Supplementing Earnings from Liability Management

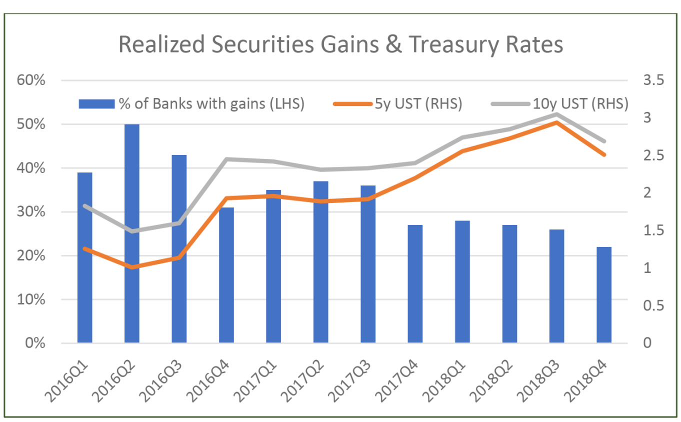
By Andrew Paolillo, CFA, *Director of Member Strategies & Solutions*

Many banks have utilized securities gains to supplement core earnings. Changing market conditions may make relying on investment gains challenging going forward. The Symmetrical Prepayment Advance can offer flexibility and diversification in supporting net income.

Two primary goals for the investment portfolio of a bank are to provide liquidity and earnings. Depending on the makeup and size of the loan portfolio, the need for liquidity and earnings coming from investments can shift.

For example, a bank with a very strong loan-to-asset ratio, led by a strong commercial franchise, will likely not require the investment portfolio to reach for return, but instead will focus on more liquid investment alternatives. On the other hand, banks with lower loan-to-asset ratios will find that to achieve return on assets and return on equity goals, investments will have to be a key contributor to earnings, as there are fewer high-yielding loans on the balance sheet.

Occasionally, banks will utilize some of the liquidity that high-quality bond investments can offer to realize gains to supplement earnings. The chart below, using data compiled from S&P Global Market Intelligence on New England banks, looks at the three-year trend for the percentage of banks that have realized securities gains. Additionally, the yields for five-year and 10-year UST Treasuries are included.



After peaking at 50 percent in the second quarter of 2016 (with five-year and 10-year Treasury rates at 1.01 percent and 1.49 percent, respectively), the number of banks realizing gains has steadily dropped. By the fourth quarter of 2018, just 22 percent of banks realized gains.

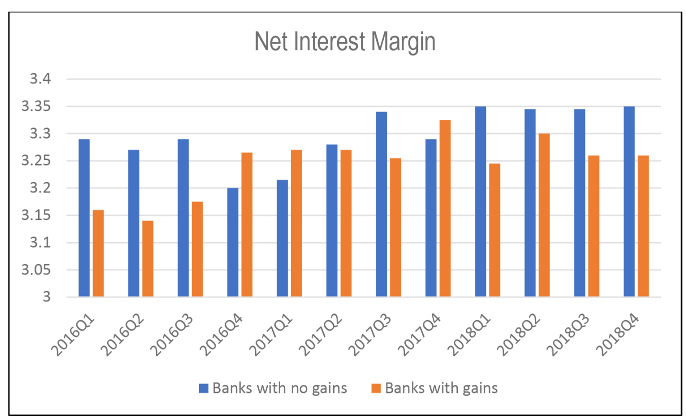
Part of the reason for the decline can be attributed to rising rates. As yields move higher, prices on bonds go lower, and unrealized gains dissipate.

Another driver of declining gains can be found by looking back on a horizon greater than three years. Investments acquired pre-2007 were likely initiated at considerably higher book yields, so shrinking durations and rising rates have sharply reduced the universe of bonds that could qualify to be sold at gains now, versus five to seven years ago.

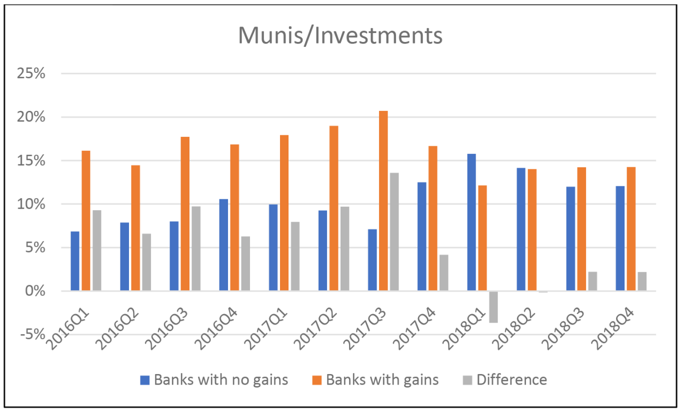
Net Interest Margin and Sector Exposures

