

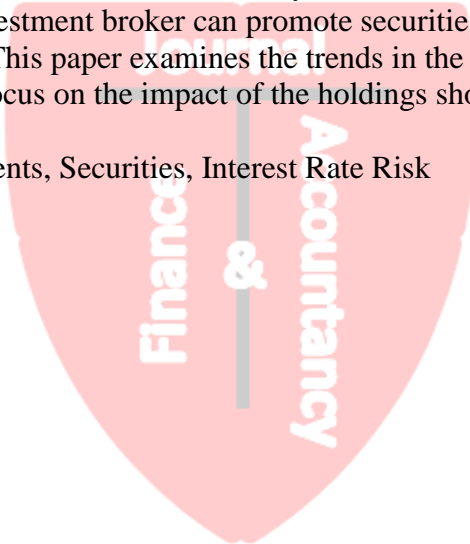
## Banking trends in the investment portfolio

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### ABSTRACT

Following the banking crisis of 2008, banks were faced with a shortage of loan demand and a decline in the interest rates, causing them to search for opportunities to maintain an adequate level of earnings. The logical place to seek an earnings substitute was the investment area where they could invest in municipals, government obligations, and mortgage-backed securities. Over the past several years rates have continued to drop, reducing the attractiveness of securities from an earning standpoint. With loan demand returning to the pre-crisis levels and with the possibility of interest rates rising, those banks with low-yielding securities are faced with disposing them, without losing a substantial amount of money. This is driven by the unknown of what interest rates will do over the next year or two. Additionally, another element in the equation is how the investment broker can promote securities that are not the best fit for a bank's investment portfolio. This paper examines the trends in the bank investment portfolios from 2009 thru 2013 with a focus on the impact of the holdings should interest rates rise.

Keywords: Banking, Investments, Securities, Interest Rate Risk



## **INTRODUCTION**

Much has changed over the years in the area of investment portfolios in banking; however, many of the problems of the past have surfaced as present problems in how banks manage their investment portfolios. For example, quality of the investment, liquidity of the investment, and interest yield are still problematic in banking, especially since the banking crisis of 2008. While interest rate risk has been a measure utilized by bank regulators and bankers since it was introduced subsequent to the banking meltdown of the 1980s, it has become a critical issue since interest rate yields have been among the lowest in history. The anticipated recovery of the economy could drive interest rates up substantially which would reduce the marketability of the low yielding securities without substantial loss. Even in today's economy, many bank investment portfolios reflect a substantial book loss.

## **ROLE OF THE INVESTMENT BROKER**

One of the key elements of obtaining a quality investment for the bank that will meet its purposes is how the bank obtains its securities for its portfolio. Most banks, especially community banks, seek out an investment broker to advise the bank on good securities to purchase for the bank's portfolio. Since the broker gets its earnings out of the sale price to the bank, it is possible that a broker will suggest a security that will make the broker more money rather than what is in the best interest of the bank. It was noted by John Brunett (2013) that it is not unusual that investments in community banks often contribute little, if anything, to the bank's bottom line because of the broker's need to sell securities and make money. Some banks have sought to combat the problem of the broker selling the bank a security that does not fit the bank's goals by utilizing a second broker who is paid a fee to review investments and is not involved in the sale of securities to the bank.

## **PORTFOLIO LIQUIDITY**

Important to a bank's investment portfolio is its ability to be sold for liquidity purposes without sustaining a loss. However, Walker (2008) found that banks facing increased pressure on their profits tended to increase the duration of their investment portfolios, which tended to reduce the portfolio's liquidity. Wagner (2007) notes that the need for increased liquidity can cause a lack of stability because it provides for an opportunity for the bank to take more risk. As far back as the mid-1950s liquidity was much the same issue as it is now, except for the fact that approximately two-thirds of the bank assets were in government bonds (Scott;1956), as opposed to today's bank assets, generally in the area of one-third or less (SNL Financial, 2014). However, with risk being the mantra of the regulatory authorities, today's investments tend to spread risk by being in government bonds, municipal bonds, and mortgaged-back securities. So the issue today as it was sixty to seventy years ago is the match of interest rates and maturities that, other than quality of a security, result in the liquidity potential of the investment.

