LESSONS LEARNED

by Steve Brown

One lesson bankers have learned from targeted savings accounts, or accounts where the customer labels the account and then saves for something specific (vacation in Hawaii, Junior's college), is that they are effective. In fact, CNNMoney reports people that use these accounts will save 31% more on average than those who don't. Maybe you should revisit your deposit account structures and work with clients to "private label" them with customer-specific goals in mind to boost funding. You may not need it right now given the flood of funding, but at some point in the future you might, so it pays to get started early. Speaking of lessons learned Ã¢Â€" what can bankers take away from the trading loss at JPMorgan?

First, to be fair, there is still a whole bunch of stuff we don't know, so we will take the general observation road at this point. Jamie Dimon, CEO of JPMorgan, has indicated that some of the issue was driven by new models used by traders that erroneously indicated risk was about half the level of older models used prior to the issue. That has triggered regulators to indicate "key model characteristics, assumptions and parameters" will be closely scrutinized. The bank itself has said the strategy was "poorly conceived and vetted" and traders "did not have the requisite understanding of the risks they took." All of this will certainly trigger a regulatory (and bank-specific) "lessons learned" to review what happened, how it happened, what actions were taken, what worked and what didn't. We don't speak for the regulatory agencies obviously, but we would be dollars to donuts that once this works through the system, bank exams that follow will get much tighter model scrutiny. Expect regulators to look at all models you use, how you use them, whether assumptions are passed up to the board and a multitude of other factors around any models of significance that your bank may be using.

While the script is still being written around the JPMorgan problem, one takeaway for community bankers is that this isn't new news for regulators. In fact, in April of last year, the Fed released new guidance on managing model risk in banking. Given this latest industry example, it makes sense to take a hard look at the guidance to be sure you are adhering to it.

Given the guidance is 21 pages long, we cannot do it justice in here, but key pieces are worthy of highlighting nonetheless. To begin, model usage is critical to bank quantitative analysis and ultimately, decision-making, so having a solid model and inputs are fundamental to this process. Tying back to JPMorgan, the 2nd paragraph of the guidance even indicates overreliance on models can have "possible adverse consequences (including financial loss)" if they are incorrect or misused in the decisioning process. In broad terms, regulators expect banks to have a strong model risk management program that not only incorporates validation, but also sound model development; implementation; use; governance; control mechanisms; and an appropriate incentive and organizational structure. In short, model risk management has become much broader and deeper than ever before.

Perhaps the biggest issue for community bankers is defining what a model is and what it is not. The guidance definition is pretty broad, indicating the term "model" refers to "a quantitative method, system, or approach that applies statistical, economic, financial or mathematical theories, techniques and assumptions to process input data into quantitative estimates." If that is too murky for you, consider the definition also covers "quantitative approaches whose inputs are partially or wholly qualitative or based on expert judgment, provided that the output is quantitative in nature."

Given the gravity of the situation around JPMorgan, it is certain that model risk and the lessons learned from this experience will be on your next regulatory test. We will go deeper into this subject in a future edition, but in the meantime, we wanted to get you thinking about it. Finally, you might find it interesting that when it comes to targeted savings accounts, including a picture of what the person is saving for boosts their commitment.

Related Links:
Credit Rating Reg

BANK NEWS

Credit Rating Reg

The OCC put forth their final rule on the utilization of credit ratings on investment securities and foreign bank deposits. Under the new standard, banks would have to determine if the issuer has sufficient capital and cash flow to meet its obligations over the projected life of the asset and not rely on a 3rd party credit rating. If approved, the rule goes into effect 1/1/2013. The final rule can be found under the RELATED LINKS section.

Wells Fargo M&A

The Bank said it plans to purchase insurance companies that will help the Bank increase its share of wallet with consumers and small businesses. In addition, the Bank restated its objectives to grow wealth management and retail brokerage operations. In related news, the Bank announced the acquisition of WestLB's $6B subscription business that provides revolving, term debt and letters of credit to private equity and REITs.

Last Ditch Effort

Capitol Bancorp ($2.1B, MI) seeks to convert its current $158mm of debt to preferred or common equity in a final effort to prevent a prepackaged bankruptcy filing.

Offshore M&A

In order to raise capital, French banking giant Societe Generale will sell a portion of their shipping loan portfolio to Citigroup. Terms were not disclosed.

Construction

Under the new Basel III rules, construction lending would likely go into the "high risk commercial real estate" category and require a 150% risk weighting.