Changing Investments
Understanding the impact of low rates on community bank portfolios

by C.J. Pickering and Jim Taylor

Rates started down in December 2000, fell more than 450 basis points in 12 months and are now at 40-year lows. Community bank portfolio yields have held up remarkably well. However, there are some differences between high performance and low performance banks that are beginning to penalize the low performers.

ICBA Securities provides bond accounting services for 456 community bank investment portfolios. Statistical analyses show that the portfolios of these banks, although higher in yield by 10 to 20 basis points, otherwise closely mirror the characteristics of all community banks with assets between $30 million and $500 million.

To identify the differences between high performance and low performance portfolios, the 456 banks were divided into four quartiles based on the TEY (tax equivalent yield) of their investments. Through the third quarter of 2002, the high performers had a TEY of 6.08 percent, 211 basis points higher than the low performers yield of 3.97 percent.

The Changes
As shown in the graph above, the last time that the spread between high and low performing bank portfolios was greater than 200 basis points was in 1994. During 1993, the spread was 264 basis points. During 1994, as rates climbed from 3.0 percent to 5.5 percent, the spread was 214 basis points. And during 1995, as rates began to stabilize at the higher level, the spread had shrunk to 174 basis points.

The spreads between the high and low performers continued to tighten from 1995 to the end of 2000 when the difference was 91 basis points. Then as fed funds rates fell from 6.25 percent to 1.75 percent, the spreads widened to 1.73 basis points in 2001 and to 2.11 basis points by September 2002.

The pattern is clear. When rates rise or remain stable, the spreads between low performance portfolios and high performance portfolios tend to shrink. When rates fall, the spreads widen. And the reason seems equally clear. High performance portfolios have durations that range between 1.0 to 1.6 years longer than the durations of low performance portfolios.

Shorter durations cause low performing portfolio yields to rise and fall more rapidly than those of the high performance portfolios. The longer duration, high performance portfolios are more insulated from rate swings and, therefore, tend to hold on to their higher yields longer when rates are falling. In other words, the longer duration portfolios’ yields fluctuate, but they fluctuate at a higher level and with less volatility than do the shorter duration, low performance portfolios’ yields.

Drawing Conclusions
For completeness sake, it should be noted that the durations of both the low-performance and high-performance community bank portfolios shrink during falling rates—callable bonds are called, mortgage-backed securities prepayments speed up and portfolio managers invest in shorter-term securities. Although both types of portfolios become shorter, the low performers tend to shorten up even more than do the high performers.

High-performance portfolio managers are now purchasing securities that will give them reasonable yields in today’s low rate environment, but will also give them cash to reinvest when rates become more attractive.

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