RISK MANAGEMENT & STEVEN COVEY

by Steve Brown

We were saddened as you likely were when you found out Steven R. Covey died over the summer. This American educator, author, businessman and motivational speaker certainly had an impact on the life of the business person. He encouraged all to link habits with effectiveness and to seek private victory within the walls of your own soul before trying to do so in the public realm of business. His teachings on private victory focused on being proactive, beginning with the end in mind and putting first things first. Once you are a master of the private victory, seek the public victory through win-win relationships, seek first to understand and then be understood and then synergize. He will be missed, but his teachings live on. Some bankers do a very good job at exploiting risks, while others do not. Unfortunately, not every executive knows how to use good risk management tools to increase performance. Risk is defined as the probability of good and bad outcomes and the usefulness in decision making on the possibility of these outcomes. In banking, few decisions lead to guaranteed results, so the possibility of bad outcomes resides in every decision. Simply avoiding risk, however, can lead to disastrous results. Banks earn profits by avoiding some risks and seeking others. Bankers that manage risks well create some of the most successful banks in the industry. Few fields require more attention to risk than banking, because of the risk associated with both asset and liability products and the interaction between each product (portfolio risk management). Recent research finds people often behave irrationally in response to risk. To manage risk effectively, one must measure risk properly. Risk measurement started in the 1600s by Blaise Pascal and was later refined by Jacob Bernoulli. Work by these and other scientists gave rise to the first form of risk management by insurance companies and actuarial estimations of expected losses on policies. Modern risk management tools in banking involve a form of probability-based risk analysis, where outcomes are based on their expected probability of occurrence and each outcome is calculated for risk and reward. All outcomes are then added to derive a risk-return analysis. This is the underlying simulation that drives most risk adjusted return on capital (RAROC) loan pricing models. Bankers must be able to measure both risk and reward and assess any above market returns to be truly effective. Avoiding all risk would put the bank immediately out of business, while accepting risk without obtaining adequate rewards has the same impact. The best strategy is to find those risks that the bank can exploit to its advantage. The question is which risks are central to community banks? Key risks include: credit, operations and legal risks (as it is impossible to run a bank without charging for and being exposed to credit, operations and legal risks). Consider that most other risks can be avoided or hedged (naturally or synthetically). Risk is ubiquitous in the industry and it creates opportunities for profits (not just a threat to earnings and capital). To be successful, bankers must have a rational basis for avoiding or accepting risks by using quantitative models and qualitative gut checking. Management must attempt to measure risk, even if such measurement appears complex or nebulous because doing so leads to better decision making. Then, decide which risks to keep (and be compensated for) and which risks avoid or hedge because they are not part of the core competency of the bank. The end result of risk management is not to just minimize losses but maximize bank value. To do that, make all employees responsible for risk management. For example, your sales staff may not be making lending decisions, but they should be incented to provide fair and complete information to allow credit to make an informed underwriting determination. Finally, community banks cannot exploit every risk, so you must choose the ones you can quantify, actively manage and receive adequate compensation for to achieve ongoing success. Banks that flourish by accident or luck are rare. As Steven Covey once said, "The main thing is to keep the main thing the main thing."

BANK NEWS

M&A

LCNB ($827mm, OH) will buy Citizens National Bank of Chillicothe ($152mm, OH) for $19.6mm in cash & stock.

M&A

First State Community Bank ($1.3B, MO) will buy Bank Star of the Leadbelt ($116mm, MO) for an undisclosed sum.

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American Bank $385mm, (SD) will buy Mansfield State Bank ($13mm, SD) for an undisclosed sum.

Branch Change

American Founders Bank ($390mm, KY) will close one branch and sell another, as it seeks to improve efficiencies and focus more efforts on online banking and serving business customers.

SBLF Update

The Treasury reports the 328 banks participating in the Small Business Lending Fund (SBLF) boosted lending to small businesses by $1.5B in 2Q or about 27% over baseline levels. Overall, 89% of participants increased small business lending over baseline levels and 76% increased lending by 10% or more.

TAG Extension

Former FDIC Chair Shelia Bair said the Transaction Account Guarantee (TAG) that provides unlimited insurance for noninterest bearing checking accounts should be extended for 2Ys and not allowed to expire at the end of this year. She said Congress should lower the coverage to $1mm through the end of 2013, $500,000 through 2014 and then down to $250,000 level at the end of 2015.

Wells Sued

The Gov't is suing Wells Fargo for fraud related to approving poorly underwritten government-backed mortgages that led to $190mm in insurance claims on defaulted loans. Wells allegedly lied about problems with 6,320 loans it had determined were "seriously deficient" from the FHA.