Financial Managers Society

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Hanging in the Balance

Sorting through the tough balance sheet questions facing community institutions

By Mark Loehrke
Writer/Editor, Financial Managers Society

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The Federal Reserve may have finally gotten the ball rolling in late 2015 with its first interest rate increase in years, but anyone anticipating a clearer, more predictable path going forward was likely nevertheless disappointed.

Community institutions today face just as many questions and uncertainties with respect to their balance sheets as they did before the long-awaited rate move. But regardless of what the Fed does or doesn't do going forward there are still decisions to be made, questions to be answered and strategies to be calibrated in the meantime.

Are we appropriately positioned for the current environment?

How can we boost our net interest margin?

Where should we be looking in our investment portfolio?

Are we pricing our loans and deposits correctly?

FMS took these issues to six experts in the field to get their take on what's happening – and, in some cases, what should be happening – on the balance sheets of community institutions.

What should be the number one concern for most community institutions with respect to their balance sheets in the current environment?

David Sweeney, Managing Director, Chatham Investment Advisors:
The continued low-rate environment and flattening yield curve will impact the repricing of loans made years ago, therefore reducing loan yields and net interest income. For example, in the first half of 2011, the 5-year swap rate averaged 2.20% – those 5-year loans are now coming due and will be repricing at the current 5-year swap rate of 1.33%. Accordingly, institutions rolling over 5-year loan relationships will be seeing a sharp decline in yields, without an offsetting decline in interest expense.

Charles McQueen, President, McQueen Financial Advisors:
I think matching yields to the risk they're putting on their books is probably the top concern for institutions right now. For example, if you look at what's going on today with indirect car lending, you'll find people putting on 10-year car loans at extremely low yields in the 3% to 4% range. There's negative equity in these loans, and I think in many cases there's not the proper risk adjusting going on. Usually the response we'll hear is 'well, everyone else is doing this, so we have to compete at these rates.' So I think risk-adjusted return is the big thing to watch out for.

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> *Bart Smith, Managing Director, Performance Trust Capital Partners, LLC*

Todd Cuppia, Director of Balance Sheet Strategies, Chatham Financial:
To provide some context to the recent flattening of the front end of the yield curve, the interest rate spread between the 5-year swap rate and 1-month LIBOR has essentially been cut in half over the course of the last three quarters, narrowing nearly 80 basis points since the second half of 2015. For reference, the spread has averaged 135 basis points over the course of the last 25 years, leaving today's 82 basis-point yield spread in the 35th percentile in historical context. To make matters worse for management teams, the implied forward curve is pricing in an additional 30 basis points of curve flattening in the coming years. This highlights the need for financial institutions to use every tool available to actively manage each incremental basis point of income or expense. While many management teams have done well to rationalize pricing in many areas of the institution for the current environment, there are still meaningful efficiencies that can be gained by optimizing the institution's wholesale funding and investment strategies to help mitigate the impact of a flattening curve.

Michael Davis, Director of Strategies, SunTrust Robinson Humphrey:
The main concern should be preserving or maintaining their margins and accompanying balance sheets. This includes finding the next round of loan growth, priced appropriately, and the optimal mix of corresponding funding. Our clients have recently lowered their expectations for loan growth over the balance of 2016 – couple this with a relatively flat yield curve pressuring margins, and institutions may feel forced to relax credit standards or pay up for local loans/deposits. We suggest institutions think differently – if the local market is not conducive to quality, organic loan production, consider secondary loan packages with adequate return and solid or desired credit and interest rate risk profiles. On the funding side, banks have largely reduced wholesale funding since the crisis, leaving ample borrowing capacity. Assuming an absence of low-yield, short-term asset-based liquidity, with the curve flattening this may be a good time to lock in low-cost funding.

Greg Garcia, Senior Managing Director, FinPro, Inc.:
In the current environment, we still expect to see net interest margin compression with earning-asset yields continuing to decline. A lot of loans put on five years ago are coming up to their repricing periods, and a lot of our clients are seeing refinancing and new loans put on at lower yields than their predecessors. With the recent decline in the 10-year Treasury rates, we think we're going to continue to see margin compression in 2016 and probably into 2017. So that's probably the primary concern right now.

Bart Smith, Managing Director, Performance Trust Capital Partners, LLC:
I think the biggest concern is that community institutions are not structuring their balance sheets for current earnings. There is so much posturing for hypothetical rate scenarios that institutions leave millions on the table as they wait for higher interest rates. Clearly, we are in a historically low-rate environment and the risk of rates going up is very real. However, the risk of a prolonged low-rate environment is also very real and maybe even more likely. Institutions need to plan for success in all reasonable rate scenarios and ensure that their policy parameters and risk tolerances are appropriately considering the full range of risks that are present. Overprotective risk strategies almost always lead to weaker earnings and less capital accretion, which can actually increase the institution's overall risk posture over time.

