Weekly Relative Value

Back to Basics: Diversify with Bank Notes

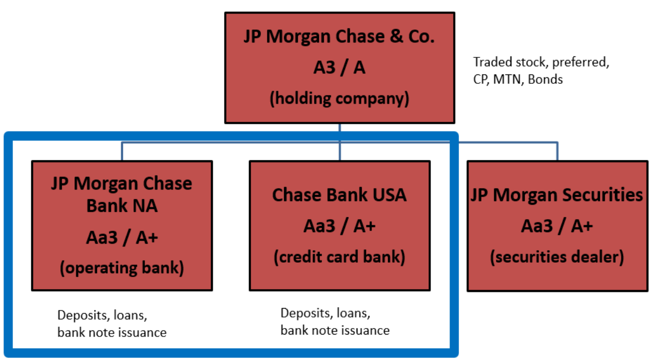
Historically, credit unions have invested primarily in certificates of deposit and Agency-backed securities. In doing so, credit unions may have overlooked attractive investment alternatives to prudently diversify their investment portfolio. But that has been changing quite rapidly.

For the past two years, we have highlighted bank notes as one of the best relative values in the short duration space due to the comparative yield advantage, high liquidity and improving credit fundamentals. This message has clearly resonated. Over the past 18 months, 49 credit unions have invested over $300 million. In doing so, many credit unions have enhanced their income and better diversified their investment portfolios with bank notes.

That said, we believe that bank notes remain significantly underutilized within the credit union universe. In this week's edition of the Weekly Realtive Value, we once again review the key attributes and characteristics of bank notes and discuss why they remain a viable investment for credit unions looking to diversify and enhance income.

WHAT ARE BANK NOTES?

Bank notes are senior, unsecured obligations of a bank – not a bank holding company. A bank holding company is a corporation, and corporate bonds and notes are not permissible for federal credit unions. However, bank notes are not corporate bonds because they are issued by the bank itself.



However, unlike certificates of deposit, bank notes are not insured by the Federal Deposit Insurance Corporation or any other agency. Nonetheless, they rank pari passu with the uninsured depositors of the bank. Unlike the other securities that credit unions have purchased, bank notes do involve credit risk.

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BANK NOTE ELIGIBILITY

The National Credit Union Administration (NCUA) investment regulation defines a bank note as “a direct, unconditional and unsecured general obligation of a bank that ranks equally with all other senior, unsecured indebtedness of the bank, except deposit liabilities and other obligations that are subject to any priorities or preferences.”

The NCUA requires bank notes to meet several criteria, including the stipulation that it must qualify as a depositor bank, for it to be a permissible investment under the Federal Reserve’s Regulation D.

To qualify as a bank, the institution must meet both of the following requirements:

1. It must be a national bank or any institution supervised by a state banking commission.
2. Its business must be substantially confined to banking.

Therefore, securities issued by bank holding companies, finance companies, investment banks and loan companies are not exempt from registration – even though many investors think of these institutions as “banks” – because their businesses are not substantially confined to banking.

Consistent with the NCUA Policy Section 703.14 (f), to be an eligible investment for federal credit unions, floating rate and fixed rate bank notes must meet the following criteria:

- Senior notes only (no subordinates)
- Rated, but NO ratings restrictions
- Remaining maturity of less than five years

BENEFITS OF BANK NOTES

As shown in the table below, bank notes offer a significant yield advantage over comparable fixed rate Treasuries and Agency debt. Spreads range from 35-75 basis points and pick up over Agency bullets. The reason for higher yields is the credit risk of the underlying issuer. Below are representative yields and spreads for bank notes maturing in one to five years.

Bank Notes vs. Agency Securities			
	Bank Note	**Agency**	**Yield Spread**
1-Year	2.65%	2.06%	+59 bps
2-Year	2.75%	2.33%	+42 bps
3-Year	2.96%	2.51%	+45 bps
4-Year	3.12%	2.63%	+49 bps
5-Year	3.17%	2.73%	+44 bps

FIXED RATE BANK NOTES

For illustartive purposes, the next table shows the comparative data for a three-year bank note versus a three-year Agency bullet with an assumed $5 million invested in both securities.

	Average Duration	Average Yield %	Annual Income	Average Quality
3-Year Bank Note	2.89	2.87	$145K	A1
3-Year Agency Bullet	2.85	2.56	$129K	Aa

Total Rate of Return Analysis l Rate of Return (36 Months) Aged						
	-50bps	**-25bps**	**0**	**+50**	**+100**	**+200**
3-Year Bank Note	2.85	2.85	2.86	2.87	2.87	2.86
3-Year Agency Bullet	2.54	2.54	2.55	2.56	2.57	2.59

When comparing the prospective relative returns of various fixed income sectors, bank notes offer a superior risk/return profile relative to Agency debt and mortgage-backed securities (MBS). In every rate scenario, bank notes outperform a comparable duration Agency bullet. The bank note income differential is $16 thousand per year, or approximately $48 thousand over the term.

