NON-OKTOBERFEST ALM MANAGEMENT

by Steve Brown

When it comes to naming festivals, Oktoberfest is the worst. The Munich celebration mostly takes place in September (as it was shifted long ago for better weather). Usually, when August rolls around, Germans try to wrap up their summer holidays and start to live a little healthier in preparation for all the chicken, sausages, pork knuckles, dumplings and of course, beer - lots of it that will be consumed at this event. The average festival-goer will consume 1.3 liters of beer (about 4 12 oz. beers) per day and it is not uncommon for the more "enthusiastic" to throw down 7 liters per day. The concept of trying to live a little healthier today in preparation for binging in the future has its logical problems. For starters, it doesn't really matter how healthy you are today, if tomorrow you are drunk, you are still drunk (happier maybe, but not healthier). In addition, nutrition is fungible, so if you live healthy for a week and unhealthy for two weeks, it is hard to know the right balance of when you pass your targeted "health" point. The net result is likely that you do more harm than good over those 3 weeks. Finally, there is the theory that humans rationalize their actions today, so that they can logically justify taking on more risk in the future. Germans may sober up the second week in Sept. only to allow themselves to indulge come the start of Oktoberfest in the 3rd week. If you are asking yourself why we are spending so much time on fall German nutritional habits, it is because that it is a similar practice to how banks rationalize taking on more long term fixed rate loans. Instead of treating interest rate risk as a holistic practice, some bankers tend to think in discrete terms (not unlike starving yourself today so you can drink and eat tomorrow). Many a CFO and CEO will allow their lenders to compete by rationalizing their actions and saying "we can handle $20mm in 7Y fixed rate lending so let's go out and fill up the bucket!" Look, if you analyze your asset-liability position and find that your loans are going to reset faster than your liabilities in a rising rate environment and you need to add more duration to your assets, then fine. However, we rarely see it work that way. Largely, like our Bavarian friends, we see a rationalization of interest rate risk. In one quarter, presentations are made in ALCO meetings how the bank is matched and the next quarter, when there is a need to book more fixed rate loans, there is suddenly duration room. Sometimes, bankers are content with their current position and then go out and match-fund fixed rate loans against brokered CDs or FHLB advances. The problem here is that our $20mm of 7Y fixed rate term loans is rarely analyzed and monitored. Going out and matching the 7Y loans against 7Y FHLB advances has a couple of issues. For starters, your average FHLB non-callable 7Y advance has duration of about 6.7. However, the average 7Y CRE loan has duration of about 3.8, or almost half. You can see already this process is flawed from the start, not to mention the issue that taking additional funding also drives up production costs hurting margin. This was the case back in 2010 when many banks ran out and took 5Y FHLB money, only to see some of the loans they were hedging run into problems or get refinanced. A bank is the sum total of its parts and it has an asset-liability profile that is dynamic; changing as rates change, loans prepay and new assets come on. Because of this profile, ALM management should also be dynamic and not be thought of as a series of 1x events. If a bank wants to book more fixed rate loans, it should think about focusing resources on reducing the duration of the investment portfolio, marketing more non-maturity deposit accounts and increasing cross-selling. In addition, a bank should consider a variety of our hedge programs that either allows for the mitigation of interest rate risk on a loan by loan basis (called our "BLP Program") or holistically by capping liability costs (our "Liability Hedge Program"). Both of our proprietary approaches come without the need for hedge accounting or the use of complicated swaps. Before you break out the lederhosen and start the 4th quarter push for loan growth, contact us to see how our programs can help you originate more fixed rate loans without altering your ALM position. It is a whole lot better than overindulging against the din of oom-pah music.

BANK NEWS

Municipal Risk

A new report from the Fed that looked at a broader sample of municipal bonds finds there have been about 36x as many muni defaults over the past 40Ys as previously understood. The Fed's data found there were 2,366 defaults from 1986 to 2011 vs. only 47 defaults from S&P's data and 71 from Moody's data. According to the Fed data, G.O. debt seldom defaulted, while industrial development bonds issued by a government authority on behalf of a company saw the most defaults at 28% of the total. Other sectors that saw higher defaults included housing bonds (17% of defaults); bonds to finance nursing homes (12%) and healthcare projects (11%).

New Regulation

Banking regulators have issued a proposed rule that would require creditors to obtain an appraisal (meeting certain specified standards), provide applicants with notification and give applicants a copy of the written appraisal used for "higher-risk mortgages." A higher-risk mortgage is defined as a "residential mortgage loan" secured by a principal dwelling with an APR that exceeds the average prime offer rate for a comparable transaction as of the date the interest rate is set by 1.5 or more percentage points (for a first lien residential loan of applicable size). The proposal is 211 pages long and comments are due by October 15.