THE CONVEX NATURE OF CAPITAL RISK

by Steve Brown

Convex mirrors can be found in many offices all over the world, creating a wide angle view that can be quite handy at times. They enhance security and stop people from crashing into one another when they turn a corner at work. Convex mirrors are like normal mirrors in that they both reflect back light, but convex mirrors make the light rays appear to spread out because the mirror itself bulges toward the light. Since most bankers don't make a lot of loans on mirrors or mirror companies, we will now end our science discussion before you begin to get a headache and wonder how those mirrors in hotel bathrooms can zoom in so close on your face that you can see imperfections only visible to a gnat. Speaking of mirrors that help you see around corners, you should know we are now in an era of banking regulation called "dynamic capital supervision." This change began after regulators concluded that static capital management is too blunt a tool given changing risk profiles post crisis. The beginning point of this evolution revolves around stress testing. No, we are not talking about loan stress testing, but rather capital stress testing. The idea is that doing so gives bank management teams and directors a good idea of what sort of capital situation they could be in during an adverse situation. Then, capital stress testing asks the question - what are the odds that a given situation (stress) could happen, what capital and liquidity you would have if that occurred and what steps you would take in what order to mitigate the impact of the event (your contingency plan). In a nutshell, this new dimension of bank regulation takes traditional static views of capital ratios and enhances them with forward- looking analysis to get a better understanding of the impact of various events in an ever-changing industry. Regulators look to stress testing to assess the capacity of a bank team to understand and manage their capital position, evaluate capital distribution plans against overall capital positions and make sure the bank meets all capital requirements on a going forward basis despite a shifting environment and new regulation (such as Basel III and other new capital rules that are currently out for comment). Another way of thinking about this is to consider that stress testing is a forward looking and dynamic process. That means management teams have to think about what scenarios they are going to run and why. This very process results in benefits to the organization that some might say are as important as running the test itself. As a tool in the banker's tool box, stress testing is useful when analyzing capital, liquidity and other areas of risk that reside in the bank. We have all learned many lessons during this period of economic crisis and one of them is the added value of testing how to protect capital using dynamic techniques that change as economic or industry conditions require before an impactful event actually happens. Preparation is critical to avoid making hasty decisions under duress and dynamic capital analysis does just that. Whether your team is trying to reduce the risk of shocks that could jeopardize your ability to meet obligations, or you are testing strategies you might employ to gain market share or customers, dynamic capital planning can be beneficial. As you round the next corner in capital planning in banking, don't forget to look up and use the convex mirror placed near the ceiling as a dynamic way to avoid bumping into something that might not be easily seen.

BANK NEWS

Stimulus Coming

In what seems like a coordinated effort,late articles from the NYT and WSJ report that Fed officials are close to adopting fresh stimulus either next week or most likely on 9/13. While QE3 with MBS is most likely, more QE3, a discount window rate cut and/or a cut of the Reserve Rate at the Fed (IOER) are all on the table.

Basel III

A group of banks released public disclosures on how the proposed Basel III capital weightings might impact their Tier 1 capital ratios. SunTrust, First Horizon, Huntington and TCF get hit the hardest of those banks that released the calculations driven by their holdings of home equity loans, interest only/balloon mortgages and non-performing assets. BofA, Citi, BONY and others would see their ratios increase.

Corp Bonds

The FDIC released a final rule under Dodd Frank that prohibits savings banks from purchasing corporate securities unless they underwrite and can prove the issuer can meet its financial commitments for the life of the instrument. The rule establishes standards that savings banks need to follow in order to determine credit quality (looking at cash flow, management, 3rd party analysis, probability of default, etc.).

Risk Group

Moody's, State Street and MIT announced a joint venture that would quantify risk and provide independent research on the systemic risk in global financial markets.

CC Settlement

JPMorgan Chase said it will pay $100mm to settle litigation it improperly increased the minimum payments of credit card customers as a way to generate higher fees.

Housing Bottom

Zillow reports Q2 home prices rose Y/Y for the 1st time since 2007. In other news, S&P predicts home prices won't get back to their mid-2006 peak until 2023.

Debt Burden

A study by Accounting Principals finds 68% of recent college grads are carrying an average of nearly $40,000 ($27,000 in student loan debt plus $12,742 in credit card debt) in debt and 31% are finding job prospects so weak they wish they had chosen a different major. An astounding 83% said they cannot afford a car, groceries, rent or a cell phone.