Where do you see the best opportunities for increasing net interest margin in the coming years?

Sweeney: If the institution has excess liquidity on the balance sheet and views the current low-rate environment as one that will stick around for a few more years, now may be the time to further test how low it can move deposit rates PLUS lending fixed rates for terms over five years and/or buying longer-duration securities.

McQueen: The main thing to focus on is having a diversified lending portfolio. Most balance sheets are too short and too fearful of rising interest rates. People are so worried about rates rising when they should be focused instead on maximizing their net interest margin in any rate cycle, and not trying to maximize it for the opportunity of rising rates. So I think there's an opportunity to put a few more longer-term loans on the books, but really the key should be a diversified holding of numerous loan types and investment types to get the correct duration and to make sure income is as high as possible.

Cuppia: This is the $64,000 question facing our business, and there is no easy answer. The industry, in the aggregate, has already picked much of the low-hanging fruit. Securities as a percentage of total assets have fallen back to a 20-year low, entirely reversing the marginal increase that took place following the credit crisis. Currently, banks and thrifts with less than $10 billion in assets are holding around 18% of total assets in the bond portfolio, down from 30% in the 1990s. This dynamic leaves little room for margin expansion from reshuffling the allocation from bonds to loans or through a yield/liquidity trade-off in the bond portfolio. At the same time, data from the FDIC indicates that long-term assets (5+ years) as a percentage of earning assets at insured depository institutions is the highest that ratio has been since the time series began in 1996. To combat the long-term secular decline in net interest margins, many banks increased the amount of interest rate risk embedded in their balance sheets, which also leaves management teams with little room for margin expansion from asset allocation or by increasing the target for asset duration. In this difficult and hypercompetitive operating environment, we continue to see the best opportunities to expand margin in strategies that wring every basis point of savings out of wholesale funding sources, which can be meaningful and are often overlooked by management teams.

Davis: Many of our bank clients have shifted to an asset-sensitive position hoping for a higher rate environment to expand the margin. While the Fed increased the benchmark rate at the December meeting, expectations are for just one or two more rate hikes this year. Additionally, the longer end of the curve has fallen since the Fed meeting, further pressuring margins. Over the next few years, just maintaining margins could be a challenge should the current rate environment persist. Replacing excess short-term, low-yielding liquidity with quality loans (via the secondary market if necessary) or well-structured investments is a basic starting point to combat ongoing margin pressures. Absent asset-based liquidity, the prudent use of wholesale funding may provide a beneficial, low-cost mechanism to fund available spread assets.

In this difficult and hypercompetitive operating environment, we continue to see the best opportunities to expand margin in strategies that wring every basis point of savings out of wholesale funding sources, which can be meaningful and are often overlooked by management teams.

Todd Cuppia, Director of Balance Sheet Strategies, Chatham Financial

Garcia: Institutions need to continue to focus on loan growth, and shifting their balance sheets to more loans. One way to try and offset some of this is to replace lower-yielding investments with higher-yielding loans. I think the institutions that can lend are the ones that are going to win, not necessarily by widely expanding their net interest margin, but just by maintaining. On the liability side, there's not really a lot of room left. Most deposit pricing has kind of bottomed out. M&A is another part of it, where we're seeing institutions that can lend and have really strong pipelines actually looking to acquire deposit-generating institutions. I think we'll see more of this type of activity throughout 2016 and 2017.

Smith: To increase margin, I think community institutions need to take an honest look at the composition of their earning assets. In their most simplistic form, earning assets are comprised of core and non-core asset groups. Core assets include the primary loans and relationships that go to the most loyal and profitable customers. These assets provide the highest and most stable returns and generally have net yields that exceed a company's target ROE. Non-core assets include loans and securities that extend beyond the core asset base. While generally lower yielding, when managed properly this part of the balance sheet can create a real boost to net interest margin and generate differentiating returns to net income.

Given the above, I believe it's critically important that management understand and intentionally manage non-core asset allocations. Too often, community institutions will over-concentrate in familiar loan categories, which are core in the sense of product or collateral type, but very much non-core in the sense of pricing and/or terms. In other words, they underprice and/or under-protect themselves in a known space instead of exploring less familiar spaces that can offer a better risk-reward trade-off. Exploring and deploying alternative asset opportunities through a comprehensive and thoughtful balance sheet strategy can actually improve overall profitability and reduce risk.

