



## KEY RATES ::

Fed Funds Target	0.25%
Discount Rate	0.75%
Prime Rate	3.25%
3-mo LIBOR	0.31%
2-yr Treasury	0.24%
3-yr Treasury	0.34%
5-yr Treasury	0.68%
10-yr Treasury	1.73%
2-yr Swap	0.36%
5-yr Swap	0.81%
10-yr Swap	1.77%
5-yr A Corp Yield	1.56%
5-yr A BQ Muni Yield*	1.75%

\* Tax Equivalent Yield

## ECONOMIC DATA ::

Q3 GDP Growth	2.7%
October CPI YoY	2.2%
Unemployment Rate	7.7%

## SPECIAL EVENTS ::

12/13 - TAG Extension Bill fails to pass US Senate, killing any chances of its passage as a piece of standalone legislation.

## UPCOMING EVENTS ::

12/31 - Fiscal Cliff Deadline

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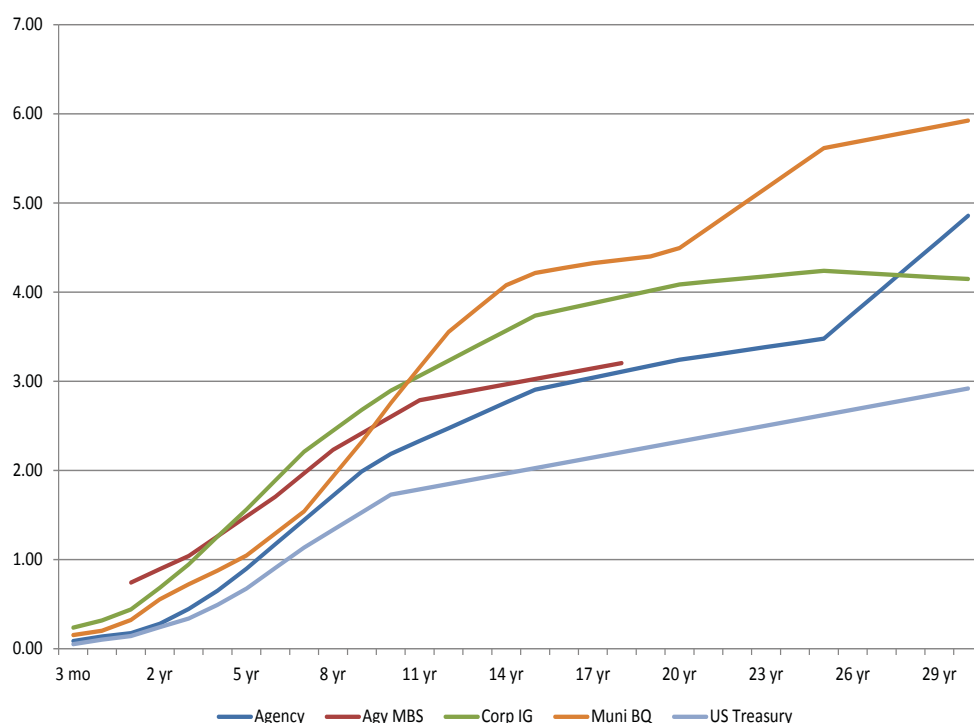
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## Yield Curve



All data as of 12/13/12

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## Value in Issuing Callable CDs | Cliff Reynolds, CFA

As both investment managers and ALM consultants, we often think of the market from both sides of the transaction – buy and sell. For a bank that is both a buyer and seller of debt, value is at the center of determining the best way to invest cash (buying debt) and the most efficient sources of funding (selling debt). While diversification is a common point of discussion throughout the bank, alternatives to the standard fixed-rate, bullet-structure brokered CD are often overlooked as opportunities for value.

Diversification of funding sources is important, and the benefits of diversification extend to having deposits with varying levels of optionality. For a bank with 100% of their term deposits in a straight bullet structure, adding some callable, brokered CDs could benefit the bank's risk profile given the range of possible outcomes in the market.

