Vining Sparks provides bond accounting services to over 530 community banks in the country. In the last two months we have seen the average portfolio lose 2% in value. Bank Directors that were not on the Board prior to 2007 may not have seen such a movement up in rates. So what is a Director to do? Here are 3 questions to answer.

1) Do we plan to sell any bonds in the portfolio at a loss?
2) What will the regulators say and how do we answer them?
3) Is there an opportunity presenting itself?

Most community banks rarely sell securities. Those that do usually do sell bonds do so to: (1) fund loans; (2) change their asset liability risk profile or (3) meet deposit runoff. Currently many banks have plenty of liquidity and or ample liquidity funding options via the FHLB. There are times that swapping a short term security taking a loss and locking into higher yields with better prepayment protection makes sense. A good example of this is municipal securities, where an investor takes advantage of the municipal curve slope.

In periods of rising rates it is important to have the correct perspective. Often a regulator will become hyper focused on the loss in the investment portfolio, rather than the substantial increase in NIM. The bank will often more than offset an unrealized loss in the investment portfolio with real earnings that can be placed into investor pockets via dividends. Most banks have adequate capital for an upward 300-400 basis point move. The current Bloomberg interest rate forecast projects a movement to 3.0% in the 10 year treasury which is up 118 basis points from the Monday before the election. Banks are very profitable in this scenario.

Finally, rates often top out in the 10 year area within 12 months of the 1st increase in fed funds. That would point to the current 10 year being about half way to the projected top of the market movement. The obvious unknown is what takes place in the current political climate. I believe that although while there is much focus on a nationalistic view, that we still live in a world economy. This I believe will cause rates to be limited in the move upward. While America can potentially create limited inflation the rest of the world is dealing with deflating. This would argue for extending portfolio duration based on the projected 10 year rate of 3% and a projected increase of 75 basis points in Fed Funds from the current level to year end 2017. Consider comparing your investment options to your average loan yield. If your loan yield is 4.03% in a rising rate scenario investments may be an attractive alternative. If you can lock into municipals with a 10 year call and 15 year final at greater than a 4.25% tax equivalent yield (TEY) there is a valid argument for such a trade. Coming out of short under 5 year municipals and replacing them with greater than a 4.25% TEY allows is a viable swap. If a loss on a municipal is taken, now is a good time. The loss on sale is treated favorably from a tax standpoint but the new income tax free. This has been a time tested trade over decades.

Rising rates are a good thing for Community Banks. Knowledge alleviates fear within Board Rooms. Spending time educating the Board Translates into opportunity.

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