Back to Basics

Investing in Bank Notes

By Tom Slefinger, Senior Vice President, Director of Institutional Fixed Income Sales at Balance Sheet Solutions, LLC. Tom can be reached at tom.slefinger@balancesheetsolutions.org.

Through the years, many credit unions have restricted their investments to CDs, agency debt and mortgage-backed securities. However, as the world turns, so do the markets. Agency debt issuance has declined significantly since 2008, and there are no signs debt issuance will increase anytime soon. With the Fed's financial repression and shrinking agency debt market, yields on short agencies have declined to levels that are much less attractive than they have been historically. So, how can credit unions enhance income and reduce ongoing margin compression, while taking on manageable and prudent risk?

Situation

Over time, government-sponsored enterprises (GSE) have slowly reduced their holdings, which accelerated during the last 12 months ending June 30. For example, both Fannie Mae and Freddie Mac reduced their portfolios by more than $100 billion. The latest reports show Fannie with a $452.8 billion portfolio of mortgages and mortgage-backed securities and Freddie with a $419.9 billion portfolio. As the mortgage supply shrinks, so does the supply of government agency debt issuance.

Bank notes offer attractive spreads to comparable duration Treasuries and agency debt.

For decades, high quality GSE debt from Fannie and Freddie served an important function in the cash markets and there is no ready substitute. Absent explicit restrictions, GSE debt often acts as the proxy for U.S. government securities. Fannie and Freddie also tend to be considered a "core" portfolio holding exempt from issuer concentration limits. And when a portfolio is supply constrained or when general credit market conditions worsen, GSE debt often is relied upon to keep portfolios fully invested. However, today yields on agency bullets and callables have declined dramatically, and spreads to comparable duration Treasury debt have contracted.

In other words, at current valuations, the benefit of investing in agency debt has been greatly diminished and no longer offers a compelling risk/return trade off as the sector used to. In some cases, credit unions would be better off investing in Treasury securities.

Solution

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 mortgage-backed securities and collateralized mortgage obligations.

How can bank notes better diversify your investment portfolio, while enhancing income and total return?

First, let's define 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 CDs, bank notes are not insured by the FDIC or any other agency. They nonetheless 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.

For a bank note to be a permissible investment, the NCUA requires that it meet several criteria, including the stipulation that **it must qualify as a depositor bank** 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; and 2) its business must be substantially confined to banking.

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.

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

Bank Note Eligibility: According to NCUA Regulation 703.14(f): *A Federal credit union may invest in the following instruments issued by an institution described in Section 107(8) of the Act:*

1. ***Bank notes with original weighted average lives of less than five years.*** *(It should be noted that bank notes with original weighted average maturities of five years or greater are not permissible investments for federal credit unions, even if the remaining maturity is less than five years.*)
2. ***Banks or institutions the accounts of which are insured by the FDIC.***

In terms of diversification, bank notes allow a credit union the ability to prudently shift and diversify away from call, prepayment and extension risk, while maintaining enhancing yield. Bank notes offer a significant yield advantage over comparable fixed rate Treasuries and agency debt. Spreads range from 35-75 basis points spread pick up over agency bullets *(see table below)*. **The reason for the higher yields is due to the credit risk of the underlying issuer.**

Fixed Rate Bank Notes				
Term	**Quality**	**Yield**	**Spread to Treasuries**	**Spread to Agencies**
2 Year	A	1.34	+66bps	+43bps
3 Year	A	1.57	+53bps	+55bps
4 Year	A	2.04	+76bps	+38bps
5 Year	A	2.13	+68bps	+56bps

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. The table below shows the relative returns over a 24 month time horizon. Bank notes are highlighted in red.

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

				Total Rate of Return (24 Month Time Horizon) — Parallel Yield Curve Shift					
	Yield	G-Spread	Eff. Dur.	-50	0	50	100	200	300
Bullets									
1 Year Bullet	0.30	9	0.98	0.15	0.18	0.38	0.58	0.97	1.36
2 Year Bullet	0.73	8	2.00	0.74	0.73	0.73	0.72	0.71	0.71
3 Year Bullet	1.10	8	2.97	1.76	1.51	1.26	1.01	0.51	0.02
4 Year Bullet	1.39	13	3.83	2.44	1.96	1.49	1.02	0.09	-0.82
5 Year Bullet	1.60	12	4.69	2.96	2.26	1.56	0.88	-0.47	-1.80
Bank Notes									
2 Year	1.34	66	2.01	1.35	1.34	1.33	1.32	1.31	1.29
3 Year	1.57	53	2.95	2.22	1.96	1.71	1.46	0.97	0.48
4 Year	2.04	76	3.93	3.11	2.61	2.11	1.61	0.61	-0.38
5 Year	2.13	68	4.48	3.40	2.74	2.09	1.45	0.19	-1.05
10Y MBS									
2.5's	1.26	29	2.49	1.30	1.11	0.91	0.69	0.14	-0.49
3.0's	1.37	24	2.90	1.54	1.30	1.01	0.67	-0.16	-1.12
15Y MBS									
2.5's	1.61	49	2.99	1.64	1.39	1.05	0.62	-0.44	-1.65
3.0's	1.33	27	2.36	1.25	1.10	0.89	0.59	-0.21	-1.22
3.5's	1.67	49	2.80	1.59	1.40	1.13	0.75	-0.30	-1.62
20 Y MBS									
3.0's	2.10	71	3.72	2.27	2.02	1.45	0.64	-1.36	-3.57
3.5's	2.07	70	3.48	2.19	1.96	1.50	0.83	-0.96	-3.08
CMO									
3Y	1.59	52	2.97	1.73	1.37	1.06	0.79	0.21	-0.49
4Y	1.79	51	3.44	2.00	1.58	1.09	0.53	-0.72	-2.33
4.5Y	1.92	72	3.54	2.10	1.85	1.24	0.48	-0.94	-2.84
5Y	2.15	75	3.56	2.28	1.91	1.29	0.54	-0.91	-2.60