To the market, brokered CDs are just a bond; so they are analyzed and priced as such. Different features like embedded call options have value that must be reflected in the price of the security. To the issuer of the CD, the ability to call the bond at predefined intervals provides the flexibility to refinance or retire the debt when it's advantageous. For a buyer on the other hand, having the bond called away from them when rates fall would be a negative event so the issuer of the debt must pay a higher coupon to the investor. In a sense, the call option is a form of insurance for the bank - with the insurance premium being the higher interest cost to insure its fixed interest costs against falling interest rates. From a marked-to-market perspective, callable liabilities will decrease in value in an uprate environment according to the duration of the instrument – just like bullets. However, in a downrate environment, when bullet liabilities rise in value, callable CDs will be capped near par because of their embedded option.

Historically speaking, the additional cost to issue callable CDs is very low. Depending on what maturity you are considering and how a given dealer prices the option – payups for callable, brokered CDs can be only ten basis points over bullet CDs - and in some cases the same as bullets. (The additional costs for callable CDs during normalized interest rate environments have commonly been twice or three times the current cost.)

This market-determined cost tells us something about expectations for interest rates – they aren't expected to be very volatile. Buyers are willing to accept very small increases in yield in exchange for selling the call option to the bank and risk having the bond called away from them if rates fall. With rates so low, it's hard to believe they have anywhere to go but up, but that mindset has existed since the financial crisis ended in 2009 – and we all know what has happened since then. In reality, the future is just as uncertain as ever.

Like all strategy discussions we have in ALM, the decision to issue CDs with a call option instead of the traditional bullet structure should be considered in the context of the balance sheet as a whole. Future refinancing costs will ultimately determine the profitability of such a decision. Given the low cost of issuing fixed rate liabilities with an imbedded call option, it should at least be considered by any bank looking at alternative funding options.

### Quick Facts: Callable Bonds

- A callable bond gives the issuer the option to retire the debt at predefined intervals.
- The cost of the option is paid to the investor in the form of a higher coupon rate.
- Higher expected volatility of interest rates translates into higher option costs.

## Dodd Frank - Credit Guidelines | Ryan Craft, CFA

Don't forget to send a Christmas card to Messrs. Dodd and Frank. With the implementation of their ambiguous bill and continuing debate on the details of Basel III, there is much regulatory uncertainty going into 2013.

One issue that has been solidified and will go into effect on January 1, 2013 is new guidelines on how to define investment grade securities. In June, the OCC issued a bulletin outlining new rules and guidance for banks and thrifts to use in determining what is an "investment grade" security. On November 15th, the Federal Reserve issued a letter supporting OCC Bulletin 2012-18 and the amended regulations in 12 CFR Part 1. The FDIC followed up on November 16th with a Financial Institution Letter (48-2012) endorsing the changes and effectively stating that these regulations will apply for all FDIC insured banking institutions next year regardless of size.

The amendments to the Federal Register remove any requirement for banks to rely on external credit rating agencies when determining the creditworthiness of an investment. Instead, it redefines Investment Grade as "the issuer of a security has an adequate capacity to meet financial commitments under the security for the projected life of the asset of exposure" and "...the risk of default by the obligor is low and full and timely repayment of principal and interest is expected."

*"I predict future happiness for Americans, if they can prevent the government from wasting the labors of the people under the pretense of taking care of them."*

- Thomas Jefferson

This means that banks must now treat all credit securities as non-rated securities and justify the credit of the security with internal due diligence and credit analysis. The primary thrust of the new rules is to put less emphasis on external ratings. In the past, investors have made purchases of credit securities where the only credit due diligence has been to look at the rating assigned by Moody's or S&P. The new regulation does not prohibit the use of ratings, but requires the bank to justify the credit worthiness of the security with other factors.

This may or may not be a big deal for your bank. For our clients, this will be a non-event as Acropolis already has these processes in place and performs and documents this due diligence for them. Regardless of how much credit your bank's portfolio is exposed to, we recommend that every institution review their current policies and procedures before the New Year to ensure compliance. Regulators are likely to review your bank's Investment Policy to look for specific credit procedures, both pre-purchase and ongoing review, along with documentation to prove that these procedures are being followed. Factors such as specific credit ratios, demographic information (for municipal bonds), and market spreads should all be taken into consideration and incorporated into policy.