## **NATIONAL TRENDS IN INVESTMENTS TO ASSETS**

Referring to Attachment I, the overall trends comparing U. S. banks and thrifts together, in 2009 27.87 percent of their assets were made up of investments. Interestingly, 2010 saw their

investment assets rise to 28.30 percent which would tend to indicate that loan demand had not started to increase. This indication of a trend could not be confirmed when investment assets decreased to 28.03 percent in 2011. However, when investment assets increased to the highest level since the financial crisis to 28.43 percent of assets in 2012, the question arose about what impacted loan demand reduction to a level causing almost a half of one percent in one year. Apparently, it took four years to see investment assets to drop approximately a full percentage point in one year to 27.44 percent in 2013. Does this signal an economic recovery in progress or some other anomaly? A slightly different picture appears when you examine banks, thrifts, and TARP participants.

Looking at banks as a class, they showed the same trends as the collective group with 2009 at 28.06 percent increasing forty basis points in 2010 to 28.46 percent. A drop of approximately twenty basis points was the result in 2011 to 28.27 percent. Continuing the group trend of an increase in some fifty basis points to 28.72 percent in 2012. The apparent improvement of the economy in 2013 apparently because of loan demand, the investment assets decreased almost a hundred basis point to 27.74 percent.

Thrifts as a class started out in 2009 over five hundred basis points below banks at 22.82 percent. The trend continued in 2010 below banks by almost five hundred basis points below banks at 23.57 percent. Unlike the banks, thrifts reduced investments substantially 2011 through 2013 by five hundred basis points—2011 investments were 20.75 percent, 2012 investments were 19.10 percent, and 2013 investments were 18.23 percent. The thrifts investments were nine hundred and fifty basis points (9.5%) below the investments of banks.

TARP participants are banks that required government assistance to increase their capital during the financial crisis. Most of these participants are very large institutions. They had the largest swing in their investment portfolios ranging from 31.11 percent of their assets in investments in 2009, dropping almost six hundred basis points in 2010 to 25.78 percent. Against the trends of the banks in general and thrifts, they increased their investment assets by some nine hundred basis points in 2011 to 34.66 percent, and in 2012 continued the increase by moving almost eleven hundred basis points to 45.47 percent. At the end of 2013, the TARP participants were near the level of the thrifts by dropping from the previous 45.47 percent to 18.61 percent.

## **INVESTMENT TRENDS RELATING TO ASSET SIZE**

Conducting a study concerning trends in investments in banks, bank asset size might better reveal relevant information regarding trends emerging within asset categories. This paper examined banks from \$250 million in assets to those over \$10 billion in assets. An interesting pattern was revealed in the banks from \$500 million in assets to those up to \$5 billion in assets. These banks increased their holdings of securities from a low of one percent to a high of five percent. Banks in the \$250 to \$500 million in assets and the banks \$5 billion and over in assets reduced their holdings from a low of one-half of one percent to a decrease of three percent.

With regard to the thrifts, the pattern of the trends was similar to the banks except the amplitude of change differed. Thrifts \$250 million in assets to \$1 billion in assets increased their holdings of securities from a low of one percent to a high of four percent. Those thrifts from \$1 billion in assets to over \$5 billion in assets decreased their holdings from below one percent to a decrease of eight percent.

## **INVESTMENT TRENDS RELATING TO GEOGRAPHIC LOCATION**

The division of the geographic areas were Mid-Atlantic, Midwest, New England, Southeast, Southwest, and Western. Among the banks in these regions, those that reduced their investment holdings were the Mid-Atlantic five percent and New England six percent. The other four regions increased their securities holdings with Midwest three percent, Southeast one-half a percent, Southwest four percent, and Western three percent.

The thrift institutions by regions all displayed a reduction in their investment portfolio holdings. Beginning with the Southwest at eight percent, Mid-Atlantic at eight percent, Midwest at three percent, Southeast at three percent, Western at one-half of one percent and New England at one-half of one percent.

## **CONCLUSIONS**

As the economy continues to reach full recovery, the threat of rising interest rates has heightened concerns among banks, thrifts, and TARP participants in general due to the impact the higher rates would have on not only liquidity in terms of being able to sell the securities, but also in terms of the lost revenue should rates rise. TARP participants have shown the most concern by the volume of sell-offs this past year. The thrifts have not been as active in moving out of the investment portfolios as have the TARP participants. Banks have been selling investment securities, but not at the level as TARP participants and thrifts. Indications are that the TARP participants were moving out of securities to repay TARP debt and not necessarily totally out of concern for increasing rates. As far as banks and thrifts are concerned, it is obvious that there is a concern for liquidity and profitability.

Judging for the trends relating to asset size, the largest banks appear to be acquiring additional investment securities at the prevailing rates without concern for what rising interest rates might do to impact them while the smaller banks tend to show the most concern for what rising rates might do to their liquidity and profitability.

