The Key To Unlocking Diversification

by Steve Brown

We were shuffling through our favorite weekly business magazine over lunch the other day and two articles caught our attention. In one, a retired camera salesman in New York City invested his entire life savings in the bonds of the Venezuelan state petroleum company. The yield was so attractive that he then took out a home equity line of credit to buy even more. After the drop in oil prices, the principal value has tanked 37% since Sep, though the investor is still holding on in the hope for better performance. Then there was the story of a large, well known global mutual fund which bought Ukraine sovereign debt, eventually growing the fund's holdings to half the Ukraine's outstanding foreign-owned bonds. The bonds are now worth 54 cents on the dollar and the fund manager hopes an IMF bailout will help recoup the fund's losses.

It seems that individuals and professionals alike can compile a body of knowledge for a compelling enough argument to make an investment. Both of these investment strategies were successful for awhile. We question the advisability of taking large positions in risky investment vehicles though. There has been long term stability in a number of previously volatile areas of the market, including interest rates, oil prices, certain currencies and commodity prices to name a few. A period of stability does not mean that these investments are no longer risky, but complacency can easily set in when previously volatile investments are stable over a long period of time. This miscalculation no doubt drove the size of the investment position these investors took. In the end, both investment strategies were undiversified and this exponentially increased the risk.

Community banks are by nature undiversified. They typically operate in a specific region, they have expertise with certain kinds of lending - most often CRE - and tradition typically keeps lending structures similar as well. The loan portfolio in most community banks is almost entirely real estate-based. The securities portfolio generally is as well. While MBS, CMOs and government bonds have little credit risk, they are also nearly all based on real estate.

One tactic that community banks have tried to use to diversify is to increase their C&I loan portfolio. There are numerous difficulties though, in that a bank's lending team may not have the expertise to do the underwriting and ongoing maintenance for the loans. There is tough competition from the bigger banks too, as they naturally gravitate more toward this asset class. A report from Harvard finds community banks with assets <$10B saw their C&I loans fall 23% since 2010. As if that were not enough, these banks have seen their market share (based on assets) fall 12% over the same period. Technology advancements, low interest rates, low margins, heavy regulation and high compliance costs were also cited as contributors to the decline.

There is another way to on-board C&I loans and that is to purchase them. PCBB through its National C&I Program can help your bank to meet its loan growth objectives and diversify its portfolio. The program provides an underwriting jumpstart package, performs loan servicing and provides ongoing updates to minimize the workload so your bank can quickly add C&I loans to its portfolio. The C&I Pipeline Report is now online and it is interactive, so give us a call if you would like access in order to take a look around.

As for the investors in Venezuelan oil and Ukrainian bonds, there is a lesson in risk assessment, but also a more important one about not putting all one's eggs in one basket. If your bank is 100% invested in real estate, it's probably a good time to take a look at diversifying the portfolio.

BANK NEWS

Assets & Funding

FDIC data finds that from 2013 to 2014 the quarterly yield on earning assets declined 21bps (3.67% to 3.46%) but the quarterly cost of funding those assets only declined 5bps (0.39% to 0.34%).

Allowance Shift

FDIC data finds the loan loss allowance to loans has declined from 3.14% at the end of 2010 to 1.48% at the end of 2014 (166bp). By year it declined 58bp during 2011, 45bp (2012), 38bp (2013) and 25bp (2014). Assuming the pace continues, one would expect the ratio to dip to around 1.37% this year (based on 11bp average decrease over the past 4Ys).

Scary Customers

LexisNexis reports the percentage of customers who would share their mother's maiden name to get a reward in order to open a new account (56%), make an online doctor's appointment (42%), file a tax return (29%) and receive coupons (18%). We are not entirely sure how community bankers can use this information but found it both intriguing and spooky at the same time.

Compensation Plans

Research by Deloitte finds businesses that are considering or have recently considered redesigning their compensation or equity plans reviewed the following: increase emphasis on performance based pay (32%); modify merit increase and distribution guidelines to drive more pay to higher performers (27%); revise base pay structures (26%); improve performance management tracking and administration (25%); change incentive plan targets (23%); modify incentive plan formula or eligibility (22%) and shift compensation mix toward more incentive pay for specific job levels (18%).

OCC

The regulator is responsible for about 1,700 national banks and federal savings associations holding $10.6T in assets or about 69% of all assets in US commercial banks and thrifts.