ALLIGATORS AND ERM

by Steve Brown

Only crazy people jump into a sand pit to wrestle an alligator. After all, the force of a large alligator's bite is nearly identical to the crushing weight of a small pick-up truck. As with a bad alligator-wrestling match, volatility in the financial markets during the past few weeks has left bite marks on bankers' industry-wide. Such aggressive market behavior is one reason why Enterprise Risk Management (ERM) has become so important to community bankers. Over the years community bankers have realized that if they are going to ask their most senior executives to attend a specific meeting, the high cost of that meeting means it must also be productive. That is one reason why top performing banks seek to manage credit, operational, interest rate, legal and other risks in one meeting. This format helps such banks better control risk, while improving profitability. These banks have expanded their asset-liability committee meetings (ALCO) to encompass a deeper discussion about enterprise-wide risk. Historically, risk management has often been thought of as a simple trade off between risk and reward. ERM takes that concept to a new level, providing a framework where bankers can analyze and manage risk across their entire institution. ERM begins with the assumption that banks that consistently make good risk decisions will be rewarded with higher market value and happier shareholders. ERM applies a systematic and holistic approach to risk. This allows a bank to allocate scarce resources, improve capital efficiencies and reduce expenditures. In short, ERM enhances shareholder value by optimizing the balance between risk, reward and available resources/capital. So far, the premise sounds simple, but one of the trickiest things about ERM is that since it is comprehensive risk management, it also requires input from every area of the institution. This includes credit, finance, operations, marketing, legal and even board members, to name just a few. A comprehensive ERM framework is not magic dust, but rather an extended process that allows community bankers to not only better understand their risks, but also how those risks are interrelated. ERM provides the foundation upon which a bank can manage risk in order to maximize shareholder value. ERM also gives banks that adopt it a competitive advantage. As an example, a bank with a robust ERM process has the ability to not only leverage specific risks, but also control others to ensure their institution remains within acceptable parameters. Properly designed, ERM is an active risk management and decision-making tool that ultimately boosts profitability. By providing bankers with a way to measure and manage risk throughout the company, they can also decide which risks to keep, which to leverage and which to sell off. Areas of risk can be identified before real problems surface and processes/procedures can be applied to ensure regulatory compliance and profitability are maintained. The mere process of collecting and storing loss data can help bankers quantify current and future risk exposures. Once bankers collect, analyze and quantify their exposures (and interlinked risks), they can then actively manage it. Then, when a given risk becomes too much, ERM gives bankers a tool to help them take action to mitigate the risk. ERM provides a consistent framework to help bankers understand the cost / benefit tradeoff of strategic objectives. This in turn, provides a basis to quantify and leverage risk to maximize profitability and shareholder return. Once it is fully operational at the bank, ERM provides transparency to shareholders, ensures better decisions are made and allocates capital more efficiently. Today we have introduced the concept of ERM, so tomorrow we will provide community bankers with concrete steps they can take to begin building an effective framework at their own institution. Before jumping into the alligator's ring, we felt it was imperative to provide enough basic training to help bankers avoid being bitten.

BANK NEWS

M&A

ViewPoint Bank ($1.6B, TX) will acquire the asset and loan origination business of Dallas-based Banker's Financial Mortgage Group Ltd. for $1.2mm.

Flight to Quality

As fear from the subprime contagion spreads, investors are fleeing to the safety of Treasury securities. The 3-month T-Bill had its biggest yield drop last week since the stock market crash of 1987.

Mortgage Woes

National City ($81B, OH) said it would merge its mortgage and home-equity lending businesses, citing the roiling credit markets as a reason for the consolidation.

Fannie's Risky Loans

FNMA said its net income dropped 36% in 2006 and expects more delinquencies and credit losses as the subprime carnage continues. The company disclosed that negative-amortizing ARM loans comprised 3% of its single-family business volume, interest-only ARMs accounted for 7% of volume, and Alt-A loans were 12%.

Bankruptcy

There were 751,056 bankruptcy cases filed in federal courts for the 12-month period ending June 2007, a 49% decrease from a year ago. However, June's total was greater than the year-over-year increases for March 2007 and December 2006, indicating a slow upward trend.