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S&P: Advisory Firms Pitch Community Banks on Interest Rate Risk Management Services

Advisory firms are pitching their services to small financial institutions seeking to manage interest rate risk on their balance sheets.

Amid the recent bank turmoil, more clients are hedging their portfolios against duration, in part because the cost of duration hedging has come down, advisers said in interviews. Hedging against duration is a strategy to reduce a portfolio's interest rate risk, as the longer a bond's duration is, the more sensitive it is to rate changes. Other steps to consider are pledging collateral to federal agencies to generate liquidity and building bond portfolios with laddered maturities, the advisers added.

Yet while lending institutions of all sizes face similar challenges, small banks often lack the tools to navigate the uncertain environment as well as bigger competitors, Derivative Path Inc. Head of Balance Sheet Strategy Isaac Wheeler said in an interview.

"I think community banks kind of drew the short straw," Wheeler said. "Even for our clients that do a good job of managing interest rate risk and have active hedging programs, they're not always as active as maybe a really large institution would be, just because they don't have the internal resources or the bandwidth to manage the hedging programs."

Minimizing rate risk

Banks should aim to build a laddered portfolio, composed of fixed-income securities with different maturity dates, Charles McQueen, president and CEO of McQueen Financial Advisors II Inc. said. The advisory firm launched new outsourced chief investment officer management services at the end of March to help clients manage their investment portfolios, providing guidance on governance, investment, spending, board education, setting long-term targets and portfolio review.

While a laddered portfolio might sacrifice some yield, it will be safer in the long run, McQueen said. Financial institutions that opt to sell securities should get multiple bids from brokerage firms of varying specialties and disciplines first. The problem, he added, is that many financial institutions are not well-versed in the sales process.

"They're just going to one broker who might not even specialize in the type of product they're trying to sell and they're getting terrible bids," McQueen said.

After Silicon Valley Bank's demise, banks are as hesitant as ever to make significant investments in bonds. Silicon Valley had high levels of uninsured deposits and deployed many of the funds into the bond market when interest rates were low. The value of the bonds the bank purchased came under pressure after interest rates rose significantly. The underwater portfolio reduced the bank's access to liquidity when deposit outflows accelerated, and concerns about Silicon Valley's ability to meet customer demands for cash culminated in a run and the second-largest bank failure in US history.

Counterintuitive as it may seem, banks should buy longer-duration bonds while rates are up, Artisan Advisors LLC founder and managing partner Jeff Voss said in an interview. Banks that lock in asset yields on the funding cost side as Fed rate hikes continue can position themselves to take advantage when rates come back down, Voss said.

Additionally, banks can create liquidity sources in their bond portfolio by pledging collateral value to institutions like the Federal Home Loan Bank or the Federal Reserve, Voss said.

“If nothing else,” he added, “they’ve got that set aside in a time of need.”

Banks can also use derivatives to synthetically shorten the duration of fixed-rate assets such as municipal bonds or mortgage-backed securities, providing a benefit if interest rates rise, Chatham Financial Corp. managing director Todd Cuppia said in an interview.

“The bank could use a pay-fixed interest rate swap to hedge the market value sensitivity of fixed-rate assets,” Cuppia said. “As interest rates rise, the fixed-rate bonds will decline in value, while the pay-fixed swap increases in value.”

Other risks

Beyond bond portfolio risks, another concern for banks might be the falling value of long-duration, fixed-rate lending portfolios, both Voss and Wheeler said.

“I guarantee you if they’re doing fixed-rate lending, the value of those portfolios is falling considerably,” Voss said.

Perception risks can also crop up in moments of crisis in the broader industry, Darling Consulting Group Inc. President and CEO Matt Pieniazek said in an interview. Banks must clearly communicate why unrealized losses and security sales are not a sign of weakness, he added.

“Given what I call the March Madness in banking that took place last month, you’d better have a good story,” Pieniazek said.

by Alex Graf

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