What is your top investment portfolio recommendation and warning for community institutions right now?

Sweeney: Any suggestion we make is predicated on two things – what is the overall interest rate risk position of the institution and what are the liquidity needs of the institution? Accordingly, if the institution is asset sensitive and wants to stay asset sensitive, we would suggest floating-rate or short-term (less than two-year maturity) instruments. If the institution wants to be more liability sensitive, we will recommend longer-duration instruments. In terms of liquidity risk, if the institution has adequate collateral for pledging and overall liquidity needs, we can then start to suggest additions to the 'yield portfolio' into 'non-pledgeable' instruments, such as corporate bonds, municipal debt, CLOs and/or non-agency issues.

That said, the warning for community institutions is to be careful when buying CLOs. The buyer needs to ensure it understands the manager and the assets in the trust, as well as the reinvestment period. There are a number of solid CLO issues outstanding in the market, but there will be CLO issues that will perform poorly. We advise our clients to be particularly careful in this asset class.

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> *Charles McQueen, President, McQueen Financial Advisors*

McQueen: We're big fans of taxable municipal bonds, but this is also where my warning would come in – if you're not doing your homework on municipal bonds, you can be in trouble very quickly. You need to do your own internal credit work or hire someone who's not the broker. Coming from a guy in Detroit, we understand municipal bankruptcy really well, and there are going to be a lot of municipal bankruptcies coming in this country. But what we tend to find is that where there are problems, there are usually opportunities as well. So while there are a number of states that are struggling, there are plenty of states that are doing great. By doing your homework, you can get really good yield without taking the risk that other people might be because they didn't do their homework.

We also like pass-through mortgages right now because we like the idea of getting a little longer duration, given our outlook on rates. I don't really want a one- or two-year duration investment portfolio; I'd rather have a three- or four- or five-year duration portfolio. Obviously this has to be appropriate given your asset-liability management position and your interest rate risk position, but being a little bit longer can help in this environment and is one way to get a little bit better yield without taking on credit risk.

Cuppia: In the current environment, it is more important than ever to maximize the yield of the portfolio, subject to prudent interest rate risk management and rigorous due diligence of the appropriate level of liquidity and credit risk. In that regard, when looking at the yield per unit of duration of each investment in the portfolio, be sure to consider the many ways that duration can be aggregated. As a simple example in the current interest rate environment, the yield spread between the current 5-year Treasury note and a two-bond portfolio containing a 3-month T-bill and a 10-year Treasury, weighted to have an equivalent duration to the 5-year note, is currently 24 basis points. Understanding the yield curve and optimizing portfolio structure in the context of prudent risk management will be imperative for institutions trying to navigate these choppy seas.

Davis: Our investment portfolio recommendations are normally institution-specific, depending on the risk profile, return requirement and other operating goals and constraints in play. However, absent institution-specific information, we generally recommend focusing on near-term earnings without adding substantial price volatility or extension risk. Products that could achieve this are SBA floaters/post-reset ARMs which can provide better yield than the 5-year Treasury and carry limited price volatility. If there's room for incremental duration, municipals appear attractive given solid yield ratios to Treasuries. We also like agency-wrapped multi-family-backed investments with balloon-like features – these can offer attractive current yields without extension risk and relatively short finals compared to residential MBS.

Our main warning would be to avoid staying too short, on the whole, with the portfolio. Reinvestment risk poses a real threat to much-needed earnings support from the investment portfolio, adding further pressure to margins given the challenges in the current low-rate environment and low loan levels of many institutions. A well-constructed portfolio can provide the cash flow, price stability, yield and credit risk protections necessary to provide the more optimum performance needed in today's challenging environment.

Garcia: On the recommendation side, we still think fixed-to-floating rate corporate bonds are a pretty good play. This is high-quality investment-grade corporate debt that's offering enhanced yield today and helping with some interest rate risk protection on the back end.

From a warning perspective, we're definitely concerned with non-traditional investment products, including private-label and subprime residential mortgage-backed securities. You have to be really careful when evaluating these types of things, but in many cases it's probably best to just steer clear because you can't really understand the underlying characteristics of the collateral or the cash flows. Another area of concern is some of the municipal bonds that are coming from oil-producing states, and how the energy crisis right now may affect those. I can see some budget contests coming up in some of those areas.

