quantify the impact of a 12-24 month delay before market rates begin to rise.

How long is too long?

Although remaining fully invested and extending asset duration may be the appropriate course of action to mitigate downward pressure on balance sheet performance, caution and discretion should still be employed by treasurers and chief financial officers as they execute purchase strategies.

The earnings implications are clear when extending investments further on the yield curve. Any cash currently employed to purchase bonds is less cash you'll have to reinvest if and when interest rates rise. In this regard, carefully study the convexity risk that accompanies duration exposure in the bonds selected as candidates for purchase. A bond with a 3-5 year duration in the current rate environment may have a much longer life if market rates shift higher. By minimizing the potential added extension, investors limit the downside risk of deploying cash today because bonds will "roll down the curve" and portfolio duration will gradually shorten before interest rates rise.

Duration and convexity will also impact your bank's funding posture. Of course, less bond cash flow increases potential liquidity risks should lending activity increase and/or deposit growth become challenged. In this regard, price risk in the bond portfolio is also increasingly relevant. Should your bank need to sell bonds to satisfy liquidity needs, potential losses could be incurred if market rates are higher. Additionally, collateralized borrowing capacity will diminish with an increase in unrealized losses.

For public institutions, depreciation in the bond portfolio will also negatively impact tangible equity ratios. It is worth noting here that there is increased discussion within the regulatory community that suggests a tangible equity measure may be added as another component in assessing capital adequacy for the CAMELS rating.

Bankers should understand their capacity to accept potential depreciation in the bond portfolio before making a decision on how far to extend cash in the bond portfolio and/or how much convexity risk is tolerable.

Should I trade off interest-rate risk for credit risk?

In lieu of accepting additional duration risk, a number of banks are maintaining/increasing yields by adding credit exposure to the bond portfolio. While this may be an appropriate strategy for some, capital and liquidity strengths are critical to justify this tactic.

Capital stress testing should be a prerequisite in that investors need to examine not only default probabilities, but also to recognize that in the event the marketplace applies a negative viewpoint on the sector, industry, or specific issuer, wider credit spreads would cause value depreciation. Or worse, create risk of impairment that would permanently impact capital levels, even if the bond(s) continue to cash flow and perform. These issues are of particular importance for banks with a sustained elevated level of problem loans.

With increased regulatory emphasis on documenting internal credit risk analysis within bond portfolios, we are seeing many banks that decide to invest in corporate debentures do so only after their internal credit departments have prepared an appropriate review.

So what is the right move?

As a general viewpoint, we are reluctant to recommend the addition of meaningful duration and negative convexity to bond portfolios at this point in the rate cycle. Given a choice, we would rather see banks take interest rate risk in the loan portfolio with solid credits. However, we recognize that lending activity in many markets remains sluggish, assuming prudent and conservative underwriting standards are maintained.

As alluded to in the commentary above, there is no single or exactly correct answer to this question as it relates to the investment portfolio. Simply recognize that staying fully invested and accepting some incremental downside exposure to rising rates may be a "necessary" evil in the current marketplace.

The extent to which you engage in or continue this dance with the devil should depend on your overall risk profile. Establish a formal game plan for investing in the current marketplace with the following question and answer sequence:

• How much margin/income will be sacrificed each quarter/year if interest rates do not rise and short term assets accumulate?

• How low can I expect margin/income to trend when rates eventually do rise?

• How much depreciation can my liquidity position tolerate?

• And how much loss can my capital position absorb before reaching internal minimums/targets?

Although a greater yield burden is placed on the investment portfolio, the key to successful investing in the current

marketplace remains, as always, careful selection of assets that are a good fit, given the credit, liquidity, and interest rate risks present within the aggregate balance sheet. Leave speculation to those with trading portfolios.

ABOUT THE AUTHOR

Darnell Canada is managing director at Darling Consulting Group, Inc., and has been with the firm since 1996. He works extensively with community banks and is a speaker and active educator, participating in a wide range of educational programs, including ABA's Stonier School of Banking and the Graduate School of Banking at LSU. Prior to joining the firm, Canada was an FDIC safety and soundness examiner. He has received a B.S. in finance from Bentley College and a M.S. in finance from Boston College.

Previously Canada wrote, "A liquidity stress scenario you may not have considered," for ABABJ.com in May 2011. You can read it [here](#).

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