AMBASSADOR FINANCIAL GROUP

Notes from the Ambassador Bank Vault **September 27, 2018**

Asset/Liability Management: The West Coast Offense May Help Your Bank

The majority of community bankers and bank stock investors favor conservative asset/liability ("A/L") policies, but it appears that more institutions are stretching pricing and underwriting standards to realize faster loan growth. The tables presented below show that banks operating in the western half and southeastern region of the United States generally sport higher net interest margins despite lower loans-to-total assets and higher loan-to-deposit ratios. **Given that these regions have growing economies and appear to have fully recovered from the Great Recession, it may be logical to infer that these banks have optimized returns by strategically deploying funds in investment securities vs. aggressively pursuing loan growth due to pricing and potential credit concerns.**

On September 26, 2018, the Fed raised federal funds rates for the third time this year to a target range of 2.0-2.25% while affirming its outlook for gradual rate hikes into 2019. The statement included language that dropped the word "accommodative", which seemed to acknowledge that rates have moved closer to a "neutral level." As the yield curve flattens, we are reminded that banks become great not by making good loans, but rather, by avoiding bad ones. In other words, banks need to consider whether originating loans with a 100% risk weighting makes sense when funded with higher cost, non-core, funding. The alternative to deploy funds into assets with a 20% risk weighting should be given more consideration in the late stages of a credit cycle.

- Ambassador Financial continues to recommend that proactive asset/liability officers deploy a barbell approach with regard to investment portfolios to help mitigate the effects of the flattening yield curve.

- As we go to press, the spread between 2-year and 10-year Treasury notes was only 26 basis points compared with 54 basis points at January 2, 2018, and 83 basis points a year-ago. Due to the Fed's apparent policy to raise federal funds rates to a "neutral" level, it is likely this spread narrows further.

- The implementation of an effective asset/liability strategy is company-specific and should include board policies regarding liquidity and capital.

- Corporate issues with shorter final maturities (often floaters) and community bank debt often have attractive risk-return profiles.

- Portfolio managers should consider selling short tax-exempt bank qualified municipal bonds as this sector is overvalued compared to alternative investments.

- Although outside the scope of this article, core deposits, which we define as all deposits other than certificates of deposit and other time deposits, are especially prized in a rising rate environment due to their greater stability and relatively lower cost of funds.

Investment Portfolio Strategy

Rising short-term rates provide openings for many community banks to put excess liquidity to work through the investment securities portfolio rather than through marginal loans. Both 15 and 20 year mortgage-backed securities ("MBS") pass-throughs remain attractive with yields around 3.50% and durations under 4.5 years. Also with the 10-year Treasury note moving higher, taxable municipals in the 10-15 year part of the curve offer yields nearing 4%.

Opportunities also exist to sell securities and use the proceeds to reposition the portfolio more profitably in the current interest rate environment. Due to more volatility, there are market moves that facilitate the sale of securities out of an overvalued sector and reinvestment into an undervalued sector. Presently, short, well-rated tax-exempt, bank qualified municipals trade with tax-equivalent ("TEY") yields at or below the yields on comparable maturity Treasuries. This can be attributed to both the decrease in corporate tax rates, which effectively lowered TEYs, and relatively strong retail demand for short municipals. Given this phenomenon, we have been analyzing strategies that center around selling municipals with one-four year maturities. In addition to taking advantage of the exuberant market pricing, this part of the curve is most exposed to price declines due to rising short term rates, given the Fed's quest to normalize Fed Funds.

Ambassador Financial has executed this type of strategy for many clients and are often able to pick up 30 to 50 basis points over the taxable equivalent yields we sold by reinvesting into 15 year 4% MBS. This type of paper has offered spreads near +60, yields near 3.30%, and base case durations of only 4 years. **The shorter amortization schedule helps minimize extension risk in a rising rate environment, while providing significant cash flows.** If rates push lower from here, there is potential for significant price appreciation given where this paper had been trading in the last several years. Many times, the sale candidates have a duration around 3 years while the reinvestment is around 4 years. Interestingly, however, in the Treasury curve there is only a three basis point difference going from a 3 to a 4 year duration. In this strategy, we are able to increase this differential by more than 10 fold. By moving into the MBS we can also improve credit quality, help prevent margin compression, and generate monthly cash-flow.

