Notes from the Ambassador Bank Vault **December 27, 2017**

Asset Liability Management and Accounting: Flexibility and Awareness are the Keys to the New Year

"Some rise, some fall, some climb…" – Grateful Dead

The unusual combination of Fed tightening and a major tax reform stimulus package complicates community bankers' plans regarding investment and funding strategies. In addition to dealing with economic effects – higher after-tax earnings and a flattening yield curve – finance officers also need to recognize the accounting consequences that could result from tax reform. (As we go to press, it appears that passage of Federal income tax reform is imminent.)

- The yield curve is flatter. As of December 26, 2017, the spread between two and ten-year Treasury Notes was only 55 basis points compared with 133 basis points a year ago.

- One size does not fit all. Developing an effective asset/liability strategy is company-specific and should include Board policies regarding liquidity and capital. For instance, institutions with strong loan demand and/or terrific core funding will have different asset/liability strategies than banks without these attributes.

- Optimize the risk/reward ratio. Ambassador Financial continues to recommend that most banks construct a balanced investment portfolio with a mix of Libor or Prime-based floaters paired with longer duration assets.

- Longer-duration assets have outperformed fixed-rate assets on the short-end of the curve. The 30-year Treasury yield dropped 24 basis points while the 10-year Treasury yield increased two basis points since January 1, 2017. The yield on the 2-year Treasury increased over 60 basis points causing market price erosion for short securities.

- The ship hasn't sailed yet. Seasoned CMO floaters tied to One Month Libor have seen interest rates reset higher throughout the year (72 basis points) as the Fed continues to normalize Fed funds. Guidance indicates three interest rate hikes next year which suggests these investments should continue to perform well in 2018.

- Accounting for income tax rate changes. The Financial Accounting Standards Board ("FASB") should take a hard look at the impact materially lower tax rates will have upon deferred tax assets (DTAs) and liabilities (DTLs). As it stands, the accounting treatment for accumulated other comprehensive income ("AOCI"), including unrealized gains/losses tied to Available For Sale Securities (AFS) does not make sense intuitively.

- The FASB can make a technical adjustment quickly. The American Bankers Association (ABA) has expressed its concerns regarding the accounting for changes to income tax rates within Accounting Standards Codification Topic 740, Income Taxes (ASC 740).

Unless your bank enjoys strong loan demand and investment securities are used primarily to provide liquidity, investing strictly at the short end of the curve is probably too conservative given shareholder demands for a higher return on equity. **Ambassador Financial continues to endorse a balanced investment portfolio strategy for most institutions – this blends Libor or Prime-based floaters with longer duration assets.** Ambassador also suggests that banks generally avoid an outsized position of longer-term duration securities in order to help mitigate interest rate risk. The FDIC expressed concerns in its *Third Quarter 2017 Quarterly Banking Profile* that some banks have responded to the interest rate environment and competitive lending conditions by "reaching for yield" through investing in higher-risk and longer term assets.

The announcement following the latest Federal Open Market Committee that the federal funds rate would be increased by 25 basis points to a range of 1.25% to 1.50% generated little, if any, surprise to the market. According to Bloomberg's world interest rate probability function, traders had assumed a 100% probability of the 25 basis point rate hike. The Fed also forecasted three interest rate hikes in 2018. This was also in line with market expectations; and we surmise that outgoing Chairman Janet Yellen had little desire or need to create a major policy change before Jerome Powell assumes the chair position. Minneapolis Fed President Neel Kashkari and Chicago Fed President Charles Evans dissented citing that inflation remains below the target level of 2.0%.

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.

And speaking of AFS….. while the passage of Federal tax reform, including a significantly lower corporate tax rate, will provide a nice boost to earnings, bank investors, analysts, bankers, and board members also need to be aware of an odd (and probably unintended) accounting issue caused by much lower tax rates. Because of the timing of the tax reform bill – passage could occur before year-end – we question whether financial statements for the period ending December 31, 2017, will need to include the effect of new tax rates.

ASC 740-10-45-15 states that the effect of changes in tax rates be recognized, including adjusting deferred tax assets and liabilities, at the date when the law is enacted and their changes to be presented in net income from continuing operations, even when the corresponding deferred taxes relate to items presented in AOCI. This ASC also notes that the adjustment of deferred tax assets and liabilities requires knowledge about when they will be realized. These requirements present significant challenges, especially considering the possibility that decreases to corporate income tax rates occur in 2019, while other aspects of the bill are effective in 2018. This standard also applies to other items in AOCI including, but not limited to hedges, pensions, foreign exchange adjustments, and other-than-temporary impairment ("OCCI") related to Held-to-Maturity Securities.

Income statement adjustments frequently have different effects upon regulatory capital versus AOCI adjustments. Institutions under $250 billion in assets exclude AOCI from regulatory capital and as aforementioned, unrealized gains/losses are not recognized in regulatory capital. The mismatch will require ongoing reconciliation and make it more difficult for users of financial statements to access the bank's financial position.

A potential solution – supported by the ABA – allows "backwards tracing", a requirement in International Financial Reporting Standards, which would result in the related items to be reflected within OCI (and AOCI). This should enable most companies to apply the income tax rate change to their DTAs and DTLs without significant additional documentation.

This AOCI issue is just starting to garner attention – but Ambassador recommends that our clients consult with their tax advisors sooner rather than later to best prepare for possible accounting changes.

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