Smith: In reverse order, my top investment warning is that institutions should not base their investment decisions on the performance of individual securities in isolation. The investment portfolio should be viewed as a compilation of securities that together are working to perform broad objectives for the institution as a whole. Different securities in the portfolio should be performing different functions (e.g., liquidity, income, etc.) and they should perform differently in various economic and interest rate scenarios. Certain securities may perform poorly in certain scenarios while other securities will perform very well. The goal of the portfolio should be to have a mix of securities that will perform best in all conceivable scenarios and create the greatest long-term benefit for the organization.

I think my number one recommendation would follow that warning. There is no single investment opportunity that is perfect for the current environment (for instance, I could argue that a long-term Treasury security is not a great option in the current environment). More than ever, institutions should be looking to build strong multi-purpose portfolios that meet a variety of needs and risk scenarios and complement the overall balance sheet risks and strategies. Generally, if institutions are willing to accept a moderate level of credit risk, opportunities in certain municipal categories and well-structured asset-backed positions represent alternatives to Treasury and agency options that are not overly compelling at the moment. When considering these investments, in addition to credit, institutions should evaluate their positions across rate scenarios, because we all know that a single yield and expected average life are woefully inadequate as measures for optimizing performance.

From what you've seen, do you feel most community institutions are pricing their loans correctly in the current environment? How about their retail deposits?

Sweeney: Commercial loan pricing at smaller institutions is usually driven by what the competition is doing. So if competition is pricing with small credit spreads, your choice is to either meet the price or lose the deal.

In terms of retail deposit pricing, I haven't seen too much of a reaction to the first Fed move late last year. If the Fed continues to raise rates, my biggest question is what the bigger banks in the U.S. do to retain and capture non–maturity deposits, which are very valuable in the Liquidity Coverage Ratio. Will the biggest banks move checking and money market rates faster than they have in the past? If so, the non-maturity deposit beta assumptions used by community institutions could be too low. The impact would be less asset sensitivity and more liability sensitivity (as measured by both NII sensitivity and EVE sensitivity for these institutions), equating to tighter net interest margins as rates rise.

McQueen: On the loan side, we tend to see people pricing their mortgages and commercial lending fairly appropriately. The area where we see people making bad pricing decisions is indirect auto lending. When you go through the dealer reserve and all of the expenses associated with putting some of those loans on the books, they don't always make sense.

On the deposit side, we've seen some institutions want to raise rates because the Fed raised rates a little bit, which I don't think is correct at all. I think you really have to pay attention to the margin, and one of the key components to that is keeping the cost of funds low because the yield on assets remains stubbornly low in this environment.

Davis: This is a very difficult operating environment with margins bouncing around all-time lows. To keep loans on the books, institutions really have no choice but to pay up (meaning yields go down) – especially in very competitive areas. Fortunately, the industry isn't recording increases in loan losses, so it would be hard to say pricing isn't correct for today's environment, although pricing must effectively incorporate all risks assumed and not just credit. In other words, based purely on credit exposure and the shrinking level of non-performing loans, today's pricing doesn't reflect imbalance.

However, to the extent that undue extension (interest rate) risk may not be adequately priced in, that's an altogether different and more challenging assessment. To evaluate this effectively requires institution-specific knowledge of lending markets, terms and conditions. As a result, there are concerns as to whether pricing is accurate given the overall low-rate environment and room for substantial rate increases to occur.

Banks have done a great job on the deposit side of the balance sheet, with the majority of deposits pricing near their natural floors. Also, most banks left core funding costs the same following the Fed rate hike. Going forward, keeping deposit betas very low will be important to allow margin expansion, should the Fed continue to increase the benchmark rate.

Garcia: I think community institutions are generally being realistic with their pricing in terms of staying competitive on rate in order to get the growth they need – the ones that are winning are sacrificing rate, but they're not sacrificing credit quality or terms. They're recognizing the economic cycle that we're in and thinking that we're going to be in a low-rate environment for some time. So they're the ones that are seeing margin holding or only suffering a slight decline, as opposed to those institutions that think they have to keep loans priced high to try to maintain margin but at the end of the day are shrinking their earning-asset base.

It's kind of a tale of two institutions – the haves and the have-nots. The institutions that can't lend can't afford to raise their deposit pricing, and therefore they're kind of getting pushed to the side a little bit.

Greg Garcia, Senior Managing Director, FinPro, Inc.

From a competitive perspective, I think a lot of institutions are priced right in line with what's going on in the market; however, when you talk about pricing compared to risk, I do think that institutions to some extent have not priced risk effectively into some of the yields that they're putting on their books today. When you start looking at interest-only loans or longer-term loans relative to credit, they're priced at levels that, quite frankly from a risk-return basis, don't make a lot of sense. This certainly doesn't apply to all institutions, but we are starting to see some abnormal pricing out there.

