

Portfolio planning tips for 2020

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What will this year bring to your bank's portfolio? We asked the strategists at Vining Sparks about what community banks should expect in 2020 and what strategies you should consider putting in place to better your balance sheet.

By Cheryl Winokur Munk

As community banks head into 2020, uncertainty abounds about what the year will hold, especially given the whirlwind ride of 2019.

It's anyone's guess. For instance, at the start of 2019, the general feeling among bankers and industry watchers was that interest rates would stay steady or possibly tick a bit higher. That was before unexpected factors such as President Trump's trade war tariffs, a slowdown in the global economy and geopolitical uncertainty threw a major wrench into expectations. Some banks were simply unprepared for the extent to which these external factors would weigh on U.S. markets and influence the Federal Reserve to shift course.

Instead of a steady or rising rate environment, banks were dealt the opposite. At the end of 2018, the Fed funds target range was lifted to 2.25–2.50%, representing the ninth increase since tightening began in late 2015. However, by the end of July, that range had dropped to 2.00–2.25%, with the expectation of further cuts into 2020. Mortgage rates, meanwhile, also nosedived. Toward the end of 2018, 30-year mortgages were in the 4.5% range. By August, they were hovering around 3.6%.

The interest rate drops "caught most people off-guard in terms of their balance sheet planning and investment planning for their banks," says Mark Evans, director of trading for Vining Sparks, ICBA's

exclusively endorsed broker-dealer, in Memphis, Tenn.

These abrupt changes put many banks in the precarious position of having to shift strategy midyear. Adding insult to injury is that the uncertainty is ongoing—exacerbated perhaps by the 2020 election cycle—which continues to make forecasting the future quite difficult. Bankers are finding themselves caught in the crosshairs as they struggle to plan ahead amid mounting external forces beyond their control, including the looming possibility of recession.



At the same time, community banks have to be careful not to plan for too pessimistic of an outlook. Despite pockets of concern, the U.S. economy overall has shown strength, Evans says. “Lower interest rates have contributed to a shortening of investment portfolio duration, an increase in short-term cash flow and improved market valuations of portfolios,” says Dan Stimpson, an investment strategist for Vining Sparks.

“The slope of the yield curve continues to pressure net interest margins, while the majority of community banks are exposed to falling interest rates for earnings [EAR] and economic value [EVE],” he says. “As elevated market volatility and uncertainty is expected to remain a challenge, portfolio strategies should be focused on supporting asset-liability committee [ALCO] and balance sheet needs, including liquidity, interest rate risk management and income.”

The takeaway for community banks is to be proactive and willing to make changes when the environment changes, Stimpson says. This means thinking multidimensionally about how different scenarios could play out. It means ensuring they aren't blindsided as they were in 2019 by the directional shift in interest rates.

Planning for a new year

As community banks plan for 2020, there's likely to be significant debate about what's going to happen next and how the bank should position for these scenarios. The questions that they will be dealing with will be things like: Do we think the Fed will continue to cut rates? Do we think the U.S. will experience negative interest rates, as we've seen throughout a lot of the world? What do we expect to happen with loan demand and credit quality? “How banks feel about those questions will drive how they structure their balance sheet and their plan for 2020,” Evans says.

The biggest risk out there that will turn everything upside down, he says, is if we experience or forecast negative rates in the U.S. “That's something we've never had, and it will create unique pressures on banks more extreme but similar to the pressures we saw when the Fed funds rate got close to zero in the last cycle,” he says.

Because of the uncertainty, Evans recommends that community banks prepare for a wide variety of possible circumstances. Projections need to take into account what could happen if rates are down sharply or if they rise sharply. Banks shouldn't just plan for one scenario or the other, he says. “Even if you don't think one of those scenarios is likely, you need to know what happens to you in those scenarios,” he adds.

What's needed, strategists say, is a greater focus on fundamentals that can help propel banks through potentially rough times ahead. In their planning, community bankers need to be especially mindful of an important budgeting consideration: anticipated loan production. “When building their plan, banks tend to be overly optimistic about loan production,” Evans says, “and at [the] point in time we are at, where the economy appears to be starting to pivot, often banks' plans get thrown off because both lending demand and credit standards end up causing them to have less loan production and more cash that has to be invested than they were anticipating.



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Areas of focus

Dan Stimpson, investment analyst at Vining Sparks, offers suggestions for banks based on their primary need.

Boosting liquidity

Review projected bond and balance sheet cash flows under various interest rate scenarios and rate shocks compared with expected liquidity needs.

