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Bank Insights

How to Spot the Risks in Your Investment Portfolio

By Leonard J. DeRoma

Understanding the risks in an investment portfolio may not be second nature to most community banks. Lending officers are trained in credit analysis, not bond performance. To know the risks, you must first have a feel for the bond buying process.

1. **Bond houses are not storage facilities.** They make money by moving bonds. Your friendly local bond salesman working for a good regional firm or the local office of a national firm is generally compensated on selling products. Many bond salesmen will make multiples of what a community bank CEO earns. Regional firms get a lot of product from national firms. The more they sell, the more access to better product they get, and thus the more they can be paid.
2. **Bond salesmen are not created equal.** Some have a very deep understanding of the product they are selling. Others do not.
3. **Disclosure requirements, while institutionalized, vary widely.** Some bond houses will provide you with a prospectus and expect your organization, as a sophisticated investor, to do the homework. Other shops or salesmen will take the time to walk through various aspects of the bonds they are selling.
4. **Many banks are "passive buyers."** They look at what's on the shelf and make a purchase. This is opposed to the bank that says, "I want to add some variable rate, short duration, low factor GNMAs to my portfolio to offset a certain risk." Bond houses like passive buyers.
5. **Markets are always thinner when you want to sell.** As much as the bond house has a moral responsibility to make a market in something it sold you, there is no hard and fast rule as to how "tight" that market should be. In periods of difficult liquidity, bond desks will make a bid based on how long they think they are going to end up getting stuck with inventory. See point 1 above.
6. **Mortgage-backed securities can be very complicated.** Much PhD mathematical ink has been spilled trying to understand and model the behavior of bonds and aspects such as negative convexity, extension risk, and modified duration. During times of rapidly changing rate environments or expectations, most of those models (a) break down, and (b) if they don't, bond houses will probably not be sharing their proprietary information.
7. **Municipal securities are often underwritten by local bond houses with an expectation that local banks will invest in them.** The taxing power of the municipality or the authority provides ostensible comfort against default. Other municipal bonds are issued on a private or semi-private basis. In times of liquidity crunches, there will be almost no liquidity in these securities at any (reasonable) price. The market in municipal bonds by its very definition is primarily local, reducing the potential buying population.

Now that we have presented the pitfalls, most bond salesmen are actually serious, dedicated people who truly want the investments to work out. It's not in their best interest to have a client complain. However, the salesman is contending both with his management and the market.

Given the enormous increase in deposits, which has outstripped the growth in loans in the past 15 years and particularly over the last 5 years, almost every bank will have some need for a "sponge" to soak up excess liquidity. That will be intensified as liquidity oversight moves toward a Basel III-style Liquidity coverage ratio, which counts some securities as High Quality Liquid Assets. Here are some suggestions to keep your portfolio safe, especially for banks that don't have the appropriate level of expertise in-house:

1. Establish an investment portfolio policy. This is required. Be clear as to what the purpose is and to what pieces of the portfolio are assumed to be stores of liquidity, yield enhancements, or loan replacements.
2. Translate the profile into meaningful buckets—types of assets, maturity bands, duration bands, credit quality, fixed versus floating.

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3. This a primary CEO responsibility. It should be clear that the overall picture necessitates CEO involvement. The CEO sets the tone. ALCO translates, executes, and monitors it.
4. Take the time to thoroughly know the firm and individual with whom you are dealing. Use FINRA's BrokerCheck®. It provides backgrounds on the licenses held by the sales force, including violations. The same goes for the sales force and firm. Make sure you also meet the salesman's manager.
5. Be very clear with the salesperson as to what the objectives are. Be honest. If you're a buyer of $20mm don't think you'll impress him if you tell him you're a buyer of $100mm. Make sure the salesman is an institutional salesman. Retail brokers often try to sell bond product, but it is a rare one that takes the time to understand this market. If he handles your personal portfolio, he probably isn't the right salesman for the bank.
6. Have more than one dealer. This just keeps everyone honest. One of those dealers should be a national firm, if your volume warrants it.
7. Always remember that you're the customer. Don't be afraid to ask a lot of questions. Don't be afraid to miss a trade.
8. Have a view on interest rates. It's often unbelievable how portfolios can be constructed without anyone having a direct view of interest rates. This will prevent buying things that obviously don't fit the policy.
9. Stay on top of your AOCI. Monitor the portfolio.
10. Don't be afraid about changing the portfolio if your view of interest rates changes.
11. If you don't feel comfortable managing a bond portfolio and don't feel that the necessary expertise is resident, consider engaging an outside investment manager to handle the process.
12. While the investment portfolio is generally a much smaller piece of the balance sheet than loans, it can't be ignored and left to run itself. The above points should give senior management some confidence in beginning to get a better handle on what they own.

