Balance Sheet Management in A Strengthening Economy:
Should I Worry about Higher Rates?

Recent employment figures have clearly establish a path for the Federal Reserve to tighten. However, the hints that have been forthcoming since December suggest that all but the most dense market participants have been taking precautions against rising rates. That's why the yield curve is shaped as it is.

This leads me to an unusual conclusion on the eve of a Fed tightening cycle: liquidity and capital management are likely to take precedence over interest rate risk as an Alco issue over the next year and one-half. This article will explore why I believe this to be the case and what to do about it.

Most Likely Scenario

The early June employment report topped off a three-month run of excellent job figures. Plus, inflation appears to have bottomed and is now heading upward. These were the last two factors necessary to convince the market and the Fed that rates had to increase from their multi-decade lows. In fact, the market got wind of the change before Mr. Greenspan and his cohorts did and has already begun the tightening process. Given the momentum already established, most economists are expecting the economy to continue to grow at 4% or more for the foreseeable future.

What can we expect if the majority is right? First of all, interest rates will rise. This means that a Federal Funds rate of 2% by year-end and possibly as high as 4% by the end of 2005. With good employment growth, wage and salary income will start to participate in the recovery, and higher inflation means that businesses will gain some pricing flexibility. The implications for banks fall into three main areas — interest rates, business growth (loans and deposits), and credit quality.

Rates are going to go up, but there are two outstanding questions on that point. First, by how much, and second, has the market already anticipated a worse case scenario? The yield curve gives us a graphic answer. It tells us Federal Funds are likely to move up to their post-war average of 4% plus. However, the yield one can obtain by extending maturity takes this into account. In other words, if I own the two-year Treasury at its current yield of 2.7%, I have already covered a rise of about 35 basis points every three months for the next two years.

These facts lead me to believe that the costs of rising interest rates are essentially baked into the cake for the near future. Note I said costs not risks. Costs are what you anticipate while risk is the unanticipated change from expectations. In order to profit from hedging, the costs would need to exceed the estimates I have mentioned. Interest rate management at this juncture needs to adjust. The most likely scenario, not flat rates, is the one that should be modeled as the base case. Once that is established, the risk is that rates rise even faster or that they lag present expectations.

I believe that the risk to changes in interest rates from present expectations are small. The chances that they rise by more than expected are quite unlikely because the market almost always over-reacts. If they rise by less, then not all of the potential liability cost increase will take place. So let's turn to what I believe are the more important Asset/Liability issues.

Liquidity: Too much or too little?

I would define the normal range of liquidity as a Loan/Deposit ratio above 60% and below 85%. According to my figures, 40% of IBANYS members were outside the range. And almost all of

these were below 60%. I believe that this is a problem as or more significant than that of overall interest rate risk.

Core deposit rates have been unnaturally low for the last two or three years. During this time, banks with excess funding have been able to cover costs and prosper for two reasons. First, the yield curve stayed quite positively sloped. From the end of 2000 to the end of 2003, short-term rates fell by 550 basis points. The five-year Treasury declined by 175 basis points while 30-year mortgages fell by 125 basis points. Obviously, just replacing assets and liabilities over this period of time enhanced the margin.

Second, with rates falling, security gains were available on the investments held. Whereas in 2000, IBANYS members took security losses equal to 1.6% of pre-tax income and even in 2001 took modest gains of only 1.3%, calendar year 2003 saw a significant 5.7% of pre-tax income attributable to security gains.

Rising rates will substantially eliminate the easy profits available from investment activity. Banks with excess liquidity that beat the devil with investment strategies over the past three years need to adjust. One response is pretty clear: loans.

There’s good news and bad news on this front. The good news is that a self-sustaining recovery should be good for loan quality. If you are going to reach for credit it makes sense to do so when the chances of improving economic performance are good. In fact, loan loss provisions for IBANYS member banks were lower in 2003 than they were in 2000 on both an absolute and a relative basis. During 2003, less than 6% of total revenues went into the reserve down from 8% in 2000.

The bad news is that the prospects for the kind of loan demand that can sate community banks is not ideal. My last article for this newsletter indicated why I believe that mortgage-related loans are likely to slow. I also believe that the demand by consumers for debt in other forms may lag as well. The consumer is both laboring under high debt loads and is going to experience higher costs as interest rates rise. This means that it is going to be tough for those banks that have not already established some loan momentum with the last potential borrowers — business customers — to get traction.

Too much liquidity in the context of a flattening yield curve along with mark-to-market gains reversing into losses is a difficult situation. I see only two options. First, make the dicey bet that the market has already adjusted longer-term rates to fair levels and add to term investments. Second, start the loan engines and try to make up for the squeeze in deposit costs by changing the mix of assets towards loans.

Capital Issues

At the end of 2000, roughly 35% of IBANYS members had capital ratios less than 8% while at the end of 2003 about 44% did. Since the percentage with ratios below 7% held roughly constant in the low teens, we can deduce that the percentage with ratios between 7% and 8% showed dramatic growth (from about 20% of members to about 30%).

This means that the last few years have found community banks becoming much more efficient with their capital. This is a good thing. But like all good things, there is a point of too much. Too

much leverage may be the real Achilles Heel of Asset/Liability Management over the next eighteen months.

Banks have leveraged both with loan growth and with deposit growth. Either one will create a need for capital. I believe that it is critical that this factor move to the top of the list of balance sheet issues. By and large, banks are going to be able to handle organic growth even if it is strong. After all, there is no point in growing if you aren't getting a profit benefit. However, as other opportunities arise whether for acquisition or discretionary leverage, capital may not be as ample as it has been. Growing aggressively from a 10% base offers more of a cushion than doing so from an 8% base.

Access to capital is not as easy as access to funding or even adjusting the balance sheet through security sales at a loss. Those last two items are fundamentally under the control of bank management while raising capital is dependent "on the kindness of strangers."

With the economic and market landscape changing, I believe it is very important to look at needs over the next few years to be sure the cushion you want will be there. BCA Research recently examined long term trends in equity prices, comparing financial services with energy. Energy garnered 25% of the dollar value of the S & P 500 in the early 1980's while financials were holding only 5%. As of the last date available, those percentages have reversed. I don't necessarily believe all financial service stocks will go into a twenty-year bear market, but I do believe that some of the tailwinds that have helped banks prosper will dissipate. That means more planning and it means those who anticipate needs better will be winners.

This is an important turning point in the economy and the markets. Paradoxically, rising rates should not be a worry. They may generate more costs, but if you haven't already prepared for the rise, there is little that can be done now. Liquidity is an issue if you have too much, mainly because investment options are a lot more risky now. However, the biggest issue for community banks in my opinion is capital. The time for projection and planning for needs has come, and if the world is becoming less hospitable for financial assets and more so for hard assets, time is of the essence.

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