Independent Banker

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Portfolio

[tag] Portfolio Management

[hed] Too much of a good thing?

[dek] Balance is key when it comes to capital.

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As the days grow shorter and the transition to fall approaches, management focus often begins to shift from the current calendar year to the year ahead. As part of that process, it is often helpful to explore the challenges and opportunities each presents.

Though much could change over the remaining months of 2024, the year to date can easily be characterized as one of relative stability when compared with the dramatic shifts we’ve experienced over the past several years. Balance sheet composition has largely normalized, funding costs have slowed their ascent, liquidity and credit metrics largely remain on solid footing, and the industry continues to build capital at a healthy clip.

But as other challenges have receded, profitability has stepped to the forefront. Community bank net interest margin (NIM) fell 12 basis points in the first quarter of 2024, while annualized return on assets (ROA) and return on equity (ROE) were below 1% and 10%, respectively, and the proportion of banks that were unprofitable was the highest of at least the past five years.

[subhed] Here’s the rub

Strong capital levels are essential for maintaining a resilient banking system, but carrying excess capital makes it challenging to generate sufficient returns on that capital. Growth strategies may help improve ROE, but an inverted yield curve makes it difficult to generate enough spread to improve NIM or ROA. As such, strategies that both improve profitability and utilize excess capital may provide a dual benefit at a time when help is hard to come by.

Though portfolio yields have steadily moved higher over the past two years, industry averages are still well below current market rates. And so, portfolio repositioning strategies are one path available to virtually everyone that can provide the dual benefit referenced above. Though many banks have historically been reluctant to realize losses on security sales, the strategic rationale for doing so has rarely been stronger:

* While rate cuts are not a done deal, the Federal Reserve has held its policy rate steady for more than a year, which is typically an indication that the next move will be towards lower rates.
* Regulators have expressed support for strategies realizing losses to improve profitability.
* With benchmark Treasury rates already well below their highest level from the past 12 months, the opportunity to take advantage of 5% to 6% purchase yields could soon be a distant memory.
* Funding costs rising more rapidly than anticipated may call into question the ability to quickly lower deposit pricing if short-term rates decline in the future.
* Repositioning a portion of your portfolio today creates potential for harvesting gains if rates decline in the future (as opposed to seeing lower losses on existing positions).

[subhed] Taking a hard look

Two key considerations come into play when evaluating portfolio repositioning strategies that take an up-front loss.

First is the question of economic benefit: Does the strategy create more income than it consumes, and over what time frame does it do so?

This can be evaluated in myriad ways, but the strength of bids in tax-exempt municipal bonds almost universally creates value-enhancing opportunities, because bid prices are driven by individual investors with a higher marginal tax rate than C-corp banks (though this is less the case for institutions organized under subchapter S).

Discussions become more nuanced with other asset classes, but many institutions have gotten comfortable with strategies that earn back the loss in relatively short time frames. While the definition of “relatively short” varies, we often find that management teams are comfortable with strategies featuring earnbacks of three years or less.

[subhed] Navigate the nuances

The second consideration is the question of whether end-of-year incentive compensation is tied to reaching specific profitability targets and, if so, how recognizing losses on security sales affects your bank’s ability to achieve those targets. This is often a delicate conversation, though we would generally advocate for open dialogue in pursuit of the best outcome for the bank. If such an arrangement exists, conversations generally fall into one of three categories:

1. *<i>Spending the excess<i>.* If profitability is tracking ahead of budget, strategies can be structured to move a portion of the current surplus into future periods. (This is ideal.)
2. *<i>The big miss<i>.* Whether due to subdued loan growth, elevated noninterest expense or other factors, many institutions seem poised to miss budget for 2024. If you’re already going to miss, a reasonable case can be made for missing big in pursuit of more favorable outcomes over the coming years.
3. *<i>Looking ahead<i>.* Potentially the most challenging of the three, this refers to situations where the institution is otherwise on track to hit targets, but the portfolio repositioning in question would cause profitability to drop below budgeted amounts.

The third category likely requires discussing whether realized losses may be excluded from the bank’s income for incentive compensation purposes. An exception may be granted due to both the unprecedented nature of the extraordinarily low interest-rate environment in 2020–2021 and the historically rapid increase the following year.

However, granting an exception for losses today invites further conversation about the handling of similar situations in future periods, as well as treatment of recognized gains in a different yield curve environment.

While there is no single “right” answer to these questions, simply having the discussion can provide useful information regarding the best path forward for your institution. And from there, it’s a matter of which challenges lie ahead.

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[quick stats]

**A look at the first quarter of 2024**

12

The number of basis points NIM fell

<1%

The annualized ROA rate

<10%

The ROE rate

[ends]

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