GIGI ON LOAN DIVERSIFICATION AND THE SUPER BOWL

by Steve Brown

One of our criticisms of the banking industry is it needs more diversification. Bankers are usually too staid in their ways, too male and just too human. That is why we were happy to meet Gigi, a hamster that is involved in loan portfolio management for an unnamed bank.

Aside from Gigi's skill at shoving 45 cheerios in her mouth at one time (picture), she also has acumen in loan portfolio diversification. Put several loans in front of this hamster and she will not only select those that aid in diversification according to a pre-designed asset allocation plan, but will price them accordingly to ensure that more loans are won to achieve true balance sheet diversification.

While diversification can mean many things to many people, the bottom line is that taking risk and expenses into account, the loan portfolio provides the highest return (not only on a period of time historically, but also on a projected basis). This is important because while different asset types may provide diversification in terms of legal, reputational and interest rate risk; if credit risks overwhelm each of the other risks in a stressed scenario, true diversification fails to be achieved. For example, while residential mortgage loans and commercial real estate are separate loan types and call report classifications, the two asset classes tend to move together (approximately 86% of the time over the last 10Ys). The brilliant part about Gigi is that she not only understands some bank loan classes move together, but that subclasses do so as well. For example, while a bank may think they are taking steps to address their risk profile by only doing multifamily loans in their CRE portfolio and only originating conforming SFR mortgages, problems arise. While it is true that the expected loss is lower in each of the respective sub-sectors compared to most other alternatives; the correlation, if those subsectors made up 100% of their respective sub-portfolios, would increases from 86% to 89%. Over a long enough time frame, this correlative impact overwhelms the risk of lower individual sector expected loss rates. That ends up actually creating more and not less risk for a bank.

Gigi's intelligence doesn't stop at loan type. What sets her apart from other hamsters and loan portfolio managers is that she knows geography is significantly more important than loan type diversification. Geography accounts for about 16% of a bank's performance vs. 11% for asset allocation decisions. Thus, where you make your loans is often more important than what type of loans you actually make. Geographic correlations vary widely from region to region. Certain states such as CO, TX, NM, NY and PA are easy ones for banks to achieve diversification; as they contain zip codes that exhibit the greatest disparity in performance over a 10Y period. Here, banks only need to go about 75 miles from their headquarters to achieve satisfactory diversification. Meanwhile, other states such as CA, AZ, FL and KS are much harder; as almost the whole state tends to move in lock-step both up and down. For these states, banks need to have a service area of about 300 miles across in order to achieve proper geographic diversification.

Of course, diversification is a very specific endeavor and what works for Gigi may not work for your bank. Different underwriting and asset mixes can change things. Diversification, for instance, is much easier to achieve in C&I lending than it is for CRE, which is easier to achieve than SFR, which is easier to achieve than auto, which is easier to achieve than student. Thus, the larger the C&I portfolio, the less geographic diversification is needed.

If all that is not enough for you this morning, consider that Gigi is also tireless. She prefers to work through the night and does not take any time off. She is fairly astute at picking football games as well and has a 4 and 1 record for picking past Super Bowl champions Ã¢Â€" that is on par with Kutai the Oregon orangutan, Princess the NJ camel and that Octopus. Gigi is going with the Patriots this weekend in a tight victory. While not every bank can find a Gigi, any bank can increase their knowledge of diversification to help lower risk and increase performance.

BANK NEWS

M&A

Center Bancorp ($1.4B, NJ) will buy Saddle River Valley Bank ($120mm, NJ) in an all-cash deal equal to 90% of book value at deal closing time.

SBLF

The Treasury Dept. reports the Small Business Lending Fund is projected to return a net profit of $80mm vs. an initially projected cost of $1.3B to taxpayers. Participating institutions have increased lending to small businesses by $3.5B so far, or about 10% over baseline levels.

Riskiest Nonbanks

Treasury Secretary Geithner said nonbank financial companies deemed systemically risky will officially be named this year.

First Report

The CFPB has released its first semiannual report to Congress outlining its activities. The report indicated the CFPB had hired more than 750 employees; fielded 13,210 consumer complaints (70% involved credit cards, 18% involved mortgages and 12% were other); launched a supervision program to promote compliance with consumer protection laws; and evaluating and developing disclosures that make financial productsÃ¢Â€Â™ costs and risks easier to understand.