BY MARK WICKARD

Immediate Investment Portfolio Strategies For A Rising Rate Environment

Part Two: Floating Rate Securities vs. Adjustable Rate Securities

The Problem: : Most CU's do not differentiate between variable rate alternatives – specifically floating rate and adjustable rate - which leads to: 1) Lower / lagging investment income; and 2) Declining market value / increased devaluation in a rising rate environment.

In our last two articles, we focused on the negative effects of rising rates on both net interest margin (NIM) and the mistakes most CU's make in investment portfolio strategy, thereby causing unintentional harm to their institution.

In this article, we will focus on addressing those problems. Specifically, from the standpoint of how adding floating rate investments are not only preferable to fixed rate bonds, but also adjustable rate bonds.

Why Differentiate Between Floating Rate and Adjustable Rate Bonds?

For purposes of clarity and comprehension for this discussion, we distinguish variable rate investments into two distinct categories. The importance of this distinction and differentiation will not be lost on the reader when taking into context how the FED (FOMC) has steadily raised the FED Funds Rate 7 times (175 Basis Points) since December 2015.

Here are the 2 distinct categories of variable rate investments we make for purposes of educational clarity and portfolio strategic opportunity:

1. ***Floating Rate Bonds:*** Floating Rate bonds have a frequent resetting coupon under one year. Thus, a frequently resetting coupon will react quickly and positively to rising rates from an income / earnings perspective. As will be explained, floating rate bonds which reset every 1-3 months are strategically beneficial.
2. ***Adjustable Rate Bonds:*** Adjustable Rate Bonds have an infrequent or irregular resetting coupon. These coupons reset one year or greater. Thus,

they are slow / late to react to a rising rate environment. Although "adjustable in name", they fail to adequately respond to a CU's need for rapidly increasing income to offset the squeeze on their NIM.

What to Look for in Selecting the Best Floating Rate Alternatives for Your Credit Union.

Let's take a look at what characteristics are most desirable in selecting a floating rate bond. Then we will look at what characteristics to avoid – this breakdown will reveal why floating rate bonds can outperform adjustable rate bonds in a rising rate environment.

The Optimal Floating Rate Characteristics to Look for When Selecting Floating Rate Bonds for your Portfolio:

– *Frequent Reset:* Look for a coupon that can react quickly to changing rate environments – particularly bonds with monthly or quarterly resets.
– *High Coupon CAPs*: Make sure any coupon CAPs are high enough to allow your investment to react appropriately to a rising rate environment.
– *Cash Flow:* Monthly cash flow into a rising rate environment can be beneficial as the coupon resets and the credit union can lend or reinvest those funds at higher rates.
– *Small Market Value Change / Low Duration:* Negligible devaluation (market value decline) in a rising rate environment.
– *Good ALM tool:* A frequent resetting coupon can behave like cash on your ALM report with a potentially significant yield enhancement.

Characteristics to Avoid When Selecting Floating Rate Bonds for Your Portfolio:

– *Infrequent / Periodic Reset:* Avoid bonds with infrequent or irregular coupon resets. These bonds will be late to react to changing rate environments (i.e. 1 year or longer resets).
– *Low Coupon CAPs:* Low coupon CAPs will reduce your investment's ability to react appropriately to a rising rate environment.
– *Cash Flow:* The lack of monthly cash flow into a rising rate environment can be very problematic and can contribute to earnings risk.
– *Significant or Moderate Market Value Change / Low Duration:* Higher devaluation (market value decline) in a rising rate environment.
– *Poor ALM tool:* An infrequent resetting coupon does not benefit the credit union's overall ALM position.

A Look at the Permissible Types of Floating Rate (Frequent Coupon Resets) Bonds and Adjustable Rate (Periodic/Infrequent Coupon Resets)

It is helpful to know the most common types of both floating and adjustable rate bonds in the permissible Credit Union Investment Universe. From a regulatory standpoint, §703.14 of the NCUA Rules and Regulations provides what characteristics make a variable rate investment (either floating or adjustable) permissible. However, this regulation does not articulate at all which *specific investments* are permissible.

The following is a description of the most common types of variable rate investments permissible for CU's, along with a very brief definition:

Floating Rate Bonds (Frequent Coupon Resets) Brief Definitions

– *Floating Rate Agency Bullet*
  • Bullet (non-amortizing) that resets monthly or quarterly issued by most Agencies
– *Floating Rate GNMA HECM*
  • Amortizing (monthly P&I) that resets monthly only issued by GNMA (100% Full Faith and Credit of the U.S. Government)
– *Floating Rate Agency CMO*
  • Amortizing (monthly P&I) that resets monthly issued by most Agencies

– *Floating Agency DUS (multi-family)*
- Balloon (sometimes monthly P&I) that resets monthly issued by most Agencies

– *Floating Rate Bank Note*
- Bullet (non-amortizing) that resets monthly issued by large investment grade banks

– *Floating Rate SBA Pool*
- Amortizing (monthly P&I) that resets monthly or quarterly backed by Small Business Administration

Adjustable Rate Bonds (Periodic Coupon Resets) Brief Definitions

– *Agency Step-Up Callables*
- Callable bonds with a pre-determined schedule of coupon changes issued by most Agencies (caveat: 90% + of CU's do not buy these securities correctly)

– *Agency Fixed-to-Float*
- Callable bonds that start with a fixed rate coupon for the first 2-3 years then revert to a floating rate. These typically have "stepped CAPs"

– *GNMA ARM's*
- Amortizing (monthly P&I) that have an initial fixed rate period (typically 3-7 years) with an annual adjustment thereafter. Maximum annual reset = 1.00%

– *Agency ARM's*
- Amortizing (monthly P&I) that have an initial fixed rate period (typically 3-7 years) with an annual adjustment thereafter – issued by FNMA & FHLMC. Maximum annual reset = 2.00%

A closer look at the specific characteristics of Floating (frequent reset) and Adjustable (periodic reset) Bonds which are permissible and most common for CU's

We will now breakdown the specific and differentiating characteristics among variable rate alternatives from the same types of floating and adjustable rate bonds identified in the previous section.

