The Vertical Game

Fixed-rate SBA bonds can be a positive tool for your bank’s portfolio

By Jim Reber

It appears that community banks just can’t wean themselves from their investment portfolios. In spite of the improving loan demand, and presumably borrowers’ improving credit conditions, the percentage of banks’ balance sheets that is represented by bonds is still near all-time highs. As of March 31, 2015, one-third of total industrywide footings were in cash or investments.

As the 2015 football season kicks off, I see a metaphor in a game plan involving downfield passes (“the vertical game” to strategy wonks) and investing in certain fixed-rate securities. In recent columns I’ve discussed how expensive cash is, and that community banks in particular are convinced their asset-liability posture is in good shape for rising rates. What has changed as 2015 has progressed is that (drumroll, please) investment yields have improved. This may be reward time for you patient community bankers out there.

Deep end of the barbell

For those community banks that effectively have a “barbell” structure to their investment portfolio, the long end can be a challenge to build out. You’ll recall that a barbell has roughly equal amounts of dollars in very short items and relatively long ones. What is “long” remains subjective. Some community banks like the comfort of five years and less, while others dwell in 25-year land.

Nevertheless, for the investors who can buy some long-term durations (defined here as five or more years), the menu is pretty limited. The most popular longer-term community bank bond is a tax-free municipal, whose supply is restricted by IRS rules and small municipalities’ borrowing capabilities. Tax-free munis’ cousins, taxable munis, became more visible in the aftermath of the financial crisis in
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the vehicle known as BABs, but they are more difficult to find today.

Now, however, community banks looking for the long ball (or the Hail Mary or the bomb) have been turning toward a hybrid instrument known as an SBA Development Company Participation Certificate, or a DCPC. These are the fixed-rate alternatives to the SBA floating rate pools known as 7(a)s.

Risk/Reward upgrade

DCPCs represent full faith and credit instruments of the federal government, and are used to finance construction of small-business facilities. Because they involve capital projects, their payback period is longer term, and their rates are fixed for either 20 or 10 years.

The SBA conducts auctions monthly for 20-year pools (bimonthly for 10-year pools) to determine a borrowers’ rates. There is a correlation between the DCPC coupons and the corresponding Treasury curve, so as the market yields on the Treasury notes rise, so do the rates on fixed-rate SBA securities.

In early July, SBA issued new 20- and 10-year bonds, whose initial yields were 2.85 percent and 1.70 percent, respectively. These were nearly the highest yields available in 2015 and reflect an improving domestic economy.

Watch the volatility

By now, you risk-minded community bankers will have figured out that there is baggage attached to these items, and I agree with you: The durations of the DCPCs, and consequently their price volatility, are quite high. A new 20-year fixed-rate pool will have a duration of about six years. This is the outcome of three qualitative aspects: 1) The loans amortize on a straight-line basis; 2) Principal and interest are paid semi-annually; and 3) There is a prepayment penalty for half of the amortization period, which does pass through to the investor.

What the prepay penalty in essence creates is very little cash flow in the early years of a pool. This insulates an investor who purchases a DCPC at a price above par but lengthens out the payback period. The result is an instrument that can fill out the long end of a barbell.

The playbook for many community banks can now perhaps include a couple of deep routes, to capture some improved market yield. To be sure, longer yields can continue to march higher, in which case the prices for these fixed-rate instruments will drop. The amount of investment that’s right for your community bank should be quite clear by this point in the rate cycle. If there’s room for DCPC investments, the reward may well be worth the risk.

New ICBA Securities Chairman

Tim Zimmerman was named chairman of ICBA Securities in June. Zimmerman is the president and CEO of Standard Bank in Monroeville, Pa. He previously served on ICBA’s Executive Committee as its secretary and has chaired the Consumer Financial Protection Bureau’s Community Bank Advisory Council and ICBA’s Federal Home Loan Bank Task Force.

Kick the Tires

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