THE PORNOGRAPHY OF RISK

by Steve Brown

Last week, both Moody's and S&P put the US credit rating under review for a potential downgrade. The Treasury is currently posting a US total debt subject to limit at $14.344T (and increasing) - above the $14.294T limit thanks to some borrowing tricks with Federal employee retirement accounts. The potential downgrade of US debt is interesting to think about, as it places the nature of risk in its convoluted perspective and may help banks better think about risk management. At the heart of the matter is the question - what is risk? Despite being advanced practitioners of risk management, only a half dozen banks that we know of have actually taken the time to define "risk." Is risk the probability of lower capital? Of earnings? Is risk about the volatility of earnings? Is risk the inability to realize your dreams? Is risk, like pornography, hard to define but you know it when you see it? Regardless of how your bank defines risk, a downgrade would matter little. While this may sound myopic to some, our definition of risk works for us, as we have now grown more confident with this latest test.

Because the entire global credit structure is based on the US Treasury, a downgrade to the Treasury does not increase theoretical risk by our way of thinking. Risk, because of how we have defined it, is based on a one-dimensional spectrum which ranges from risk-free at one end, to defaulted debt at the other. A downgrade just shifts the entire spectrum, keeping everyone in the same space. In other words, because most definitions think of risk in relative and not absolute terms, a shock to the whole system doesn't change risk.

For example, a loan is only "risky" or "safe" based in comparison to the US's ability to repay its debt. This "risk-free" rate, by definition is risk-free. In other words, risk that is everywhere is nowhere. Bonds and loans, unlike oil, don't have any intrinsic value; they are only promises of future repayment. As such, their worth is a function of the future itself. If a financial crisis is on the horizon that impacts all asset classes (including cash because of the link to the US dollar), then all instruments are "safe," even if the risk of US collapse had doubled. The current risk is not in Treasury bonds, but in the future itself.

While theory is nice, there is the practical fallout of a downgrade. The statements by Moody's and S&P are curious, as ratings should reflect the probability of getting repaid. Here little has changed over the last couple of months, or the last 50Ys for that matter. The US has the ability to print money and pay its debts in exactly the same capacity as it did in the past. If the rating agencies wanted to downgrade the US, they should have done so when debt as a percent of GDP (now equal to Portugal) skyrocketed up. However, even that notion of risk is in question, as a case can be made that the US is actually more, not less financially responsible to increase the debt and ceiling. Given the historically low position of rates and the threat of future inflation, the US has been currently borrowing at a negative real rate. That means that if we borrow $1 today, we will need to pay back less than a dollar in the future, giving us a hefty and healthy "risk free" return on our capital.

Our point is that while we often talk about risk, the true nature is hard to discern. What can be learned from this nadir of debt management is that it helps if you have a document that defines risk, so that you can test it against different situations. Our definition, for what it is worth, is that risk is the probability that we will not achieve a stated objective. Here, a US downgrade would impact us little for the reasons we have described. While our current definition may not be right, over time we will be able to test our definition and evolve. This will not only help us better understand what risk is, but what it is not.

BANK NEWS

Closed (55 YTD)

The FDIC closed: One Georgia Bank ($186mm, GA) and sold it to Ameris Bank. Ameris gets 1 branch, all deposits and entered into a loss share for 79% of assets. High Trust Bank ($193mm, GA) and sold it to Ameris Bank. Ameris gets 2 branches, all deposits and entered into a loss share for 86% of assets. First People's Bank ($228mm, FL) and sold it to Premier American Bank. Premier gets 6 branches, all deposits and most assets. Summit Bank ($72mm, AZ) and sold it to The Foothills Bank. Foothills gets 1 branch, all deposits (0.25% premium) and essentially all of the assets.

CFPB

President Obama said he will nominate former Ohio Attorney General Richard Cordray to lead the Consumer Financial Protection Bureau, bypassing Elizabeth Warren.

Economic View

A NABE Survey of small business owners finds 76% believe economic growth will be greater than 2% in the 2nd half of 2011 (down from 94% in Apr). Meanwhile, those predicting GDP will be < 2% jumped to 23% (from 5% three months ago).

Citi Cards

The Bank is rumored to be considering retaining its private label card business instead of selling it due to improved profitability outlook.

Stress Test

Of the 91 institutions the EU tested, 8 failed, a number lower than expected.

Muni Defaults

Despite dire predictions from some analyst and regulators, muni defaults fell 60% in the last 6 months compared to the same period last year.