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Bank Asset/Liability Management

Prepared by Peter Mihaltian

Should the Federal Reserve Raise Short-Term Rates...Then What?

It has been interesting over the last couple months to see the reaction from ALCO members when the topic turns to interest rates. In short, the general consensus from the retail deposit members is that we are starting to see/feel like we are in a rising rate environment. Conversely, participants from the lending side of the balance sheet, specifically fixed-rate Commercial Real Estate (CRE) along with Commercial and Industrial (C&I) loans, clearly have the opposite reaction as their loan rates are continuing to be priced lower than their offering rates over the last few years.

Who's right? Sadly, from the banking margin perspective, both sides are right. Furthermore, understanding this current dynamic and how it plays into your 2017 budget/profit plan will be of great significance to your bank's bottom line.

Shape and Slope of the Yield Curve

Reviewing the long end of the yield curve, it is quickly apparent that the 10-year rate, the long end, has come down more than 100 basis points (bps) over the last four years (see Exhibit 1 on page 2), thereby driving down most longer-term loan rates (5 years and greater) along with fixed-rate investment securities. Moreover, in December 2015 we saw the Federal Reserve (Fed) increase the short end of the yield curve when they doubled the targeted fed funds rate from .25% to .50%. The short end of the yield curve is a good proxy for banks' deposit pricing for their Non-Maturity Deposits (NMD) along with shorter-term CDs (2 years and under).

As a result of these changes, we are seeing a flatter yield curve that is causing the deposit side of the house to worry about paying potentially higher rates while the fixed-rate loan side worries about lower loan rates in the future.

The current 2-10 spread *(lingo for the 10-year Treasury bond minus the 2-year Treasury note)* is roughly 1.00%, as of

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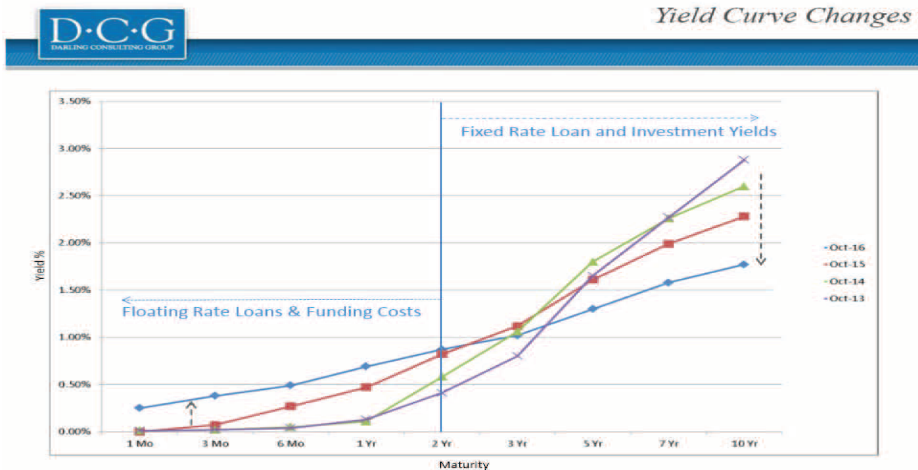
Exhibit 1



November 2, 2016. Quick primer: the higher the number the steeper the yield curve and, conversely, the lower the number the flatter the yield curve.

Since banks are in the margin business, a steeper curve is greatly preferred. Going forward, for strategic purposes and for potential strategies, one should presume a flatter yield curve in 2017. The real question is: How does the yield curve continue to flatten from here? Is it short-end up or long-end down? Each scenario has its own set of unique challenges and game plans needed to offset the potential reduction of Net Interest Income (NII).

Short-end Up

The current market consensus shows a 78% chance that the Fed will increase its targeted fed funds rate another 25 basis points at the December 2016 meeting. Reviewing the Fed's current *Dot Plot* along with additional statements from Fed officials, expectations are that we could see another two additional rate increases in 2017, resulting in the targeted fed funds rate at a high of 1.25% by the end of 2017. Should we get to a 1.00% or 1.25% fed funds rate, one would expect to see deposit pricing pressures within various markets as banks try to cope with substantially higher wholesale funding costs.

