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Shifting Bond Market Forcing Banks to Rethink Securities Strategies

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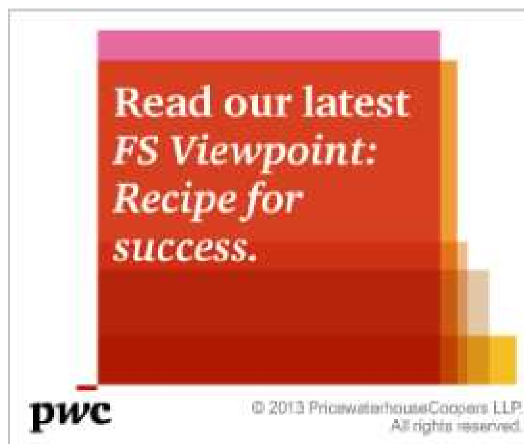

Add the collapse of the bond market to the growing list of threats to community banks.

Bond prices have fallen worldwide, and the average yield on 10-year Treasuries has increased for two-straight quarters. Many community banks are over-weighted in long-term securities, as part of a quest for higher yields, creating an embedded risk if the current trend continues.

To that end, balance sheet management — particularly dealings in securities — is more important now than it has been in recent memory, industry experts say.

"The drop in the bond market complicates the planning process," says Hugh Wellons, a lawyer at Spilman Thomas & Battle in Roanoke, Va. Combined with razor-thin margins and higher regulatory costs, "banks now are getting squeezed from three sides, financially."

The bond market's "30-year rally" is over, according to Richard Fisher, president of the Federal Reserve Bank of Dallas, and other market watchers. Fisher had been pushing the Fed to slow its program of buying $85 billion in mortgage-backed securities each month. Fed Chairman Ben Bernanke expressed concerns last month that had "increased a bit," because of low interest rates.

An increased likelihood of rising rates has prompted some banks to take action. Management at Palmetto Bancshares (PLMT) knew rates would eventually rise, says Roy Jones, the Greenville, S.C., company's chief financial officer.

Recent market developments, along with Bernanke's comments, led Jones to adjust Palmetto's securities holdings. The $1.1 billion-asset company sold a package of fixed-rate mortgage-backed

securities and agency-backed securities. It then parked the proceeds into variable-rate mortgage securities.

"We felt we had a higher degree of exposure to rising rates than we wanted and we re-invested into some securities with less exposure," Jones says, declining to disclose the securities' value.

Palmetto is taking the added step of including amortization periods in some loans, in order to "not go too far out on the yield curve," Jones adds. "So we will get cash back quicker in case rates do rise, and we can invest in higher rates."

A rise in long-term rates should benefit banks that are skewed toward shorter-term, says Jose Marina, chief financial officer at Banco Popular Espanol's TotalBank, a $2.5 billion-asset bank in Miami.

"It helps our rate risk profile," Marina says. "With the 10-year Treasury rising, it will increase the yield on our loans, while the cost of our deposits will not change at all."

Over the next three to six months, TotalBank will likely buy short-term Ginnie Mae securities as a way of providing cash flow, Marina says. "We don't take a lot of risk in our investment portfolio, and I don't see us changing that strategy that much," he says.

The link between rising yields and wider margins is far from iron-clad. The average yield on 10-year Treasuries rose to nearly 2% during the first quarter, but the banking industry's yield on earning assets fell 11 basis points in the first quarter from a quarter earlier, to 3.72%, according to the Federal Deposit Insurance Corp.

Many banks moved into long-term securities in the past year to boost margins, says Sreeni Prabhu, chief investment officer at Angel Oak Asset Management in Atlanta, which manages securities investments for community banks. Banks should shift to shorter-duration notes, but that's not easy "when rates are so benign," he says.

"As yields kept getting lower and lower, the only way to make more spread was to extend duration," Prabhu says. "In the last month, a lot of banks are worried about rising rates and they want to move them off the books."

Prabhu counsels these banks to sell off the securities and take a loss, but undercapitalized banks don't have the cash available to take the hit.

For well-capitalized banks, Prabhu suggests shifting about 20% of a securities portfolio into floating-rate holdings with a higher degree of credit risk. "Don't give up all of your liquid book, but you might as well take the credit risk since you're not seeing much loan growth," Prabhu says.

That might soon change, Wellons says. Rising Treasury yields makes securities portfolio management more difficult, but it's also a sign of good things to come in terms of loan demand. Even bank examiners are becoming slightly more tolerant of credit risk, he says.

"Regulators are allowing banks to take off the training wheels on lending, even for some banks that recently had trouble," Wellons says.

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