LISTS AND COUNTING MONEY

by Steve Brown

Let's face it - bankers love numbers and also tend to create numbered lists of things that need to be done. That isn't any wonder when you consider how deeply embedded numbers are into the very fabric of the industry. While some would say that is because bankers like to count and recount the money all day long, we say it is just how the banking system works.

To help community bankers take steps along their never ending road to improve performance, we offer the following numbered list this morning of the top 6 things community bankers should be thinking about when it comes to the investment portfolio.

1. Duration. Yields are at a very low historical level and while the economy doesn't look like it will improve in any major way anytime soon, it will eventually happen. Banks should be working to get their investment portfolio duration overall down to about 2.0 to 2.5, to limit the impact of an eventual upturn in rates.

2. Prepayments. There are lots of programs right now for people who are behind on their mortgage loans to refinance. As such, prepayment speeds have doubled over the past few months for most mortgage-backed securities coupons above 5.0%. Bankers should know cashflows are coming back in much faster than anticipated, so understanding how much is flowing in on a monthly basis is critical if you want to maintain performance.

3. Liquidity. One quick way a bank can gauge its liquidity of the investment portfolio is to look at the haircuts applied to different security types at the Fed Discount Window. Treasuries are the most liquid security type held by banks, so they generally only require only a 2% haircut (depends on maturity). That means banks can pledge Treasuries they hold in the portfolio and borrow 98% of market value. By comparison, banks can borrow about 98% of agency or AAA-rated private label MBS, 97% of bullet or callable agencies, 97% of municipals and 97% of agency or AAA-rated private label CMOs. As of the end of 1Q, community banks < $1B in assets held about 2% of the portfolio in Treasuries and about 69% in US Gov't obligations (agencies and mortgages issued by GSEs) so most are already very liquid. Since liquidity remains at a premium, banks should continue to shift allocations toward lower-risk sectors.

4. Municipals. Historically, municipalities have performed very well and with very low credit risk. These days, however, pressures related to the economic crisis have left 41 states facing huge budget shortfalls that will result in lower services, cutbacks and nearly unheard of firings of state workers. These issues are spilling over into local communities with a vengeance, so bankers holding municipal bonds must be wary. Compounding the problem, some banks are booking losses due to loan stresses, so municipal bond tax benefits are reduced and yields are lower. Given all that risk, bankers should be wary of how much exposure to the sector they are willing to take until the dust begins to settle. As of 1Q, banks < $1B in assets held 22% of their investment portfolio in municipals. While we generally like municipal exposure (given risk/reward), at this juncture it makes sense to limit it to about 15% overall.

5. Structure. Added regulatory scrutiny and better risk management practices have reduced the amount of highly-structured securities held in community bank portfolios over the years. While perpetual preferred agencies are not really considered highly structured, they do serve as a historical lesson that having a maturity on every single security purchased ensures that at the very least, the investment dollars will be returned by that final date (assuming no credit events). Remember as well that if the return you are being offered is high vs. alternative equivalently-rated securities, there is probably hidden risk embedded so care should be exercised.

6. Basics. At this point in the risk cycle, our final advice to bankers is to stick to the basics. Yield levels are low and stresses remain on the lending portfolio, but interest rate risk lurks just beyond the shadows. Stay liquid with agencies, mortgages, Treasuries and at least AA-rated municipals, while focusing on a portfolio duration of 2.0 (and a singular investment duration maximum of 3.0). Every bank is different, but these are good guidelines to help protect the organization over the medium-term and ensure one hasn't taken on too much risk when the economy starts to recover. Remember that at the end of the day, staying safe and sane is Rule #1, given the low availability of capital in the market to offset potential credit hiccups.

Now that our discussion has concluded, it appears to be time once again for bankers to go and count the money - enjoy.

BANK NEWS

Securitization Accounting

FASB 166 (goes into effect in 2010) will require loans securitized through special purpose entities to be accounted for on the originator's books if the seller still holds a risk position (such as a "make whole" or performance guarantee). The action affects larger banks that are frequent issuers of mortgage and SBA obligations.

FHLBs

The last 2 FHLBs posted their financial results for 1Q. The delay's associated with OTTI clarification caused FHLB, Pittsburgh and Topeka to have charges of $31mm and $1B, respectively. That said, Pittsburgh produced a $24mm loss, while Topeka had earnings gains of $61mm.