In examining the trends by geographic areas the results are very mixed. It would appear that those areas most impacted by the economic downturn have been the most active in disposing of investment securities, while those banks in areas with less impact by economic downturn have been less inclined to dispose of their securities out of a concern for liquidity and profitability should rates rise. Looking at the thrifts by geographic areas they have responded much like the banks, with the economic downturn being a factor just as was evident in the banks.

It would be reasonable to conclude that as the economy continues to improve and the likelihood of a general rise in interest rate becomes reality, all financial institutions are going to have to focus on their positions in their investment portfolios. Under risk profiles utilized by regulatory authorities, the concern for a rise in interest rates would cause an institution's investment risk profile to be increasing which would give rise to the need to give special attention to reducing these securities in the portfolio that have a low interest rate which might require being sold at a discount with rising rates, producing a loss.

## **RECOMMENDATIONS FOR FUTURE RESEARCH**

It appears that the largest amount of investment securities in terms of dollars is in the banking industry. Therefore, a questionnaire sent to seven hundred banks questioning their

comfort level with their investment portfolio, liquidity concerns, impact of the portfolio holdings on income, and their plans concerning increasing or decreasing their portfolio. By sending that number of questionnaires in would be slightly over ten percent of all banks, and assuming a fifty percent response rate you would reach at least five percent of all banks. As part of the survey distribution, it would be important to send out questionnaires based upon the representation of banks in each size range so as to have an accurate distribution by bank size. Such a survey would be valuable to the banking industry.

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## ATTACHMENT 1

### Investment Securities to Assets

SNL Banking Index	2009 2013	2010	2011	2012	
SNL U.S. Bank and Thrift	27.87	28.30	28.03	28.43	26.71
SNL U.S. Bank	28.06	28.46	28.27	28.72	26.97
SNL U.S. Thrift	22.82	23.57	20.75	19.10	18.27
SNL TARP Participants	31.11	25.78	34.66	45.47	18.61

### SNL Asset Size Index

SNL U.S. Bank \$250M-\$500M	19.24	19.55	21.40	19.01	15.52
SNL U.S. Thrift < \$250M	20.36	20.05	30.70	14.01	8.45
SNL U.S. Thrift \$250M-\$500M	23.19	22.63	22.17	21.78	23.88
SNL U.S. Bank < \$500M	18.84	19.75	20.60	18.65	15.52
SNL U.S. Thrift < \$500M	22.78	22.23	23.14	21.15	23.29
SNL U.S. Bank \$500M-\$1B	19.41	20.63	21.03	21.88	21.24

SNL U.S. Thrift \$500M-\$1B	15.92	15.80	16.98	19.10	20.48
SNL U.S. Bank \$1B-\$5B	17.83	19.67	22.64	22.19	21.68
SNL U.S. Thrift \$1B-\$5B	21.96	24.41	23.49	23.36	21.63
SNL U.S. Bank \$5B-\$10B	23.34	24.48	24.70	21.49	20.87
SNL U.S. Thrift \$5B-\$10B	23.61	24.04	27.81	25.50	21.28
SNL U.S. Bank > \$10B	28.58	28.88	28.56	29.11	27.22
SNL U.S. Thrift > \$10B	24.25	24.26	18.66	16.15	16.21

**SNL Geographic Index**

SNL Mid-Atlantic U.S. Bank	34.59	34.25	32.28	32.74	29.75
SNL Mid-Atlantic U.S. Thrift	28.34	28.22	22.42	21.14	20.31
SNL Midwest U.S. Bank	18.57	20.06	22.09	22.01	21.97
SNL Midwest U.S. Thrift	15.39	15.78	18.43	17.95	18.77
SNL New England U.S. Bank	51.09	51.26	46.25	48.61	44.69
SNL New England U.S. Thrift	15.51	18.61	13.23	15.32	15.19
SNL Southeast U.S. Bank	24.34	25.00	24.15	26.19	25.05
SNL Southeast U.S. Thrift	NA	14.01	24.99	13.13	11.15
SNL Southwest U.S. Bank	20.48	22.90	23.60	23.82	20.76
SNL Southwest U.S. Thrift	23.23	29.95	29.36	22.95	25.34
SNL Western U.S. Bank	18.97	19.92	24.76	22.60	22.52
SNL Western U.S. Thrift	16.89	20.83	22.50	20.53	16.34

SOURCE: SNL Financial LC, Industry Trends & Statistics