Managing interest rate risk

Review effective annual interest rate (EAR) and economic value of equity (EVE) positions, focusing on a range of the most likely rate scenarios and worst-case scenarios, with the goal of neutralizing internal rate risk (IRR) positions to create stable earnings and economic value regardless of changes in interest rates.

Maximizing yield

Review bond sector allocations, duration, price volatility and capital at risk, convexity, coupon structure for mortgage-backed securities (MBS) and collateralized mortgage obligations (CMO), and fixed versus floating allocations.

Back to basics

At the same time, bankers need to focus on these three tenets: their liquidity needs and cash-flow structure of the balance sheet; neutralizing interest rate risk; and driving yield, Stimpson says.

The typical community bank has strong on- and off-balance sheet liquidity and capital, exposure to falling interest rates, stable loan growth and pressure on net interest margins, he says.



For many community banks, bond portfolio sector allocations remain diversified, with consistent high-performing portfolios allocating to longer tax-free municipal bonds, Stimpson says. Duration has shortened as rates have fallen, and price volatility is in the lower end of the suggested range given the low level of capital at risk.

Mortgage-backed securities (MBS) and collateralized mortgage obligations (CMO) purchases have shifted to lower coupon structures and commercial/multifamily collateral, including the Fannie Mae Delegated Underwriting and Servicing, Freddie Ks, Ginnie Mae project loans and Small Business Administration (SBA) fixed-rate Development Company Participation Certificates (DCPC) and small business investment companies (SBIC), which offer protection against falling interest rates.

Floating allocations have remained relatively low as banks have been cautious to add floating rate bonds given their falling rate internal rate risk (IRR) exposures and short portfolio durations,

Stimpson says.

Bond recommendations

Stimpson strongly cautions banks not to forget about the bond portfolio as a big contributor to performance. With strong loan growth over the past several years—to the tune of around 6%, according to FDIC data—some banks haven't focused as much on their bond portfolio, he says. But it remains an important driver for the bank.

Within their bond portfolio, Stimpson recommends community banks carefully review their municipal allocation. Top-performing bond portfolios generally have about 40% of their bonds in municipals. He also recommends that banks review their cash-flow ladders and cash-flow projections in a range of interest rate scenarios and that they review price volatility and duration and capital-at-risk.

Another area they should focus on is reviewing their sector allocations. Banks should seek to determine how much they need to lean on different bond sectors to derive the results they are seeking, Stimpson says.

To the extent that banks are looking at adding floating rate bonds to their portfolio, creating a do-it-yourself floating rate bond through interest rate derivatives could be something to consider, says Katharine Bray, director of sales and trading for Vining Sparks' Interest Rate Products group.

Some banks do this already, but it's something that others should consider, she says. If they prefer floating rate bonds, they can create their own through a series of longer muni bond purchases and entering into interest rate swaps to create a floating rate. Doing this will create a much higher yield than what's available on the market.

"Any decision you make should always look for the most efficient solution and, oftentimes, using derivatives is the most efficient solution," Bray says. "It isn't something that should just be ignored. Banks should at least learn and understand and see if it's a more effective way to manage their portfolio and their balance sheet."



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What should be on your bank's 2020 checklist?

Community bankers might expect another wild ride in 2020. Their challenge is to deftly deal with these uncertainties without knowing exactly where things are headed. It's even more complicated than the situation in late 2017 and 2018, when banks were dealt the biggest changes in corporate tax law in 30 years, says Mark Evans, director of trading for Vining Sparks in Memphis, Tenn.

The reason it's more challenging this time around, Evans says, is because interest rate and economic circumstances are precarious for the first time in many years. "That's a different

change, but it's certainly one of the biggest ones we've seen in five years or so," he adds.

Here are a few best practices to help community banks ensure the strength of their portfolio:

- **Thoroughly reevaluate your community bank's asset and liability exposure and liquidity.** This means looking at the different scenarios and the bank's income, economic value of equity and cash flows in those scenarios, and deciding whether you like the way it's positioned or whether one of those scenarios is so troubling that you want to adjust to mitigate that, Evans says.
- **Develop a plan for how to make these adjustments.** The best places for community banks to make balance sheet adjustments are either in their investment portfolio, wholesale funding or interest rate swaps or other off-balance sheet derivatives to bring things into balance. "There's a lot of capacity to adjust through these things," he says.
- **Obtain buy-in from senior management for the plan.** Sometimes there's a debate between the lending side and investment side of the bank over some proposed solutions. "At the end of the day, banks have to expediently form a consensus around a plan," Evans says. "If you delay implementing the plan, market circumstances can change and cut against you."

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