That Was Then …

Why looking back a few years can be insightful

By Jim Reber

I was careful to not title this column “Those Were the Days.” The All in the Family theme song from the 1970s might take some readers back another 40 years to the era of Herbert Hoover and LaSalle automobiles. I only want to look back about 48 months.

The year 2008 will prove to be a watershed period in U.S. banking. That was the year in which you and I became the proud owners of Fannie Mae and Freddie Mac, and it looks like we’re still going to be providing them a foster home for a while longer. 2008 also saw the demise of Bear Stearns, Countrywide and Lehman Brothers.

We started January of that year with a Fed Funds target of 4.25 percent and closed in December at 0.25 percent, where we stand today. It was in October of 2008 when the much-reviled Emergency Economic Stabilization Act, which contained the TARP legislation, was signed into law. For community bankers, the year stands out as a tipping point.

Days of yore

Those of you involved in your community bank’s investment portfolio may have scant recollection of what your portfolio looked like back then. Loan-to-deposit ratios were at record highs, and loan demand, while having peaked several years earlier, was still relatively strong. The bond portfolio in many cases was thought of simply as a warehouse of liquidity. (Not that there’s anything inherently wrong with that.)

To illustrate, let’s analyze the 550-plus community banks that use Vining Sparks, ICBA Securities’ clearing broker, as their bond accounting provider. In June 2008, that sample of community banks had an average tax-equivalent yield of 5.11 percent, but that is a decidedly one-dimensional statistic. It sounds good on the surface, but does it illustrate a hard-working asset class?

One factor to consider is its real return, that is, the nominal yield (5.11 percent) minus inflation. In June 2008, the year-over-year change in prices as measured by the Fed’s preferred index, Core PCE, was peaking at 2.5 percent. So we can say that banks earned about 2.6 percent on a real basis.

Another yardstick is to measure the yield against the cost of carry. Community banks’ overall cost of funds in mid-2008 was again about 2.5 percent, so the simple spread was around 2.6 percent. It’s not as much as the loan spread, but that’s for good reason—bond portfolios have superior credit quality.

New world order

Now let’s see where things stand today. The average tax-equivalent yield is down to 2.88 percent. This is the lowest rate in the history of ICBA Securities’ bond accounting, which stretches back at least 20 years. So this is another measurement of how low interest rates in general are today.

Inflation, it may interest you to

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learn, has gone down only marginally over the past four years. Current year-over-year price changes are about 1.8 percent. While that number can go down (or up, for that matter), the real return from the bond portfolio is now only about 1.1 percent.

Cost of funds, as we know, is at a record low. Community banks have pushed their funding costs down to about 0.75 percent, but still, the net interest spread is a historically low 2.1 percent.

A big deal in portfolio management today is the growth that most community banks have experienced as a residual of poor loan demand. The ICBA Securities sample has seen the average portfolio grow from $52 million to $82 million in four years, which works out to a 58 percent increase. Some banks have seen their portfolios quadruple or quintuple.

The conclusion: Bond portfolios are contributing less to the bottom line now than in 2008, in spite of being a much greater part of the average balance sheet.

**Hallmarks of performance**

Other observations from comparisons of the last four years:

- Portfolios with high concentrations of tax-free munis continue to have good risk-reward profiles.
- Average durations, which measure both price volatility and estimated period of time to receive principal and interest, have fallen dramatically from 3.5 years to 2.1 years.
- Fixed-rate mortgage-backed securities and collateralized mortgage obligations still comprise the largest single portfolio segment, with over 43 percent in both 2008 and 2012.
- I’ve saved the best for last: The average unrealized gain has grown from a net loss of 1.63 percent to a net gain of 2.34 percent.

You may want to spend some time comparing your portfolio to other, higher-yielding peers to identify opportunities for margin improvement. The growth of the average portfolio, which looks like it may last for a while, behooves you to consider these benefits. Or as Archie Bunker might say, “Edith, don’t be so knave.”

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