HOCKEY AND BANKING CAN BE ROUGH

by Steve Brown

In ice hockey, it is estimated that 40% of pro players get at least one concussion each season. While bankers may not be lying on the ice wondering what hit them, many have been telling us it feels that way given the ongoing net interest margin compression. As margins get squeezed, loan demand softens and rates seem as though they will not move for quite a few years, investment leverage programs (whereby a bank borrows thru FHLB advances and purchases securities) are expected to ramp up again. As mentioned in this column before, we are not big fans of leverage (how many broker-dealers would say that), since you are adding risk for only an incremental return. On an accounting basis, most leverage programs look great. On a risk-adjusted return on capital basis however, they often fall short. That said, most management teams are evaluated on accounting returns, so if your bank is going to embark on a leverage trade, here are some high sticks to try and avoid. The argument to add leverage right now is because there is just no other easy way to get return. Rates are relatively low and low rates tend to limit optionality. As rates rise, cash flows become more and more predictable. This brings us to another point, which is the importance of analyzing cash flow. Since all bond performance is a function of cash flow, hedging anything else (like book yield, duration or average life) is asking for trouble. The 2nd biggest problem to avoid with these programs results from not shocking the cash flows to see the variability of both the borrowing and the investment. To really understand the problem, banks should dismiss static rate shocks and opt for a dynamic approach. In the real world, when rates go up, prepayments or calls occur less often, liquidity changes and spreads tighten. A static shock misses a large part of the risk. To really understand leverage and the impact on the bank, it must also be shocked over a period of time. This allows bankers to understand what will happen down to the monthly cashflow level. Before bankers embark on a leverage program, they should shock rates each month over the life of the investment and then change assumptions according to interest rate, prepayment and liquidity projections. In this manner, surprises are eliminated and performance is enhanced. Finally, a leverage tactic is also not just a one-time event. Programs should be reviewed often and adjusted any time the cash flow differences move more than 20% (like last Tuesday). A bank involved in a leverage program should always be asking if they need to increase borrowings or purchase more securities to better hedge cash flows. A properly structured program should be able to conservatively add $180k per year for each $10mm of leverage. If properly designed, this amount should be relatively constant across rate scenarios. If your bank is looking for extra earnings and plans to undertake a leverage program, do the proper analysis upfront and be prepared to manage the program on an ongoing basis. Doing simple things outlined above will help bankers avoid a concussion, or being sent to the penalty box.

M&A

Boston Private Financial Holdings ($4B, MA) will acquire Charter Bank ($322mm, WA) for $70.8mm, or approx. 3x book. Boston Private is the holding company for Borel Private Bank & Trust (CA), First Private (CA), Gibraltar Private (FL) and Boston Private (MA).

BANK NEWS

M&A

In a bid to get more customers, a subsidiary of Harleysville National Bank ($3.2B, PA) bought regional investment advisory firm McPherson Enterprises (MD) for an undisclosed sum. McPherson specializes in estate and succession planning and life insurance for high-net-worth owners of construction and aggregate businesses.

Internet Banking

Heartland Bank ($750mm, MO) becomes the latest independent bank to apply for a charter to open an Internet only bank in order to go after more deposits. Heartland expects approval and operations to open my May and forecasts $50mm+ in deposits by year end

SubPrime

The FFIEC proposed expanding the non-traditional mortgage guidance to include 2/28 and 3/27 ARMS marketed to borrowers with lower FICO scores.

Starting Up

About 190 banks opened in 2006, 6% more than in 2005 and a 53% jump from 2004. Investors pumped $1.8B in capital into the 2006 class, nearly 3.5x the level of 4Y prior

Biz Customers

A survey of small business customers finds 64% say health care costs are effecting their growth, 52% are under 35Y of age and 46% say the economy is getting worse.

Micro Customers

Data from the SBA shows small businesses borrow an average of $600B each year in loans less than $1mm in size.

Competition

Analysis shows that in 2006, the average interest rate charged on a 3Y unsecured business loan was 12.7% at banks. Credit unions continued to make inroads into the sector, charging an average of about 13% less than that.

FOMC

FRB St. Louis President William Poole (voter) said that while there "could be a recession," the FOMC "does not see a recession coming" and is still forecasting growth above 2.5%.