BALANCING THE RISK APPETITE STATEMENT

by Steve Brown

Researchers from the University of Chicago have found that men are 94% more likely than women to apply for a job if the potential salary is described as being highly dependent on competition with other employees. Based on this survey, it would appear men enjoy competition in the workplace more than women. Maybe that is why some men have difficulty on workplace teams where working together is important to attain a specific objective. This is perhaps something for you to consider, as you work to achieve various goals and objectives this year.

Speaking of goals and objectives, one your bank may be working on has to do with creating a risk appetite statement. These have become an important aspect of banking following the crisis of 2008 and more banks are getting on board given increased regulatory scrutiny and the fact this is a best practice. These days, regulators frequently ask directors and management teams to provide their risk appetite statement and then test it to see how well it is being followed.

Recently, the RMA did a survey of banking executives asking them whether their bank had a formal written definition of the amounts and type of risks they were willing to take on as an organization in exchange for a desired level of return. While 62% of large banks had one, only about 32% of banks under $1B had a formal risk appetite statement. Reasons for the difference varied, but some of the most common were that risks were handled through policies; the credit culture; concentration limits by asset type; in various committees; through general statements or verbal communication. These may all work in some fashion, but without a true risk appetite statement, it is difficult to ensure the bank's risk/reward tradeoff is completely understood in all areas of the organization.

In designing the risk appetite statement, it is important to tie it into the strategic plan. That way, when new products or opportunities surface, you can quickly compare them to the standard of the statement and see whether they fit or may need to be modified or abandoned. The statement makes sure you have a baseline to operate from and that the Board has weighed in with agreement. Once that is done, management has pretty clear direction upon which to run the bank.

Once you have the risk appetite statement in place and you begin to follow it, the next question that arises is how often to revisit it to make sure it remains relevant and effective. Here again, the RMA survey provides some insight. Larger banks in the survey said they either revisited their risk appetite statements annually (40%), quarterly (23%) or under not set cycle (39%), the last of which points to how much flexibility might be needed given such significant changes in the banking industry right now. We think community banks should put it on the schedule for at least an annual review, but not be shy about modifying it more frequently if conditions dictate.

Balancing risk and reward in any bank is difficult, but competition dictates we do so every single day, so creating a risk appetite statement is no longer optional. Set up your Risk Management Committee, start with the risk appetite statement and get things rolling to truly set a balanced tone at your bank.

BANK NEWS

FDIC Report

The quarterly report is due out this morning.

European Stress

The European Central Bank reported bank borrowings using its emergency marginal-lending facility jumped to the highest level in 19 months, as liquidity concerns overseas spiked. Problems related to some large German banks and ones in Portugal, Spain and Greece were speculated to be primary reasons for the unexpected increase.

Muni Stress

A new study by the Center on Budget and Policy Priorities finds 44 states face a combined $125B of budget deficits next fiscal year. Deeper service cuts in these states are likely to be needed.

Better Economy

The Fed updated its forecasts and now projects the economy will grow between 3.4% to 3.9% this year (up from 3.0% to 3.6% forecast in Nov.) and that the unemployment rate will be 8.8% to 9.0% (down from 8.9% to 9.1%).

Modified Loans

S&P research finds banks are better than government programs at making sure modified single family residential loans don't re-default. In 2008, 80% to 85% of loans re-defaulted, but as of late 2009 that had dropped to 50% to 55%.

Hotel Sector

This sector has rebounded to an average occupancy rate for the Top 25 markets of 64% in 2010, up from 60% in 2009, according to Smith Travel Research.

Film Lending

Loans to finance major motion pictures are down and prices continue to trend up, rising about 200bp over the last 3Ys to L + 5.50%. While there used to be 30 major banks lending, now the count is down to about 12. That said, more regional banks are taking a look at the sector to possibly get back in.