LEARNING TO MAKE MISTAKES

by Steve Brown

Much has been made off Thomas Edison's 2,998 mistakes where he tried to heat various items before coming up with the carbonized cotton filament. Edison recorded and published his failures, as well as his successes knowing that one led to the other. Compare this attribute to banking's great failures and you get a completely different picture. When banks run into problems, it is rarely a result of a single error in judgment. While we have done research on the financial reasons that banks fail (liquidity, fraud and credit quality in that order), today we touch on the psychological characteristics. Having worked with banks in the 80's, we experienced first hand how common mistakes can turn into cataclysmic events. Management cultures that fail usually suffer from one major characteristic Â– arrogance. The driving force of intelligence, hard work and creativity oftentimes give way to a feeling of superiority. This culture of supremacy has blinded many bank management teams from admitting early on that they have a problem. American Savings, Superior Bank, First Penn, and Continental Bank are all examples where management identified problems early on, but did not take the necessary steps to diagnose and correct them. In each case, it was not one single problem (such as rising rates), but rather a series of problems (liquidity and credit quality) and poor management decisions that caused a downfall. Looking forward over the next 5 years, credit quality is expected to decrease. After such a long string of successful credit quality years, we wonder which banks will see problems early enough and take corrective action. On the other hand, for every bank that has failed, 10 others fail to take enough risk and let opportunity pass them by. This ultimately results in a performance failure. Corporate America is littered with firms that have fallen into this category Â– Kodak, Xerox and Chrysler to name a few. If banks do not make mistakes, they are not taking enough risk, and not taking enough risk may be the most dangerous type of mistake a bank can make. Bank management that cultivates a culture to allow mistakes, but quickly discloses those mistakes and works on fixing the root causes, will be the one that excels in execution in coming years. Taking a cue from Thomas Edison and developing a problem solving culture is as important as fixing common problems of loan growth and deposit costs.

JUNE INVESTMENT PORTFOLIO PERFORMANCE

For the month of June, yields rose 2bp to 8bp for bank portfolios and credit/mortgage spreads increased 5bp resulting in a total return for the month of just above 3.6% for the average bank. The average book yield increased 2bp to 4.94%. Duration extended 0.12 for the average bank and now stands at 2.78. At present, the average bank has mark-to-market loss of about 1.38% in it. For allocation, for the month of June, banks decreased corporate and municipal holdings slightly and increased agency exposure by 2%. The average bank now has 45% of their investment portfolio in agency debentures, while holding 24% in mortgages.

BANK NEWS

M&A

Marshall & Isley ($48.6B, WI) will acquire First Indiana ($2.1B, IN) for $529mm in cash, or 2.53x book value.

M&A

First Nat'l of Nebraska will acquire Mills County Bank ($34mm, IA) for an undisclosed price.

Legal Woes

An Italian judge ordered Bank of America to stand trial for market rigging in connection with the 2003 bankruptcy of Italian dairy firm Parmalat.

Bill Pay

Yahoo announced that it will discontinue its online bill pay service as of Nov. 1 stating that it does not fit their core competencies.

Derivatives

Due to the increase in fixed rate loan demand, derivatives at banks increased to a record $145T, or up 10% from 4Q.

Overdraft Protection

The House Financial Services Financial Institution Subcommittee will hold a hearing on overdraft protection starting on Wednesday.

Subprime

Bidding interest is showing signs of returning to the subprime mortgage market as WMC Mortgage, a unit of General Electric Co., successfully sold $3B of nonprime loans last week, or two-thirds of its portfolio.

Affinity Program

Bank of America will roll out its new Major League Baseball rewards program. While the details have not been released, rumors abound that it will target checking, certificates of deposits, debit and credit card products in order to give consumers baseball tickets and clothing items in exchange for usage. In addition, it is rumored that fans will be able to place pictures of their favorite players on their checks.