BALANCE SHEET OPTIONALITY

by Steve Brown

If you play golf, sooner or later you will find yourself behind a tree. When that happens, invariably you will run through the options in your head. Does it make more sense to safely punch out to the fairway, or do you go for the green? In our youth, we would go for it and then watch in amazement how a ball that is struck with the strength of Hercules could land 1 inch from where we began.

As our experience level has grown, however, we shifted tactics, played a smarter game and reviewed our options before swinging. Like a veteran golfer, an experienced banker will first look at the bigger picture before setting tactics. Interestingly, when you ask 100 bankers about derivatives risk within their bank, 90% will tell you they have none. A great many bankers will deny they have any optionality at all. Ironically, every bank has optionality and most are embedded derivatives.

We bring this up because recent increases in interest rate volatility, changes in asset valuations and shifts in liquidity have brought into question many bank's ALCO assumptions. One alarming trend that has taken place occurs when a bank invests in callable agencies in their investment portfolio, has declined to put prepayment penalties in their loans and has taken out putable advances from the FHLB to fund it all. Add to this mix a greater amount of construction loans, increased usage on lines of credit, hybrid loan structures and indexed CDs and we find that some banks have dramatically mortgaged their future by taking on more negative convexity.

Remember, the more negative convexity a bank has, the worse it will perform when interest rates shift either up or down. Should rates go up for example, loans and securities extend out in duration, causing greater exposure to interest rates. On the liability side, higher rates result in more customers paying penalties and walking away from CDs. In addition, higher rates cause putable advances to go away precisely at a time when you need them the most. Negative convexity can also be seen when rates fall. Loans prepay shortening asset duration, while liabilities extend maturities (since they are not called, put or redeemed at the same frequency as when rates rise). Negative convexity can be devastating to a bank's future profit as it hits operating margins.

Worse yet is the fact that many banks have grown past their asset-liability infrastructure. Many currently do not possess the models or skill to handle embedded options, such as the puttable features or caps/floors on loans. Not knowing what you don't know is the same as aggressively hitting a golf ball from behind a tree Ã¢Â€" you don't know how it is going to turn out.

All banks should be taking a look at their asset-liability assumptions because many will find that the current market has created a greater amount of optionality. While the lure of getting larger margins immediately is attractive, proper modeling and scenario analysis can help a bank better understand the entire course to ensure greater profitability in the long run. Once risk is identified, definitively declare whether you are going to accept it or will hedge the exposure through a myriad of credit and interest rate management tools (contact us if we can help in this area).

Suffice it to say that options are so deeply embedded into the fabric of banking, complexity is here to stay. Like the game of golf, there are no erasers on the pencils, so experience and knowledge can play a large role in performance and capital preservation. The key to winning is to completely understand your options.

FOMC OUTCOME

The FOMC acted as expected, leaving the Fed Funds target and discount rates unchanged. The policy statement was also predictable, as the Fed said it sees greater upside risk to inflation than previously believed. Despite the jawboning, they stopped short of signaling a timetable or even a commitment to hike rates. Our prediction for the long term is that the Fed will continue to watch and wait for longer than the market expects. The intermediate-term outcome is not positive for community banks, as the inflationary bias will serve to push long-term rates up, without a corresponding increase in Prime. The result will be higher funding costs for the next several months and lower earnings. For those starting on 2009 budgets, note that Fed Funds is expected to average 3.11% next year.

BANK NEWS

M&A

Community Bank ($4.7B, NY) will acquire 18 Citizens Financial (Royal Bank of Canada) branches in New York State. Citizens said they are selling the branches in a strategic shift to larger metro areas. The deal reportedly includes $630mm in deposits (for a 12% premium) and $135mm in loans.

M&A

Wilmington Trust has agreed to purchase UBS Fiduciary Trust Co. from UBS AG for an undisclosed amount.

Standardized Basel II

The FDIC approved an interagency proposal that gives banks the option of adopting alternative risk-based capital adequacy rules based on Basel II. These "standardized" rules would be less complex to implement than the "advanced" requirement, but would better align risk with capital requirements and boost risk management practices.

Radian Asset Assurance

Moody's lowered their rating on this municipal bond 3 notches to "A3." This will cause a permanent impairment at many banks.

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