AMBASSADOR FINANCIAL GROUP

Notes from the Ambassador Bank Vault **November 6, 2017**

Asset Liability Management: Stay Ahead of the Curve

Higher interest rates along with a flatter yield curve should encourage bankers to take a hard look at investment portfolios and consider repositioning through the sale of lower-yielding securities. This balance sheet strategy is not for everybody, but Ambassador recommends this approach on a company-specific basis. **Banks that are willing and able to absorb an immediate loss can deliver higher future earnings (assuming all other things equal) as those proceeds are reinvested at higher yields, thus improving net interest margins.** This strategy should not increase interest rate risk as proceeds can be reinvested in securities with similar durations. Corporate treasurers, moreover, may elect to buy shorter-duration securities to reduce extension risk and/or pay down higher costing borrowings depending upon individual circumstances.

Banks with strong capital levels and investment portfolios that are accounted for as available-for-sale ("AFS") securities are the prime candidates to reposition. Under GAAP, net unrealized gains or losses are excluded from earnings, but rather, are reported in other comprehensive income until they are realized. Unrealized losses are not included in regulatory capital, although they reduce book value and GAAP capital levels if accounted for as AFS.

- The fourth quarter (assuming a Dec. 31 fiscal year-end) is best for balance sheet maneuvers, which include one-time losses. Investors and analysts typically focus more on expected forward earnings versus trailing 12-month earnings.
- Analogous to the earn-back period in connection with an acquisition, the earn-back time resulting from securities repositioning is much less (typically 12-15 months).
- Interest rates have increased as the Fed starts to unwind its $4.5 trillion balance sheet amid market expectations that the Fed will raise interest rates in December. As we go to press (November 1), the yield on 10-year Treasuries was 2.37%, which represents a 21 basis point increase from September 1, 2017, and 53 basis points from November 1, 2016.
- Bank profitability is affected more by the slope of the yield curve rather than the absolute level of interest rates. The spread between two-year and 10-year Treasuries was 76 basis points on November 1, 2017, compared with 81 basis points on September 1, 2017 and 78 basis points from the same time, last year.
- On a national basis, loan growth slowed somewhat in the third quarter of 2017, which suggests that banks should scrutinize investment portfolios in order to supplement interest income.
- Banks with larger securities portfolios and significant reliance on CDs/borrowings are of particular concern. The wildcard is whether deposit rates will rise as the Fed raises short-term rates. If so, that will mitigate benefit from improved earning asset mixes.

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