The second strategy that we continue to implement focuses on increasing floating rate securities or "barbelling" the portfolio. The move in the 2-year Treasury closely follows FOMC decisions, which makes it difficult to invest in this part of the curve. Floating-rate assets tied to LIBOR, or similar indices such as Prime, have performed well. Prime and 1-month LIBOR trade at the highest level in almost 10 years and this trend should continue for the foreseeable future if the Fed opts for additional rate hikes. At the same time, longer term rates could move lower in anticipation of the end of the interest rate and economic cycles. **Over the past 30 years, when the Fed is lowering Fed funds, the curve generally steepens, and when the Fed raises rates, the curve generally flattens.** Once a FOMC tightening campaign ends, long rates often begin to fall in anticipation of the next Fed easing cycle. Consequently, the longer duration assets on the opposite side of the barbell will lock in higher yields and provide significant price appreciation potential.

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Appendix: Figures 1 – 5

Figure 1: Net Interest Margin*

	2Q2018 (%)	1Q2018 (%)	1Q2017 (%)
Mid-Atlantic			
Median	3.49	3.45	3.42
Average	3.44	3.40	3.40
Midwest			
Median	3.74	3.64	3.61
Average	3.64	3.59	3.58
Northeast			
Median	3.12	3.12	3.20
Average	3.28	3.25	3.30
Southeast			
Median	3.74	3.69	3.70
Average	3.85	3.78	3.78
Southwest			
Median	3.92	3.80	3.60
Average	4.00	3.94	3.87
West			
Median	4.06	4.03	3.85
Average	3.96	3.89	3.84
All U.S.			
Median	3.68	3.62	3.59
Average	3.69	3.63	3.62

Figure 2: Loan-to-Deposit*

	2Q2018 (%)	1Q2018 (%)	1Q2017 (%)
Mid-Atlantic			
Median	95	94	94
Average	92	92	91
Midwest			
Median	91	90	90
Average	90	88	88
Northeast			
Median	103	104	102
Average	100	99	99
Southeast			
Median	90	87	86
Average	86	84	84
Southwest			
Median	92	91	90
Average	89	88	88
West			
Median	86	84	83
Average	85	84	83
All U.S.			
Median	92	91	91
Average	91	89	89

Figure 3: Yield on Interest-Earning Assets*

	2Q2018 (%)	1Q2018 (%)	1Q2017 (%)
Mid-Atlantic			
Median	4.13	4.06	3.92
Average	4.19	4.09	3.98
Midwest			
Median	4.41	4.24	4.11
Average	4.36	4.24	4.12
Northeast			
Median	4.09	3.95	3.85
Average	4.15	4.05	3.93
Southeast			
Median	4.52	4.37	4.25
Average	4.54	4.42	4.31
Southwest			
Median	4.52	4.41	4.19
Average	4.72	4.60	4.41
West			
Median	4.51	4.37	4.26
Average	4.48	4.36	4.23
All U.S.			
Median	4.33	4.22	4.09
Average	4.39	4.37	4.14

Figure 4: Cost of Funds*

	2Q2018 (%)	1Q2018 (%)	1Q2017 (%)
Mid-Atlantic			
Median	0.74	0.66	0.58
Average	0.81	0.71	0.62
Midwest			
Median	0.73	0.66	0.53
Average	0.78	0.68	0.56
Northeast			
Median	0.95	0.81	0.67
Average	0.92	0.78	0.64
Southeast			
Median	0.71	0.61	0.51
Average	0.75	0.66	0.57
Southwest			
Median	0.80	0.73	0.60
Average	0.73	0.66	0.58
West			
Median	0.43	0.41	0.36
Average	0.56	0.47	0.41
All U.S.			
Median	0.73	0.65	0.54
Average	0.77	0.67	0.57

Figure 5: Selected Balance Sheet Ratios*

	Loans/Assets 2Q2018 (%)	Securities/Assets 2Q2018 (%)	Loan Growth YTD 2018 (%)
Mid-Atlantic			
Median	75.0	15.8	8.6
Average	73.0	17.4	12.8
Midwest			
Median	73.0	18.0	7.2
Average	72.0	19.0	12.4
Northeast			
Median	79.0	11.0	7.6
Average	78.0	13.0	9.3
Southeast			
Median	74.0	15.0	8.1
Average	71.0	17.0	7.4
Southwest			
Median	75.0	16.0	6.7
Average	72.0	16.0	9.7
West			
Median	72.0	14.0	8.5
Average	72.0	16.0	12.7
All U.S.			
Median	74.0	15.0	8.1
Average	73.0	17.0	11.8

Source: S&P Global Market Intelligence
*Banks with assets between $500 million and $20 billion