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ADVISORY

Portfolio Management In A New Era

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Bank balance sheets have changed significantly over the last few years, largely as a result of events surrounding the recent financial crisis. Insured deposit balances increased by $2 trillion (25.0%) in 2011, while loan balances fell slightly by $0.2 trillion (2.5%). New regulations have also introduced several complications into the investment management process. As an example, the implementation of Basel III by U.S. banks will require gains and losses from investments to be reflected in regulatory capital, thus introducing significant exposure to rising rates. In addition, the Dodd-Frank Act (DFA) directs banks to end their dependence on rating agencies on determining whether or not a security is investment grade. This will clearly require more sophisticated internal analysis.

Given the excess liquidity in the banking system, the historically low level of interest rates, and the evolving regulatory environment, it is clear the investment portfolio management process has become a much more complicated and burdensome for financial institutions of all sizes and complexity.

Changes in the Regulatory Environment

Financial institutions should have a keen awareness of the impact of existing legislation and proposed legislation under Basel III and the DFA:

1. The DFA stipulates banks can no longer rely exclusively on rating agencies when investing in credit related products. While banks can include the ratings as part of their review, they must also develop their own internal analysis utilizing a variety of data sources to determine the credit quality of their investment purchases. This will require significantly more time, effort and sophistication from those involved in the portfolio process. In many cases banks may need to subscribe to financial data vendor service companies (Bloomberg, IDC, Intex, etc.) at significant additional costs.
2. U.S. regulators recently announced a joint interagency proposal altering the measurement of risk-weighted assets for regulatory capital calculations under Basel III. This applies to all U.S. banks regardless of their asset size and is scheduled to be fully implemented by January 2015. These new calculations will significantly alter the capital requirements for credit-sensitive instruments such as Non-Agency RMBS, CMBS, ABS, corporate bonds, and municipal securities. It is important to note that this is *not* necessarily all bad news – Angel Oak believes that these changes are creating opportunities for institutions willing to pursue new ideas. For example, the newly proposed risk-weighted asset calculations for structured financial instruments takes into account:
    - The instrument's seniority in the capital structure
    - Historical delinquencies and cumulative losses in relation to credit support
    - Underlying collateral characteristics

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These proposed calculations are more complex than the current ratings-based approach, and the results are in many cases positive. Bonds that are senior in the capital structure with strong credit support and high ratings may have a similar or slightly higher risk-weighting compared to the current methodology. Using the current ratings-based calculation methodology, junk rated bonds would carry a 1,250% risk weighting. Under the newly proposed methodology, in instances where the bonds are senior in capital structure and have adequate credit support, the risk weighting may be relatively low, i.e., less than 100%.

To demonstrate the differences in the current ratings-based approach and the newly proposed approach we have two examples that we have termed the "clean" bond and the "ugly" bond. The "clean" bond has relatively strong credit support in relation to delinquencies. However, Moody's has the bond rated just above investment grade, and as such, the bond now has a 100% risk weighting. Under the new method, given the relatively strong credit support in relation to delinquencies, the bond will have only a 20% risk weighting. (See below)

	"Ugly"	"Clean"
Current Rating		
S&P	AA-	AAA
Moody	Caa2	Baa1
Capital Structure	Super Senior	Senior
Delinquencies	30.69%	3.49%
Credit Support	42.83%	9.99%
Current Risk Based Capital Treatment		
Capital Charge	100.00%	8.00%
Risk Weighting	1250.00%	100.00%
New SSFP Capital Treatment		
Capital Charge	5.63%	1.60%
Risk Weighting	70.36%	20.00%

The "ugly" bond has very high delinquencies, but has even higher credit support. Given the poor rating of Caa2 by Moody's this bond should have a dollar for dollar capital charge, or 1,250% risk weighting. Put simply, the new more complex method captures the positive relationship between the credit support and delinquencies and assigns a 70.36% risk weighting to the bond. In these cases, the outcome is much more favorable under the new method.

3. Finally, under the proposed Basel III rules, unrealized gains and losses in the investment portfolio will no longer be excluded from regulatory capital calculations. This exposes banks to declining risk-based capital ratios when interest rates rise. On the following page, we have provided two examples of the effect this change would have on Tier One capital ratios. Both examples illustrate a bank having total assets of $500MM and a $125MM investment portfolio.

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Example One assumes the portfolio has a 3.5 year duration and rates rise 300 basis points while Example Two assumes a 4.5 year duration and rise of 400 basis points in interest Rates (see below). The Tier 1 capital ratio falls by roughly a third to 8.6% in Example One and falls by more than a half in Example Two to 5.7%. This is a significant effect on the Tier 1 Capital ratio, especially considering that once fully implemented in January 2019 the minimum ratio (including the Capital Conservations Buffer) will be 8.5%!

Example One

Total Assets	500,000
Investments	125,000
Market Value Loss	(13,125)

	Before	Unrealized Loss (+300bp)	After
T1 Capital	40,731	(13,125)	27,606
Total RW Assets	324,192	(2,625)	321,567
T1 Capital Ratio	**12.6%**		**8.6%**

Example Two

Total Assets	500,000
Investments	125,000
Market Value Loss	(22,500)

	Before	Unrealized Loss (+400bp)	After
T1 Capital	40,731	(22,500)	18,231
Total RW Assets	324,192	(4,500)	319,692
T1 Capital Ratio	**12.6%**		**5.7%**

$ in thousands / ignores any potential tax adjusments

How Can Portfolio Management Prepare?

With a larger concentration of assets in the bank's investment portfolio, additional regulatory complexities, more sophisticated investment options and increased capital requirements the role of the investment officer has become significantly more important. An easy solution adopted by many institutions has been to keep the portfolio invested in very short-term government "guaranteed" products (Treasuries, Agency/GSE debt, and Agency MBS). However, it is difficult to generate sufficient earnings in the current low rate environment to replenish capital, fund growth strategies, and ensure long term survival. Angel Oak believes portfolio and bank managers should be considering the following creative ideas to remain competitive and thrive in the current challenging environment:

Get smart quickly - become familiar with the changes that Basel III and Dodd-Frank will bring. While the rules will be phased in over time beginning January 1st 2013, many banks will be adopting some of these new initiatives immediately.

Analyze your institution's investment portfolio - review positions to assess how these changes will affect your capital requirements and earnings at risk.

Seek expert advice - determine what additional tools and resources will be required to comply with the new rules.

Be open-minded about new investment strategies - current Federal Reserve interest rate policy is creating significant risks for the extension trade, but there are opportunities to enhance yield by targeting appropriate floating rate credit sensitive instruments.

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Consider outsourcing some portfolio management functions to experienced professionals that have the ability and resources to:

- Fully understand your institution's appetite for interest rate and credit risk
- Identify appropriate investments providing superior risk-adjusted returns, and
- Offer best execution obtained by a consistent and informed presence in the fixed income marketplace

If your institution needs help understanding the effects of Basel III and DFA on your investment portfolio or the overall balances sheet, please do not hesitate to contact us at Angel Oak Advisory:

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