RISK AND THE NATURE OF CANDY

by Steve Brown

It happens every Halloween night. The kids go out and we sit patiently at home waiting for trick-or-treaters. Between knocks, a battle rages over just how many of those mini-3 Musketeers bars we should allow ourselves to eat. We give in and the next thing we know our blood sugar level is that of Kool Aid. On a normal night, we go for a run, do a couple of sit ups and even have a salad for lunch in order to accommodate a small desert. Instead, because last night was Halloweeen, we stuffed an unplanned 8 candy bars into our mouths before we felt a need to check ourselves into Self-control Anonymous. Halloween, and our chocolate problem, underscores the nature of risk. If it is planned, it is not risk. Many banks stay away from certain lending lines, given a higher level of perceived risk. Consumer loans, agriculture, leasing or unsecured corporate credit are often turned down, citing higher levels of risk. This is a mistake. Higher loss rates are not a function of risk. A higher expected loss offsets an income stream. Instead of making 8%, you make 7% because you reserve 1%. If a loan portfolio has a 1% loss rate, there is no risk. The seasonal analogy is that if you go out for Halloween and you expect it to be cold, you grab a jacket. While it is still cold outside, you have just eliminated that risk of being cold for that given temperature. While bankers throw the term "risk" around loosely, true risk only arises to the extent that performance becomes worse than planned. It is the variability or volatility of the income stream that is the nature of risk. If you expect a 7% return, but could receive 3% return, you are exposed to risk. This is an important point, as we repeatedly hear that a bank will stick to real estate lending because "that is what we know" and that the "losses have been zero." Because of concentration, we can quantitatively prove that some banks are exposing themselves to more risk by adopting this strategy. Even though loss rates may be higher in our Sales Finance Program, adding consumer exposure diversifies the overall portfolio, thereby adding greater stability to earnings. While real estate lending has preformed well recently, it is also highly correlated to the economy. Currently, real estate lending growth has slowed and quality is decreasing (higher delinquencies). As a result, bank earnings have become more volatile. This is an indicator of risk. Meanwhile, banks with diversified lending portfolios have not suffered. Just because an alternative investment may have a higher loss rate, does not mean a bank is taking on more risk. When banks say they don't have the expertise to understand unsecured corporate lending, they are missing the point of risk management. Banks have the ability to acquire the talent needed and build infrastructure, so that an investment's true risk can be understood and mitigated. This additional cost and corresponding investment risk may be far less worrisome than having CRE concentrations in excess of 600% of Tier-1 capital. Banks are designed to take a variety of risks and have the ability to architect themselves around such exposures. Understanding the true nature of risk and how to best manage capital will ensure a stable, high-performing income stream. We could go on about risk, but those leftover 3 Musketeers are still calling our name.

BANK NEWS

M&A

BancorpSouth ($11.8B, MI) will acquire Signature Bank ($847mm, MO) for approximately $170mm, or 1.96x book.

Employees

A study by Mercer HR Services of the savings objectives of people finds 12% fewer are saving for retirement (76% now vs. 85%) than did so 3Y ago, 52% more are trying to pay down debt and 26% more have been saving for unexpected expenses.

Branch Churning

A new study by bankstocks.com finds the largest 20 banks expect to add 3% more branches this year than last. Specifically, Bank of America plans to open 100 branches this year, while closing 75 while Wachovia is opening 30 net new branches (closing nearly 220 branches).

ARMs

The FRB estimates 20% of outstanding mortgages have variable rates and that 50% of those will reset interest rates over the next 12 months (many will reset 5%).

Slapped

Israel Discount Bank ($9B, NY) has been assessed a $12mm fine for failure to establish a BSA/AML program.

Possible Competition

Citigroup has announced plans to open branches in areas where customers of its Smith Barney brokerage business live in an attempt to ramp up bank product sales. States with some of the highest concentrations of SSB offices are CA, FL GA, IL, MA, MD, MI, NC, PA, TX and WA.

Multi Family Sector

The drop in home buying has helped push apartment rents up 5% over last year in the largest 25 markets across the country.