AVOIDING BAAAAD RISKS THRU BETTER MANAGEMENT

by Steve Brown

Numerous reports in the press over the years indicate sheep really do have such strong herding instincts that they will follow each other over a cliff. Stranger still, other animals that don't get as much press apparently will do the same thing (documented with cows and lemmings). Scientists say this behavior usually occurs during mating, or when the animals are spooked, but they cannot explain every reason (some seem to be driven by nothing more than the will to jump). Some would argue that bankers have also been known to "herd" around ideas or services, but we venture to say most we know will not go so far as to follow another banker over a cliff.

As with sheep and banking, however, a proper risk structure might help one avoid going over a cliff. In fact, a recent study by Grant Thornton found some banks are already down that road, with over 71% of public banks saying they have a chief risk officer at the bank. That isn't surprising when you consider the same survey found the biggest concern for audit committee members is monitoring enterprise risk management (ERM). What is interesting, however, is that only 32% of private banks had a chief risk officer. As this data shows, there is more work to be done, but to get started; banks should have an independent officer to monitor, report and help manage the aggregate risk of an organization.

Another study by KPMG on the same subject is also enlightening. In it, executives were asked to identify key areas of focus for their bank in the coming year. In order, these executives said they planned to improve reporting and measurement of risk (78%); improve risk governance (77%); and build a better risk culture (77%). While most said they have a risk management program in place, many admitted there were shortcomings around its execution (not the least of which was setting the right tone from the top down). That is probably a key reason 92% said they have either carried out or were about to carry out, a review of risk management companywide. Overall, 42% also said they expected to make fundamental changes to their program.

Bank executives are all seeking a better way to identify, measure, monitor and control such risks as credit, market and liquidity, to name a few. The Dodd Frank Act and Basel III all place pressure on management teams and directors to do a better job managing risk. Banks will continue to work toward creating an enterprise wide view of risk, enhance data collection and move even further into this new realm as the year unfolds.

As bankers know, managing risk is multifaceted and it certainly isn't easy to do, but there are things you should be thinking about. For instance, consider broadening your risk management practices beyond measuring just downside risk and include it as a component in achieving business objectives. Test new products and services against the risk appetite statement to be sure they make sense. Use risk models when you can to help identify exposures, but don't forget they have inherent limitations. Strengthen risk management by augmenting model limitations with human judgment. Statistical models are fine, but today is never exactly like tomorrow and historical performance is very often a very poor predictor of future performance, so you have to go further than that. Overall, to avoid following another banker over a cliff, having a risk manager and a better risk management discipline will help.

The question that should always be asked is whether the business decision you are considering increases, decreases or keeps risk the same. Then, make sure you understand the reward you are trying to capture and the risk inherent in pursuing it. If it is an acceptable risk, proceed, but if you aren't sure or you don't fully understand the risk, do more analysis until you do. It is easy to follow the herd, but very difficult to lead it.

BANK NEWS

Mortgage Servicing

The American Banker is reporting the GSEs may soon float a proposal that would alter servicing rights in a number of ways including the possibility of lowering the service fee on its purchased mortgages. The move could dramatically reduce the value of servicing cash flows, thereby hurting capital at many banks.

Home Prices

According to Zillow data, November marked the 53rd consecutive month (4 Ã‚Â½ years) that home values have fallen. That means that home values have fallen 26% since their 6/2006 peak. This is worse that the 25.9% decline seen during the Depression years between 1928 and 1933.

Social Networking

A senior analyst at Javelin Strategy and Research quoted in the American Banker indicates 75% of consumers are unlikely or very unlikely to interact with their bank through social media. Banks still have work to do here if they intend to change customer minds.

Investment Programs

Research on community bank investment programs (such as annuities) finds the penetration rate is about $245 per $1mm in deposits. This compares to banks with assets above $4B, where the rate is $341 per $1mm (about 39% higher).