## Economic Update - Enough Already! | Brent Vondera

Not much has changed over the past 2-3 quarters with regard to U.S. growth. The consumer continues to spend, not at the rate during the normal expansion (about half that rate), but well beyond what an ounce of common sense would instruct (personal consumption as a percentage of GDP should be back to the long-term average of 65%, yet it continues at an elevated 70%). Inventories remain a flickering light, adding to growth in one quarter and taking it back in the next as sales growth remains tepid. Trade data shows global activity is on the wane. And overall economic clarity is nonexistent with a bevy of rare challenges confronting the outlook.

What *has* changed is a mixed picture. Business-equipment spending has begun to subtract from GDP, while housing has begun to contribute again – even if it is choppy and artificial means fuel the improvement. In total, this is a net negative as business-equipment spending accounts for 8% of GDP and housing just 2.5%.

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On the international scene the song also largely remains the same. A Europe in recession continues to kick their debt bomb down the road, so while the fuse quickly becomes shorter, the timing of the detonation is determined by how far Draghi is willing to take monetary policy...or how far the Germans allow him to take it. And from the Pacific theatre, the Chinese slowdown continues; the latest Japanese recession deteriorates; and the emerging/frontier markets in the region are unable to escape the adverse affects.

In sum, while the third-quarter GDP print was revised up to 2.7% from 2.0% (it was mostly due to unwanted inventory rebuilding, which will have a payback effect in the current quarter), we remain stuck in this 1.5%-2.0% low-growth environment. Europe is in recession even before they've confronted their debt problem, in earnest anyway. And what's been a source of growth from Asia and other emerging-market regions is now stumbling.

So I thought I'd discuss a more meaningful topic, which is the outlook – a view over the horizon. This is what matters for investment decisions and framing an expectation of future annualized returns over the longer term.

While we're all familiar with PIMCO's "new normal" of 2% for several years, we may want to prepare ourselves for the possibility of a more lasting weakness that borders on stagnation. After all, for those who haven't faced it yet, current economic challenges are very much as deep as anytime over the past 100+ years.

Of course, the conventional wisdom (the poster child of herd mentality) seems to expect we can continue along this low growth path as we await the escape velocity that allows the economy to stand on its own – the assumption being that aggressive monetary policy will eventually deliver such vigor.

The view ignores a condition I call short-termism. Policymakers are clearly afflicted by this condition, and it spells deep trouble for the future as they neither allow markets to clear nor seem to care about the consequences of their actions. (The conventional wisdom I speak of is unable to see the perils of this policy as it's a zeitgeist brainwashed by Keynesian groupthink – a philosophy trapped by this short-termism as its foundational principle is: "In the long run we're all dead." John Maynard Keynes)

That is, instead of delivering us from this economic purgatory of high indebtedness and low growth, the policy path we're on only perpetuates economically sinful endeavors. Aggressive monetary policy encourages households and government to take on even greater levels of debt, and they both merrily oblige.

So long as the powers that be continue to thwart markets from clearing (or disallowing recession from fully playing out) capital will be misallocated, too much cash will sit fallow on corporate balance sheets and investors will chase assets merely for their attractive yields without regard to risk or valuation. All of these things result in insufficient levels of economic growth, which results in high joblessness, stagnant incomes, and yet more debt.

It is that debt which is the ultimate killer. Look, the debt excesses are greater than they were when the financial crisis was tripped off in 2008. Any improvement on the household side has simply been shifted to the public sector -- and it's been a lopsided shift as household debt has declined 6.9% since peaking in 2008, while federal government debt has surged 70% over the same timeframe. Our government currently spends \$410 billion just to service that debt – even with Bernanke flooring interest rates. At normalized rates, that number goes to \$1.2 trillion, which will suck up 48% of current revenues.

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So close to 50% of revenues just to service our debt load, that borders on a game-over moment. Then, consider that mandatory spending (Social Security, Medicare, welfare, VA benefits and current interest expense) already eats up all federal revenues, and you can see we're in quite the spot. This is the real "fiscal cliff." It's a chasm actually, a crevasse that's been in the making for many years, and exacerbated by the runaway spending of the past four fiscal years. The longer we wait, the wider that chasm becomes, making bridging the gap all the more difficult.

And our so-called leaders either fail to see this train wreck in the making or simply don't care because it's part of their agenda to Europeanize America. Well, one of our leaders understands the debt-service issue. That person is Mr. Bernanke, who knows the topic all too well, which is a major reason he's implemented QE – it's called debt monetization. What he fails to see is how it's killing us. This is a guy who seeks to mirror the destructive monetary policy the Japanese have engaged in; a policy that's completely sucked the life out of that economy (stagnant for 20 years now).

