



November 4, 2015

*Weekly Post: Reviewing the Investment Portfolio and keeping loans on the Balance Sheet*

Dear Clients-

One of the tasks of the ALCO committee is to periodically evaluate their investment strategies to manage the balance sheet under today's current market conditions: low yields, tight spread off the Treasury/Swap curve, and the upward sloping yield curve. While the Fed may eventually raise the short-term rates, the global economic conditions may limit the rise of rates across the maturity spectrum thus resulting in a flatter curve. ALCO may consider investment strategies such as “riding down the curve “ and the rotation into loans.

**Challenge**

Morgan Stanley Wealth Management this week summarizes the current US market conditions. OAS (option adjusted spread) is the spread net of time value and the option cost, as I have described in previous Weekly Posts. The table shows that the mortgage-backed securities (MBS) OAS is only 15 basis points. The spread to compensate for credit risk is also very tight with AA bonds’ OAS only 11 basis points. By way of contrast, a 30 year fixed rate mortgage loan typically has over 120 basis point, net of hedge cost.

		Duration (Yrs.)	Yield-to- Worst (%)	OAS (bp)
Investment Grade	MBS*	3.91	2.42	15
	AAA	4.07	1.51	27
	AA	4.96	1.87	11
	A	6.75	2.90	120
	BBB	7.31	4.08	221

- How to managing the interest rate risk in selling securities and keep loans on the balance sheet?

**Solution**

You can obtain your institution's duration of any loan categories in Risk Officer [please contact us if you would like assistance in reviewing it]. If the investment portfolio has a duration less than that of the loan portfolio, then the balance sheet duration would increase and balance sheet is more liability sensitive. Conversely, if the investment portfolio duration is longer than that of the loan portfolio, then the balance sheet will be more asset sensitive.



If you go to ALM Transactional Platform, you can use “bond sale monitor.” This function enables you to select bonds for sale, knowing the aggregate unrealized profit and loss. The fair prices are updated daily so that you can monitor the impact of the sale of the investment portfolio on your reported income.

Bank: Bell State Bank & Trust (ND)								
Bond Sale Monitor								
Summary	Sell Size	Size	Book Price	Fair Price	Unrealized gain	Yield	Dur	
U.S. Treasury securities	47,013	47,012	0.00	0.00	0	0.00	0.00	
<b>Total</b>	<b>47,013</b>	<b>47,012</b>	<b>0.00</b>	<b>0.00</b>	<b>0</b>	<b>0.00</b>	<b>0.00</b>	

  

U.S. Treasury securities	Sell Size	Size	ID	Desc	CPN(%)	Matur
U.S. Government agency obligations (ex	<input checked="" type="checkbox"/>	20,547	20,547	25465858	3m treasury	0.01 1/30/2
Issued by U.S. Government-sponsor	<input type="checkbox"/>	20,547	20,547	25465859	3m treasury	0.01 2/28/2
Securities issued by states and political s	<input checked="" type="checkbox"/>	20,547	20,547	25465860	3m treasury	0.01 3/30/2
Mortgage-backed securities (MBS)	<input type="checkbox"/>	0	0	25465861	3m treasury...	0.00 12/31
Residential mortgage pass-through s	<input checked="" type="checkbox"/>	1,973	1,973	25465862	9m treasury	0.03 1/30/2
Guaranteed by GNMA	<input type="checkbox"/>	1,073	1,073	25465863	9m treasury	0.03 2/28/2

**Numerical Example**

You may adjust your investment portfolio duration anticipating more loans added to the balance sheet. The THC Investment Analytics report provides the OAS, duration, and weighted average life values and other key analytics enabling you to better evaluate the bonds that you consider buying and selling.

Description	Coupon Rate(%)	Maturity (year)	Market Price	Yield to Worst	OAS (%)	WAL (year)	Eff. Dur
FG 2.5 10/1/2030 FIXED	2.500	14.83	101.81	2.085	0.273	5.43	5.10
FG 3 10/1/2030 FIXED	3.000	14.83	103.95	2.020	0.260	5.01	4.04
FG 3.5 10/1/2030 FIXED	3.500	14.83	105.41	2.205	0.520	4.51	3.33

You can also do the trade simulation to evaluate the impact of the transaction on your balance sheet and generate the Bond Swap report for your ALCO meeting.

**Conclusion**

We can use the investment strategy to manage interest rate risk and liquidity risk as we change our loan portfolio. We can use duration and OAS to determine the risk and valuation respectively. The Bond Sale Monitor shows that unrealized gain on the transaction. Trade Simulation and the Bond Swap report shows the impact of the trade on the balance sheet.

*Please do not hesitate to contact THC staff if you have any questions regarding investment strategies.*

Regards,



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