EXAMINATION WARNING ON MARKET RISK

by Steve Brown

A couple of weeks ago, we waved a warning flag for bankers to make everyone aware of what we saw as potential "crackdown" areas for regulatory examination teams this year. In that publication, we focused on credit risk and provided specific areas bankers should devote effort to ensure their next examination goes as smoothly as possible. While each regulatory team may focus on different components at different times within different banks, we highlighted specific things bankers could do to prepare. Today, we take a similar tack to highlight areas of focus under market risk (the risk to a bank's financial condition, as a result of adverse movement in market rates or prices). Given the flat yield curve, recent FOMC rate increases and rising deposit costs, regulators are keenly focused on how banks are managing this risk. In particular, examiners will focus on how bankers model such risk, which model is being used, the level of sophistication of both the model and the operator, the robustness of board reporting and whether the bank has incorporated more sophisticated techniques. For banks exhibiting rapid growth, those with a high degree of interest rate risk, or considering an acquisition, a strong modeling process is imperative. In addition, regulators will also focus on how banks have implemented such systems and whether concepts and techniques are being applied consistently and appropriately. Finally, regulators will look at the personnel running such models to determine whether they have the technical expertise to understand and implement them. Regulatory scrutiny has been heightened as a result of some banks operating models in an incorrect fashion and providing erroneous reporting to senior management and the board. It is critical for banks to model, measure, manage and control interest rate risk. The bank should ask itself and document mitigation factors it has considered, forward testing conducted to measure risk exposures, the likelihood of each scenario and what it would do if unacceptable levels of risk are reached in certain scenarios. Dynamic rate shocks are required to help banks understand how they will be impacted by a flat yield curve. In particular, a rising rate environment in conjunction with a continued flattening of the yield curve by itself presents the potential for heightened interest rate risk for independent banks. The flat yield curve can pressure bank margins, so testing is imperative. There is no doubt that a flat yield curve hurts independent bank profitability. Given recent rising rates and flattening of the yield curve, banks should expect examiners to focus on trends in net interest margin, flexibility to change and overall balance sheet composition. Given that independent banks get only about 25% of their net operating revenue from noninterest income, compared to nearly double that percentage for larger banks, having a strong handle on market risk should go a long way during an examination.

BANK NEWS

Negative Savings

Proving Americans are not afraid to live paycheck to paycheck, the Commerce Department reported the personal savings rate fell in 2006 to its lowest level since the Great Depression of 1933. For last year, the savings rate was a negative 1% (meaning consumers spent more than they made and dipped into savings).

Competition

Bank of America has announced a significant expansion to its online offerings to small business customers. Enhancements allow business clients to track expenses, income, set/monitor budget goals, monitor performance of accounts at both BofA and at other financial institutions and place limits/alerts on accounts.

Mortgage Sector

Research shows FNMA and FHLMC issuance of interest-only (IO) mortgages soared to $39B in 2006, up from only $4B in 2005. In general, 24% of all IO mortgages in the first half of 2006 were fixed rate, compared to only 13% in the prior 6 months. In addition, IO loans as a percentage of hybrid ARM issuance grew to 50%.