DIVING INTO RISK FROM ANOTHER PERSPECTIVE

by Steve Brown

In order to handle the shift of people leaving their farms and searching for higher paying jobs in cities, China will need to build the equivalent of all of New York's residential and commercial buildings every 2Ys for the next two decades. That can add material risk to any country and while growth is good, sometimes too much growth can eventually have unintended consequences. Whether you believe the S&P downgrade of the US began the current cascade of market volatility, or you think it is more driven by problems in Europe, we nonetheless take a look at some of the factors S&P has surfaced in its bank rating methodology to try and stay ahead of the curve. While few community banks are rated by S&P or other major ratings agencies, these factors can be helpful in understanding how outsiders might view the future value of your franchise.

Complexity is a relatively new area of focus that you might find interesting. Here, in the ratings methodology, S&P notes that one of the key issues that add significant risk in banking is the increasing level of complexity in products, business lines, regions and organizational structure. The agency indicates that in many cases, complexity has also outgrown the capacity of bank executives to manage risk. Simple is better when it comes to maintaining a moderate risk position, so areas the rating agency monitors closely include the number and type of complex business lines; transparency of earnings sources; a siloed approach to risk management; high dependence on models with complex assumptions to measure and manage risk; portfolios that have risks with a low probability of occurrence but high loss severity; balance sheet strategies driven by regulatory arbitrage and operations in many locations or with an organizational structure with multiple legal entities that adds complexity. Some of these are directly applicable to community banks while others may not yet be, but suffice it to say from a credit rating agency viewpoint, the more complex your bank, the closer the look you are going to get and the more risk controls you should have in place. In and of itself, the rating agency views an absence of complexity as rarely sufficient to improve a bank's overall risk position, but on the flipside, the more the complexity the greater the risk and the more the bank is viewed negatively.

Concentrations and diversification are important factors when evaluating the strength of a bank. Here, the rating agency analyzes whether the bank has a material risk exposure by single name in the loan portfolio, geographic sector and investment portfolio. The more concentrated the bank is, the more sensitive it is to event risk, so that increases concern. The offset to this is capital, so banks that run higher concentrations would be expected to have higher capital levels in order to balance out the risk profile. When it comes to diversification, the agency looks at how well segmented the loan (and other) portfolio is by industry and sector and whether correlations are being addressed. To improve the risk profile of your bank, put a process in place to measure, monitor and manage concentration risks closely.

Finally, take a look at interest rate risk. Here the rating agency takes a close dive into how the bank manages its asset liability management function and where it fits in strategically. Measures that are reviewed include sensitivity of bank earnings to changes in interest rates or the shape of the yield curve based on stress testing; senior management awareness and engagement in setting the level of acceptable risk; the repricing gap between funding sources and assets and the optionality characteristics of assets and liabilities.

As you drop your weight belt and head back to the surface of banking this morning, you will find utilizing common sense and incorporating some of these concepts will help protect you like a shark cage in the infested waters of the industry.

BANK NEWS

Deposit Inflows

Fed data released this week for last month shows an 8.4% YOY increase in deposit volume. This week's ABA survey shows 31% of banks have seen an influx of deposits as a result of recent market volatility as well. It is important to note that best practices at banks are to increase marketing communication with depositors during such times of stress, reassuring them on the strength of the FDIC, the bank's safety and ample liquidity in the system.

Foreclosures

RealtyTrac reports foreclosures are down 4% from June and 35% from the same period last year. Unfortunately, most of the slowdown is a result of longer time on the market and problems with documentation.

Gold Coins

A spike in gold prices has led the US Mint to suspend production of gold collector coins for the 1st time in history. The move affects only gold numismatic products sold to collectors and not gold bullion coins sold to investors.

NCUA Suit

The NCUA filed a lawsuit against Goldman alleging the investment bank sold mortgages it knew would perform poorly to credit unions.

Strategic Default Risk

A survey by FNMA finds 27% of underwater borrowers think it is ok to walk away from their mortgage now - about double the level of 1Y ago.