Now that bank notes have been defined, how can you analyze credit risk, particularly for banks?

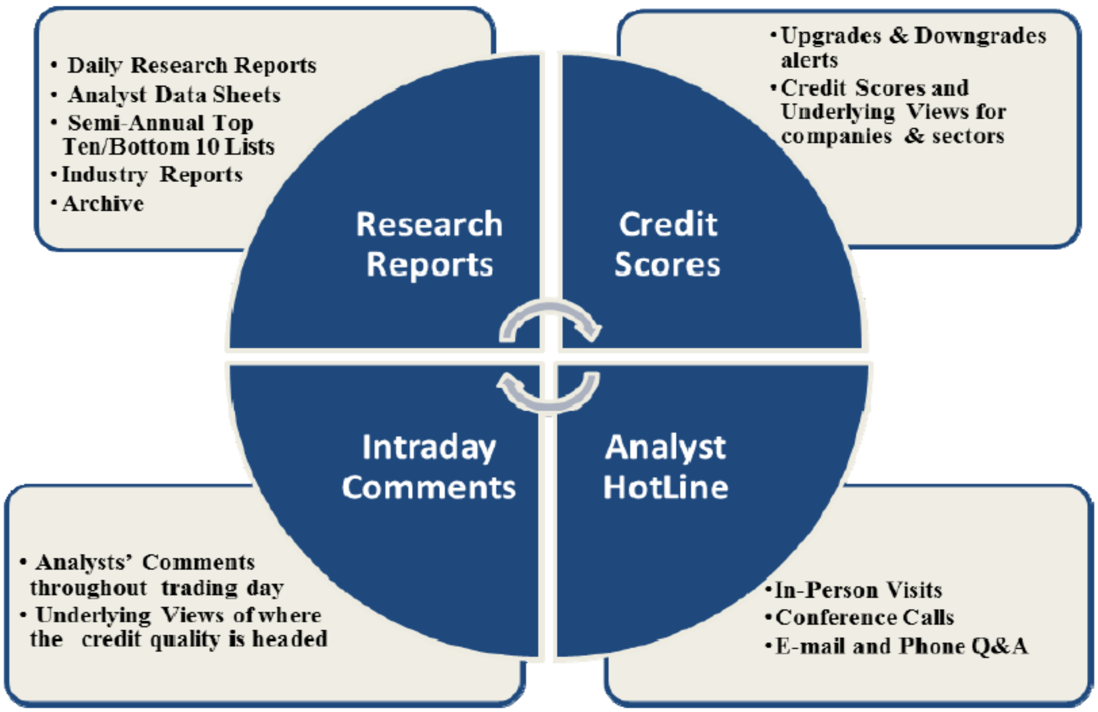
Answer: Gimme Credit

Part of the intimidation of analyzing credit risk may be in data collection and time and resources necessary to analyze and monitor credit risk. To fill this void, Balance Sheet Solutions has partnered with **Gimme Credit**, LLC – *a leading independent provider of corporate bond research.* As one of the most experienced independent credit teams in the industry, Gimme Credit provides concise, solid analyses and recommendations aimed at maximizing relative value, preserving capital and anticipating changes in credit quality.

Through Gimme Credit's partnership, 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 then send out alerts.

Gimme Credit
Summary of Services



For more information, please contact your Balance Sheet Solutions' Fixed Income Representative.

Final Thoughts

There are no signs debt issuance will increase anytime soon. Because of the Fed's financial repression and shrinking agency debt market, yields on short agencies have declined to levels that are much less attractive than they have been historically. Unfortunately, this environment could linger for some time to come. One way for credit unions to enhance income and reduce ongoing margin compression is to accept manageable and prudent credit risk through the world of bank notes.

Because a bank note is 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 (via Gimme Credit).

More Information

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 ultimate goal of optimizing investment portfolio performance at the credit union level.