Note: BrokerCheck® is a registered trademark of FINRA. ▪

About the Expert

Leonard J. DeRoma is a founding partner and CFO at Invictus. He began his career at Citibank in the 1970s working with Kamal Mustafa in corporate finance. Using new techniques, together they developed sophisticated financial planning and modelling tools to help provide financial advisory services to Citibank's corporate finance clients. At Lehman Brothers, he managed global financing activity; for Barclays Capital, U.S. Fixed Income investment banking, trading, capital commitment, derivatives, sales, underwriting, foreign exchange and research. As the President of Barclays U.S. securities business, he was in charge of product development, was an advisor to the U.S. ALCO committee and chaired the U.S. Risk Management Committee. He managed the same businesses for McDonald Investments and KeyCorp. He has a Bachelor of Science in Electrical Engineering from the Massachusetts Institute of Technology and a Masters of Business Administration from the Harvard Business School. He has served on several industry boards and associations, including the Public Securities Association and the Bond Market Association.

From Stress Testing to M&A, Financial Innovator Revamps Analytics

By Lisa Getter

When bank regulators referred to FreeCapital™ at a bank conference earlier this year, no one in the audience was confused. That's because Invictus Consulting Group, which introduced the metric, has been at the forefront of bank analytics that have changed the very lexicon of community banking.

These new metrics are necessary to facilitate any meaningful analysis for community banks that are undertaking strategic planning or mergers and acquisitions. The recession led to economic changes and a radical new approach to regulatory capital calculations that rendered traditional analytical techniques invalid. Here's a glimpse at the Invictus glossary:

FreeCapital is the difference between the bank's actual capital and its regulatory mandated capital. It is the capital that is available to bank management for the imple-

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mentation of all strategic and capital actions and can be calculated only through stress testing. Community banks can use stress testing to prove to regulators that they can operate with a lower regulatory capital requirement than the regulator might otherwise impose. This increases the bank's FreeCapital, which, when effectively deployed, can make a dramatic improvement to the bank's ROI.

LoanLayering uses an Invictus proprietary algorithm to redefine loan balances and balance projections, taking into consideration vintage and maturity schedules. It overcomes the limitations and misleading conclusions that arise from the traditional static analysis of a bank's current outstanding balances. It has a profound impact on the calculation of regulatory capital requirements and future profitability by bringing into consideration loan vintage, pricing and the inherent repayment schedules that define the pro forma performance of loan portfolios.

LoanDecay and portfolio **HalfLife** represent an extension of the LoanLayering approach. They replace static balance sheet and P&L analysis in the creation of bank strategic plans and the analysis of potential bank acquisitions. LoanDecay is a highly quantified metric that provides a key basis for analytics. HalfLife is a valuable comparative ratio that summarizes the effective duration of different portfolios.

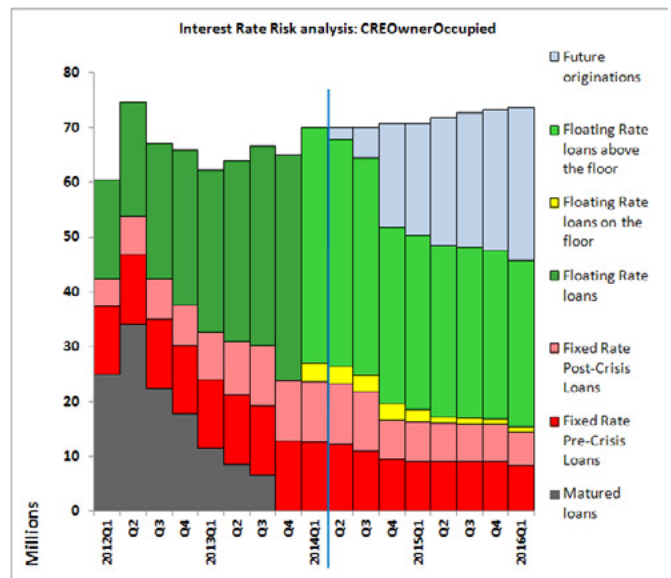
IncomeDecay takes into consideration LoanDecay and incorporates the impact of loan vintage and the relevant interest rates to measure the pro forma earnings contributions of specific portfolios and their sensitivity to changing rates and yield curves.

Invictus Return on Required Capital Ratio is a ratio that supersedes the faulty Return on Assets ratio, which gives an incomplete assessment in today's regulatory environment. That's because different asset categories carry different risk profiles and unique regulatory capital requirements, which contribute to a bank's total regulatory capital obligation. Given the traditional risk/reward nature of different loan categories, high return portfolios tend to carry higher capital requirements. Banks with high return and high risk portfolios will naturally have higher ROA ratios but, very possibly, low returns on the capital required support these high risk assets. The Invictus Return on Required Capital Ratio puts the necessary focus on the return on capital associated with different loan portfolios.