Frequent Coupon Reset

FLOATING RATE CMO
- Tied to 1-MO LIBOR | Resets Monthly
- Yield Range: PAC1 | PT = ~3.25% to 3.40% (Base Case)
- Yield Range: SUP = ~3.40% to 3.75% (Base Case)
- Typical CAP Range Between 5.00% & 7.00%
- Index Duration = -0.08%

FLT RATE SBA - EQUIPMENT
- Tied to PRIME | Resets Monthly or Quarterly
- Yield Range: ~2.30% to 3.00% (Base Case)
- Small Business Administration – Full Faith & Credit

FLT RATE SBA - RE
- Tied to PRIME | Resets Monthly or Quarterly
- Yield Range: ~3.30% to 3.90% (Base Case)
- Small Business Administration – Full Faith & Credit
- NO CAP
- Index Duration = -0.60% to -0.90%

GNMA HECM
- Tied to 1-MO LIBOR | Resets Monthly
- Yield Range: PT = ~2.90% to 3.15% (Base Case)
- Typical CAP Range Between 7.00% & 13.00%
- Duration = ~ -4% - ~-6%

FLT RATE BANK NOTES
- Tied to 1-MO LIBOR | Resets Quarterly
- Yield Range: 3YR to 5YR = ~2.30% - 3.00%
- Typical NO CAP
- Index Duration = -0.25%

FLT AGENCY BULLET
- Tied to 1-MO LIBOR | Resets Monthly
- Yield Range: ~1.75% to 1.95%
- NO CAP
- Index Duration = -0.08%

PERIODIC Coupon Resets

Typical Characteristics

AGENCY STEP-UP CALLABLES

- Callable Monthly, Quarterly, Semi-annual, Verde
- Maturity Range: Typically 5-YR to 15-YR
- Yield Range: YTW ~3.00%
- Yield Range: YTM ~3.50%

- +300 BPS Devaluation = -5% to -25%

- **AGENCY FIXED-TO-FLOAT CALLABLE**
- Callable Monthly, Quarterly
- Maturity Range: Typically 10 – 20 Years
- Fixed-Rate Coupon: ~2.50% - 3.00%
- Floating Rate Spread: ~1.50% - 2.50% to 3M LIBOR
- These securities have CAP's that start lower and gradually increase per set CAP schedule.
- +300 BPS Devaluation = -~17%

GNMA ARM

- Tied to LIBOR or US TSY
- Initial Fixed Period 5 – 10 Years
- Yield Range: ~2.85% to 3.25%
- Backed by Adjustable Rate Mortgages – 100% Full Faith
- Initial CAP = 5.00% | | Periodic CAP = 1.00%
- Lifetime CAP Varies
- +300 BPS Devaluation = ~ -6% to 12%

AGENCY ARM

- Tied to LIBOR or US TSY
- Initial Fixed Period 5 – 10 Years
- Yield Range: ~2.75% to 3.20%
- Backed by Adjustable Rate Mortgages – Implied Backing
- Initial CAP = 5.00% | | Periodic CAP = 2.00%
- Lifetime CAP Varies

+300 BPS Devaluation = ~ -8% to -13%

Conclusion: What to do now?

While not exhaustive, this introduction to the different types, definitions and characteristics of the most commonly utilized variable rate bonds has hopefully clearly established one essential guidepost – that it is critical for a C.U. Portfolio Manager to know the difference between Floating and Adjustable Rate Bonds.

The importance of this difference is underscored when the FOMC has not wavered from its intent to raise the FED FUNDS Rate 3 to 4 times during 2018. What we can do now is to identify:

1. The characteristics of those bonds most beneficial to your CU's income / earnings as well as your ALM and NEV position. As an example, a Credit Union with an asset mix of predominately Fixed Rate, should look to diversify into more frequently resetting coupons, i.e. Floating Rate Bonds.
2. The under-allocation of Floating Rate Bonds available vs. the presumably over-allocation of both Fixed and Adjustable Rate Bonds in your portfolio. A consideration of reallocation through a buy / sell swap strategy can quickly rectify an earnings and devaluation dilemma.

So Why are Some CU's Better Positioned with their Investment Portfolios to Benefit from Rising Rates?

We maintain that the difference is education. Your education is essential to the success of your portfolio. The detailed discussion and analysis of Floating Rate Alternatives is paramount to how we work with our clients before any recommendations are made.

In Part Three of this series on Immediate Investment Strategies for A Rising Rate Environment, we will focus on strengths and weaknesses in bonds we have discussed today. We will point out the practical utilization of the best available alternatives over the types of bonds which are commonly recommended to CU's.

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