WALKING THE WING OF RISK

by Steve Brown

As with wing walkers at air shows, bankers struggle against the winds of risk. Soon, national banks will be able to set aside capital, based on the level of risk contained in a given loan or group of loans. Under Basel II methodology, national banks may be able to set aside less capital for a given loan than independent bank competitors who do not adopt it. Since independent banks will have to compete for loans within the general marketplace, understanding how risk is calculated under the Basel II methodology is important to understand. While we have some of the key underlying concepts of risk at various times before, they are vitally important to understand. The first of these is termed Probability of Default ("PD"). Under Basel II, PD is defined as the likelihood that a given loan will not be repaid and fall into default. PD should be calculated for each loan, by analyzing the credit risk of the counterparty, incorporating the credit history of the counterparty, nature of the facility, guarantees, behavioral scoring, any outside insurance (i.e. credit protection) and other factors. PD for each loan is then mapped back to an internal risk grade with an associated PD, to eventually calculate a weighted PD for each sector within the loan portfolio. The problem with PD is that it does not, however, provide a complete picture of the potential credit loss of any loan, sector, or portfolio. As such, banks need to include measurements that indicate how much they could lose in the event of such a default. To do this, we must introduce the concept of Loss Given Default ("LGD"). LGD is expressed as a percentage of the exposure (i.e. 32%, 40%, etc.) and is critical for banks to know, as it represents the magnitude of likely loss on a given exposure. As with PD, LGD is specific to each facility, since losses are influenced by individual characteristics (such as amount of collateral, subordination, collateral type, product type, other borrower characteristics etc.). LGD is determined by the bank based on validated and extensive data analysis. Exposure at Default ("EAD") is the overall potential exposure of a portfolio of loans at some point in time. While EAD seems straightforward, it can become a bit tricky when you consider that for un-drawn commitments it should include an estimate of future lending exposure prior to default. In addition, EAD should incorporate forward valuation, facility type and commitment details. By multiplying PD with LGD and EAD, bankers can calculate an expected loss for any given loan or portfolio. We cannot state strongly enough that independent banks should take the time to understand these concepts. This is the first time loan pricing will be quantitatively linked to actual risk and capital allocation. These concepts are already being utilized by larger banks, so in order to help you compete, BIG provides integrated products and services that incorporate and leverage them Â– designed specifically for independent banks. We encourage independent bankers to review our Credit Stress Analyzer (loan credit shocks), Loan Pricing Model (based on risk adjusted return on capital), ALLL Quantifier (evaluates loan loss reserves), Relationship Profitability (customer and product profitability), Outsourced Asset Liability Management (balance sheet risk management) or Liability Coach (lower funding costs). We just want you to understand you are not alone, as we continue to roll out products and services to assist you as you walk the wing of risk.

BANK NEWS

Regulatory Confusion

The U.S. Treasury's Inspector General issued a report concluding that the OCC failed to issue a required cease-and-desist order to Wells Fargo NA in conjunction with weak internal BSA controls.

Instead, the OCC issued an informal, non-public action letter, along with their last safety and soundness exam. At issue is whether the inadequate testing of business lines, lack of oversight and failure to file SARs rose to the level of BSA violation. The Treasury said it did, the OCC said it did not.

No Fee

PNC Bank is joining the growing number of banks who have dropped ATM fees. The bank also announced it would reimburse fees for customers who get cash at competitors' ATMs.

Lucky Penny

A recent survey by Coinstar found nearly 79% of Americans are in favor of keeping the penny, despite a legislative effort to eliminate it. Nearly 51% of respondents also expressed concern that prices would be rounded to the nearest nickel if the penny were gone, while 63% said they felt it was a symbol of American culture, history and economics.

Stolen Checks

A former JP Morgan Chase mailroom clerk has plead guilty to conspiracy charges stemming from nearly $100mm in stolen corporate checks. The former clerk would hide the checks in his socks and other clothing and then pass the checks on to co-conspirators in return for cash payments.