HOW TO MAKE MONEY TODAY

by Steve Brown

If you want to make money today, try the classic "dollar auction" stunt. Go to a group of people at work (the more the merrier) and announce that you are going to auction off a dollar bill. Bidding will start at 5cents and will be increased in 5cents increments. The only rules are that the auction will end when no one bids higher and the 2nd highest bidder pays their highest bid to the auctioneer. Bidding will enthusiastically begin at 5cents and ratchet up sharply from there. Somewhere around 55cents, players will realize their dilemma. At this point, competitors are locked into a win-lose game with the auctioneer making more than $1 (if they stopped bidding at 55cents, the next highest bid (50cents) will have to pay and the auctioneer will walk away with $1.05). The problem is that person that is bidding 50cents no longer cares about the auctioneer and just wants the dollar to make a profit or limit their losses. This bidding war can theoretically continue indefinitely. In practical situations, it ends when someone chooses to fold. Usually, bidding goes well past a dollar, as players are bidding $1.75 to win just so they will only lose 75cents, but ego-driven games can go above $10.

While amusing, the game is also highly instructive and illustrates how a sequence of rational decisions can result in an absurd outcome. Called "irrational commitment" by game theorists, the concept is at work in events such as war, drinking games, labor negotiations, the setting of CD rates, building of branches, asset sales and a host of other endeavors where a losing participants also pay a price for competing.

The important question for bankers is how can irrational escalation be avoided? First, it is important to recognize the traits of a competition fueled by irrational commitment as highlighted above. If realized early enough, a favorable outcome can be obtained. For these types of games, there are only 2 strategies to employ. The first is cooperation. Assuming doing so isn't illegal (e.g. anti-trust, tying, etc.), cutting a deal with the competition will result in the best possible outcome. In the dollar auction game above, agreeing to stop the bidding early and splitting the profits would be the best outcome from the participant's standpoint. The problem is that getting everyone to cooperate is difficult. Every player has incentive to deviate from the competitive pact. The more participants, the lower the incentive becomes to cooperate and the higher the probability someone will break ranks (thereby ruining the chance for a cooperative outcome).

Absent of cooperation, the other strategy is to not enter such games (if you do, cut your losses early and get out). Because of the structure of the game, the odds of playing for losses are greater than playing for profits. As such, contrary to what your ego tells you, the best outcome is to remove yourself from the game and save the embarrassment and potential losses.

Of course, the best course of action is to be the auctioneer, so we will start the bidding at 5cents.

BANK NEWS

Net Income Irony

On a day where President Obama will decree that large banks need to be broken up (due to their risky endeavors in areas such as investment banking and trading), Goldman Sachs posted much higher than expected earnings (because of gains in investment banking and trading). Goldman turned in a profit of $4.95B, or 60% higher than forecasted. The earnings release also contains other humorous subtext, as another reason for the outsized profit was a reduction of compensation expense to employees. In addition, also to appease the public, Goldman gave $500mm of its bonus pool to charity.

Earnings

Wells Fargo reported 4Q profit fell 87% from the end of 2008 to $394mm, as earnings were hit by costs related to repaying TARP and an 18% jump in nonperforming assets from prior quarter.

FDIC Expansion

The FDIC announced it will open a satellite office in Chicago, IL and staff it with 500 people to manage receiverships in the region. The FDIC already has similar offices in Jacksonville, FL and Irvine, CA

More Regulation

President Obama has reportedly reiterated to the Senate Banking Committee that he wants a stand-alone Consumer Financial Protection Agency to be created.

Consumer Debt

Consumers reduced borrowing by the most on record in Nov. as they cut credit card use by 20%.

FHA Requirements

The agency issued stricter guidelines, requiring a 10% down for borrowers with a FICO below 580 and increasing the mortgage insurance premium from 1.75% to 2.25%, and dropping seller concessions from 6% to 3%.

Compensation Tariffs

Bankers should know that VT Representative Peter Welch has proposed a 50% tax on employee bonuses above $50k at banks that received bailout funds from TARP.

ABA Outlook

A group of ABA economists estimates a 3.1% rise in GDP for 2010 with consumer credit expanding 3.2%. Chargeoffs are expected to drop 30bp to 4.7% and delinquencies should decline by 50bp to 4.2%.