Stepping In A Bear Trap Is Painful

by Steve Brown

The typical bear trap is about 44 inches long, weighs about 45 pounds and has a jaw spread of about 16 inches. These traps are so strong they can snap a 2x4 piece of wood entirely in half. Suffice it to say, you have to be careful when wandering around the woods to avoid stepping on one as it would certainly be a very painful encounter.

Speaking of the pain from stepping into a bear trap, our discussion this morning we believe is an interesting one and particularly so, as it is true. It ended with a large $6B community bank agreeing to pay a $500,000 penalty to settle charges with the Securities and Exchange Commission (SEC) that it had improperly performed hedge accounting. The treasurer at the bank was also fined personally to settle charges he caused the accounting violations. That is where it ended, but where did it begin you may wonder.

It began simply enough. The bank was seeking to protect itself against interest rate risk using interest rate swaps, as it served its business clients by offering them fixed rate CRE loans. The bank then designated the loans and swaps as fair value hedging relationships under complex generally accepted accounting principles (GAAP) dictated by the Financial Accounting Standards Board (FASB). Under those rules, entities (such as banks) must recognize all interest rate swaps as derivative instruments. As such, they must measure them at fair value on their balance sheet as either assets or liabilities. To reduce the byproduct issue of potential earnings volatility in the income statement, entities are allowed to use fair value hedge accounting for derivatives as long as the transactions meet certain requirements.

Ok, we know your coffee may not be coursing through your veins just yet, and we have already covered enough droll matter to put a sloth to sleep, but hang in there because this topic is important to community bankers.

The key to this complex accounting rule is that it allows entities to use fair value accounting, but only as long as the transactions meet specific requirements. Under the rules, entities must review and analyze their hedging relationships on a periodic basis and must discontinue the use of hedge accounting if the effectiveness of the instruments falls outside a certain range. Doing this process requires pretty good math, modeling and reporting skills.

Based on the news reports, it appears this bank did not follow the rules as laid out and instead allowed unsupported adjustments to be made to hedge effectiveness testing so it would continue to receive favorable accounting treatment. This apparently went on for about 4 years and was missed by management, auditors, directors and potentially other experts along the way, before employees eventually reported their concerns to management and a whistleblower complaint surfaced.

The damage to the bank from this is unknown at this point, but we are certain they did not want to have the SEC investigate them, make public announcements on the matter and deal with potentially aggressive regulatory follow up at a minimum.

The good news for community bankers is that this can all be avoided. 10Ys ago, we began offering our Borrower's Loan Protection (BLP) hedging product to solve this very issue. You see we knew the derivative accounting rules were complex, because we have on our staff people that have been involved in that world for almost 30Ys. We also knew community bankers most often have generalist finance teams on staff and that the accounting rules around derivatives are very specialized, so we had to find a solution. That was the genesis of BLP, where we do the complex hedge accounting, the business customers of community banks get the fixed rate loan they want and our community bank customers get a floating rate without having to deal with the complex hedge accounting issues.

Right now rates are low, but the Fed is pushing them higher. In addition, the difference between the 10Y swap rate and the 20Y is about 16bps. This environment means more savvy business customers are very likely to seek longer term fixed rate loans from community banks, while those banks will need a solution to do so (to compete effectively), as they manage interest rate risk (by transforming those payments into floating rate ones).

If your team has strong loan growth goals this year and you want some help on this, give us a call. We are almost entirely owned by community banks so we never compete with you. We are here to help and if we can assist your team, we want to do so. There is a simple and time-tested solution available, so contact us and we'll show you how to avoid the potential bear trap of arcane hedge accounting rules as you serve your customers and capture more loan business.

BANK NEWS

Debt Pressure

The Department of Education has revised its data after a closer review and now finds at least 50% of students at 1,000 schools analyzed had either defaulted or failed to pay down at least $1 on their student loan debt within 7Ys.

Mobile Usage

An ABA/Ipsos survey finds 58% of consumers say they use their mobile device at least 1x per month to manage their bank account, 33% use it more than 3x per month and 72% say their bank's mobile app is very good or excellent.

Strategic Moves

PwC research finds surveyed directors say their board has done the following in the past 12 months regarding strategy: looked at emerging technological trends (62%); looked at long-term economic, geopolitical, and environmental trends (55%); studied competitor initiatives that could introduce disruptive approaches (53%); evaluated alternative strategies to those presented by management (33%); and visited a customer, distributor or supplier site (19%).