Given world economic events, the price of oil and relatively low inflation, one could anticipate the 10-year Treasury remaining in the 1.50% to 2.00% range. Consequently, the yield curve would continue to flatten to a range of .25% to .75%. Should this scenario play out, banks' overall deposit strategies *(products/pricing)* become paramount. Regardless of the total number of times the Fed increases short-term rates, below are some thoughts/actions to consider within your game plan:

- Understanding the bank's total liquidity position
- The ability to hold/lag deposit pricing
- Understanding of a deeper dive into specific depositors/Core Deposit Study
- True *core* customers vs. the single relationship customer
- Understanding your Marginal Cost of Funds (MCOF) – what to do if you start to lose deposit balances
- Timing of new account/product introductions for the most rate sensitive customers
- Potential need for defensive vs. offensive strategies
- Impact/role of your wholesale funding strategy
- Outlook for deposit vs loan growth
- Understanding public funds' seasonal flows and strategy

On the asset side of the balance sheet:

- Floating and variable loans converting into fixed-rate loans

While not all inclusive, banks that take the time and effort to review their deposit base and analyze how it relates to their overall liquidity position and interest rate risk (IRR) profile will stand to gain greater control over any potential negative impact to net interest income.

Just as important for senior managers and ALCO members is their ability to communicate your bank's plan of action to all of your organization's customer contact employees. The last time the Federal Reserve started a rising rate cycle was June of 2004. Yes, 2004. Chances are that anywhere from 30% to 60% of your people have never been through a rising rate scenario. Having everybody on the same page will be critical to the success or failure of your game plan.

Long-end Down

The third quarter U.S. GDP came in at 2.9%; however, prospects for the fourth quarter are roughly in the 2.0% to 2.5% range. With expectations for weaker global growth, a continuing strengthening US dollar, the path to higher growth in the U.S. in 2017 may fall short of expectations.

When the Federal Reserve increased the targeted fed funds rate in December 2015, the 10-year Treasury was 2.30%. Since then, the 10 year has fallen to a low of 1.32% on July 6, 2016 *(post Brexit vote)* and is currently 1.80%. If current economic events continue and U.S. growth slows more than anticipated, it is not unreasonable to think that the 10-year could fall to 1.50% or even lower. Should that happen, some potential negative outcomes could arise and should be reviewed for consequences. For example:

- Loan pricing: We have been hearing that standard 5-year/20-year amortizing Commercial Real Estate loan deals, on average, are being priced in the 4.00% to 4.25% range. It's not unreasonable to expect to see the *best* new deals starting with a 3 handle, e.g. 3.85%, 3.75% or lower.
- Is there a pricing level where you would start walking away from potential deals? If so, what are your alternatives?
- Prepayments: Expect current real estate assets' *(residential, CRE and investment securities)* prepayments to increase the longer we remain at these lower rate levels, thereby exacerbating pressure on NII as increasing cash flow continues to reprice/recycle lower.
- If you extended duration in your investment portfolio over the last couple years, now may be a good time to review your positions and assess whether it makes sense to take some gains today or live with the prepayment risk tomorrow.
- Premiums: If you paid premiums when purchasing current investment securities in your portfolio, you should assess the potential negative effects of premiums being written down faster than originally anticipated given the potential for higher prepayment speeds.

On the liability side of the balance sheet:

- For liability-sensitive banks, there may come a time when it makes sense to start extending wholesale borrowings *(FHLB advances and brokered CDs, along with the potential use of interest rate swaps).*

Note: The following long-end of the yield curve analysis was completed before the U. S. presidential election. Since the election, we have seen the 10-year Treasury move up to the 2.20% range, basically to the same level as a year ago. However, even with this latest back-up in long-term rates, the bullet points mentioned above are still valid and should continue to be part of your 2017 game plan.

What's Next?

While nobody can accurately predict the movements of both short- and long-term interest rates, 2017 is shaping up to be a challenging environment at best. In fact, I would argue from a budget/profit plan perspective, 2017 is going to be more difficult than 2016, which was generally tougher than 2015.

Should the yield curve continue to flatten with the short end up or the long end down, or maybe a combination of both, banks that understand the impact of the optionality within their balance sheet and, more importantly, have a game plan to deal with the issues outlined above stand a greater chance to outperform those who sit on the sidelines as spectators.

— Patrick Ward
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