Managing the Balance Sheet in a Changing Environment

The key responsibilities of the ALCO are the management of liquidity, and interest rate risk. These responsibilities have been a challenge in 2016 primarily due to changes in the yield curve in mid-year (Brexit impact). As we enter 2017 your bank's ALCO is facing another event causing changes to market interest rates, the 2016 Presidential election. The current post-election changes for the most part are positive, but the question facing bankers and forecasters is: How permanent is the optimism towards economic growth, and is the new interest rate environment just a short-term reaction or will the steepening slope of the yield curve continue through 2017?

Economic data has been very positive in the 4th quarter of 2016: 3rd quarter GDP growth was revised to 3.2% and the 4th quarter growth appears to be strong. Consumer spending is rising along with consumer confidence. The housing market is strengthening along with the labor market. The unemployment rate is 4.6% and wages are beginning to rise. All of this activity is moving inflation rates to levels desired by the Fed. All of this positive news bodes well for bank lending, but should be a caution sign for liquidity management.

Short-term interest rates are certain to be increased at the December 2016 Fed Open Market Committee meeting, and if the growth of the economy remains strong, and inflation continues to rise the Fed will surely move the short-term rates up more aggressively in 2017. Intermediate and long term rates are the major post- election stories. From November 7th to November 28th the rate on the two year Treasury note increased 32 basis points; the five year note was up 59 basis points or 49%; and the 10 year note was up 67 basis points or 42%. It is too early to predict whether rates will hold at these levels, but it is hard to believe the 10 year is moving back to the 1.70% range.

Business Cycle, Interest Rates and Liquidity Management

The U.S. economy is seven and on half years into an expansion and the Fed Funds rate is 75 basis points [I'm assuming a 25 basis point increase in December 2016]. At this point in a normal business cycle, the Fed Funds rate would have pushed above the long-term average of 3.30%. The present situation creates a serious dilemma for a bank's ALCO. At this point in a business cycle the consensus forecast would be a decline in market interest rates relatively soon; and therefore balance sheet management would be straightforward: lengthen asset duration and shorten liability duration. But in the current business cycle the expectation is for rates to increase, not decrease; therefore avoid liquidity risk and become more asset sensitive.

Recent developments are encouraging; that is, market interest rates are beginning to move higher which is normal at this point in a cycle, but we have a long way to go. Look at the positive results of rising intermediate and long-term rates in the 4th quarter of 2016. These higher rate will provide ALCOs and investment officers with better options in choosing investments as we enter 2017: the recent trade-off between yield and duration extension has been sub optimal at best. Granted portfolio values have moved from a net positive position in early November to net negative in early December 2016, but most community banks are not trading securities for gains.

Secondly, higher intermediate rates will slow down or put an end to commercial loan modifications and payoffs. The level of cash flow coming from bank commercial loan portfolios in 2016 is unprecedented. We are running faster to maintain the portfolio, but this should slow significantly at the current level of 5 and 10 year interest rates. Granted these higher rates will also impact the origination volume in residential mortgage lending, but if your bank does not sell loans this is a positive, as all refinancing does is lower the yield of your portfolio.

At some point the increase in short-term rates will begin to impact the cost of asset funding; although most forecaster do not see this as an issue until late 2017: Short-term interest rates are always critical to liquidity management. We had never experienced short-term interest rates below 1% until 2008, when the Fed Funds rate bottomed at 25 basis points. Maybe over the last eight year of historically low rates we have been lull to sleep.

Liquidity management over business cycles is normally straightforward because the yield curve tends to track the movement of the economy. When the economy is strong and near the turning point interest rates are high and the yield curve is relatively flat. Decision making is simple, take liquidity risk by lengthening assets and shortening liabilities. When the economy is weak interest are low and the yield curve is positive and steep. Why can't we apply prudent liquidity management principles in the current environment? The economy has been growing for seven years, the unemployment rate is below 5%. But market interest rates are reminiscent of a recession not of an economy seven years into expansion. Liquidity management is being turn on its head; that is many bank managers are taking on liquidity risk at seven years into an expansion. And it has been difficult to question their judgement as all forecasts were calling for moderate increases in short-term interest rates through 2017.

Loan to asset ratios have been rising over the last two years and balance liquidity is declining which is normal as the economy expands, but who cares, liquidity is very cheap given overnight rates. Be careful, maybe something happened on November 8th that has changed the environment. Optimist is stronger, and there are expectations for great use of fiscal policy [roads and bridges] and great deficit spending. The bond market has translated this into inflation expectations and the yield curve has steepened. But it is more than the election, economic data has been substantially more positive in the last couple months. Managing liquidity continues to be relatively easy given the level of overnight rates, but the rate environment can change quickly as we have seen in November 2016. Banks are observing the impact of changes in intermediate rates, both the positive and negative. Could we see the same impact on short-term rates in 2017? If you think that is possible, rethink your liquidity position and review your options if we are to face higher short-term rates.

Jim Clarke, Ph.D., is principal at Clarke Consulting, Villanova, Pennsylvania. Jim conducts a seminar, "Managing the Balance Sheet in the Current Environment" for the Illinois League of Financial Institutions in March [March 28 in Springfield and March 29 in Naperville]. He can be reached at JJClarke2@aol.com.