Competitive Implications of Holistic Balance Sheet Management

Compared to their larger brethren, *the smaller banks have reaped greater benefits from the new tools for improving credit portfolio diversification.*

BY DAVID M. ROWE

BANKING'S 25-YEAR transition from the originate-and-hold model to the originate-and-distribute paradigm has presented special challenges to regional and local banks. Often the techniques employed in the originate-and-distribute model required new specialized systems and analytical methods. Smaller institutions often found it difficult to attract and hold staff with the requisite skills to deploy and manage these new requirements.

Maintaining effective senior management oversight and control presented still further problems. The background of most senior executives was deeply rooted in the pre-existing model of banking. This background often provided very limited perspective on how to manage and control the legal, operational, accounting, and risk management aspects of the new originate-and-distribute model. Unlike the large national and global banks, smaller institutions often lacked the resources to develop their own in-house systems to support the new model.

Over time these disadvantages have begun to ease. Staff members who started their careers in the early years of the transition are now in their 40s and moving into more responsible senior roles. They bring much broader and more relevant personal experience to the task of managing the new paradigm. In addition, systems and procedures have become more standardized, allowing the emergence of vendor applications to support accounting and operational aspects of the new model.

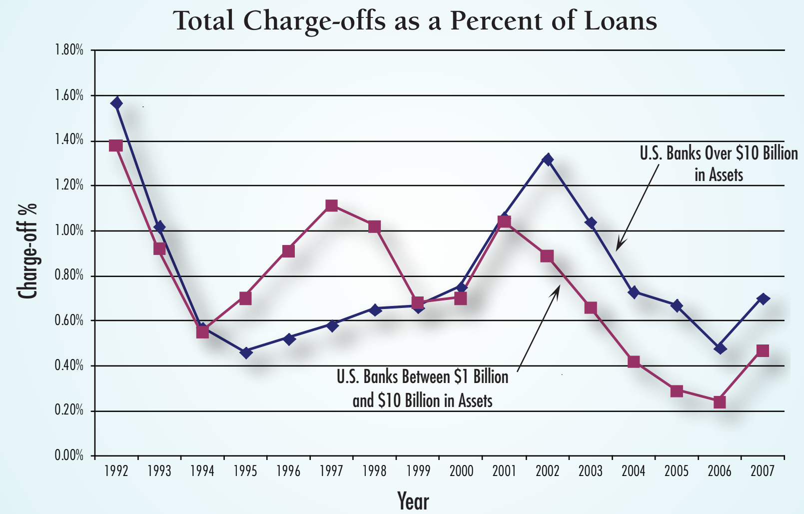
While more liquid credit markets have posed important challenges to local and regional banks, they also offer potentially greater benefits to them than to the larger, more diversified banks. By their very nature, banks with modest geographic reach tend to originate loans with relatively high regional and industrial concentrations. As recently as 15 years ago, these concentrations were reflected on the balance sheets of such banks. As a result, smaller banks tended to bear disproportionately high concentration risk and correspondingly higher capital requirements to achieve a given credit rating. Indeed, one incentive for bank consolidation in recent years has been to reduce the volatility of credit losses through improved credit portfolio diversification.

Today, local and regional banks have many more creative ways of diversifying their credit portfolios. As a result, they can maintain active loan origination, where they have special industry expertise, without fear that the resulting portfolio concentrations will produce unacceptable exposure to local economic stresses. It is interesting to note that, starting in 2002, U.S. banks with assets of between $1 billion and $10 billion have had consistently lower charge-offs as a percent of loans than banks with total assets greater than $10 billion (see Figure 1).[1] Furthermore, the relative performance of these smaller banks has improved steadily since the mid-1990s, when their charge-off ratios were notably higher than those of the largest banks. While these data are by no means conclusive, they are at least consistent with the hypothesis that, compared with the large banks, the smaller institutions have reaped greater benefits from the new tools for improving credit portfolio diversification.

Furthermore, assembling complete portfolio data is a less daunting challenge for the smaller banks than for their larger competitors. This is crucial since any analysis is no better than the data on which it is based. Detailed analysis of diversification characteristics is essential to proper measurement of portfolio credit risk.

The more complex an institution becomes, however, and the more complicated the structure of its exposures, the more vulnerable it becomes to potential data errors and model misspecification. It is common to hear stories of large global institutions taking days or even weeks to assemble their total exposure to a troubled name. This

Figure 1



raises serious questions about how effective their credit portfolio management can be if the essential data underpinning the analysis are so fragile.

While smaller institutions can more easily assemble the necessary data, holistic balance sheet management is necessarily a complex undertaking. Managers at smaller banks need to expand their focus beyond traditional expertise in local markets. Critical assessment of national and global trends and of the structural underpinnings of new credit instruments, such as credit default swaps and CDOs, is becoming increasingly important for strategic decisions.

Perhaps the most important challenge, however, is the development of technical staff who can understand the details of portfolio credit risk models while retaining a firm sense of their limitations. While senior managers don't need to be familiar with the minute details of such models, some effort to master their basic structural characteristics is vital. This effort can support portfolio modeling by promoting a sense that it is actually an activity that makes a difference to senior management decisions. Such familiarity also helps keep the modelers grounded in the seasoned common sense that comes only with years of experience.

Requiring modelers to explain and rationalize the results of their analyses to an experienced and critical audience is essential. It may be uncomfortable for many technically oriented analysts, but it will serve to highlight the indispensable need to blend judgment with the results of statistical analysis. Modelers always need to remember that the roots of credit risk analysis, like those of economics in general, are in commerce and not mathematics.

Summary

The emergence of new instruments for transferring and managing credit risk has been accompanied by advances in modeling such risk at the portfolio level. These symbiotic developments make sense because portfolio modeling was of largely academic interest before instruments for transferring credit risk became available. Many banks had an undesirable concentration of credit exposure to their home regions or specific industries, but there was little they could do to address the problem. This situation began to change with the advent of credit default swaps and other credit derivatives.

Although data consolidation and maintenance issues are often less of a challenge for smaller banks than for their larger counterparts, the expanded skill set and broader worldview required for effective credit portfolio management can be daunting. On the other hand, the portfolios of local and regional banks have traditionally been more prone to undesirable geographic and industrial concentrations of credit risk, compared to the larger, more inherently diversified institutions. Managers at the smaller banks can take heart in the knowledge that new tools for credit risk transfer and credit portfolio management offer significant advantages to their institutions—advantages that are arguably greater than those available to larger banks. ❖

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Notes

1 At the end of 2007, 425 U.S. banks had assets of between $1 billion and $10 billion while 86 had assets greater than $10 billion. The number of the largest banks has remained fairly stable since the turn of the millennium, whereas the number of banks with $1 billion to $10 billion in assets has risen by over a third, to 425 in 2007 from 314 in 2000.