In the floating rate arena, bank notes offer attractive spreads to three-month LIBOR. Also, unlike the typical floating rate collateralized mortgage obligation (CMO), floating rate bank notes do NOT have a “cap” on how high rates can go. For credit unions that need protection against higher federal funds rates, these securities provide optimum protection.

FLOATING RATE BANK NOTES

Floating Rate Bank Notes			
Term	**Quality**	**Spread to 3M Libor**	**Cap Structure**
3-Year	Baa2	+38 bps	Uncapped
5-Year	Baa1	+115 bps	Uncapped

In the table below, I compare the total return of the floating rate note versus a three-year Agency bullet. In a rising rate environment, the uncapped bank note outperforms the three-year fixed Agency note by a significant margin.

Total Rate of Return (12 Months) Aged						
	-50bps	-25bps	0	+50	+100	+200
3-Year FRN Bank Note	**2.13**	**2.19**	**2.24**	**2.35**	**2.45**	**2.66**
3-Year Agency Bullet	3.79	3.31	2.82	1.87	0.92	-0.93

ANALYZING AND MANAGING CREDIT RISK

Of course, greater rewards carry corresponding risk. So, while bank notes offer income advantages, portfolio managers rightly focus on credit risk and the research and analysis needed to validate bank note purchase decisions.

Credit unions run financial institutions and regularly look at key credit metrics (Tier 1 capital, Tangible equity, Return on assets, Non-performing assets) in their ALCO/management meetings. The same credit/performance metrics for their institutions apply to banks and other financial institutions.

Thus, analyzing credit risk, particularly for banks, should not be daunting. The terminology is the same and is fairly easy to comprehend. Frankly, one could argue the credit risks that credit unions accept with their consumer loan portfolios and mortgage cash flows are more complex.

Furthermore, by adopting and implementing internal policy guidelines (see the Sample Bank Note Investment Policy on page six), limiting maximum concentration risk (i.e. issuer (obligor) and sector) credit risk can be better managed and controlled.

GIMME CREDIT

Part of the intimidation of analyzing credit risk may be in data collection, and the time and resources necessary to analyze and monitor credit risk. To fill this void, Balance Sheet Solutions has partnered with Gimme Credit LLC, the premier independent provider of corporate bond analysis and investment recommendations.

Unlike Wall Street underwriters or rating agencies, they have no bias. Gimme Credit strives to tell the “hard truth” about credit. Experienced senior credit analysts provide concise, solid analyses and recommendations aimed at maximizing relative value, preserving capital and anticipating changes in credit quality.

Through this partnership with Gimme Credit, Balance Sheet Solutions is able to provide the requisite credit metrics and analysis to assist credit unions in making an informed pre-purchase investment decision regarding the credit risk of each bank note issuer.

To ensure that credit risk is being constantly monitored, Gimme Credit provides the necessary ongoing surveillance and oversight of all credits owned. If changes occur or are expected to occur, Gimme Credit will send alerts. Most importantly, in addition to having access to the fundamental credit reports and data sheets, all credit unions also have direct access to a team of experienced credit analysts for specific question issuers or sectors. In other words, each credit union now has a team of credit professionals fully at their disposal.

Gimme Credit Products

Investment Reports	Credit Scores
• Daily Research Reports • Semi-Annual Top 10/Bottom 10 Lists of Improving/Deteriorating Credits • Industry Reports	• Upgrades & Downgrades Alerts • Credit Scores and Underlying Views By Company, Market, Sector and Rating Groups
Intraday Comments	**Analyst Direct**
• Underlying View of Issuer's Credit Quality • Credit Scores Quantifying the Direction of Credit Quality for Companies, Sectrs and Overall Market Indices	• Hotline Senior Analyst Access • In-Person Visits • Conference Calls • Email and Phone Q&A

WHY GIMME CREDIT?

- Provides credit unions with independent and unbiased credit analysis
- Provides necessary due diligence to support the investment decision
- Ensures ongoing credit surveillance and monitoring
- Pro-active, real time response to credit changes (upgrades/downgrades)
- Enhances portfolio risk management process
- Diversifies the portfolio to increase yield and income
- Opens up investment universe to credit unions

This service is free to investing credit unions.

To learn more about the services of Gimme Credit, please talk to your Balance Sheet Solutions Fixed Income Representative.

SUMMARY

Historically, credit unions have been slow to move into credit products for their investment portfolio. As such, many have restricted their investments to certificates of deposit, Agency debt and mortgage-backed securities. That said, as more credit unions undersatnd the risk/reward benefits of bank notes, we expect interest in bank notes will continue to rise.

Because of shrinking Agency debt, market yields on short agencies have declined to levels that are much less attractive than they have been historically. One way for credit unions to enhance income is to accept manageable and prudent credit risk through the world of bank notes.

As discussed above, bank notes offer attractive spreads to comparable duration Treasuries and Agency debt. Bank notes also offer attractive yields and prospective total returns that exceed short MBSs and CMOs. In terms of diversification, bank notes allow credit union the ability to prudently shift and diversify away from call, prepayment and extension risk while maintaining and/or enhancing yield.