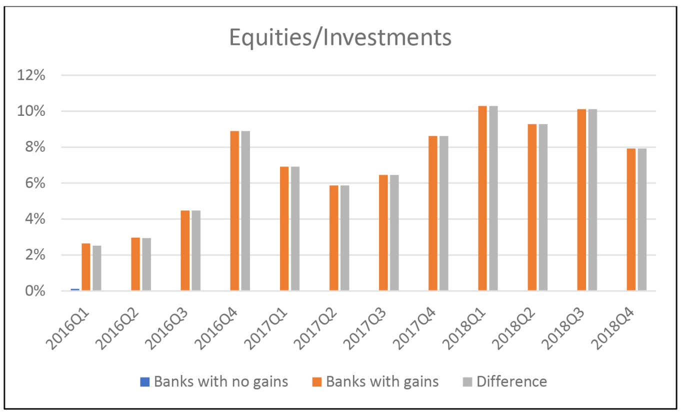
In researching this topic, we were curious to see if there were any similarities among banks that took securities gains. Here's what we found:

In most quarters, banks that took gains had a lower Net Interest Margin (NIM). For example, in the fourth quarter of 2018, banks that didn't take gains had a NIM of 3.35 percent, versus those that did at 3.26 percent. That makes sense intuitively, as a weaker margin would presumably make a bank more inclined to supplement earnings from realized securities gains.



Within the investment portfolio, the two sectors most prevalent in gain takers versus non-gain takers were municipal bonds and equities. Again, that is consistent with what we would expect to find, considering both the structural factors and recent historical performance of both munis and stocks.





Challenges with Gains Taking

There are two challenges with consistently taking gains from the securities portfolio. One, banks are subject to the fluctuations of the market. In short windows of time like quarter-to-quarter, conditions may shift, making it sub-optimal to sell bonds, let alone at gains.

For example, during the Taper Tantrum sell-off in 2013 and the post-election sell-off in 2016, there was weakness in underlying Treasury rates as well as dried-up liquidity and increased volatility in spread products, leading to sharp price weakness as well as poor conditions for execution. And as noted earlier, the path of rates over the last decade is such that going forward, there is less room for securities to appreciate and offer future opportunities for gains.

While the math for equities versus fixed income is obviously different, the same principles apply. Consider the S&P 500 in the fourth quarter of 2018, where the peak-to-trough price movement was nearly 20 percent. Selling on the heels of a large decline like that just to capture a gain runs counter to the approach of a long-term investor.

Secondly, realizing gains is the act of pulling forward all the expected future income from a security and capturing it in the current period. The structure of the portfolio is slowly chipped away as superior securities, with favorable book yields and characteristics, are removed from the balance sheet. Often, the question of “what is the best course of action for the portfolio structurally from a risk and return perspective?” is sidelined in favor of “what (and how much) needs to be sold to hit the target amount of gains?”

Funding Solutions

With future opportunities to supplement earnings from the asset side diminishing, FHLBank Boston has a solution to accomplish the necessary goals.

The Symmetrical Prepayment Advance is a fixed-term and fixed-rate advance, like the Classic Advance, but it contains a special prepayment feature that allows users to prepay the advance at its approximate market value. As rates rise, prepaying the advance can generate a gain, potentially alleviating the need to sell securities inefficiently.

In addition to the possibility of gains in a rising-rate environment, a less obvious but still impactful benefit is that the Symmetrical Prepayment Advance can provide relative value in a flat or declining market. When rates move lower, estimated prepay fees are typically lower for a Symmetrical Prepayment Advance versus a Classic Advance.

In this instance, prepayment does not produce a gain, but the cost of prepaying the advance is muted, which affords the user greater flexibility to manage the overall interest-rate risk and liquidity profile with minimal impact to current earnings.

Whether taking securities gains is something that is done opportunistically (as evidenced by the 50 percent of banks that took gains as rates hit historic lows in 2016) or consistently (the 20 percent to 30 percent that continued to take gains as rates rose through 2018), the Symmetrical Prepayment Advance can be used as another tool when it comes to supplementing earnings.

Incorporating a product on the other side of the balance sheet, and with a wholly different liquidity and execution profile, instead of relying on longer duration municipal bonds or large cap equities, the Symmetrical Prepayment Advance offers considerable diversification and flexibility in maximizing the moving target that is earnings.

A funding-strategy model can help you develop strategies to hedge interest-rate risk and maximize profitability. Our strategy team works with members to provide customized funding strategies based on your institution’s overall sensitivity position, objectives, and other needs. Please contact me at 617-292-9644 or andrew.paolillo@fhlbboston.com or contact your relationship manager for details.