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Bank Asset/Liability Management

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Increasing Long Assets – Are Executives Betting the Bank?

Financial institutions have been increasing their asset duration consistently since the Great Recession. This is a statement of fact - long term asset levels as measured by the FDIC have been on the climb and are at record levels. To define this measure, the focus is on assets with a term or repricing greater than 5 years. It appears that banks of all charters, shapes and sizes are at higher levels today than at any time, per the FDIC statistics. Certainly a different world than 10 years ago when most banks could count the loans with repricing terms greater than 5 years on one hand!

The main reason these long term asset holdings have grown for most banks relates to one thing – lack of sufficient loan growth. Because of sluggish or light loan demand and the need to grow earnings, institutions have been taking on more risk in order to get more volume and yield. Unfortunately some are doing this with slackened credit standards, while others have done it by extending longer terms to customers. In general, we have seen a willingness to look at longer duration assets to support earning asset growth. For example, many institutions have increased the amount of 30-yr mortgages held on the balance sheet. The rates on these assets have generally been between 3% and 4.50% during the cycle and typically carry little credit risk when properly underwritten. I don't think anyone pre-crisis would have said, *"Once we get into an historic low rate environment I think we will start to portfolio one of the longest duration loans that we can make."* It has been our observation that the practice of putting fixed-rate residential mortgages in the portfolio, mostly 30 year and some 15 or 20 year, has been far more widespread than it was in 2006.

Furthermore, we also know that with rates as low as they have been and with loan demand being less robust, your commercial customers have been able to *hold you over a barrel* to get rates and terms, e.g. greater than 5 years fixed, that they were unable to widely obtain beforehand.

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Taking on risk to rising rates in order to grow loans and earnings has become common. Are banks booking these loans betting, or hoping, that rates won't really increase materially in the near term? The answer to whether this is a shrewd use of asset duration or an increasing bet lies in the addition of proper context with other key balance sheet attributes.

What is *Long*? How Do We Measure It?

In call reports, the dollar amount of loans and investments is reported with maturities and/or repricings greater than 5 years. This number is also reported without any factor for contractual payment or potential prepayment. Most loans, unless they are interest only balloons, have amortization schedules and are also prone to demonstrate some prepayments over the life of the loan. Let's first consider the impact of the amortization terms. A commercial loan with a 10-yr fixed rate and 20-yr amortization has an average life of roughly 9 years. Compare that to a 10-yr fixed rate mortgage with 10-yr amortization. Both have a 10 year final but the 10-yr amortization has an average life expectancy of less than 5 years, which is a little more than half the life of the 10yr/20yr! General banking wisdom seems to be entirely comfortable with a 5-yr fixed rate loan with a 20-yr amortization on the commercial side, yet may consider a 10-yr amortizing loan to be *long* based on the final maturity. Clearly, there is a difference in actual duration and theoretical exposure to rising rates.

In addition to amortization, many loan products are prone to prepayments. Take the conventional lifing expectations of a conforming 30-yr mortgage. This loan has historically averaged about 8-yr average life after amortization and expected prepayments, even in a non-refinance environment. Jumbo 30-yr mortgages tend to experience even higher prepayments than conforming loans and have an expected life of roughly 5 years. Refinancing for a lower rate is not the only factor that drives prepayment activity. Even in rising rate environments, there are other factors that go on in customers' lives, and businesses, that cause prepayments. Understanding the amortization and prepayments can also help to avoid structures that seem shorter but are in fact long assets. There are a number of banks that will purchase or originate anything residential other than a 30-yr fixed-rate mortgage because *they are too long*. Take for example 10/1 ARM and 15/30 fixed-rate mortgage structures. Each of these has a *life* similar to the 30 year but more often than not are priced as if they are lower risk. This is how broad-based presumptions about asset durations lead to counterintuitive risk/reward decisions.

Here is an example of how important it is to build amortization and prepayments into your analysis. Bank ABC has reported that 43% of its assets reprice or mature longer than 5 years on its call report for September 30, 2017. If amortization and prepayments are considered, the percentage of assets greater than 5 years drops to 23%, which is a much lower and more accurate depiction of how cash flows will actually work through the balance sheet and income statement.

Factoring amortization and prepayments is essential to understand the risk in these assets but it doesn't explain away the FDIC's statistics on the lengthening trend on balance sheets. I am sure the relative numbers net of amortization would still comparatively bear out to be at record high levels.

The answer again may depend on other factors, such as how these assets are funded.

Long Term or Core Funding – Conceptual Capacity

Before reaching the conclusion that a higher level of *long term* assets might be indicative of an exposure to rising rates, one needs to consider the funding side of the balance sheet. The more stable core funding, e.g. core non-maturity deposits, CDs or wholesale greater than 5 years and equity, an institution has, the more these assets can be supported with less exposure to rising interest rates.

To see this in action, let's consider Bank ABC once again. If we assume that ABC is $1.5 billion, we can compute that the net 23% of loans and investments greater than 5 years on an amortized basis is roughly $345 million. Let's also assume, for the sake of simplicity, that non-earning assets, e.g. fixed assets, non-accruals, etc., are equal to other non-financial liabilities. Furthermore, Bank ABC has the following for core funding – equity ($150 million) and core NMDs ($420 million) for a total of $670 million in core funding. We can see that Bank ABC is using roughly 51% ($345/$670) of its long term core funding to fund assets greater than 5 years. This number taken on its own would seem to indicate that there is more long term asset capacity based on the 51%. Knowing this information, along with other tools, NII simulations being the primary tool, to complete the full IRR profile, can provide context as well as demonstrate trends in long term asset exposure when reviewed over time.

Considering the funding sources is critical to gaining an understanding of whether or not an institution might be *betting* on a rate forecast. Because of a slow growth, low rate environment, institutions have been forced to gain a deeper understanding of what drives their interest rate risk position. This has enabled them to enhance their profitability in the near term and may have even *helped* their interest rate risk profile. Many banks today are *more exposed to rate declines than rate increases!*

This is where having reliable models with sound assumptions, accurate prepayment analytics and a detailed understanding of the stability of the deposit base provides substantial value to an institution. Many banks, for reasons described earlier, used longer term assets to help fill a void for growth during this cycle. They challenged the norms for what were acceptable practices in building a loan portfolio in an opportunistic and thoughtful fashion. Net long term assets to core funding measures for most banks we work with indicate stable levels rather than continuing increases in the overall *long asset* position. Furthermore, interest rate risk is bank specific. Much of what we read in regulatory bulletins and/or general industry articles seems to indicate that interest rate risk exposure is *only to rates increasing*. This may not be the case for your institution. Applying what you read or hear about other banks to determine your own risk preference and profile might be hazardous to your bank's health! There has never been a more profitable time to have a sound and reliable interest rate risk model and process. Knowing your risk and making decisions based on that risk profile will guide you best through the most uncertain of cycles.

— Robert M. Lallo
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