MOVING SLOWLY TO FIND & MANAGE RISK

by Steve Brown

If you have ever dropped something into the trash can by mistake, you know it can be really gross to have to fish it back out. Speaking of gross, recall our story a few weeks ago of an enormous garden snail found recently in a Houston residential neighborhood. It was a giant African Land Snail and this is among the first reports of one found in Texas. The gardener who found the 8 inch snail allowed it to escape, however slowly; not realizing peril lay ahead in the immanent destruction of vegetables. This particular snail also carries a nasty parasitic disease that can make humans sick. As a result, residents have been warned not to touch them and to walk for their lives.

The story about an enormous slow-moving gastropod led us to consider Dodd Frank and corresponding revisions around risk embedded in the Community Bank Supervision Comptroller's Handbook. This is because no discussion of risk moves quickly, so we will spend two issues discussing these changes as we move like a snail through the updates to keep you informed.

As many bankers already know, there are eight standard regulatory categories of risk: Credit, Interest Rate, Liquidity, Price, Operational, Compliance, Strategic and Reputation. Core meanings of these risk categories have not changed even in this latest update, but the definitions now include industry terminology and assessment factors to make them more relevant in the post- crisis environment.

The Handbook defines risk as "the potential that events, expected or unexpected, will have an adverse effect on a bank's earnings, capital, or franchise or enterprise value." Wait - repeat that last part? As far as we know, the addition of the language "franchise or enterprise value" is new and we read regulatory literature all the time. Risk assessment in the past has primarily focused on capital and earnings.

In the appendix to the Handbook, each category is further explained. Here, the language on franchise or enterprise value shows up in two categories - strategic risk and reputation risk.

Maybe we had better dust off our old finance textbooks and remember the definition, as we consider the intention. Enterprise value is defined as "an alternative to market capitalization as a measure of a company's value." Colloquially, we would call it the theoretical takeover price.

Let's look more closely at the two categories that reference franchise and enterprise value in the Handbook.

Strategic risk arises from adverse business decisions, poor implementation of business decisions or lack of responsiveness to changes in the industry. Assessment of strategic risk includes more than analysis of the bank's strategic plan. It focuses on opportunity costs and success of implementation of plans. It also includes how management analyzes economic, technological, competitive and regulatory factors and how they affect the bank's strategic direction.

Reputation risk, meanwhile, arises from negative public opinion. It may impair the bank's competitiveness and ability to establish new relationships, as well as serve existing customers. This risk is inherent in all aspects of the banks' business and there is increased reputation risk associated with outsourced products. The bank's culture, effectiveness of its problem- escalation processes and deployment of media are important in the assessment of management preparedness. In this publication, we have long espoused the importance of technology and embracing change. Banks have to stay in touch with shifts in customer needs or risk losing out over the longer term. It just makes competitive sense, so how to do so and stay within the new Handbook rules is more than just a good idea. We will discuss the other risk categories tomorrow to help.

BANK NEWS

Largest Banks

The Wall Street Journal reports research by Morgan Stanley and Oliver Wyman Group that examined the world's largest 15 banks, found regulatory changes and market conditions were consolidating activity among the top five. In 2012, this group accounted for 51% of all revenues and 62% of all profits for the top 15.

Changing Behavior

Research by Guardian Analytics finds about 54% of small business owners access their business accounts from mobile devices, up from only 23% 2Ys ago.

Small Biz

A study by Borrell Associates finds 75% of small business owners say the ability to target advertisements by customer location is important when it comes to mobile marketing campaigns.

Credit Cards

A survey by CNNMoney finds most people carry 1 or 2 credit cards (44%), followed by 3 to 5 (37%), more than 5 (16%) and 0 (3%). Meanwhile, the average card balance in 2012 was $1,688 vs. $1,952 in 2010.

Housing Sector

Harvard reports home improvement spending climbed 9% in 2012 vs. the prior year.

Students

Research by EverFi finds 63% of students say their parents are responsible for educating them about how to manage money.

Retirement

A survey by Vanguard finds about 33% of people ages 25 to 34 do not save anything in their 401(k).

Lending

Banks seeking loan opportunities should note the price of building supplies is up 9% over the past 3Ys. Plywood is up 34%, framing lumber has jumped 25% and insulation is up 18%.