Steve Kinner is a senior managing director at Promontory Interfinancial Network.

Matt Pieniazek is president at Darling Consulting Group.

BALANCE SHEET

Managing the Balance Sheet for 2020 and Beyond

Bankers are weathering a dramatically different interest rate environment than they had prepared for a year ago and will need a new set of tools and strategies to craft versatile balance sheet solutions.

Sustained low rates and flat yield curves are challenging operating environments for most banks. With both firmly in place, bankers must act decisively to mitigate their effects. Fortunately, there are several options banks can implement to properly position their balance sheets to be impactful down the road.

Falling interest rates are a major headwind for banks, creating massive challenges to maintain healthy net interest margins. With the benefit of hindsight, we know that many bankers probably wish they had taken steps several quarters ago to reposition their institutions' balance sheets for a different rate environment. But it's not too late for bankers to act. Executives can leverage their bank's asset-liability committee to consider and enact strategies that can help them successfully navigate the shifting interest rate environment.

Bankers can start by focusing on their deposits and other liabilities. Lowering their cost of funds will be key for all institutions in a sustained lower-rate environment.

Without a diligent reduction in deposit rates, few institutions will be able to outrun margin pressure with prudent loan or asset growth. To that end, executives should consider deposit products that are versatile enough to maintain relationships while controlling pricing.

Promontory Interfinancial Network offers banks several ways to attract and retain customers with large balances, while providing flexibility if market conditions change. Using services like ICS®, the Insured Cash Sweep® service, and CDARS®, banks can take in large-dollar deposits and choose to keep the amount of the deposits on balance sheet or sell the underlying funding to other institutions while maintaining full ownership of the customer relationship. Institutions can switch back and forth between funding options as their needs change, and can provide an attractive and adjustable rate without upsetting local market pricing.

Bankers may also opt to pursue wholesale options that extend funding in an inverted yield curve environment, to increase current earnings and reduce rising rate exposure. Bankers should keep in mind that not all wholesale funding options are created equal. Some can eliminate counterparty risk. And those offered by Promontory Interfinancial Network count as deposits, not borrowings, and don't require collateralization or stock purchases.

A shorter-duration wholesale option may be more strategically appropriate, especially in situations where a bank needs to become aggressive in lowering its deposit rates. Here, wholesale funding may be a good supplement, enabling banks to keep their funding short with an option to layer interest rate caps on top of those borrowings instead. This approach allows institutions to ride funding costs down if rates continue dropping and provides the protection many will need if rates increase.

At the same time, bankers may want to take a close look at assets and consider defending their institutions' margin from the top. This is vital because many banks took steps over the past year or more to increase their asset sensitivity, given fears of a sustained rising-rate environment.

Executives now should consider modeling the extent to which their bank can prudently grow to assuage some of the margin pressure. They may need to revisit lending policies, instilling discipline around prepayment penalties for loans and incorporating loan-rate floors. They may want to identify and earmark pools of funds for credits they would be comfortable originating with fixed rates and related prepayment penalties to reduce some exposure to a sustained, lower-rate environment.

Additionally, bankers can consider their approach to the securities book. Without a steepening of the yield curve, it may be difficult for institutions to find yield without taking on some risk in duration, credit, prepayments or calls. However, call-protected securities can help executives reduce margin erosion if rates decline further, as well as create an opportunity to book gains should the economy soften and asset quality deteriorate.

The current low-rate environment will pose a major challenge for the foreseeable future. But the right strategy and tools to manage rate sensitivity in a bank's assets and liabilities can position a bank to adapt and successfully navigate the shifting interest rate environment.