

Pad the Portfolio

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Secondary mortgage market is attracting community banks

By Jim Reber

Finally! Loan-to-deposit ratios have stopped falling. In March 2016, according to the FDIC, net loans on all commercial banks' books topped \$8 trillion for the first time. The growth was broad based, with improvements in C&I, commercial real estate and residential mortgages. For all of 2015, community bank lending was up around 10 percent.

However, the reality for community banks is that mortgage loans, in particular, have been tough to come by. There are a lot of reasons for this, including scale, regulatory burden and consumer demand. Community bankers (being forever resourceful) have responded by purchasing large volumes of high-quality mortgages to round out their loan portfolios.

Most of the purchasers seem to view this as a complement to their investment activities, not a subset. To be sure, there are steps an investor has to take prior to acquisition that aren't necessary when buying a bond issued by the federal government. Nonetheless, the thought processes are similar, as are the objectives.

The need

Before we celebrate the growth in our loan portfolios, let's take a step back and analyze where most community banks stand at this point. Investments as a percentage of total assets are still far greater than they were in 2006. The average community bank has about one-third of its assets in cash and bonds, compared with less than one-quarter a decade ago.

Cash, it should be mentioned, remains a hot potato. We know that overnight rates are up about 25 basis points (0.25 percent) since December, but the rates are still less than the typical community bank's cost of funds. Deposits on the other hand have still been relatively easy to come by, and strategies are available to fix the cost of longer-term deposits at attractive rates. The trick for you community bankers is finding assets that meet your bank's risk/return criteria, as funding remains historically cheap.

The strategy

ICBA VOICE

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Alberto Alemany is the chief financial officer of Schuyler Savings Bank, a \$116-million-asset ICBA member in Kearny, N.J. Schuyler Savings is located in a highly competitive market but was interested in adding high-quality mortgage loans to its balance sheet. The bank made the decision to go outside to add to its loan portfolio. Alemany says, "The management team and the board felt we were diversifying risk by going outside of our market."

Another factor in deciding to purchase loans was the scale they provided. "We ended up buying \$8.4 million in mortgages," says Alemany. "It would take us a long time to grow our loans by that much, given refis and payoffs."

The benefits

The loans purchased by Schuyler Savings had higher yields than its own lending rates and didn't cannibalize its market footprint. It also met every credit-quality standard the bank had set for itself. "To give the board a level of comfort, we did extensive due diligence utilizing our own independent underwriting analysis," Alemany says. "And we bought only the loans that equaled or exceeded our own standards."

A year later, the portfolio is doing quite fine, thank you. Alemany says, "The loans we bought have performed very well since the purchase. If we hadn't gone outside the bank, we'd have just employed the excess liquidity somehow and gotten average returns. This way, we have actually higher yields than if we had made the loans ourselves."

Webinar with Free CPE in September

ICBA Securities' webinar series "Community Banking Matters" continues on Sept. 13 at 10 a.m. (Central time). Justin Sparks and Dennis Porcaro with Vining Sparks will present a Municipal Market Update and will discuss both strategies and credit. To learn more, contact your Vining Sparks sales rep or visit www.viningsparks.com.

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