WHO WILL BE LEFT TO OVERSEE THE OVERSEERS?

by Steve Brown

After writing our piece on loan committee efficiencies on Monday and Tuesday, we have heard from a number of banks, every regulatory body (except the OTS) and a number of directors (including ours). Many comments either disagreed with us or ran to the effect of "nice thought, but you may want to talk to the regulators." This is a fair enough position, so we would like to address our following comments directly to our regulatory readers today. In short Â– Get the board away from making credit decisions. First, let us point out the obvious that evaluating credit risk is one of the most difficult and intellectually challenging tasks that take place within a bank. It requires not only strong analytical ability, but also a firm grasp on current loan performance trends. We would never think we were qualified to suggest auto inventory levels for a car dealership, make investment decision for a home developer or comment on a medical procedure, what exactly makes directors qualified to pass credit judgments? Granted, directors tend to be bright and successful in their individual endeavors, but few have experience with estimating default and recovery rates in lending. Are they really qualified to opine on both risk and return from a debt perspective? If the board is going to approve loans, why not approve deposit pricing since that has a greater impact on shareholder value? All the evidence that we have points to the fact that board loan committee decisions have (at best) the same delinquency and default performance than those loans approved by line officers. This merits some explanation, as the reality is that loans approved by board loan committees actually fair slightly worse, but this is to be expected since these loans are somewhat adversely selected. CCOs tend to send loans to committee that they are either unsure about or have policy exceptions, some of which tend to be riskier loans (mostly for reasons other than size). If you look at loans with similar expected loss amounts that get approved at the line level and those that get approved at the board loan committee level, the performance is statistically the same. The conclusion is either: a) banks are sending their largest loans to committee, but these are not necessarily the riskiest, or, b) CCOs can do just fine approving loans on their own. Evidence points to a little of both, but all this is secondary to our point. The crux of our argument is that once the board is placed in a position of actually rendering a credit decision, they cease being a board and become line personnel. Once this is the case, they become vested in the process and have a more difficult time rendering an unbiased opinion. Boards should be overseers of the loan process. They should approve submitted policies, ensure that procedures are being followed and review both loan approvals and declines for compliance of those policies and procedures. In addition, boards should continually evaluate if those loan approvals and declines are commensurate with the stated target risk and return objectives. If board members are making operating decisions, who is left to oversee one of the most important processes in the bank?

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BANK NEWS

Still Branching

The latest June 2006 data shows banks grew branches at a 2.9%.

George is Coming

The Fed announced that banks will distribute the new $1 coin with the likeness of each president in the order they served. Look to place orders mid-January for the first Feb. release. The release will occur 4x per year, so banks are starting their planning now over how to market the campaign and tie it in with bundled products for kids, students, senior accounts, collectors or first movers that always like to be the first on the block with the latest in fashionable currency.

JP Morgan

Chair William Harrison announced his retirement and will hand the reigns to CEO Jamie Dimon.