ENTERPRISEWIDE RISK TARGETS - OUR APPROACH

by Steve Brown

Over the past couple of years, we have struggled to find a common language and measurement scheme to manage risk. After countless meetings, interviews with major banks and Fortune 500 corporations, we have arrived at a framework. We would like to spell it out in hopes of testing our structure and soliciting your opinion.

In our enterprise risk committee, we are proposing a "Risk Appetite Statement" to our board that is an expression of desired return and a given level of risk. It is management's job to present a matrix of

potentially obtainable returns each year and the corresponding level of target risk. Upon selection by the Board, management is then charged with maximizing return, while minimizing risk under the constraints. In addition, management also is operating under a maximum level of risk that can be taken for a given amount of capital at risk.

Now, coming up with the return portion of the equation is easy. For simplicity, we are expressing return in a standardized nominal return on equity. While risk-adjusted and excess capital return numbers were considered, we opted for an accounting return measure due to its transparency and experience of the board in working with return estimates.

Coming up with a language to frame and discuss risk was infinitely more difficult. What really mattered to us was the negative risk to capital. That is, while volatility measures (both positive and negative) are a good proxy for risk, we needed something that could easily be tracked and so settled on a strict capital measure that only impacted a downside case.

Once potential negative capital swings was chosen as the measure of choice, we picked a time horizon and a measuring frequency. Here, we chose a 1Y time horizon with quarterly measuring intervals. This decision is still subject to testing, but we wanted to pick a suitably long horizon to measure a material amount of a risk cycle, while not too long as to sacrifice gross accuracy. While a year is much longer than most measuring horizons, we limited potential compounded movement by only measuring projected risk quarterly. Over time, we hope to become more efficient at the process and move to a monthly measuring cycle.

Finally, a methodology had to be chosen. Here we selected not one, but a set of 3 different approaches in order to take the best of all. First, we chose to look at risk utilizing a value at risk statistical model utilizing two different calculation methodologies (variance-covariance and Monte Carlo simulation). This approach gives us an objective statistical valuation of all revenue streams that basically serves to mark every revenue stream to market to the best of our ability. We set a negative side "confidence interval" that basically says that we want to be 95% certain to remain in business one year from now.

In addition to the value at risk model, we also have a scenario model where we are busy developing a set of credit, interest rate, liquidity and market shocks that will be applied to a starting balance sheet and income statement. Incorporating our Loan Pricing Model contained in our BIG Profit application, as well as our Credit Stress and ALM Model to provide inputs and

parameters for our scenario shocks is central to this step. We hope to standardize these set of shocks and use it as a template to measure given risk types.

Finally, we have the panel of the Risk Committee that needs to certify that they are comfortable with the level of risk, the modeling assumptions and model's power. This gives us a subjective "gut" or experience check to highlight risk that cannot be captured in a model.

While we understand our structure has its shortcomings, we know by defining our methodology and monitoring our accuracy, we can improve over time. If you have thoughts or comments on our approach, we would love to hear it, as we look to get some external feedback. In addition, we look to keep you updated to see how the plan develop.

BANK NEWS

Bank M&A

For the first 7 months of 2010, the average price to book ratio for bank purchases was 102.6%. The average price for 2Q was 92.8% of book, down from 117.8% for 1Q. Look for more M&A activity on the horizon as more banks choose mergers to help liquidity and more investors just want out due to lower return expectations for the future of banking.

Discount Window

One of the 243-ish rules required by the Dodd-Frank Act is the fact that the Fed needs to disclose discount-window lending information for loans extended on or after 7/21/10. The Fed announced that it will disclose the following about 2Ys after a borrowing: depository institution's name and identifying details; the amount borrowed; the interest rate paid; and the types and amounts of collateral pledged.

Freddie Mac

Reported a $4.7B loss in 2Q. Freddie officials said that the Federal Housing Finance Agency will ask the Treasury Department for $1.8B in additional funds to support the firm. The total cost for FNMA and FHLMC is estimated at $148B and will be a topic of conversation at the upcoming hearing on August 17th.