Independent Banker

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Portfolio

[tag] Portfolio Management

[hed] New trials, new tricks

[dek] Proactive investment strategies are appearing in bank portfolios.

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It’s been said before in this space, and at the risk of redundancy (not to mention banality), here it goes: Community bankers are a resourceful lot. Examples are plentiful, but simply keeping the discussion on the balance sheet, here are a few from the recent past:

* The quick work by community banks to determine whether to embrace, or to run and hide from, TARP opportunities in 2008
* The adoption of policies and procedures relating to the due diligence required pre- and post-purchase of municipal and corporate bonds starting in 2013 pursuant to the beloved Rule 939-A of Dodd-Frank
* Gradual and growing use of off-balance sheet tools, namely interest rate swaps, to improve competitiveness and defease risk (About 29% of community banks have some type of derivative contracts currently in place.)
* Increased use of loan surrogates through the pandemic, when core lending, particularly in most banks’ market footprint, was almost non-existent. Examples of these are high-quality out-of-market whole loan packages and commercial mortgage-backed securities (MBS)

[subhed] New challenges

Community bankers have always been willing to step up to a challenge, and we can click off the more material issues facing the industry in 2022. For one, net interest margin (NIM) is at an all-time low; the FDIC reported that community bank NIM was 3.13% for the first quarter this year. For another, unrealized losses in the bond portfolio were over 9% as of June 30, which is a modern-era high.

Into this cauldron we add several more ingredients. The growth in community bank balance sheets since 2020 has caused most banks’ capital ratios to shrink, even as credit quality has remained remarkably solid, and earnings, while not at record levels, have at least been respectable. Deposit growth has slowed, but was still up 10% on a year-over-year basis in March.

Another development that has affected bond portfolios is that the supply of straight agency bonds (for example, FHLB, FNMA, and FHLMC) is smaller than at any time since 1998. This has caused yield spreads in that sector to shrink, and in many cases has compelled investors to purchase agency alternatives.

[subhed] New paradigm

Proof of that is more than one-quarter of all bonds that community banks purchased in the first half of 2022 were treasuries, according to ICBA Securities’ exclusive broker, Stifel. This, again, is a high-water allocation for the sector in well over a decade. One of the motives for buying treasuries may be capital preservation, since unrealized losses for bonds classified as available for sale (AFS) impact capital ratios for financial reporting purposes, and treasuries are 0% risk-weighted.

This chain reaction has caused many banks to reclassify AFS investments as held to maturity (HTM). (The “AFS/HTM” standard went into effect in 1993 as FAS 115, and it’s believed bond portfolios have not had that large of a loss since.) Historically, around 5% of bonds have been classified as HTM; in mid-2022, the number is more like 15%. This is still another example that community bankers are keeping their eyes on their balance sheets, which most assuredly includes their equity ratios.

 [subhed] Gulf is still wide

So, given all the stimuli and responses, what do bond portfolios look like today? Starting with tax-equivalent yields, the average is barely over 2%, but rising. More telling is the gap between the top quartile and the bottom (see table). It currently is low on an historical basis, around 120 basis points, or 1.2%; in other rate environments, the difference is closer to 200 basis points, or 2%. But before we declare the lowest quartile has made up significant ground, we must also point out that bond portfolios are much larger than in 2019, so in absolute dollars, the income give-up is still substantial.

Another item of interest is that the bottom quartile has a larger unrealized loss than the top quartile, in spite of having a shorter duration, which presumably should produce less price risk. This anomaly can be explained by the higher-yielding portfolios being more highly weighted in municipal bonds, and likely premium munis at that.

Tax-free securities, especially those priced above par, react more favorably to rising rates than virtually any other sector, and the top quartile has over 40% of its bonds in that category.

The next set of unscheduled, unprecedented, unbudgeted and unwelcome trials to face community banks? No way to tell. But my money’s on the ICBA members, and their bond portfolio managers.

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[sidebar] Education on tap

2022 webinar series continues

ICBA Securities and its exclusive broker Stifel Financial conclude their 2022 Community Banking Matters webinar series on Oct. 4 at 10 a.m. Central. The topic is “Planning for the Year End, and the New Year.” To register, visit ***icbasecurities.com***

Bank strategies webinar this month

Stifel will host its 4th quarter Quarterly Strategy Webcast on Oct. TK at 12 p.m. Central. There will be multiple presenters, and up to 1.5 hours of CPE are offered. Contact your Stifel rep for more information and to register.

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The state of bond portfolios

*October 2022*

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*Source: Stifel Financial*