THE GREATEST HAIR BAND IN RISK MANAGEMENT

by Steve Brown

Sometimes a solution in risk management is simple. Take for instance the 80's rock group Van Halen. During its heyday, band managers would verbally negotiate a bowl of M&Ms be placed in the dressing room for every concert. In the contract, the band also had a separate clause that required all the brown M&Ms be removed. David Lee Roth, the band's lead singer, would pull up in his motor coach to the concert venue, go back stage and check the bowl of M&Ms. If he found a brown M&M, he would go ballistic and demand a line check of the entire production, under threat of canceling the show and payment of full compensation.

Can anyone really hate brown M&Ms that much? Don't they taste the same as those green ones? While everyone pegged Van Halen as a bunch of egotistical rock divas that needed things a certain way, the reality was that they couldn't care less about the brown M&Ms. Because a road show is technically demanding and complex in production, the Band was concerned with getting everything right in order to deliver the best show for the customer. For example, the contract called for specific amperage in the certain electrical sockets, certain security requirements, specific lighting and production checks. In order to save time, Roth inserted Article 126 demanding the removal of the brown M&Ms. If the production crew were paying attention to the contract and cared enough about the details, they would catch it. If not, chances were that production management probably skipped over some other requirements as well. Instead of a diva, Roth was actually very operationally astute, as he used the brown M&Ms as an alert for risk.

Banking has a similar version of its brown M&Ms in the form of cost of funds. A management team that focuses on their cost of funds and limits growth equal to its core deposit formation, most likely pays attention in other areas as well. This precursor of risk has even stronger predictive power in times of rapid or double digit asset growth. Looking back historically, controlled deposit growth usually meant controlled loan growth. That in turn often resulted in proactive management in underwriting and credit allocation. A majority of the time, banks with a low cost of funds also tend to have more diversified loan portfolios, with limits on construction and CRE. As a result, a majority of banks that produced a stable and low cost deposit base back in 2006 are performing in the top 25% of banks in 2010.

At our upcoming Executive Management Conference in May, we will be going in depth about the quantitative lessons learned from the 2004 to 2009 banking experience and what banking attributes should have alerted us to risk. We will present evidence why growth, brokered CDs, excessive branching and a host of other performance metrics are not necessarily precursors to troubled performance, but merely symptoms. We will also discuss how geography, loan pricing, deposit structuring and fee generation play a larger roll in success or failure than most bankers give them credit for.

Bankers are blessed with having a statistical business that is ripe for setting up risk alerts to better control performance. Whether its risk-adjusted net interest margin, cost of funds to peers, revenue per employee, efficiency or scenario planning; bankers can set up a wide variety of alerts to help them run their business. The trick is to pick the right ones and to make sure they both control risk and increase profitability. Van Halen gave us some great songs (Top of the World and You Really Got Me are our personal favorites), some the best guitar riffs ever and now we can add some insight into risk management Ã¢Â€" not bad for some guys that also sang Everybody Wants Some.

BANK NEWS

Fraud

Charles Antonucci, the ex-president of Park Avenue Bank (closed Friday by regulators), has been charged criminally with attempting to defraud TARP. Prosecutors charged Antonucci with 10 counts of fraud, bribery and other crimes, including accepting free plane rides from a bank customer and stealing $103k from pastors of a church in FL. In late 2008, Antonucci said he had invested $6.5mm of his own money into the bank, when in reality it was a loan from the bank structured through a series of fraudulent transactions.

Reform

The Dodd Regulatory Reform Bill is officially out and some of the things it creates are: a consumer division within the FRB (would write rules for banks and nonbanks); the FRB loses oversight of BHCs and state banks with <$50B in assets; the FRB would have oversight of all systemically important firms; the OTS is eliminated and merged into the OCC; a Financial Stability Oversight Council that would identify risks to the financial system and trigger a process to seize and dismantle large financial firms in danger of failing if needed; and it requires large banks provide a plan to regulators for shutting them down in case of emergency.