TAKING THE LUCK OUT OF BANKING

by Steve Brown

Good luck can be defined as the positive outcome of a series of random events, while bad luck is just the opposite. The earliest recorded banking crisis occurred in 33 A.D. Like all bank failures, this one took bad luck to expose inadequate management and faulty banking policies. After three ships sank, it was found that several banks not only financed the ships, but as bad luck would have it, coincidentally lent against the ship's cargo of textiles and commodities. Tiberius Caesar provided the first ever government bank bail out, by providing additional capital and allowing for the suspension of interest on some of the debts. It should be noted that Tiberius also was the first to institute regulatory pressure, when after the bail out he sent security forces to these banks to "look after" operations. When it comes to banking crises, this situation has played itself out more than 1,000 times around the globe, with variations on the theme since the time of Tiberius. Bank failure always starts with bad luck exposing bad management and bad policies. While the overall economy does play a role in bank failures, it is rarely the cause. A Fed study done in the 1990's correlated the failure rate between banks and the general economy at 0.24 (1.00 being perfectly correlated), or only weakly influential. While luck plays a large part in the game of business, banks by their very nature are in one of the best positions to diversify, hedge and manage risk accordingly (to prevent a bout of bad luck from becoming a catastrophic event). Throughout history, bank problems usually reach a critical point due to a concentration issue. This was one problem with unit banking (1 branch banks), as their inherent lack of diversification made these banks especially susceptible to failure. Choosing allocation targets between asset and liability classes drives almost 90% of a bank's performance, yet this topic rarely even comes up at strategic planning meetings. A mark of superior bank management is to strive to diversify every aspect of the bank (including deposits and operations) to the point where benefits outweigh costs. By diversifying, a bank can reduce risk, thereby resulting in less need for capital and thus a higher return. Diversification can be optimized in any number of ways, but it starts with credit because of the leverage nature of banks. Here, one rule of thumb is that as average weighted DSC goes down, diversification should increase. In similar fashion, the more correlated your balance sheet is to the general economy, the greater diversification required. Banks that overlook consumer, agriculture, C&I and Treasury holdings; in favor of real estate- backed exposure may think they have a lower risk profile, but usually find their correlative risk overwhelms their single asset risk (resulting in a lower than expected risk-adjusted return). At our upcoming Executive Management Conference, we will update this diversification discussion and give examples how banks can be more proactive in the strategic planning process in choosing allocations (instead of letting the market dictate the outcome for shareholders). Through proper diversification, swings of luck will be mitigated and the quality of management will then become the dominant factor to a bank's success. Luck should be relegated to its proper place - to speculators, rabbits and the Irish.

BANK NEWS

Loss Share

As of Jan 31 (the data), the FDIC has paid out $8.89B to acquiring banks under loss share agreements, a number less than expected. These agreements are in place at 236 financial institutions, with the FDIC agreeing to assume most future losses on about $160B of assets for an estimated $22B in exposure.

TARP

Of Tarp takers with less than $20B in assets, about 13% (86 of the 673) have repaid the Treasury. Meanwhile, as of yesterday, repayments, dividends, interest and other income from TARP entities have produced $244B in return to the Treasury. That is more than 99% of the $245B in total funds disbursed and Treasury now estimates the bank portion of TARP ultimately will provide a profit of $20B to taxpayers.

Hotel Loan Value

Blackstone and Square Mile Capital agreed to purchase some $385mm of hotel loans (45 properties) from the FDIC at an average cost of $0.80 on the dollar. The price represents some of the highest aggregate levels.

Economic Hit

Japanese tourists represent 18% of all visitors to Hawaii, the state's single largest source of visitors outside the US. The disaster in Japan and concern over windblown radiation is expected to hit the area hard economically, as Japanese visitors spend $2B in Hawaii each year.