COFFEE AND A FEW BEANS OF REGULATORY ANALYSIS

by Steve Brown

It is estimated that over 2.25B cups of coffee are consumed in the world every day. Here in the US, there are more than 25,000 coffee shops and according to the National Coffee Association, 49% of Americans age 18 or older drink some type of coffee beverage daily. As we enjoy our own cup this morning while we write this publication, we shift energies and focus once again on the regulatory side of the banking world.

In a recent speech, the Deputy Comptroller for Credit and Market Risk from the OCC hit on some key themes that we believe are worthy of repeating. If your bank isn't supervised by the OCC that doesn't really matter too much, as many of these same exact themes and thoughts are echoed by the other agencies. The first key point that surfaced was a lesson learned from the credit crisis - it was caused by an environment where bankers, investors and regulators had become complacent about risk. That increased pressure to compete to maintain or grow market share, in turn led to lower underwriting standards and more complex product structures, so leverage became the mantra of the time. Regulators and bankers have learned much from the crisis, but the key takeaways that resonate today are a renewed regulatory focus on underwriting, leverage, growth and concentrations. As a result, over the next few years in particular, it will remain important for banks to continually improve risk management in these areas.

The speech also points out that the crisis taught us all that risk concentrations in product and business lines can lead to difficulty. To avoid problems in this area, capital cushions are critical because understanding how risks are interconnected is a tricky business and contagion effects can spread rapidly. As a result, expect regulators to remain focused on what risks banks are taking, how those risks are being managed, how aware all of the directors are and what contingency plans are in place to protect the bank against downside risk. That means higher capital levels overall are likely and banks that want to carry concentrations in CRE or anything else for that matter will have an even higher hurdle to hit. Capital is the last line of defense, so expect to carry more and to pay for the resulting lower leverage through higher fees (charged to your customers) or better loan pricing (more reward, lower risk).

Standardization of regulation is another key focus of regulators that was pointed out in the speech. In order to surface credit migration and problems at a given bank before they become too large, examiners are focused on refining their process to incorporate more benchmarks and metrics. That approach means the data collected at the largest banks will be leveraged up in the regulatory world to identify trends and issues. For community banks it could mean more targeted examinations depending on the risk profile, so be prepared.

Another key area of focus in the speech was on getting banks to do more enterprise-wide stress testing as risk management is enhanced. Model validations, challenging assumptions feeding those models and additional regulatory guidance outlining expectations are becoming the norm. Getting in front of the data that feeds your decision making processes and making sure it is robust and forward looking is a good first step. Concentrations should be compared to the market to pick up trends earlier and include analysis by geography and product type.

We just scratched the surface on this today and understanding where the regulators are coming from is critically important to bankers, so we will pick it up again tomorrow. As for the coffee most of you are drinking this morning, you might be interested to know that the Specialty Coffee Association of America indicates larger coffeehouse chains with more than 10 units represent 40% of the market, while independent operators with 1 to 3 units have 57% and micro-chains with 4 to 9 units have 3%. Where did you buy your coffee this morning?

BANK NEWS

US Cash Position

The NYT reports insiders at the Treasury say they have enough cash to get the US to Aug. 10th (we say the 22nd) due to higher tax revenues and some additional maneuverings should the debt ceiling be hit on Aug 2nd. Regardless, hopefully banks have indentified gov't payment streams that are at risk of delayed payment, reviewed their investment policies for Treasury holdings and have indentified potential collateral problems in pledge accounts/repo.

Repo Market

To our above point, we note that the repo market is now dislocated creating an increase in systemic liquidity risk for banks. This lower source of liquidity should increase activity in Fed Funds in the coming days.

Biz Int. Checking

Capital One Bank becomes the first major bank to take advantage of the fall of Reg. Q by introducing their "Clear Interest Business Checking" product.

FSOC

The Financial Stability Oversight Council released its first annual report that recommended establishing national mortgage servicing standards; reworking money market mutual fund oversight and rules; reform FNMA/FHLMC; increase rules for mortgage securitization and enhancing capital, liquidity and resolution plans at banks.