BLAST FROM THE PAST-CIRCA LATE 2000

by Steve Brown

We are having our annual banking conference this Monday, Tuesday and Wednesday. As such, the article in this section of the publication revisits an educational piece that we ran a few years ago. We will return again on Thursday and Friday of this week with fresh material, but in the meantime, please enjoy this blast from the past as you enjoy your morning coffee.

Since 1996, banks have been required to more quantitatively identify and measure balance sheet risk. As a result, banks have raised asset-liability modeling to an art form; fitting into the gap between expressionism and neo-classicism.

By basing their models on a phalanx of assumptions, forging complex links and correlations, and potentially inputting bad data, bankers have opened themselves up to a heavy dose of "model risk." Rapid shifts in interest rates can highlight "faulty" model assumptions and shortcomings.

While most examiners can tell you their own set of horror stories about a given bank's model, suffice it to say that it is not uncommon for a bank to think they are "interest rate neutral," when they are really asset sensitive.

To eliminate this issue, bankers should continually test and validate asset liability models. In addition, since the shortcomings of most asset liability models can be found in the underlying assumptions, those assumptions should also be tested on an ongoing basis. In this area, most of the problems lie in duration assumption, with regard to fixed rate commercial loans and deposits. The key here is to have a model that is robust enough to validate the underlying assumptions.

Finally, bankers should examine correlations of prepayments, deposit decay, run-off and deposit inflows. Categories for both loans and deposits should be broken down to a granular level until statistical differences can be eliminated. Further, these categories should be tested at least annually.

A bank is both blessed and vexed with cheap computing power and a powerful array of data to make this work take less than 40 labor hours per year, if organized correctly.

The resource investment will not only serve to reduce model risk, but will give everyone on the ALCO committee a better understanding of the inner workings of the bank.

BANK NEWS

CEO Firing

After examination pressure, Alpha Bank & Trust ($371mm, GA) fired its CEO. Proving that fast growth isn't always desirable, the bank in its almost 2Y history grew to $371mm in assets by making 79% of their loan portfolio construction loans around the Atlanta region.

Doom

A new MBA survey finds 900k households are in the foreclosure process, a 71% increase from last year and the highest level in 36Ys. Meanwhile, 381k more households began the foreclosure process during the 4Q, setting another all-time record. Finally, borrowers more than 30 days late on their payment in the 4Q reached its rate since 1985.

Gloom

A new survey finds consumer confidence in the economy has fallen to a record low, as people remain concerned about high oil prices, weak housing, recession and problems in the credit markets.

Gloomier

The FRB has released a report indicating the percentage of equity (i.e. the percentage of a home's market value - mortgage-related debt) people have in their homes has fallen below 50% for the first time since 1945 (when recordkeeping was begun). The FRB reported equity declined for the 3rd straight quarter to 47.9%. Even worse, Moody's estimates 10.3% of homeowners will have zero or negative equity by the end of 1Q.

Boosting Liquidity

The FRB said it will boost its Term Auction Facility (TAF) auctions (essentially loans to banks) to $100B from $60B at its 2 remaining auctions this month (March 10 and 24). The FRB said it was doing this to address "heightened liquidity pressures in term funding markets."

Mobile Banking

Citi announced the release of its next generation platform that includes better integration with particular phones (tying function into buttons, contact database, etc) and the ability to handle person-to-person transfers. The new technology is due out in June.

IRS

Will send letters starting Monday to 130mm households explaining that all they need to do is to file their 2007 taxes to receive their stimulus payment. Payments will start to flow in May and retail banks should be ready for a marketing campaign to capture those deposit dollars.