On the liability side, we're not seeing a lot of crazy rates out there. But from a deposit-pricing perspective, we are seeing that the banks that can lend can actually be more aggressive in terms of offering higher-yielding deposit products – because if they're able to get the funds in, they're able to lend them out. It's kind of a tale of two institutions – the haves and the have-nots. The institutions that can't lend can't afford to raise their deposit pricing, and therefore they're kind of getting pushed to the side a little bit. At some point, those institutions are going to have to have a strategic discussion about what they can do.

Smith: The most recent OCC semi-annual risk perspective highlights industry concerns about loosening underwriting standards, which includes relaxed pricing and terms. Because of intense competition, all institutions are facing pressures to extend maturities at pricing points that don't necessarily correlate with economic risk. Because of this, I do have some concern that community bank loan pricing does not appear to be trending with other credit markets. For instance, when you look at corporate bonds, there has been a widening of spreads over the past couple of years, but you do not see a similar back-up in community bank lending rates. I wouldn't expect these two markets to move identically, but I might expect more of a resemblance than we are currently seeing.

In terms of retail deposit pricing, it's hard to imagine rates going much lower. The question is how quickly will retail rates rise when rates eventually increase? Historically, we know that there is not a parallel relationship between general interest rate indicators and deposit rates. However, competitive pressures could challenge that paradigm in the future. Similar to the asset side, I think institutions should consider deposit alternatives that can help lock in longer positions and provide some insulation against interest rate risk. Brokered deposits, which were rightly maligned because of their misuse during the crisis, can actually perform an insulating function in a well-structured balance sheet. Used in moderation with longer maturities and advantageous call features, brokered deposits can actually play an important role in an organization's risk management process.

FMS would like to thank our panelists for their time and insights:

Greg Garcia, Senior Managing Director, FinPro, Inc.
Greg has extensive industry experience in asset-liability management, asset quality and ALLL methodology, strategic planning, capital planning, enterprise risk management, mutual-to-stock conversions, mergers and acquisitions, de novo banking and investment advisory. In his current role at FinPro, he manages client relationships and engagements in all service areas, and plays an integral role in the development and enhancement of the company's proprietary models and analytical tools.

Michael Davis, Director of Strategies, SunTrust Robinson Humphrey
Throughout his career, Mike has been actively involved with traditional depository institutions. Working within the Fixed Income Research team at SunTrust, Mike's responsibilities include managing a team of analysts, focusing on development and implementation of balance sheet and investment portfolio reporting and strategies for institutional customers. His past experience includes running ALM models, developing balance sheet strategies and developing and modeling wholesale growth strategies.

Todd Cuppia, Director of Balance Sheet Strategies, Chatham Financial
Prior to joining Chatham as Director of Balance Sheet Strategies for financial institutions in 2015, Todd spent eleven years with Stifel Financial as a Managing Director in the Fixed Income Research and Strategy Group. In this role, Todd advised financial institutions, state and local government entities, and pension funds on cross sector relative value, macro-based portfolio strategies and derivative hedging strategies.

Charles McQueen, President, McQueen Financial Advisors
Charley founded McQueen Financial Advisors, Inc. in 1999 to provide specialized investment and consulting services to financial institutions, and today advises clients throughout the United States and manages investment portfolios with a combined value in excess of $5 billion. With over 20 years of experience, Charley oversees McQueen Financial Advisors' core services of providing investment portfolio management, asset-liability management, mortgage servicing rights valuations and tactical consultation.

Bart Smith, Managing Director, Performance Trust Capital Partners, LLC
Drawing on his 25 years of experience with the Federal Deposit Insurance Corporation (FDIC), Bart has served as an expert resource in bank policy and regulatory matters at Performance Trust since 2012. Bart's career at the FDIC included time as an examiner, senior examiner, review examiner, field supervisor and territory supervisor in regions from Texas to New York to Maryland to North Carolina.

David Sweeney, Managing Director, Chatham Investment Advisors
Dave leads Chatham's Financial Institutions Balance Sheet Risk Management Team and Chatham Investment Advisors Team. Prior to joining Chatham, Dave spent fourteen years with Ernst & Young as a Principal in the Financial Institutions practice. He also served as Treasurer and Chief Investment Officer for two community banks managing over $1 billion in investment securities, overseeing over $1 billion in wholesale funding and managing the ALM process.

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