NCAA AND RISK MANAGEMENT MADNESS

by Steve Brown

While running an office pool will give you more power than a CEO, it is worth noting that this year's NCAA basketball tournament will sap some $1.5B of productivity from offices across the country. However, entering an NCAA pool can be an instructive exercise in risk management and game theory. While you have probably completed your brackets, we wanted to use the Tournament as a teachable moment, as our tips are as applicable to loan pricing and risk management as they are to NCAA pools. First, like running a bank or making loans, successfully picking your NCAA bracket is not about guessing the winner, but rather, maximizing your expected return. You might win if you pick top ranked Ohio State, but so will everybody else. To avoid ending up splitting the pot 20 ways, it is best to be driven by a return maximization strategy. Good loan pricing and credit stress models (like ours) take into account return, the probability of an outcome and the expected amount of such outcome should it occur. Whether you are managing loan pricing or NCAA brackets, understanding the probability of winning (or losing) and the expected amount associated with each decision, should help drive your choices. For the NCAA's, pick all #1 and #2 seeds to win the first round. Yes, this is boring and you might lose, but never bet your whole bracket on UC Santa Barbara going all the way. This is similar to finding an "express" approval process for certain loans with strong debt service coverage. Why spend an hour in loan committee for a loan that has 2.5 DSC? The loan might go bad, but it is not probable. After you have part of the first round of the NCAA brackets picked, start in the center by picking the Final Four and working outwards. These are the highest probability plays and are rarely wrong. To our point earlier, filling out an NCAA bracket is like a loan process. The lower credit risk loans and the higher credit risk loans get approved or rejected with very little increase in resources. Like the NCAA, the difference between success and failure in banking is what you do in the middle. Now that you have the lowest ranked teams thrown out and your teams in the Final Four, it is time to spend the bulk of your resources. Here, if you need help in determining probabilities, use Sagarin Ratings, win/loss records, or Vegas odds. Put emotions aside, as getting married to a borrower (when lending) or a team (in NCAA) comes at a steep price. This is where you go from winning to return maximization. Every year it seems, a #9 seed beats a number #8 seed and makes a name for themselves. In fact, there is a 40% probability that this will occur. Pick the #2 or #3 teams and hope for an upset. Pick teams that are on a recent conference tournament roll, teams that play near their home location (draw more fans to the event) or teams with strong guard play (weak guards lose the ball and turnovers kill). Don't pick by committee. Sports Illustrated used to do that and had to abandon the process when it became the laughing stock of the sports world. Not to draw any parallels to loan committees, but individuals tend to make suboptimal decisions when they know they can abdicate responsibility to a committee. Choosing by committee usually gets you either an ultra-conservative solution that pleases everyone but fails or a solution with too much risk and not enough return because no one is taking responsibility. Committees are great for gathering information, but bad for decisions. Once you have your bracket set, think about diversification. Depending on the entry fee, the size of the pool and the type of pool (some get penalized for wrong guesses), look to leverage your hard work by entering other tournaments with slightly different picks. While there are over 9.2 quintillion (yes, 18 zeros) outcomes in the NCAA Tournament (and betting is illegal in most states), like banking, taking a methodical and risk-based approach should help drive earnings to the bottom line.

BANK NEWS

New Fees

JPMorgan, PNC and other large banks are changing ATM policies in an effort to collect more fees to replace those lost by new legislation. As a result, non- customers who withdraw money from some bank ATMs could pay as much as $5 soon and customers could pay $2 to use their own bank's ATM machines.

Bank Liquidation

The FDIC has clarified liquidation authority, indicating compensation will be recouped from senior executives and directors who are substantially responsible for the failure of the bank. It presumes these executives are subject to recoupment of up to 2Ys of compensation.

Japan Impact

Experts say problems in the country and the overall impact to the US should be minimal, since Japan accounts for 6.4% of US imports and 4.7% of exports.