Below is a table illustrating the World Bank's composition of global GDP, followed by the World Bank's projections of that composition by 2021.

Countries representing more than one percent of World GDP as of 2011	Percentage of World GDP 2001	Percentage of World GDP 2011	Percentage Change 2001-2011
<b>United States</b>	31.8%	21.6%	-32.3%
China	4.1%	10.5%	153.6%
<b>Japan</b>	12.9%	8.4%	-35.2%
Germany	5.9%	5.1%	-12.8%
France	4.2%	4.0%	-4.9%
Brazil	1.7%	3.5%	105.4%
<b>United Kingdom</b>	4.6%	3.5%	-24.1%
Italy	3.5%	3.1%	-10.3%
Russian Federation	1.0%	2.7%	178.2%
India	1.5%	2.6%	72.3%
Canada	2.2%	2.5%	11.4%
Spain	1.9%	2.1%	12.4%
Australia	1.2%	2.0%	65.6%
Mexico	1.9%	1.7%	-14.7%
Korea, Rep.	1.57%	1.59%	1.6%
Indonesia	0.5%	1.2%	142.3%
Netherlands	1.2%	1.2%	-4.2%
Turkey	0.6%	1.1%	81.1%

Data Source: World Bank

Projected composition of World GDP in 2021 based on duplication of 2001-2011 performance	
China	26.52%
<b>United States</b>	<b>14.60%</b>
Russian Federation	7.38%
Brazil	7.27%
<b>Japan</b>	<b>5.43%</b>
India	4.55%
Germany	4.45%
France	3.77%
Australia	3.24%
Indonesia	2.93%
Italy	2.81%
Canada	2.76%
<b>United Kingdom</b>	<b>2.64%</b>
Spain	2.39%
Turkey	2.00%
Korea, Rep.	1.62%
Mexico	1.41%
Netherlands	1.14%

Data Source: World Bank

Now, I don't ascribe to these projections for two quick reasons: One, Chinese growth numbers are a farce and GDP in Russia and Brazil slows once our monetary policy returns to sanity (and I can explain these comments if anyone cares to get into the subject – you know where to find me). Two, if we were to only engage in sound economic policy, U.S. growth would rage again – after, of course, the next great recession that arrives from the Fed unwinding it's wildly aggressive monetary stance.

However, if we continue along the current path, I'll be forced to concede the projection that has us dwindling on the world stage.

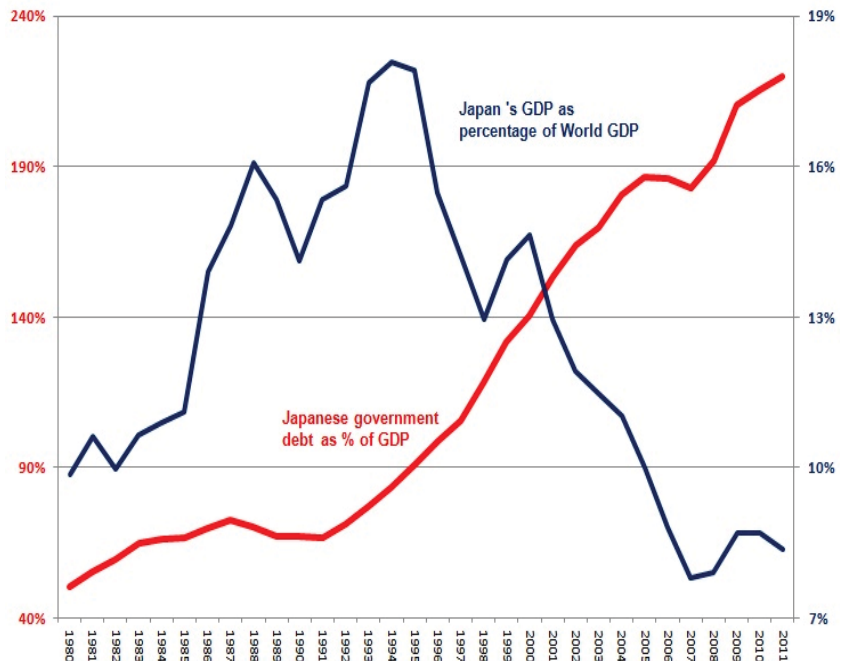
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And if you don't think it can happen, I'm sure there were millions of Japanese who believed the same thing 20 years ago.

