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Still a Money Maker

Investment portfolios are adding to community banks' bottom lines

By Jim Reber

This has the look and feel of a fallacy. Maybe you'll see a metaphor in the Funhouse mirrors at your county fair this summer. Or maybe an optical illusion in a book of riddles and puzzles. Regardless, you may be interested, and pleasantly surprised, to learn that your community bank's investment portfolio has actually performed pretty well in the last seven years.

The impression many of you have given me is that your bank's collection of bonds has been eating a hole in your bank's net income/budget/bonus plans. Ever-lower portfolio yields are now at generational troughs, even with the slight improvement in market yields over the last 14 months. Absolute portfolio returns, which peaked at about 5.50 percent on a tax-equivalent basis in 2007, are now less than half of that. Nonetheless, I'm happy to report that reality is better than perception.

How we got here

It's always instructive to review what community banks own in their investment portfolios. The aggregate totals of the Vining Sparks bond accounting population provide a great place to start. As of March 31, 2014, there were 570 community banks in the group, that own more than $48 billion in bonds. We therefore have a significant sample size.

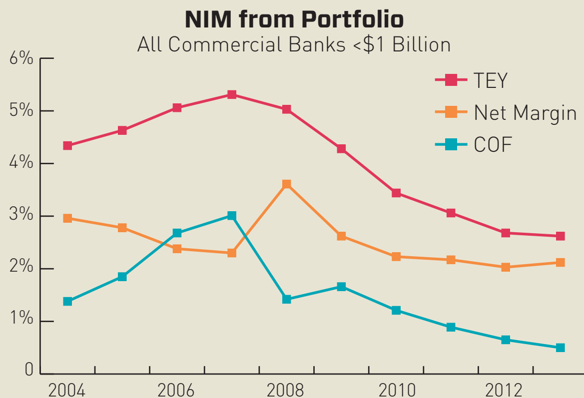
The tax-equivalent yield of the group is now 2.61 percent. This is identical to a year ago. What is different is the duration. Duration, to oversimplify, is both an estimate of when you're getting your principal and interest back, and an estimate of how much price volatility you have in your portfolio. In March 2013 the average duration was 2.9 years; today, it's up to 3.8. The reason for the extension is that, with just the modest rise in rates over the last year, a sizable amount of optionality in these portfolios is now out-of-the-money. The result is that your bank is getting its money back later rather than sooner.

Net contribution

Something else that's changed over the last year is that banks' cost of funds is now at lifetime lows. As of Dec. 31, 2013, the average bank with under $1 billion in assets was paying 50 basis points (0.50 percent) all-in for its deposits. A year ago, the average was 0.65 percent.

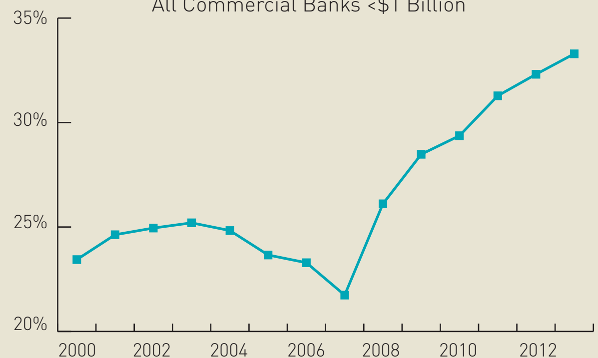
So, while the income from your community bank's bond collection is still compressed, the net contribution has actually remained relatively unchanged in the last seven years (see Table 1). Despite the spike that occurred in 2008, just as investment yields were about to fall off the table, portfolio yields net of cost of funds have been under 250 basis points for the better part of the decade. The numbers indicate that the investment portfolio is still knocking out a decent net return.

Table 1



Source: FDIC, Vining Sparks

Table 2



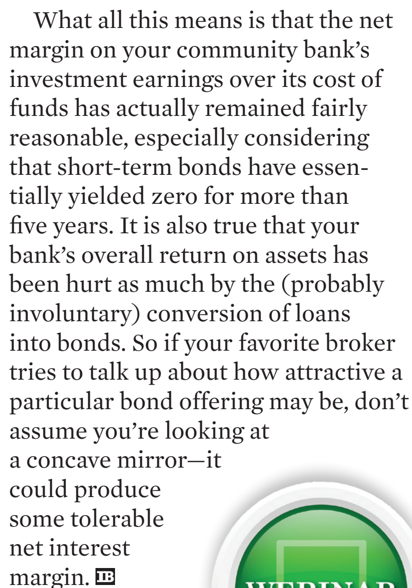
Source: FDIC

Changing mix

What has admittedly become a challenge to the bottom line is the overall makeup of a community bank's balance sheet. We all know the stories about loan demand being compromised, and the role that a lackluster economy has had on credit demand in general. Add to that the influx of low- or no-cost deposits, and there becomes a greatly expanded role for the investment portfolio.

Table 2 demonstrates that there is now a greater percentage of assets invested in the bond portfolio than at any time in recent history. In fact, there are about $14 trillion in assets in the U.S. banking industry, and fully $1 trillion of that has migrated from loans to investments since 2007.

What all this means is that the net margin on your community bank's investment earnings over its cost of funds has actually remained fairly reasonable, especially considering that short-term bonds have essentially yielded zero for more than five years. It is also true that your bank's overall return on assets has been hurt as much by the (probably involuntary) conversion of loans into bonds. So if your favorite broker tries to talk up about how attractive a particular bond offering may be, don't assume you're looking at a concave mirror—it could produce some tolerable net interest margin. IB



Learning Opportunity

ICBA Securities' webinar series "Community Bank Matters" continues on July 9. Dan Stimpson, senior strategist, will provide an update on managing investments in a new regulatory landscape. Visit ***www.icbasecurities.com*** or contact your sales rep to register.

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