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Identifying Strategy Biases ... and How to Avoid Them

Simple tactics to succeed in any rate environment

Markets are naturally cyclical.

For financial institutions, that's a constant focus when it comes to strategy implementation. That focus largely centers on the history and potential trajectory of interest rates.

It starts with the Federal Reserve's monetary policies. Whether it's establishing a target for the Fed Funds rate or the quantitative easing/tightening targets with the Fed's fixed income securities portfolio, financial institutions must adapt evolving strategies that suit the current and prospective interest rate environment.

Hindsight is 20/20. It's incredibly easy to take the armchair quarterback approach in assessing what strategies would've worked best. It's a healthy exercise, but it ignores the unknown.

Little did we know the housing market would suffer the worst crisis since the Great Depression in 2008. Little did we know the massive influx of liquidity into the financial system during 2020 would be short lived and that it would be followed by an abrupt reversal, which persists today.

So, what's the solution? A crystal ball certainly would be useful.

In the absence of clairvoyance, let's start by identifying the inherent biases we all experience.

The Fed has been in a holding pattern since December, so now is the perfect time to evaluate what biases were most prevalent over the past few interest rate cycles.

1 The first is being hesitant to challenge the status quo.

2 Next is only looking at strategies that achieve short-term objectives and a belief the current environment will last forever.

3 Then there is the thought that during times of strong liquidity and low rates you should be unwilling to extend liabilities.

4 And, of course, during times of tight liquidity and high rates you should have a strict focus on funding the loan portfolio.

5 Finally, there's ignoring peer data to achieve high-performance.

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I have good news for you. There are techniques we can employ today to help avoid and/or mitigate these natural biases in the future. It's a simple question of "what would I have done differently."

Starting with bias No. 1, I'd like to task you to think outside the box by challenging the status quo. Achieve this by educating yourself through diverse resources and advisors and being willing to offer alternative scenarios that haven't previously been considered within your institution's risk parameters.

Bias No. 2 arises when you're strictly focused on the immediate challenges and/or opportunities for your institution. And, let's be honest, that should always be your starting point. However, it wouldn't hurt to consider hedging your bets for a potential change in the current environment as well.

Let's look back at 2020 where the Fed went back to the 2008 playbook of zero interest rate policies and pumped liquidity into the system at a blistering pace. Looking back to the fallout of the 2008 crisis, we had an entire decade of low interest rates and high liquidity.

It stood to reason that we might be back in that environment for the foreseeable future. Unfortunately, that environment was short-lived, and we quickly moved into a high-rate, tight liquidity market.

What would we have done differently in 2020? For starters, funding had reached all-time lows. That's all good and great. But when you're sitting on a mountain of cash, it's not all that attractive.

Some institutions decided to extend their liabilities as a form of dry powder in the event liquidity dried up. For FHLBank Topeka members, only a small handful took advantage of near zero funding rates. By the first quarter of 2022, it became clear that it worked to their advantage.

Again, only a handful of institutions did this while most of us were stuck in bias No. 3, an unwillingness to extend liabilities when liquidity was strong and rates were low.

What would we have done differently in 2023? By this point, liquidity had vanished, interest rates and inflation were at 30-year highs, and it was all most institutions could do to just keep up with loan demand.

Yet, only another small handful of institutions took advantage of this environment by putting on investments with attractive bond yields by utilizing wholesale funding resources for funding. The majority, however, were in bias No. 4, a strict focus on loan funding during periods of tight liquidity and high rates.

This brings us to our final bias, No. 5, ignoring peer data to achieve high performance. The reality is most institutions are hyper aware of what their peers are doing. In fact, one of the most common questions my members ask me is "what are other members doing?"

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But a deeper dive into the data can reveal what exactly differentiates high-, moderate- and low-performing financial institutions.

Sometimes, this is just the difference in the uniqueness of their respective balance sheets and/or customer base. But there are also instances that reveal strategies that might help your institution's performance.

For example, when you look at peer data in our district, there's a direct correlation of institutions that utilize more wholesale funding and improved performance.

As shown in the table, the bottom quartile of our members with the lowest cost of funds achieved better net interest margin, yield/cost spread, return on assets and return on equity.

The takeaway here is diversity. Despite the current needs of your institution, always keep an eye on potential changes to the current environment and employ strategies to suit those scenarios.

Funding Profile | Banks < $1 billion

	Quartile		
	Bottom	Middle	Top
Cost of Funds	1.85	2.23	2.74
Funding Composition			
Fed Funds/Repos/Other Borrowings	1.64%	1.14%	1.33%
FHLBank Advances	**2.57%**	**4.68%**	**5.56%**
Brokered Deposits	**0.81%**	**3.88%**	**7.78%**
Retail Time Deposits	19.41%	25.68%	35.94%
Non-maturity Deposits	75.59%	64.52%	49.34%
Cost of Borrowings	**3.29%**	**3.85%**	**3.72%**
Cost of Time Deposits > $250k	4.24%	4.49%	4.70%
Cost of Time Deposits <= $250k	3.59%	4.25%	4.59%
% Maturing < 1 year			
Other Borrowings	97.37%	100.00%	100.00%
FHLBank Advances	64.29%	42.74%	64.75%
Brokered Deposits	95.25%	58.35%	56.47%
Retail Time Deposits	89.44%	90.79%	90.06%
Loans/Deposits	72.68%	81.60%	92.93%
Wholesale Funding Utilization	4.56%	9.07%	16.96%
Net Interest Margin	**3.73%**	**3.65%**	**3.54%**
Yield/Cost Spread	3.12%	2.87%	2.79%
ROAA	0.98%	0.88%	0.88%
ROAE	10.37%	9.21%	9.03%
Tier 1 Capital	11.29%	10.49%	10.55%

If you have any questions on specific strategies you'd like to consider for your institution, please reach out to me, your account manager or our helpful Lending desk for assistance.

Contact FHLBank Topeka today to discuss your advance solutions

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