It doesn't have to be this way. It's not that America has lost it. Our zest and ability to grow hasn't evaporated – not yet. It's that we suppress that zest with terrible policy choices. Nevertheless, on the current course, there is surely a point of no return moment.

Ultimately, in order to choose the correct path we must be willing to shed a monetary policy that doesn't allow recessions to fully play out; we'll also have to rid ourselves of the destructive social model that's in the process of metastasizing into an overall acceptance of government dependence.



Enough already! We don't want your "help" any longer. Here's to hoping we still have the will to desire that statement.

## Basel III's AFS Provision | Cliff Reynolds, CFA

From the board room to the credit committee to ALCO, the coming regulatory changes detailed in Basel III have become a heavy point of focus for banks of all sizes. Among those proposed changes is the adjustment to include unrealized gains and losses on available-for-sale (AFS) securities in the calculation of regulatory capital. As one of the more disputed rule changes in the current version of the regulation, the AFS adjustment is one of the most likely provisions to be changed before full implementation. But why?

There are several reasons for the controversy around this provision, one of which has to do with the current banking environment. It's a story most everyone reading this knows too well. Banks were urged to tighten lending standards and maintain an extremely clean balance sheet after the credit crisis. For many banks that meant changing the loan mix held by the bank and a heavier emphasis on the investment portfolio. In addition to the tighter lending standards that moved banks to grow their securities portfolios, risk-based capital standards continue to drive banks to favor debt securities guaranteed by the US Treasury or a government agency – eliminating most if not all opportunity to earn risk premia outside of interest rate risk (duration).

By no means does this mean that banks have traded excessive credit risk for excessive interest rate risk. In fact, the opposite is true. The aim of Basel III as a whole is to bolster banks' capital positions and better prepare the financial system for an economic downturn, but the AFS provision misses the mark. Instead, it adjusts the accounting and makes regulatory capital ultra-sensitive to interest rate volatility. As the proverb goes, "The road to hell is paved with good intentions".

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Even ignoring cases where match funding neutralizes any interest rate change – the true effect on capital that results from a change in the marked-to-market value of both assets and liabilities when interest rates change is ignored in the proposed regulation. As we understand the proposed rule, given a move higher in interest rates, the bank's regulatory capital position would be eroded regardless of any positive effect from liabilities being marked lower as well. Sure, those liabilities are outstanding until the maturity date of the instrument so the benefit most likely won't be realized – but the same could be said for the assets. No bank would ever expand due to temporary growth in regulatory capital from unrealized capital gains that the bank isn't planning on realizing – so why should they be punished when the needle moves in the other direction?

Public comments from bank executives show varying levels of volatility in regulatory capital given such a rule change. A study published by Sandler O'Neill on the effect of Basel III on the banking industry showed a 20% drop in Tier 1 Common Equity industry wide if interest rates rise 300 basis points. Factors such as the ratio of AFS securities to total assets and the duration of the portfolio would affect the impact on any particular bank, but an interest-rate shock like that is not unrealistic given the current environment.

As of the publish date of this newsletter, Basel III requirements have been delayed indefinitely by bank regulators in the US due to a "wide range of views". In our opinion, the regulation will be adjusted from its current form before full implementation. Alternatives provided during the comment period range from excluding securities that are guaranteed by the US government, state and local governments and government agencies to striking the rule from the Basel III framework entirely. The Federal Reserve, OCC and FDIC have given no official statement as to what if anything will be changed, but the statement announcing the delay leads us to believe there will be changes.

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**Unbiased** – Advice on portfolio management is completely unbiased without influence from outside factors such as trading commissions or dealer inventory. As a fee-only advisor, we are solely beholden to our clients' best interests.

**Best Execution** – Acropolis offers years of Fixed Income trading expertise and an expansive network of dealers from which to execute trades. This results in buying and selling the most appropriate bonds at the best prices, with no mark-up to our clients.

**Specialized Reporting** – Our proprietary securities portfolio reports provide detailed data on individual positions with scenario analysis and allocation breakdown.

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