Finally, because bank notes are a credit product, the key to success and prudent management in the bank note market is solid and independent credit analysis. To enhance the credit decision-making process, Balance Sheet Solutions provides independent third-party credit analysis through our partnerhsip with Gimme Credit LLC.

For more information on bank notes, please contact your Balance Sheet Solutions Fixed Income Representative.

SAMPLE BANK NOTE INVESTMENT POLICY

The following provides a sample investment policy for federal credit unions that may have interest in investing in this asset class.

The purpose of the Investment Policy Statement is to assist the credit union in effectively supervising, monitoring and evaluating the investment of bank notes in the investment portfolio. It is intended to be sufficiently specific to be meaningful, yet flexible enough to be practical.

Bank Note Eligibility: Consistent with the NCUA Policy Section 703.14 (f), floating rate and fixed rate bank notes with remaining maturities of five years or less are included on the list of “Permissible Investments” for federal credit unions. Only senior debt securities can be purchased. Sub-ordinated debt is prohibited from investment

RATIONALE FOR INVESTING IN BANK NOTES

Why add bank notes? First, most credit unions have NOT utilized this investment option.

Bank notes allow credit unions to diversify and reduce exposure to interest rates and call or prepayment risk associated with MBSs and CMOs.

Bank notes offer higher yields than comparable maturity/duration U.S. Treasuries/Agency debt instruments and provide greater liquidity than certificates of deposit.

The Bottom Line: By prudently investing in bank notes, credit unions can better diversify their investment portfolio and enhance portfolio return.

- Very Under-Utilized Investment Option
- Diversify Risk Exposure
- Reduce Interest Rate Risk
- Reduce Optionality Risk (prepayment-extension)
- Agency Sector is Shrinking
- Enhance Income and Return
- Greater Liquidity than CDs

MANAGING AND CONTROLLING CREDIT RISK

Unlike bank certificates of deposit or government Treasury and Agency securities, bank notes are not insured and subject to credit risk. Credit risk is the risk that a security or a portfolio will lose some or all of its value due to a real or perceived change in the ability of the issuer to repay its debt. The credit union shall mitigate credit risk by adopting the following:

Diversification across and within bank notes is the primary means by which the Investment Committee expects the investment portfolio to avoid undue risk of large losses over longer periods of time. To protect the portfolio against unfavorable outcomes within the bank note sector, the Investment Committee will take reasonable precautions to avoid excess concentrations. Specifically the following guidelines will be in place:

a. No single investment security shall represent more than 5% of the total portfolio assets.

b. The credit union shall establish the maximum concentration (as a percentage of the total investment policy market) for the bank note sector allocation.

c. With respect to bank notes the minimum average credit quality of these investments shall be investment grade (S&P's BBB or Moody's BAA or higher) .

d. The credit unon is responsible for doing their own pre-purchase credit due diligence analysis and monitoring credit risk on an ongoing basis.

e. In lieu of having internal credit staff, credit unions may rely on third-party, independent credit research firms, such as Gimme Credit LLC to assist in their credit analysis.

IMPORTANT NOTE: If the credit rating of a security is downgraded below the minimum rating level, the Investment Committee shall evaluate the downgrade on a case-by-case basis in order to determine if the security should be held or sold. The Investment Committee will apply the general objectives of safety, liquidity and yield in making its final determination.

Reporting/Disclosure: The investment officer shall prepare an investment report at least monthly or quarterly, including a management summary, that provides an analysis of the status of the current bank note portfolio and the individual transactions executed over the last quarter [or month]. Independent or third-party credit reports (i.e. Gimme Credit reports) must be maintained on file.

This investment policy statement should be reviewed and updated at least annually. Any change to this policy should be communicated in writing on a timely basis to all interested parties.

Note: Registration is now open for the **2018 Credit Union Executive Leadership Symposium**, September 5-7 at the Westin River North in Chicago, IL! You will hear from a wide range of speakers, including NFL Legend Mike Ditka, "The Attitude Guy" Sam Glenn, as well as credit union industry experts. Plus, back by popular demand, CUNA Mutual's Steven Rick and Balance Sheet Solutions' Tom Slefinger will battle it out in another round of "Dueling Market Views."

Please visit alloyacorp.org/symposium2018 to view the agenda and to register.

More Information

In terms of relative value, please see the Relative Value Analysis.

For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at tom.slefinger@balancesheetsolutions.org or (800) 782-2431, ext. 2753.

Tom Slefinger, Senior Vice President, Director of Institutional Fixed Income Sales, and Registered Representative of ISI, has more than 30 years of fixed income portfolio management experience. He has developed and successfully managed various high profile domestic and global fixed income mutual funds. Tom has extensive expertise in trading and managing virtually all types of domestic and foreign fixed income securities, foreign exchange and derivatives in institutional environments.

At Balance Sheet Solutions, Tom is responsible for developing and managing operations associated with institutional fixed income sales. In addition to providing strategic direction, Tom is heavily involved in analyzing portfolios, developing investment portfolio strategies and identifying appropriate sectors and securities with the goal of optimizing investment portfolio performance at the credit union level.