REVIEWING RISK MANAGEMENT

by Steve Brown

We love to find somewhat interesting information about something random and then tie it into a story about the banking industry. That is why we wanted you to know that trusting a review on the internet is a dangerous proposition, if a recent study by research firm Tower is any indication. It seems that blogs, discussion forums, and social networking sites (such as Facebook) generate 80% of messages posted about a product or service from just 16% of users. There are many out there it would appear with nothing better to do or who may feel it is their duty to be a know-it-all about everything going on in the internet. Regardless, now that you know, consider multiple sources to get the best unbiased answer the next time you are doing research or preparing to go shopping.

Speaking of unbiased answers and the banking industry, given all the focus on risk management and corporate governance these days, we thought community bankers might appreciate a few quick reviews we have prepared on the subject.

When banks get into trouble related to risk management, it usually occurs for one of two reasons. Either they did not know the risk they were getting into or they thought they had risks under control and were able to manage them effectively, but the industry, economy or other events had other ideas. Economists have coined the term "Black Swan" for an event that is high-impact, difficult to predict and rare (hence the name). These events are not only beyond our normal expectations, but are outside our analytical capabilities and, because we are human with psychological biases, we don't ever see them coming. The credit crisis is just such an event, albeit a swan the size of a pterodactyl. To protect the franchise and prepare for these unexpected events, community bankers can take steps such as stress testing the balance sheet, conducting scenario analysis, focusing on asset diversification wherever possible and seeking to maintain adequate liquidity and capitalization. While this analysis won't eliminate seeing a black swan swimming up in the lake at your cabin, they can help you be better prepared and ensure survival when they occur. These are crucial elements for any decent risk management program.

Next, it is time for ALCO to step up and deepen its responsibilities. If your bank is large enough, you will probably separate ALCO from a true risk committee function, but for many community banks, expanding the role of ALCO to incorporate more robust risk management, particularly liquidity risk, is another option to get things moving faster. Setting key metrics, identifying liquidity risks, creating projections and having a robust contingency plan can be accomplished by this committee, as you expand it from traditional capital and asset liability issues to incorporate broader strategy, contingency planning, capital assessment and liquidity risks. You already have all areas of the bank in this meeting anyway, so tacking on discussion around a few other key risks can make sense to time strapped bankers.

Finally, we end with liquidity. If this crisis has taught us anything, it is that only cash or government securities can be counted on as a true liquidity buffer when things get really ugly. Understanding this and maintaining a certain amount of each as a cushion going forward is not only appropriate, but prudent.

No matter what problem you are trying to address next in your bank, knowing the limitations (and possible concentrations) of customer reviews is a good first step in any case.

BANK NEWS

Earnings

Bank of America reported a $7.3B loss for 3Q due to a $10B write down of its credit card portfolio related to fee restrictions of Dodd-Frank. Revenue was flat, but core earnings increased (not including 1x charges) amid lower reserves. Capital One reported an $803mm profit, more than 2x 3Q09 earnings. Revenue rose 13% while loan loss provisions increased by 20%. Net chargeoffs declined to 4.82% from 5.36% in the 2Q and delinquent loans dropped 3.71% from 3.81%. Zions Bancorp took on an 8th consecutive quarter of losses totaling $185mm, down from $229 in the 2Q. Net chargeoffs fell to 2.50% from 2.64% while nonperforming assets dropped from 6.6% to 6.01%.

Foreclosure Investigation

The FFIEC said it will be investigating bank and mortgage servicer foreclosure practices to determine whether individual homeowners were improperly kicked out of their homes and proper procedures were followed. In addition to looking into the large banks, community banks are also being reviewed.

Foreclosure Reality

JP Morgan said slow courts meant the average borrower in Florida had spent 678 days without paying their mortgage before being evicted through foreclosure.

Business View

The Business Roundtable's CEO Economic Outlook finds the GDP forecast of 2010 economic growth has dropped to 1.9% from 2.7% just a few months earlier. In addition, only 31% of CEOs said they expected to add jobs in the next 6 months, compared to 39% at the last survey. This negative view breaks a previous streak of 5 positive quarters