The InvictusRatio is more meaningful in an M&A landscape since buyers can re-engineer a seller's liability structure, cost structure, and fee income capabilities.

"Invictus will have a dramatic effect in the future on the analytics of bank M&A," says banking attorney James R. Hannon , of Gozdecki, Del Giudice, Americus, Farkas & Brocato LLP in Chicago. "Based on the targeted bank's loan portfolio, Invictus can now provide an invaluable tool to the acquiring institution to gauge the consequences to regulatory capital on the merged entity. Invictus has added a whole new dimension to the due diligence process in bank M&A," he said.

Boston bank attorney Stanley V. Ragalevsky of K&L Gates agreed. "It is important for bank boards and management to analyze performance using metrics that tie capital and asset composition together in order to get a more a complete picture of risk adjusted returns. This can be crucial in evaluating merger opportunities and other strategic transactions as it seems to be the best way to estimate the overall accretive or dilutive effect a transaction will have on capital over time," he said. ▪



Invictus uses its proprietary LoanLayering analysis to examine interest rate risk. This helps banks to structure their loan portfolios for specific fixed/floating targets in mind for future originations.

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Read Between the Lines

Each month *Bank Insights* reviews news from regulators and others to give perspective on regulatory challenges.

Board Input Essential to Strategic Planning

Low interest rates and diminished loan demand are prompting many community banks to revise their strategies and business models. It's essential to make sure the board of directors is actively involved, cautions Cathy Lemieux, Executive Vice President, Supervision and Regulation, Federal Reserve Bank of Chicago, in the latest issue of the Fed's Community Banking Connections.

She writes that there are three elements critical to good strategic planning:

1. Have the "right people" and "careful execution."
2. Make sure there is expertise at the board level.
3. Stick to a plan, but revise it as often as needed.

Some banks are entering niche, unfamiliar markets, such as energy, health care and equipment financing, she writes. Commercial real estate is also becoming competitive again, especially in multi-family properties, though there is competition from larger banks and investors. That may prompt some community banks to loosen underwriting standards.

Hoenig: Community Banks Smothering Under Regs

Federal Deposit Insurance Corp. Vice Chair Thomas M. Hoenig told the Boston Economic Club in a speech earlier this month that the Dodd-Frank law would not stop government bailouts. That's because "firms remain too large, too leveraged, too complicated, and too interconnected to be placed into bankruptcy when they fail," he said.

"In the meantime, regional and community banks are smothering under layers of new regulations even though they are not too big to fail, and even though they hold significantly higher levels of capital than the largest banking and financial firms."

Community Banks Could Be Next Cyber Targets

Don't assume that hackers won't attack a community bank. That's the message from Comptroller of the Currency Thomas J. Curry in a May 16 speech. "And while the largest institutions might be the most tempting targets for the bad guys, what we've learned from other sectors and are now seeing in the financial sector is that as the larger financial institutions improve their defenses, hackers are likely to direct more of their attention to community banks," he said.

The Federal Financial Institutions Examination Council, which includes all the banking regulators, last year formed a Cybersecurity and Critical Working Group. They have plans to "more aggressively supervise smaller, community banks with cybersecurity vulnerability and risk-mitigation assessments," according to Phoenix attorney Richard H. Herold of Snell & Willmer.

Curry Calls For Real Joint Exams from State Regulators

As a result of the financial crisis, state and federal regulators need to "step up our game," Comptroller Curry told the Conference of State Bank Supervisors in Chicago. Many of the failed community banks operated with flawed business plans, inadequate capital and excessive real estate concentrations, he noted. He urged state regulators not to simply put a department's name to a report. "A joint bank examination needs to be a joint product," he said.

Russell Index Recalculation Could Hurt Capital Raising

Some public banks in the Russell 1000, 2000 and 3000 indexes may drop to a lower tier or out of the indexes entirely after recalibration at the end of this month. Invictus estimates that be as many as 270 banks affected, including 38 that could drop out altogether. This is likely to hurt the banks' stock prices. Many institutional investors and index fund managers may be forced to reduce allocations or drop the stocks entirely due to investment criteria restrictions.

The end result of a downgrade can be that acquisitive banks have a less valuable acquisition currency and/or will have to tolerate more dilution of existing shareholders during any future fundraising. ■

About Invictus

Invictus Consulting Group's bank analytics, strategic consulting, M&A and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. Bank clients have excellent results when using Invictus reports to defend their strategic plans and capital levels to regulators.

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