LIGHTING UP A FUTURE EXAMINATION

by Steve Brown

You may not have been completely on top of this, but on Jan 1, 2012, the 100-watt incandescent light bulb will cease to exist by law. You see, in an effort to save energy (the incandescent bulb wastes 90% of its energy as heat rather than light), the old fashioned light bulb is going the way of the dinosaur and will be replaced by alternative energy-saving bulbs. Of note, the 75-watt goes away 1Y later, followed by the 60-watt and 40-watt versions in 2014. We don't know about you, but while we really like the idea, the odd bluish-whitish light that emanates from these new funky bulbs is really weird.

Speaking of weird, how about lending? You see all sorts of structures out there. Maybe loan A is a 10Y maturity with a 25Y amortization, priced at Prime (but currently at a floor above the now-Prime), that will reset 5Ys from now, at the then-Prime rate (without a floor). Loan A also has a 3-2-1 prepayment structure. Maybe loan B in the alternative is priced at 5Y FHLB+350bp (but again, currently at a floor above that rate), that will reset 5Ys from now at the then-5Y FHLB+350bp (with a floor at 6%) and a 5-4-3-2-1 prepayment. Nothing about either one of these structures is intuitive when you are trying to predict where this loan will reset, but most people probably don't really care. They either say they won't be around when that happens; it just feels right; or it is what the other person is doing so what can you do. No matter what the reason, these structures are commonplace and risk rarely comes into the discussion.

Yet, we all know lending carries risk. Sure, it is part of the banking game, but lending is layer upon layer of interdependent variables where some are obvious and others are opaque. Think of the complexity of the loans outlined above; then picture yourself at a burger joint trying to determine whether you want Swiss or American cheese. Some of the very best burger places we have visited carry a limited menu because as humans, we can only process about 3 things at once before blowing apart. We simply are not designed to deal with too many variables, external factors, interdependencies, concentrations, shocks, etc. Heck, some people we know dribble coffee down their faces nearly every morning until the brain kicks into gear.

We know what you are thinking. What's the deal - here it is Friday and I have to do mathematics? Have no fear, as we won't go that far. We simply wanted to point out lending is a complex business, so it can't be made simple and still control risk. That is why regulators are demanding bankers understand concentration risks, as they incorporate loan pricing and stress testing. The purpose, really, of all of that is to give management some sort of report that can be used to break down and review a given loan or portfolio of loans given various changes. That's it. Then, once bankers have that first piece, it is easier to make plans to survive if something bad happens - enter continuity planning.

We wrap things up this morning with a thought to consider as your bank begins to prepare for the next exam. Instead of waiting to find out what's in the room, flip on the light before the examination process begins and shine some light on the risk in the loan portfolio. The better the data you collect and feed into your systems and the more you improve your documentation around it, the more likely it is the light will shine brightly on at your next exam.

BANK NEWS

Fed Speak

In a speech yesterday, Minneapolis Fed President Narayana Kocherlakota (voter) said it would be "desirable" to raise interest rates this year.

FHLB Suits

The Home Loan system has filed a lawsuit against Citigroup and Bank of America alleging misstatements or omissions in connection with mortgage-backed securities sales. This is in addition to FHLB's outstanding suits against Ally Financial, Capital One, Wells Fargo, Morgan Stanley, several foreign banks and S&P for losses on its $5.8B private-label mortgage-backed securities purchases.

CFTC Rules on Hedging

The Commodity Futures Trading Commission (CFTC) issued proposed capital rules required by the Dodd Frank Act for swap dealers (SDs) and major swap participants (MSPs) that are not subject to regulation by the Fed, OCC, FDIC, Farm Credit or the FHFA. Nonbank subsidiaries of US bank holding companies (that are SDs or MSPs) would be required to meet the same capital requirements that apply to the bank holding company.

Consumers

A new CNN survey finds more than 80% of people think the economy is still in poor shape. Top concerns include unemployment (38%), budget deficit (28%), rising gas prices (21%), mortgage costs (6%) and taxes (4%).