TAKING LUCK OUT OF THE BANK

by Steve Brown

Luck can be defined as the positive outcome of a series of random events; bad luck, the opposite. The earliest recorded banking crisis occurred in 33 A.D. Like all bank failures, this one took bad luck to expose inadequate management and faulty banking policies. After three ships sank, it was found that several banks not only financed the ships, but as bad luck would have it, coincidentally lent against the ship's cargo of textiles and commodities. Tiberius Caesar, provided the first ever government bail out of a bank, resolved the crisis by providing additional funds and allowed for the suspension of interest on some debts. In essence, he created government regulations, as he sent his security forces to these banks to "look after" operations.

If this situation sounds familiar, it is. It is not only the same type of risk that has affected residential real estate and construction, but this banking drama has played itself out more than 1,000 times around the globe, with variations on the theme since the time of Tiberius. Bank failure always starts with bad luck exposing bad management and bad policies.

While the overall economy does play a role in bank failures, it is rarely the cause. A Federal Reserve Study done in the 1990's correlated the failure rate between banks and the general economy at 0.24 (1.00 being perfectly correlated), or only weakly influential. While luck plays a large part in the game of business, banks by their very nature are in one of the best positions to diversify, hedge and manage the risk accordingly, to prevent a bout of bad luck from becoming a catastrophic event.

Throughout history, bank failures have been common in the United States, in large part because many states had unit banks (one branch banks). The inherent lack of diversification made these banks especially susceptible to failure. As unit banking dissolved, so did the number of relative failures. A mark of superior bank management is to strive to diversify every aspect of the bank (including deposits and operations) to the point where the benefits outweigh the costs. While banks that concentrate lending activity in one sector may think that expanding to other lending areas increases risk, the opposite is true.

By diversifying, a bank can reduce risk, thereby resulting in less need for capital and thus a higher return. On the margin, making 2 loans secured by office buildings is good, but making 1 loan on an office building and 1 consumer loan is better. If done correctly, the 2nd combination not only produces a higher outright return, but better performance. While the office building loans may perform better in the short-run, sooner or later there will be a downturn in the office market and it is highly likely that both loans will have problems. We call this correlative risk. The same cannot be said for office and consumer loan exposure, as this combination is non-correlative and the two will produce more stable earnings over time. This is exactly what is happening with agriculture exposure, as those banks with 10% of their loans tied to the agricultural sector tended to put in superior performance over the last 10Ys. While we will be presenting more details at our upcoming Executive Management Conference in May, the summary is that while rates of default are higher on agriculture lending, the risk has the lowest correlation to the economy and thus helps offset construction risk in many institutions.

Through proper diversification, swings of luck will be mitigated and the quality of management will then become the dominant factor to a bank's success. Luck should be relegated to its proper place Ã¢Â€" to speculators, rabbits and the Irish.

BANK NEWS

Oversight

The Treasury will propose the creation of a "Systemic Risk Regulator" to oversee banking & major market. The Fed will get more powers; enhanced bank oversight will prevent firms from shopping among regulators for the least stringent supervision; transparency will be increased for intrabank lending, capital rules for larger banks will be increased (reversing most the advantages of Basel II); and, enhanced consumer-protection enforcement.

SBA Change

In an effort to boost small business lending, the Treasury said it will purchase up to $15B in securities backed by the SBA, guarantee up to 90% of 7(a) loans, eliminate upfront fees to borrowers, eliminate fees on 504 loans and refund any fees charged to borrowers or lenders since Feb 17. Prior to the change, volume in the 7(a) program had been down 58% compared to the same period last year.

Rule Change #1

The FDIC will consider raising pricing on longer-term debt issued under TLGP, as it seeks alternatives for the special assessment.

Rule Change #2

The SEC will consider adopting a modified up-tick rule at its meeting on Apr. 18.

Bank Protest

The Service Employees International Union has scheduled a protest of major banks in many cities on the 19th "to demand more responsible corporate behavior and call on Congress to enact the change that will make it happen."