Staying On The Straight And Narrow

by Steve Brown

We found research by the US Sentencing Commission on recidivism among federal offenders interesting. It looked at offenders who were either released from federal prison after serving a sentence of imprisonment or placed on a term of probation in 2005 to see how many of these people reoffended. It found about half (49%) were rearrested within 8Ys for either a new crime or for some other violation of the condition of their probation or release conditions. If you are wondering how we can improve this, consider another study that found there is a 25% decrease in the likelihood of re-offense for incarcerated felons that have in-person visits. People just seem to need human contact.

Speaking of human contact, consider lessons learned that can come from an analysis of Banco Popular, which was the 6th largest bank in Spain at the time of its sale for 1 EUR.

On the surface, European officials of the Single Resolution Board, the equivalent of our FDIC, were quite satisfied when the bank was sold. No taxpayer money had been used in the overnight rescue and customers hadn't suffered any disruption in access to their deposits. The post analysis points out mistakes in board practices and hard governance lessons that should help all banks better manage risk.

Banco Popular's problems trace back to its appetite for EUR37B in risky home loans a decade ago. The bank couldn't unload those loans and the executive chairman at the time did not react quickly enough. It also seems board members passively let him drive the institution to the brink of insolvency.

Fundamentally, experts in financial governance emphasize the need for a strong board that has the ability to debate and sometimes present opposing views to the CEO. In this case it seems board members were too cozy with management to offer objections or ask more questions about strategy.

Then, there were also directors who were institutional representatives. They had longstanding ties to Banco Popular and that seemed to cloud independence and judgement. One director's bank was even co-managing another retail bank with Banco Popular while holding a seat on the board.

Outside testing seemed to be an issue here too. For example, when the European banking authority applied its stress test in 2016, common equity tier 1 capital represented 10.2% of assets. Even after taking into account unfavorable economic conditions, it was still concluded that Banco Popular would have 6.6% capital. While well below the 12.6% average, it would still keep them afloat. In reality, the capital cushion disappeared altogether by the spring of 2017 and some EUR4B in emergency assistance from the Spanish Central Bank was consumed in just 2 days.

While some may say this is a rather extreme example of what "not to do", there are still reminders to be gleaned from the story.

First, board members clearly need to be independent and question any issues or red flags that surface to gain a deeper understanding.

Next, banking is all about risk, so having proper controls is critical. Even if stress tests come back at an adequate level, the board may still want to look deeper based on other factors.

Finally, the board's role is distinctly different from management's role. The board is responsible for overall direction and oversight, while management handles the day to day. Here, it is important for the board to oversee and hold management accountable for not only meeting strategic objectives, but doing so within the bank's risk appetite. Doing this, along with ongoing human interaction between these two groups, ultimately serves to reduce risk at the bank.

BANK NEWS

No Charter

House Democrats have urged bank regulators to remove Wells Fargo's bank charter as a consequence for their 2016 fraud scandal. They argue that this scale of "egregious consumer abuses" could threaten the safety and soundness of the financial system.

Retail Pressure

S&P reports the percentage of US retailers that have tanked to a rating of CCC has doubled this year to 18%. Meanwhile, some 21% of retail and restaurant companies are now considered distressed.

Increased Fees

A Bankrate survey finds the average out-of-network ATM withdrawal cost is $4.69 (a 2.6% increase from 2016) and the average ATM surcharge has climbed to almost $3 (a 13Y high).

Up Rates

Although inflation has been sluggish, tight labor markets seem to have moved the needle to rate hikes for Fed PA President Harker who said he supports a rate hike in Dec along with 3 more in 2018.

Farm Support

The ABA reports there are 1,912 banks that play a critical role in financing the operations of farmers and ranchers.

Net Worth

US household net worth increased in Q2 according to the Fed, marking the 7th straight quarter of overall wealth increase. The reasons for the latest increase include high home values and stock prices.

Smart Phone Leverage

Using their smartphone allows bank customers the "one stop shop" experience with multiple providers - digital customers are 60% less likely to have all their products at only one institution, and 30% less likely than non-digital customers to buy their next product from a current provider.

Parent Debt

Research finds the number of Americans with student debt has quadrupled over the past 10Ys to $66B for those over age 60Ys. The data show the impact of parents stepping in to help children pay for the skyrocketing cost of college.

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