Community Bank Views – Update your ALM Playbook September 30, 2020

Understanding that the goal of asset/liability management (ALM) isn't to eliminate risk but to manage it in such a way to maximize current earnings while at the same time protecting the long-term value of equity, our current pandemic-induced operating environment challenges our ability to achieve such a goal. Complicating matters even further, Fed Chairman Powell recently announced changes to the Fed's long-term monetary-policy framework. According to Powell, "the (FOMC) Committee seeks to achieve inflation that averages 2% over time, and therefore judges that, following periods when inflation has been running persistently below 2%, appropriate monetary policy will likely aim to achieve inflation moderately above 2% for some time." Furthermore, the Fed plans to put more emphasis on keeping unemployment low: instead of aiming to minimize "deviations" from the maximum sustainable level consistent with stable inflation, it will seek to minimize "shortfalls of employment from its maximum level." Looking forward, the Fed is expected to tighten monetary policy at a generally slower pace than in the past to ensure that inflation climbs above 2% and stays above 2% for a time to compensate for prior downside misses. Simply stated, the Fed is expected to keep short-term rates at current levels for the foreseeable future.

Depending on your institution's current IRR and liquidity risk profile, management may need to position the balance sheet for a "lower for even longer" interest rate environment. As such, asset sensitive institutions with excess liquidity may want to consider the below best practices when developing balance sheet strategies to increase current earnings. Keep in mind that these actionable items are consistent with those taken by institutions that have 1) low liquidity risk with ample contingency funding sources; 2) limited IRR exposure to rising rates and 3) strong capital positions.

- Continue to originate quality loans funded with core deposits and/or bond portfolio run-off.

- Now that short-term interest rates are zero-bound, margin will be primarily driven by the actions taken on the earning-asset side of the balance sheet. As such, limit optionality on the asset side in defense of additional curve flattening. (While it might be hard to imagine, longer-term rates could fall from current levels!) Similarly, selectively extend asset duration - preferably in the loan portfolio whereas at least you are getting compensated for the additional price risk - effectively capturing more of the yield curve. When adding duration to the bond portfolio, understand how embedded optionality in select investments can impact their overall performance. Limit negative convexity – in defense of further flattening via a decline in longer-term interest rates. Depending on the investment, include principal lock out protection when possible.

- When redeploying earning assets, shifting duration out of the bond portfolio into the loan portfolio will likely improve margin.

- Put excess cash to work via making loans &/or purchasing bonds. Work towards a fully invested overnight position to maximize earning asset potential and increase current earnings.

- As for wholesale funding, keep term borrowings short (if not overnight) as the balance sheet's current IRR profile may not warrant the need to lock in longer-term, fixed rate funding. The use of longer-term, fixed rate funding may be more appropriate for balance sheets that exhibit elevated levels of rates up risk evidenced by strong negative percentage change from base exposures.

- For those itching to take advance of historically low interest rates by selectively locking in intermediate/longer term, fixed rate wholesale funding, adding optionality via callable bank-issued CDs or putable FHLB term advances gives management the ability to reduce funding costs assuming the curve flattens.

- In conjunction with the institution's overall funding needs, continue to proactively manage deposit rates to retain/attract relationships. Continue to review the appropriateness of all deposit pricing. Where possible – tweak NMD as well as CD rates lower to levels below wholesale borrowing costs (adjusted for marginal servicing costs). In addition to actively monitoring changes in deposit volume and mix, continue to monitor changes in competitor deposit rates.

- If it doesn't already, the early withdrawal penalty language on intermediate & long-term CDs should contain "mark to market" otherwise known as make whole language to help mitigate the increase in the institution's COFS if/when rates increase.

- Proactively monitor unfunded loan commitment volumes as distressed borrowers will likely tap existing lines which increases pressure on liquidity.

Understanding that the above bullet points are not one-size-fits-all, appropriate repositioning strategies for your institution are those based on your balance sheet's unique interest rate and liquidity risk profiles. When reviewing your institution's overall ALM risk profile, in addition to your current rate shock scenarios, include a review of the effects caused by non-parallel shifts in the curve such as a bear steepener and bull flattener as these scenarios better reflect how the curve will likely change over time. In doing so, you will have a better understanding of your institution's ALM risks.

The takeaway from this write up is that if you haven't already, consider ways to protect earnings and capital from a prolonged period of low interest rates. Understanding that ALCO plays a key role in managing the balance sheet, reach out to your ALM team as balance sheet management is in their wheelhouse.

Please reach out to your CMG representative to further discuss these concepts.

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