Second Impressions

Investment portfolios are producing respectable margins

By Jim Reber

I hope your community bank is among the thousands of which over the last two years have pulled off a logic-defying stunt: maintaining net interest margins while reducing risk. The long, slow grind to the bottom by interest rates of all maturities has produced a full litany of issues. Not the least is the popular notion that the returns on bonds are barely covering their costs of carry.

Not so fast. “Popular” does not necessarily mean accurate. The sheer length of the depressed cycle of interest rates has created several subliminal by-products. For one, depositors apparently have gotten used to virtually no return on their FDIC-insured money. Deposit growth, including for non-interest-bearing accounts, continues. The result is that cost of funds remains near record lows.

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Internal rate of return

Another consequence of the nearly decade-old rate scenario in which community banks have dwelt is that portfolio managers have had ample time to get their asset-liability positions in good shape for a rising rate environment. In fact, banking regulators made the last definitive statement on the issue in January 2010.

Something else that has kept community bank risk managers focused on exposure to rate movements is the Federal Reserve Board members’ comments and actions. Fed watchers everywhere study comments in speeches and writings, attempting to glean some nuance of shift in bias relative to monetary policy. In review, the 2016 Fed moved much more slowly than had been expected early in the year.

Love thy broker

Now back to the matter of the investment portfolio performance. As of June 30, the average tax-equivalent yield for the 500 banks that use Vining Sparks for bond accounting services was 2.47 percent. Although that is a 25-year low, it’s also only 11 paltry basis points (0.11 percent) lower than two years earlier. The average cost of funds in that same time frame fell 6 basis points from 0.45 percent to 0.39 percent.

Stated another way, the net interest margin from the investment portion of a community bank’s balance sheet is actually creating a similar return as it did several years ago. In fact, that net margin has only declined about 20 basis points since 2007, even though absolute tax-equivalent yields are less than half of what they were before the Great Recession.
Risk averted
Now for the best part of the story. Community banks have been able to maintain pretty much the net margins they had in much higher rate environments, but have been able to reduce the most visible risk to their portfolios. The biggest day-to-day issue that portfolio managers deal with is price volatility. The handiest measure of price risk is what analysts call “effective duration.” Lower effective duration equals less risk.

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Since 2014, this measure has declined substantially, from about 3.5 years to about 2.6 years. (The latter figure is also at a 25-year low.) Importantly, these community bank portfolio managers also have built in some extension protection, because the effective duration even in an “up 200” rate shock scenario is just 3.7 years.

The message?
Investment managers have worked very hard to maximize risk-adjusted returns. This entails producing reasonable net income from the bond portfolio, and simultaneously keeping a lid on risk. It appears that community banks are reaping benefits on both counts.

ICBA Securities Chairman
ICBA Securities recently elected Dennis Doyle as chairman of ICBA Securities. Doyle is president and CEO of Great Midwest Bank in Brookfield, Wis. He also serves on the boards of the ICBA Services Network and the Wisconsin Bankers Association.

Bond Accounting Services Available
ICBA Securities’ exclusive broker Vining Sparks can produce a customized set of reports each month that will simplify the management of your community bank’s investment portfolio, at a reasonable cost.

To view sample documents and pricing, visit www.vining-sparks.com or call your Vining Sparks sales rep.