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The Fortress Balance Sheet and Community Banking

Vauban

Seventeenth-century Europe was a period of political and social upheaval led by several powerful countries, including France, England, Spain, and the Dutch Republic. Sébastien Le Prestre de Vauban, better known as simply Vauban, was a French military engineer who is considered one of the most important figures in the history of fortifications. Vauban's designs were so effective that they helped to make France the most powerful nation in Europe for over a century.

One of the key principles of Vauban's fortifications was the concept of balance. He believed that a strong fortress must have a balance of different types of defenses, each with its own strengths and weaknesses. For example, a fortress should have a strong outer wall to protect it from attack, but it should also have a moat, cannons, and other defenses to provide additional protection. By having a balance of different types of defenses, a fortress could be more difficult to attack and more likely to withstand an attack.

View of Neuf-Brisach, a unique fortified octagonal town built in 1698.

The principles of balance that Vauban outlined centuries ago are also applicable to bank balance sheet management today. A strong bank must have a balance of different types of assets, each with its own risks and returns profiles. For example, a bank should not have all its assets invested in loans. It should also have investments in cash, government securities such as mortgaged backed securities, municipal bonds, and other earning assets. It should properly monitor the duration of the balance sheet and potential changes in asset fair values. By having a diverse balance sheet, a bank can reduce its overall risk and increase its chances of success in weathering a recession or economic downturn. Balance is also important for banks when it comes to managing interest rate risk. Regardless if the financial institution is asset sensitive or liability sensitive, it is prudent to have stable earnings across various rate environments within approved risk limits.

In addition to balance, Vauban also emphasized the importance of preparation in his defensive tactics. He argued that a strong fortress must be well-built and well-supplied. The walls must be strong, the cannons must be in good condition, and the soldiers must be well-trained and well-equipped. By being prepared, a fortress could withstand an attack and continue to function even in the event of a siege.

The preparation and planning that Vauban implemented are also relevant to bank management as we think about the asset liability committee. Banks are exposed to a wide range of risks, including interest rate risk, liquidity risk, and credit risk. Effective risk management policies are essential for banks to protect their capital and ensure the safety and soundness of the financial system. A strong bank must have a well-developed risk management policy in place (ALM, liquidity, contingency funding plan). These plans should identify the bank's risks, assess the likelihood and impact of these risks, and develop strategies to mitigate these risks. The various risk policies should also be adaptable to different business conditions and interest rate scenarios. The bank must also have a strong internal control

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system in place to prevent modeling issues and errors. Periodic risk assessments and stress testing of mode variables assist with this ongoing process.

By following the same concepts of balance and preparation, banks can reduce their risks and increase the chances of long-term success. On the other hand, letting the balance sheet be open to external risks that can be controlled through proper risk management is an invitation for trouble. Just as Vauban's fortifications helped to make France the most powerful nation in Europe, a successful risk management framework can help a bank to weather recession and improve long-term earnings and shareholder value.

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