POW BANK INVESTMENT STRATEGIES

by Steve Brown

Like the 4th Stooge, Shemp or the 5th Beatle, Pete Best, Pow is the often forgotten member of the Rice Krispies gang. Back in the 1950's, Kellogg's used Pow to sell the cereal's explosive nutritional value along with Snap, Crackle and Pop. The problem was that while consumers loved the 3 sound-representing gnomes living in a box of cereal, they found Pow stretched the limits of understanding as nutritional value was too complicated. Kellogg's then discontinued the character Pow. We can relate to Pow, as we constantly struggle to convince bankers that investment portfolio management is not about yield, but rather about liquidity and the counterbalancing of risk. To excel when building an investment portfolio, smart managers seek to first understand their loan portfolio. Since banks face a much larger risk/return ratio in their lending and deposit portfolios, management should start there. The more risk (liquidity, interest rate and credit) a bank takes in lending and deposits, the less risk it should take in the investment portfolio. The portfolio should serve as a compliment to the balance sheet to achieve the highest risk-adjusted return. Unfortunately, managing investments in relation to the whole balance sheet is more complicated than just managing for yield, but given earnings are so dear and risk is so high these days, we strongly believe a holistic approach is warranted. Take optionality for example. If your bank is disciplined and has been structuring prepayment protection in your loans, then you can afford to garner additional yield from optionality in the investment portfolio. However, if your bank has not been able to get protection, then optionality should be limited in the portfolio so maximum gains can be achieved when rates fall. Conversely, investment optionality extends duration when rates rise, the exact opposite banks need given this environment. While optionality is just one example, investments can be structured to support interest rate risk, credit and liquidity in similar fashion. Another overlooked aspect of an investment portfolio is its size relative to other assets. Contrary to how some portfolios are managed, the size of the portfolio should grow when credit times are good and shrink when times are bad. While counterintuitive, this is because when economic stress is extreme, lending risk is actually lower and returns are higher. As such, the math shows capital should flow out of investments and into lending. Conversely, as cap rates fall (for banks concentrated in CRE), the investment portfolio should increase in size to offset growing credit risk on the balance sheet. With each dollar of capital, bank managers must ask - "how do I achieve the lowest COMBINED risk-adjusted return for the balance sheet?" Then, alternatives need to be weighed and asset allocations made. This is done first with the goal of achieving liquidity, next by counter-balancing risk and THEN by achieving superior risk-adjusted returns. Of course if loan growth is absent, then there are investment-like alternatives to be had such as purchasing agency-guaranteed multifamily loans, C&I loans or other ideas that are able to increase the yield on earning assets while offsetting existing risk. Since we obviously have a different investment philosophy than almost every securities broker-dealer in the market, we humbly suggest that you get us approved as one of your counterparties. We are sure to present a different view from most coverage and can offer unique insight that can help your bank. We also offer a full complement of portfolio management, analytics, bond accounting and free safekeeping. Utilizing us as your broker-dealer also has the advantage of increasing your liquidity through the establishment of repo lines of credit. Finally, in addition to understanding the details of banking, we operate on a fully disclosed mark-up basis to banks that want to know, so you understand every purchase. If you think you might be able to use some Pow and get some additional nutritional value in your portfolio, contact us to receive a due diligence package to add us to your line-up. If nothing else, we would love to interview for your next bond opening!

BANK NEWS

M&A

Grandpoint Capital ($1.2B, CA) will acquire the parent company of The Biltmore Bank of Arizona ($261mm, AZ) for an undisclosed sum.

ALLL Warning

Regulators issued guidance on junior lien loan loss allowances, warning banks to monitor all credit quality indicators relevant to junior liens such as second mortgages and home equity lines of credit. The guidance indicated when estimating ALLL bankers should (1) consider all reasonably available and relevant information about the collectability of the portfolio, including data on the delinquency status of senior lien loans associated with the institution's junior liens, (2) ensure adequate segmentation within the junior lien portfolio to appropriately estimate allowances for high-risk segments, and (3) support qualitative and environmental factor adjustments to historical loss rates by an analysis that relates the adjustments to the characteristics of and trends in the individual risk segments within the junior lien portfolio. The guidance also contains principles for estimating ALLL for all types of loans.

Payment Processor Warning

The FDIC issued revised guidance for payment-processor relationships, warning banks to understand potential risks such as money laundering and fraud from entities that process payments for telemarketers, online businesses and other merchants. Board limits, verifying the legitimacy of the business operations, determining the character of the processor's ownership and conducting ongoing monitoring for suspicious activity were all cited.