MANAGING RISK FROM THE BEACH

by Steve Brown

There are few things in life that will help you relax as fast as sitting under an umbrella on a beach. Medical experts say that is because the beach produces negative ions, which when they are inhaled produce biochemical reactions that increase levels of the mood chemical serotonin. When that happens, stress is relieved, depression fades and daytime energy is boosted. We are not entirely sure about that, but we do say the cool breeze blowing in from offshore, happy laughter wafting around from people enjoying themselves and the feeling you get when you kick off your shoes and stick your toes into warm sand are big contributors to relaxation for us. One thing is for certain - it is difficult to beat a nice beach vacation in the summer.

No matter what your summer plans are this year, given all the pressure on the industry right now, many community bankers we know will at least be dreaming of a beach front villa in some faraway vacation spot. As we all wait for simpler times to arrive for the industry, one thing bankers can do in the meantime is focus on improving risk management practices. While you won't get the same feeling as visiting a beach, you will sleep better, find yourself laughing more and may even venture out of the office now and again without wearing any shoes.

To manage risk better, bankers can employ a common technique of risk assessment and quantification. This process involves looking at departments and their processes all over the bank in an effort to determine where risk may lurk. Once we have a better feel for that, it is important to analyze any potential impact on liquidity, leverage, capital and other factors. Having a good handle on this is a great way to start the process.

Any risk management process also likely includes using reports and some sort of modeling. When doing the latter, it is critically important to understand and challenge all assumptions, since they will be overriding factors driving end results. It is difficult to put controls or countermeasures in place when the report you are relying on has major holes in it right from the outset. Be sure you fully understand all assumptions driving model results and periodically test and back-test them to be sure they remain valid.

It is easy to get carried away when considering risk management and trying to get a program launched. Many banks we know understand the purpose is to address what decisions are made to optimize the risk-return profile of the bank, but few realize exactly what that means. By focusing risk management efforts on compliance first, some management teams get carried away. Risk management stretches well beyond that, encompassing such factors as setting strategy, capital allocation, product pricing, risk transfer and others. It is important to ensure the risk management process is independent, but it is also critical that it is not solely entrenched in regulatory compliance. Focusing efforts on emerging risks is important, as well as assisting the rest of the management team in moving the bank forward through the lens of managing risk and reward.

Finally, to be effective, it is important that any risk management program be forward looking. Only when it helps drive the bank's risk profile and business objectives is it truly a balanced approach. Like negative ions at the beach, a good risk program can provide a strong foundation to help recharge any management team in these trying times.

BANK NEWS

Small Biz Lending

A procedural vote failed in the Senate which means both parties remain split on the advancement of this legislation that would provide community banks with more capital and small businesses with more credit. Because of the failure the hope of passing this before summer recess is gone.

Bank Director Survey

A 2010 survey by Grant Thornton finds 31% of bank audit committee members say enterprise risk management is their single biggest fear. In addition, 35% of banks surveyed had created a risk management committee separate from audit and 65% of respondents reported having created a chief risk officer position.

RE Projects

A Wharton professor analyzed 10,000 real estate projects in an attempt to determine what factors most drive positive results. After combing through the data, he could not find any correlations except for one - the project manager. He also found that the size of the project and the industry segment were irrelevant to final performance.

Fed Stance

An article in the NY Times says a "subtle but significant" shift is occurring within the Fed, as the group has become increasingly worried about the risk of deflation.

Swap Rates

Lots of liquidity clamoring for bank and corporate risk, combined with concern over the deficit, helped push swap yields below Treasury yields for only the 2nd time in history.