KNOWING THE ODDS

by Steve Brown

In this highly competitive world, banks must have the capability to get a quick and accurate snapshot of their lending exposures in order to effectively manage risk. To do so requires knowledge of a few key terms that have become endemic in the banking industry. One of the most basic, but extremely important, is Probability of Default ("PD"). PD is the likelihood, or "odds" that a loan will not be repaid and will fall into default. One of the key components to calculate PD is loan payment history. To capture current historical default experience, bankers count up each time a loan has been late on its payment by 30 days or more (we usually ignore loans with a less than 30 day late payment as "noise in the system"). It is critical to also incorporate industry experience to ensure the data set is deep enough. Once the bank has analyzed the credit risk aspects of the borrower, it should also map the counterparty to an internal risk grade. Bankers can then sum all the data up, calculate averages, medians and conduct other analysis to create living metrics for comparison. Once bankers have collected all of the data, it becomes easier to compare loans and sectors to each other and to start to determine risk concentrations (or lending areas available to further expand). The data also gives bankers a more active way to manage customer relationships. Once the loan positions and risks are identified, bankers literally have a roadmap of borrowers or sectors at the greatest risk for default in the future (based on their payment history). Bankers can then leverage this fundamental analysis by comparing it to their relationship profitability reporting. In so doing, for example, bankers armed with this data can zero in scarce resources and focus on customer relationships with poor payment histories and a low relationship score. By aggressively targeting such customers, the bank stands a better chance of either helping the customer solve their issues, stabilize payment streams, or work on an exit strategy. If default is on the horizon for any particular loan and the degree of certainty is relatively high, the banker can take steps to insulate their downside risk including utilizing participations, loan sales, raising more capital or amending loan terms to name a few. In short, setting up a system to monitor, manage and report exposures is not only critical for banks, but gives them a competitive edge. After all, once a bank knows that a given loan has a PD of 20% (and we then know the "odds" that the loan will go into technical default are one in five), while another has a PD of 40%, the bank can move to refine loan pricing, protect its capital and focus scarce resources to insulate risk. Understanding the probability or "odds" that a loan will go into default is a critical first step of any robust and timely bank credit monitoring system. To play the credit game these days begins with knowing the odds.

BANK NEWS

M&A

Capital Corp of the West ($1.9B, CA) will purchase the CA banking business of National Bank of Arizona ($5.5B, AZ) for an undisclosed amount (National Bank is owned by Zions Bancorp). Capital Corp expects to assume total deposits and miscellaneous liabilities of about $211mm and acquire loans and other assets of about $171mm.

M&A Problems

Westborough Bank ($300mm, MA) was to be bought by Assabat Valley Bancorp ($658.8mm, MA) for $20.6mm but now two of Westborough's investors are suing saying the price is too low. The investors allege executive management violated their duty by agreeing to a low price.

Wachovia

The Bank has raised the bar for their target high net worth customer from a current range of $250k to $2mm in investable assets to $500k to $5mm.

US Bank

The Bank will be expanding their "PowerBank" concept that we reported on last year to Denver, Minneapolis, St. Paul, Cincinnati and Milwaukee latter this year. We have been monitoring their launch in Portland and St. Louis that occurred during the start of this year and the data on the concept's success remains inconclusive.

Bank of America

BofA will offer a new high-end luxury credit card to accounts with more than $100k of investable balances. Dubbed "Accolades," the Amex-based card offers a full-service concierge, travel assistance, free medical evacuations, ID theft protection and access to certain airport lounges. The card also rewards clients for continuing to do business with the bank by offering a built-in rebate of the $250 annual fee.

Federal Funds

Amid signs inflation is on the rise, Merrill Lynch and Goldman Sachs finally threw in the towel and officially called off their rate cut projections for Federal Funds later this year. The firms had been looking for as much as 75bp in cuts beginning as early as August. Echoing the sentiment, FRB Cleveland President Sandra Pinalto in a speech said inflation was "uncomfortably high."