THE SHARP EDGES OF RISK MANAGEMENT

by Steve Brown

Sometimes risk can be obvious and sometimes it may not be quite as obvious. As humans, we all carry biases that we may not even be aware of which can impact the amount and nature of risk we will accept. Risk is complex, it is difficult to manage and it is deeply embedded into the very nature of the business of banking. To more fully understand where risk lies and how the mistakes we make can significantly impact the bank, we have to delve deeper.

One area to begin is by focusing in on what we don't want to have happen. Risk management isn't about building sophisticated models that spit out results that help us feel we are in control. No, the world is way too complex and interconnected to do that and we just aren't smart enough to handle all the variables. Instead, bankers should know that low-frequency, high-impact events can and do happen. The best we can all do is to prepare, stress test, and monitor warning signs to make sure the bank weathers whatever storm suddenly appears.

Managing risk is also about acting prudently and listening to age-old advice you already know. Don't concentrate risks by sector or by customer. Don't try to "win" the risk management game, but rather think about how to avoid the pitfalls that can make life miserable. Understand that earning $1 in profits is the other side of the coin (and just as important) to avoiding $1 in losses. The list goes on and on, but one thing we like to recall is that if your mom gave you the advice some time in your life it is probably good and you should probably listen.

There is no single number that can adequately describe the risk profile of a bank Ã¢Â€" period. Here again, technical types can get caught up in concepts such as standard deviation or value at risk. While valuable tools, they do have limits, so don't overestimate their capability. For example, standard deviation works well when things are calm because most changes fall within certain limits. For instance, the average standard deviation of the S&P 500 from 1992 to 2007 was about 13.5%. By using statistics, that means any specific data point will fall within one standard deviation 67% of the time and two standard deviations 95% of the time. However, when things get volatile, standard deviation begins to break down. Recall that standard deviation is a statistical measure that calculates the dispersion around a central tendency. When the world starts rocking, the deviation from the central tendency can jump out to 10, 20 or even 30 standard deviations. The world is complex, so this happens more frequently than you might expect and its impact on a bank can be significant if models are relied upon too much.

No model is perfect and all have their issues. Bankers that understand this going in and rely on multiple sources, multiple models and constantly test and retest assumptions feeding such models stand a much better chance of protecting the bank over the longer-term.

Remember that probably the single biggest risk we face is overestimating our own capabilities and underestimating what can go wrong. If the sign says it has sharp edges and not to touch them or risk getting cut, fight the impulse to check for yourself and you are much further down the road of professionally managing risk.

BANK NEWS

Booming Workers

Economic strains have led 30% of workers to say they expect to retire after age 65, according to a new study, compared to 24% just a few years ago. Meanwhile, 40% of baby boomers surveyed said they will work past age 70 or do not plan to ever retire. This problem means unemployment levels could remain sticky and high for some time to come, until these older workers have time to rebuild their nest eggs.

Loan Sale

The FDIC released some of the terms for the $421mm Silverton hospitality and participation loan portfolio. Unfortunately, or fortunately, the price of the loans were not disclosed, but a 40% participation (the FDIC will retain the other 60%) in the loan pool was sold to Square Mile Capital.

Big Banks

Treasury Secretary Geithner urged Congress to ratify a 10Y, $90B tax on banks $50B and larger to recover bailout costs. More important, the White House is backing away from its prior plan of applying a 0.15% tax on all non-deposit funded liabilities on a bank's balance sheet. It looks like this tax will be applied to riskier assets.

Fed Powers

In response to Chris Dodd's drafted financial reform bill, an amendment is being proposed to maintain the FRB's supervision powers over not only the 50 largest firms but also community banks. Just a few month's ago, legislation was leaning towards stripping all oversight powers from the Fed.