THE RISK MANAGEMENT CHANNEL

by Steve Brown

Census Bureau data finds that the average U.S. citizen spends 65 days per year watching T.V. (3,518 hours to be exact). Some of the largest cable providers now boast as many as 989 channels. We are turning into the couch potatoes our mothers always warned us not to become. In an effort to sprinkle in a bit of brain food this morning, we thought bankers interested in staying ahead of the curve might like to change over to our educational channels to get a brief tutorial on some of the new terms floating about the industry. Risk Management has become more important within the industry as systems have evolved to support such analysis. Risk Management is the process a bank uses to ensure the probability and severity of a potential adverse event remains within acceptable and board-approved limits. RAPM is a more refined level of risk management that refers to risk-adjusted performance metrics that are adjusted to incorporate economic risk. Large banks have replaced ROA and ROE as performance metrics, in an effort to better reflect not only the return of an asset (or on equity), but also the risk inherent in generating such return. Risk-adjusted performance metrics come in many shapes and sizes, but the most common is RAROC, or risk adjusted return on capital. In its simplest form, bankers can use a spreadsheet to calculate RAROC by taking the revenue from a given asset (or liability), subtracting related expenses required to generate the revenue, subtracting expected losses that might occur as a result of putting the asset on the books and dividing by the level of capital required to support such risk. One component banks use to efficiently begin such a process for loans is by incorporating PD, which refers to the probability (or "odds") that a given loan will go into default. Large banks calculate PD for every loan on the books, taking into account both the credit history of the counterparty and the nature of the investment. Independent bankers can calculate PDs on loans in simple terms by analyzing the credit risk aspects of the counterparty and mapping them to a more granular internal risk grade (with an associated PD). Once a banker has captured PD, they will also need LGD, or loss given default. LGD represents the magnitude of loss on a given loan, in percentage terms. So, an LGD of 35% would mean that in the event a loan with such an LGD actually defaulted, the bank would have to write off 35% of the then outstanding balance. Once a bank has the PD and the LGD for a given loan (and in aggregate for a portfolio), they have some of the most critical drivers to begin refining CRE concentration risk analysis, ALLL calculation and enhance loan pricing. Finally, we end our discussion with correlation. Correlation is the relationship between groups of assets (or liabilities) and is often used in banking to quantify the tendency for individual loans to default in groups. Conceptually, the more cashflows from different assets move in similar fashion, the larger the correlation. For example, hospitality and retail are closely correlated sectors, since they are both subject to the same event risk (think in terms of how tourism or sharp economic slowdowns negatively impact both sectors in a common fashion). As a result, banks that have high concentrations in these areas should note that they are not diversifying very much credit risk exposure. That is enough education for today, so we hand you back the remote.

BANK NEWS

M&A

Sterling Financial ($9.6B, WA) will acquire North Valley Bancorp ($904mm, CA) for $196.2mm or roughly 1.88x book.

Competition

Ending days of speculation where job cuts ranged from 15k to as high as 45k, Citigroup announced it would cut 17k jobs (about 5% of its workforce). This is the first restructure for the company since 1998.

Making Change

West Coast Bancorp ($2.4B, OR) is installing coin counting kiosks in 10 of its branches. This will be a free service for customers that will allow them to receive gift certificates, donate to a charity, or receive cash for their loose change. Starting in June the bank will allow the kiosks to directly deposit the money into bank accounts.

Insurance

According to the ABA, total insurance revenue for banks declined 1.3% in 2006. After 5+ years of growth, the decline came due to lower generation of property-casualty premiums as well as lower contingent commissions.

Credit Ratings

Caving in to the furor it sparked over a new credit assessment system for financial institutions worldwide, Moody's downgraded the credit ratings of 44 big banks. Moody's had been in hot water from investors who protested the fact that Iceland's 3 largest banks received the same AAA rating as the U.S. Treasury. Moody's new system was based on an expectation such banks would be supported by their governments in the event of a financial crisis.

Slower & Lower

The IMF cut its forecast for U.S. economic growth by 25% (to 2.2% in 2007), amid weakening conditions related primarily to the housing sector.

Subprime

A recent study from Experian finds surprising evidence that subprime borrowers are more likely to pay their credit cards on time than their mortgage. While mortgage delinquencies have been increasing, card delinquencies continue to decrease. Better access to credit and increased flexibility in stretching out mortgage payments (since they take longer to default) are assumed to be the main reasons.