The Yield Curve Conundrum

How to manage margin compression
in an inverted yield curve environment.

by: Frank Farone
Managing Director
Darling Consulting Group

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Two that come to mind are one, the Fed's objective of achieving full employment without inflation, the second, managing further margin compression in an inverted yield curve environment. This article will focus on the latter.

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Portfolio Management

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Margin Pressure Likely to Continue through 2006

Margin compression is nothing new to bankers as margins have been steadily declining since 1992. However, many banks are now experiencing real pain as margins have become razor thin with no relief in sight for the remainder of 2006 and for some into 2007, regardless of which interest rate scenario plays out.

The conundrum that former Chairman Greenspan referred to was the fact that long term rates were moving in the opposite direction of rising short rates during a tightening cycle. As a result, banks are watching their cost of funds rise steadily while asset yields are barely moving.

Meanwhile, many adjustable rate loans are capping out or are refinancing to lower cost fixed-rate alternatives. Consumers with home equity loans priced off prime at 8.25 percent currently, are taking advantage of hybrid type fixed-rate "teasers" (i.e., fixed for two years at 5.49 percent, then prime or prime minus for life) or fully amortizing term loans at 5.99-6.50 percent. Commercial loans are now being priced at prime less 100 basis points for terms as far out as 10 to 15 years. This irrational pricing is wreaking havoc in the loan-pricing arena.

Meanwhile, the low coupon CDs on banks' books are coming up for renewal and repricing up into the 5 percent range from the lows reached in 2004 when fed funds were 1 percent and CDs were yielding in the 2-3 percent range. So, even if the Fed is finished hiking rates, the ***cost of funds for most banks will continue to rise.***

Is the Fed Done? Recession Ahead?

While no one knows what the future holds for interest rates, on August 8th the Fed signaled that it may have finished raising rates. Interest rate futures now show only a 16 percent chance of a quarter point rate hike in September and a 50 percent chance of an increase by year-end.

An examination of the forward yield curve at one year and beyond reveals an inversion in the curve, signaling lower short rates ahead. While the forward curve can sometimes throw a head fake, the forward curve is generally a pretty good predictor of the future *direction* of rates. History has taught us that whenever short-term rates rise above long-term rates, the economy is headed into a recession.

Yields on 10-year Treasuries have rallied to 4.82 percent while 2-year Treasuries yield 4.88 percent, continuing the inversion (technically) that began in January of this year. If the most recent inversion began this January, history would suggest we are nearing the end of a Fed tightening and a recession is likely to follow.

Recessions follow booms and there's no reason to believe that it's any different this time around. During the last 40 years, the only times home prices have fallen are in or around recessions. We are already seeing cracks (craters?) in the housing market, so a recession ahead should come as no surprise. Some economists would argue things are different this time, but are they really?

What's a Banker to Do Now?

While we don't know if the Fed has finished hiking rates, we have observed from history that ***long term rates typically peak before the final Fed tightening***. If the Fed is done, we may have seen the peak in rates, and for many, the falling rate scenario is a double-edged sword.

While the pressure to pay up on funding abates, the asset side of the balance sheet creates just as much pain or more. Those banks maintaining a short position on the asset side, waiting for higher rates to come along may have missed out on the recent peak in rates. If so, extending funding now as short-term borrowing rates are around 5.45 percent while 3-year borrowings are in the 5.20 percent range, while enticing, could prove to be costly in the near future if the Fed follows a similar pattern of tightening and easing every few years.

In an earlier article (BE&IA November 2005), I discussed various funding alternatives to consider at the time, including capped floating rate borrowings that provide protection against rising, falling and rates unchanged. While banks are encouraged to use caps as a hedge against changing rates, particularly as the cost of caps has cheapened, most bankers will likely extend borrowings before they pay the up-front cost of the cap.

Bankers are cautioned again to avoid anything with a call feature, asset or liability. Bankers tend to have short memories when it comes to selling options. Remember those callable advances of 1999/2000 that we lived with until recently? Now that they have been called away, we see many bankers going back to the trough

for 10-year/NC 6 month structures at 4.75 percent to save 50 basis points over a 6 month advance, which is really only 25 basis points over 6 months. This risk/reward tradeoff appears unattractive.

Investment and Loan Strategies to Consider *Now*!

Start with loans on the asset side of the balance sheet. Considering the inversion in the curve, more banks should be encouraging their lenders to go after or at least offer, long-term loans, including 10-15 year fixed rate terms! Most commercial borrowers would pay a premium over prime (currently 8.25 percent) to get a 10-15 year fixed-rate loan; however, most banks won't go beyond 5 years on fixed-rate commercial deals. Ironically, these loans should be priced below 8.25 percent based on their duration and the slope of the curve!

What a huge opportunity to miss out on in the current market. For banks concerned about interest-rate risk (which is why few banks offer such long terms), they can match the term with a corresponding advance structure and get their required spread and then some, or they can swap the loan back to variable using an interest-rate swap and end up with a prime plus rate. Stiff prepayment penalties should be considered. The same logic/pricing applies to home equity loans as well, or any shorter term asset priced off prime.

By locking into longer term assets with prepayment provisions attached, banks can build in a natural hedge against falling rates and pick up additional yield in the current rate environment.

Most investment portfolio managers have watched their portfolios dwindle during the past two years as cash flow has been redeployed into loans or has been used to pay down advances. Meanwhile, other bankers are anxiously awaiting the receipt of those lower yielding securities that were purchased in 2004 and 2005.

One strategy to consider now is the pre-investment of those cash flows over the next 6-12 months by borrowing short and purchasing longer term, called protected assets, provided the bank has sufficient capital. If not, selling assets in 2006 and restructuring to better position for 2007 is another strategy worth considering. We recently recommended that our asset-sensitive banks restructure their wholesale borrowings by paying off callable structures (a yield curve play) and refinancing short, albeit at higher rates. If rates fall, we roll down the curve, if not, we're making more money anyway!

Conclusion

Regardless of your view of the world, no one knows for sure where rates are headed. Make your balance sheet management decisions based on your bank's risk profile and strategic plan. Consider not only where your bank is positioned today but how future rate changes will impact your bottom line earnings. The rear view mirror provides little value in the banking business, however, history can provide some useful insights when it comes to yield curve slopes and what the market is telling us.

Frank Farone
Managing Director
Darling Consulting Group, Inc.
ffarone@darlingconsulting.com
Tel: 978.463.0400 x171

Frank is managing director of Darling Consulting Group (DCG), working nationwide with CEOs and CFOs of financial institutions to increase earnings through the proactive management of capital, liquidity/funding risk and interest rate risk. He assists clients in understanding and anticipating the effects of changing market conditions on their balance sheets, and develops and implements effective strategies based upon a clear understanding of risk/reward tradeoffs. He is a frequent author and speaker in the banking industry and is on the faculty of numerous educational and banking organizations.

Frank graduated magna cum laude from Siena College in Albany, N.Y., and holds an accounting degree from Albany Business College.

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