2 BITS, BAD HAIR AND BANK RISK

by Steve Brown

It used to be a man could go to any barber shop and get his hair cut with a pair of scissors and a relaxed conversation. Now, it is all about cutting as many heads of hair as possible as to maximize profit for the haircutting establishment (no longer a barber shop either). Instead of sitting down and telling your barber you want a trim, you now sit down and tell a cosmetologist you want a #2 haircut on the sides and a #5 on the top. They then take out marine shears, slap on a plastic clipper and quickly buzz back your dense growth. While you aren't too sure what a #2 is (other than short) or a #5 (other than slightly longer than a #2), you usually leave happy. The problem occurs when a tired/bored cosmetologist weed whacks the top of your head with a #1 (very short) and the sides with a #8 (very long) and you end up looking like a poorly groomed show poodle or whacky Uncle Bob. The lesson - sitting down in any chair for a haircut from someone you don't know adds an unknown amount of risk.

As you can already tell from our long winded opening, today's article is all about risk. Any discussion about risk in banking can be lengthy and traverse in about as many directions as there are hairs on your body (about 1.4mm for the average Joe), so we are going to try and keep our focus. The first thing to know about risk is that there are key factors that are all interrelated. Some of the most obvious and oft-cited include strategic, market, credit, liquidity, operational and reputational.

Further, because of the interrelated nature of banking and the financial system, risk resides not only inside the bank, but also across the world. We have seen this most recently in the leverage that was allowed to build up in the financial system as was seen in Bear Stearns (had an assets to capital ratio of 33 to 1), Lehman (30 to 1) and Merrill Lynch (28 to 1), to name just a few. In comparison, commercial banks like Bank of America and Wells Fargo typically run about 11 to 1. Deleveraging is painful and it is ongoing, as mega firms slowly unwind risk.

There is also no doubt that managing risk is a difficult task at any bank, let alone a community bank with limited resources. To get a better handle on what to do when it comes to enterprise risk, begin by focusing on a few key issues and assigning accountability. First, set up decent governance and policies. Banks are good at this, so it should not be a foreign idea. Here, bankers need to decide who will be responsible for managing risk within the bank and how different units will make risk management decisions. Next, focus on building a framework to assess and quantify risk. Determine what inputs and outputs are needed, how frequently they need to be updated and what the risks are inherent in the sources themselves. Third, determine what specific decisions the bank needs to make in an attempt to optimize the risk/return profile of the company. Finally, create some reports to monitor things at both the management and board level. Understand what risk measures need to be tracked; what risks are acceptable and which ones simply cause too many people to lose sleep at night due to unacceptable risk appetite.

Many community bankers we talk to say they are already overwhelmed with regulatory pressure and building an enterprise risk management process is not something to relish. Start small, identify the 3 to 5 biggest risks. Then, set up a program around those to measure, monitor and report those risks consistently and you have the beginnings of a risk management program. Once you feel comfortable with the process, take the next step and move to incorporate incentive structures into the mix.

You never know what sort of hair cut you are going to get when you wander into the shop. However, managing that risk by checking the license taped to the mirror and working with a hair cutter with at least 10Ys of experience is perhaps a good place to start before the shears start a-choppin'.

BANK NEWS

Fin Reg

The Senate vote commences at 11am ET this morning and passage is expected.

JP Morgan

The first major bank to release earnings posted $4.8B in net income, up from $2.7B from last year. Earnings were higher than the $2.8B expectations and were due to lower loan loss reserves and some strength in most business units with the exception of investment banking.

TARP Report

The Congressional Oversight Panel's TARP report notes small banks that received money from the Capital Purchase Program are "struggling to meet their obligation," "with no way either to escape the CPP or to repay their required dividends." By 2013, the 5% dividend will increase to 9%. The data shows 1 in 7 small banks are behind on at least one dividend payment.

Free Checking Replacement

While Bank of America did away with its free checking product; it just introduced its "eBanking," which is free checking without a minimum balance. It has no paper statements and no teller interaction (users need to go through ATMs for deposits and withdrawals).