Supplementing Earnings from Liability Management

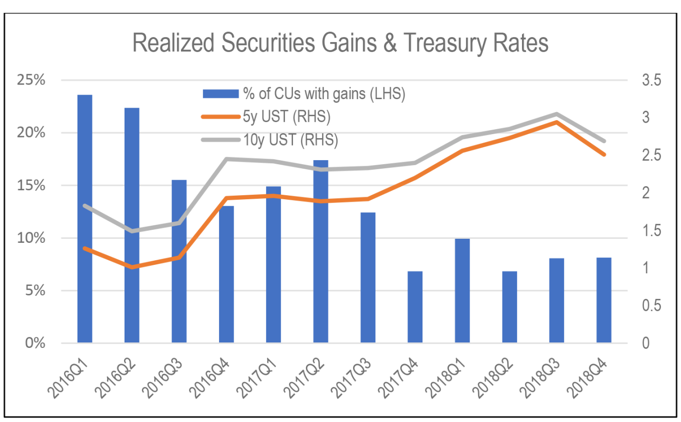
By **Andrew Paolillo, CFA,** *Director of Member Strategies & Solutions*

Credit unions have utilized securities gains and added asset duration to improve 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 credit union 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 credit union with a very strong loan-to-asset ratio will likely not require the investment portfolio to reach for return, but instead will focus on more liquid investment alternatives. On the other hand, credit unions with lower loan-to-asset ratios will find that to achieve return on assets and return on equity goals, investments must be a key contributor to earnings, as there are fewer high-yielding loans on the balance sheet.

Occasionally, credit unions 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 credit unions, looks at the three-year trend for the percentage of credit unions that have realized securities gains. Additionally, the yields for five-year and 10-year UST Treasuries are included.



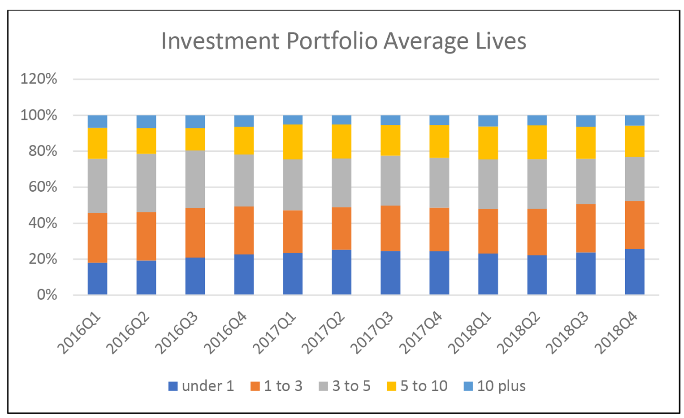
After peaking at 24 percent in the first quarter of 2016 (with five-year and 10-year Treasury rates at 1.26 percent and 1.83 percent, respectively), the number of credit unions realizing gains has steadily dropped. By the first quarter of 2018, just eight percent of credit unions realized gains.

Part of the reason 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.

Asset Duration and Net Interest Margin

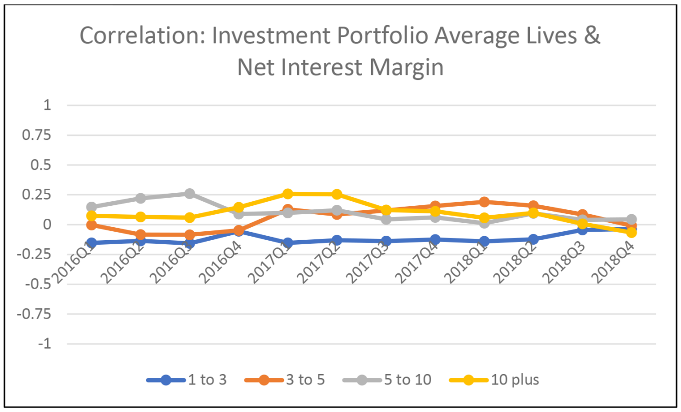
Credit unions have historically shown a willingness to take duration risk on the asset side of the balance sheet, particularly in the investment portfolio. The chart below highlights the distribution of average lives in credit union investment portfolios over the last three years, and the longer buckets (five to 10 years, and greater than 10 years) continue to account for 20 percent to 25 percent of the balances.



However, one impact of a lower and flatter yield curve is, despite the consistent exposure, extending assets is now less correlated to producing a higher net interest margin than in the past.

In 2016 and 2017, when the yield curve was steeper, having more exposure to the longer average life buckets contributed to higher net interest margin. Now that relationship has weakened.

This backdrop can create a challenge for credit unions: the earnings potential of these types of assets are reduced, and as mentioned above, the potential to supplement earnings with gains may be diminished going forward. Through this, the duration risk is still present.



Funding Solutions

FHLBank Boston has a solution that can mitigate some risks. 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 the member to prepay the advance at its approximate market value.

As rates rise, prepaying the advance can generate a gain, allowing the credit union to restructure the investment portfolio without taking the hit to current earnings from standalone bond losses. Additionally, it affords the ability to support earnings without being forced to sell bonds based solely off their gain potential. The credit union can sidestep short-term concerns and keep the focus on the portfolio's long-term contribution to the risk/return structure of the balance sheet.

In addition to the possibility of taking 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 and the cost of prepaying the advance is muted, which affords the member greater flexibility to manage the overall interest-rate risk and liquidity profile with minimal impact to current earnings.

In concert with opportunistically taking securities gains, and regularly taking on duration risk in the investment portfolio, the Symmetrical Prepayment Advance can be used as another tool when it comes to supplementing earnings and managing risk.

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 bonds, 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.