Uncertainty, Risk, and Decision-making

Here's a multiple-choice test for community bankers:

1. Interest rates may stay low or go lower still over the foreseeable future.
2. Interest rates will increase materially once the economy generates self-sustaining growth.
3. Decision-making is stymied by uncertainty and volatility in the markets.
4. I have a bank to run.
5. All of the above.

I suspect most readers have chosen "all of the above." We are troubled by the current low rate environment but can find little reason to suggest it will change soon. When it does, however, we expect rates to return to more normal levels, many percentage points higher than they are today. Every time we pick up the newspaper or check the Internet, there is more disturbing news that jostles the markets and impedes sound decision-making, but we really do have to run a business and make decisions anyway. This article will try to lay out concrete actions bank managers can take to structure decisions given the present situation.

Uncertainty Defined

Imagine a grain elevator with three side-by-side grain chutes, each one of which can be opened to let the grain out. There is a large bin at the bottom to catch the grain. If only the middle one is opened, the grain falls in one pile with a peak in the middle. If all three are opened, the grain fills the bin in a roughly equal fashion. If only the two side openings are functional, the grain falls with two peaks at either side of the bin.

The grain piles have interesting characteristics. Pretend for a moment that instead of seeds of grain that the piles represent market forecasts of interest rates. The first case is what is commonly known as a normal distribution. It is consistent with a consensus in the market around an average prediction. The second case is purely random. There is no consensus — i.e. uncertainty. The last case shows no single consensus; it reflects clear differences of opinion. Think of it as polarization. The most striking similarity: the average prediction is the same in all three cases.

This latter fact suggests that an average prediction (which is after all simply the shape of the yield curve we observe) may easily mask the process that produced the average. Furthermore, if you know which grain chutes will be open or closed, you can actually make a reasonable tradeoff between risk and reward. For example, if the middle case of uncertainty obtains, there is no advantage in trying to use the average to predict where a particular seed of grain will fall. However, if the first case is in play, then picking the average is the best estimate and choosing either extreme should be well compensated. Note that if we find the polarization case to hold, betting on the extreme is actually the smart move.

Transition to Consensus

At some point in time, the economic statistics will begin to coalesce around a consensus. The particular consensus that takes shape will provide opportunities if you are prepared. At this juncture in the markets, I believe that the first change will be from random uncertainty to the polarization case. Once the market divides into those betting on a second leg of the recession and those suggesting that geopolitical tensions will lift and provide the spark to a sustained recovery, we set the stage for determining who is right.

The best way to identify which group of market participants is providing the consensus is to look at how money is being invested. The Federal Funds rate and pronouncements by Federal Reserve officials are less important in determining the consensus because of the high level of political pressure brought to bear on the Fed.

I would look at two key factors: the ten-year Treasury rate and the level of the S & P 500. Both of these markets have been in a trading range since last fall. The ten-year Treasury has spent most of the time between 3.75% and 4.25% with two brief moves to about 3.55%. The stock index has traded mainly between 850 and 950 with two moves to the high-700 low-800 level.

As a bank manager, I would ask the following questions:

1. If it becomes likely that the economy is descending into another leg of the recession, what short-term actions should I take? As the recession progresses, are there additional initiatives we should pursue?

2. If the long-awaited recovery seems imminent, what actions should I take and how can I prepare my bank for an increase in business?

<u>Concrete Actions</u>

Let's assume you have gone through the exercise above and identified short-term and longer-term actions that would benefit your institution if either of the two possible scenarios play out. The next step is to determine just how much certainty you will need before you begin to execute the strategies. Producing a table of actions will help frame the issues. This table can serve as a template.

Scenario	Balance Sheet Action	Business Action
Clear break to new highs	Lengthen liabilities in wholesale markets	Pay ahead of competitors for term retail funds and liberalize credit terms
Modestly break range upward	Sell investments to reduce extension risk and buy caps for rate protection	Review de novo opportunities and new lines of business
Remain in the range	Reinvest cash in short (two-year) maturities	Try to steal market share
Modestly break range downward	Establish levels to take investment profits or add term liabilities	Review credit risk and establish liberal reserves
Clear break to new lows	Let investment profits run while establishing hedging strategies for reversal	Review cost structure

Of course, each bank needs to identify the actions that it feels are most appropriate for it. With the high level of current uncertainty, it makes sense to pursue low risk (and hence low return) options. However, when the uncertainty lifts, you need to be prepared with actions that are well thought out and can be implemented based on criteria developed with the benefit of deliberation.

The long period of time we have spent in the trading range suggests a rapid change in perception once the momentum toward a different environment builds. It would be a mistake to assume that the current uneasy truce between the "double-dippers" and the "recovery-is-at-hand" folks will hold forever. It would be an even bigger mistake, in my opinion, not to plan for what could be a significant move in interest rates once the process begins.

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