EASTER AND ADVERSE SELECTION

by Steve Brown

While popular, the concept of the Easter Bunny is muddled and breeds gullible, hyperactive kids. There is no good back story about the whole chocolate egg connection, nor why the Easter Bunny even has to hide eggs. Finally, while Santa has plausible cover for breaking and entering, the Easter Bunny does not. So on Easter, we get our kids up early, make them dress up, try to make them sit still in church for an hour and then turn them loose on chocolate and hot cross buns. To top it all off, the parents are really the rubes here, as any 4-year old sees right thru the Easter Bunny ruse, but knows that if they tell their parents their true beliefs those divinity fudge eggs will cease. As a result, parents go around thinking their kids still believe in the Easter Bunny for years. This is why if you show up to church for early mass Sunday morning, you get an adversely selected portion of the population that are the most gullible, Type A families all with low blood sugar trying to control the most misbehaved kids on the planet. For the highest of holy days, it is ironic that if there is a hell on earth, the early Easter mass comes pretty close.

Speaking of adverse selection, the hurtful process must be guarded against in banking. Adverse selection happens when a market rule results in the least desirable outcome. For instance, life insurance policies tend to attract applicants who take high risks. Take for instance management having to undergo an expense control initiative. In an attempt to reduce overhead, we came across two banks this week that may be taking the wrong approach for their shareholders. One is offering a buyout of employees if they quit, the other is asking all employees to take a reduction in pay. While both are nice ways of achieving lower staffing expenses, both will result in the best workers leaving (the buyouts will make this occur at a faster rate) over time.

Adverse selection is also alive and well in banking these days when it comes to pricing. In the past week, we came across several instances where a bank pushed their loan production people to book loans above a certain spread or rate, thereby attracting a lower quality of credit, without regard to risk.

Rate must be taken into account as an adverse selecting mechanism. If you need to achieve a 3% margin, it is far better to set average deposit rates at 1% and loan rates at 4% (we are talking floating rate loans here), than setting deposit rates at 3% and loan rates at 6%. The latter attracts not only a less credit worthy borrower, but a more rate sensitive depositor as well.

In stressed economic types, decisions like reducing assets, managing expenses or setting pricing are tough ones to make. The trick is to be sensitive to the market mechanisms so as not to result in the opposite of expected outcome.

By always asking yourself, "Is adverse selection in play with this project," bankers can prevent profits from being as hollow as those chocolate bunnies.

BANK NEWS

Social Media

For those still doubting the power, JP Morgan Chase released the results of their $5mm charitable give away where consumers became fans of the Bank's Facebook page and got to vote for where foundation money should go. The Bank ended up with an eye opening 2mm fans, the most of any bank in the world.

Job Market Weakness

A survey from Harris Interactive finds 76% of employees are willing to take a pay cut to stay employed, while 88% of those currently out of work say they would take less salary to get a new job.

Holy Moly

According to Reuters, foreclosure proceedings on churches grew 200% since the end of 2007 and in 2009, over 100 churches filed for bankruptcy.

Cash Back

TD Bank ran a promotion in the 1Q targeting existing customers and payment behavior. The bank rewarded customers up to $50 cash back for using their debit cards on groceries. First Annapolis Consulting notes about 60% of debit card holders use their cards regularly at the point of sale and most continue a habit of doing so, once they begin to use their debit cards at the point of sale.

Student Credit

Equifax finds student loans rose 50% from 2007 with $55B in new borrowings over 2009.

Fixed Rate Risk

The PA Lottery got a sharp lesson in risk management this week when the combination 7-7-7-7 was selected. Lucky 7s are one of the more popular tickets selected by lottery players each week. Unfortunately, the PA Lottery has largely fixed rate payouts instead of variable percentages of the pool. The result was the PA Lottery had to pay $7.2mm more than it took in.