DIVERSIFICATION - WOLF STYLE

by Steve Brown

Despite hanging out with that milkaholic Lindsey, that e*Trade kid gets it. In the television commercial, he is worried about his investment portfolio's volatility and so "diversifies like a wolf." Now, we are not sure what a wolf has to do with diversification, but since we love the marketing and have never been strong on analogies ourselves, we'll go with it.

For banks, diversification of credit quality helps manage risk. Over the last 2Ys, the inability to diversify has caused the demise of many banks. Construction risk, while once profitable, also came with 5+ standard deviations of volatility in retrospect. When a credit shock of epic proportions hit, the price for construction loans fell to an average of 35 cents on the dollar. That compares to 96 cents for agriculture, 92 for C&I, 89 for consumer and 85 for CRE. What was a nominal above average return from 2000 to 2007, was really a below average risk-adjusted return. In other words, the average bank should have been more wolf-like when it came to loan diversification.

Deciding what lending diversification should be for each bank depends on many inputs. These include choice of available credit, the volatility of those choices and the board's tolerance for risk. The more volatile the lending sectors or geography, the more a bank needs to diversify. As we will demonstrate shortly, in this market, volatility is extremely high, which means there has never been a better time to diversify.

To further highlight this point and to make this article interactive, we have built several models on our BIG Metrics platform that you can play with. One model compares your bank's loan allocation to national and regional averages by loan sector as of 1Q. Another model displayed on the free dashboard, looks at a bank that is evenly distributed across lending sectors as having a score of one. All banks are then ranked as to their score given this perfectly distributed bank and the target bank is then ranked against the industry as to diversification Ã¢Â€" the higher the score the greater the diversification. Here it should be noted that we are not saying that an evenly distributed loan portfolio is optimal, only that it provides a benchmark to compare against. Finally, at the bottom of the Dashboard is a 10Y history of real estate loan performance compared to the average community bank's loan portfolio.

Leveraging data we have collected from other sources, we marked-to-market a group of loans from their respective sectors and divided that price by the book return of those loans. Thus, a loan at par with a 6.50% yield has a price-to-return ratio of 1,538. We then standardized everything starting in May of 2000 analyzed relative performance of each sector and compared each sector to a diversified portfolio. The analysis finds not only has the industry become more volatile, but diversification has become more important with increased volatility.

The summary of the dashboard and the other analysis indicates banks may still be too concentrated at a time when volatility is still very high. This profile is working counter to producing stable earnings that is required to attract needed capital.

To get interactive and see more, go HERE and click the Diversification Dashboard on the bottom right. Many banks should make like that wise-beyond-his-years e*Trade baby and take care of volatility -

wolf style.

TACTICAL WORKSHOP DATES

If some of our writing is good, you should see us in person. To that end, we will be hosting a series of 1-day workshops focusing on setting diversification targets, bank profitability, strategic planning, lending, cost of funds and risk management in Chicago, IL (July 27th), Charleston, SC (Sept. 14th) and Falls Church, VA (Sept. 16th). For more information and to register go: http://www.pcbb.com/conference_tbw.html

BANK NEWS

Officially Extended

At its board meeting, the FDIC adopted a final rule (following the public comment period after the interim rule of Apr 2010) extending TAG through Dec 31, 2010 with an option to do so again until Dec 31, 2011. The final rule that modifies the assessment basis for calculating the assessment rate for the average daily balances in the TAG related accounts and requires participating banks to reduce the interest ate on NOW accounts to 0.25% from 0.50%. PCBB is participating in TAG, so NOW and DDA accounts at PCBB are fully insured through Dec. 31, 2010.

Nearly Extended

Congress has reportedly reached agreement to extend the TAG program through 2012 as part of the financial overhaul bill. Once this is signed into law in final form (expected in July), NOW and DDA accounts at PCBB will continue to be fully insured through 2012.

Interchange Fees

Conferees agreed to allow the FRB to set debit card interchange fees and will: take into account cost and fraud; exempt most prepaid cards (under conditions); allow merchants to offer discounts for particular payment types (credit card, debit card, check or cash), but clarifies that they can only do so for type and not based on the issuer or network.