

MOVING SLOWLY TO AVOID THE RISK OF BURNING SOUP

by [Steve Brown](#)

Yesterday we talked about risk and we pick that up again today. Before we do, however, we warn readers to blow on their vegetable soup of regulatory rules to avoid getting burned. Bankers' these days are dealing with so many changes, the occasional burn is just an expected part of the industry right now. Yesterday, we particularly focused on two risk categories from the updated Community Bank Supervision Comptroller's Handbook - namely, Strategic and Reputation. These not only reference earnings and capital, but also risk to franchise or enterprise value. Today we slurp up a little more as we review the remaining six defined risks: Credit, Interest Rate, Liquidity, Price, Operational and Compliance.

Credit risk arises from an obligor's failure to perform as agreed. We typically think of loans in this context, but the Handbook language specifically pulls in other bank activities. These include the investment portfolio, derivatives partners, foreign exchange counterparties or indirectly through guarantor performance. This risk is found in all activities in which settlement or repayment depends on counterparty or borrower performance.

Interest rate risk arises from movements in interest rates. This includes repricing risk, basis risk, yield curve risk and options risk. Banks should consider interest rate risk from both an accounting perspective (earnings) and an economic perspective (the market value of the portfolio). Not to be confused with pricing risk (which focuses on the mark-to-market portfolio), interest rate risk focuses on the value implications for all portfolios in the bank, including held-to-maturity and available for sale.

Liquidity risk arises from an inability to meet obligations when they come due. This may come from an inability to access funding sources or to manage fluctuations in funding levels. It can also result from the bank's failure to address changes in market conditions that affect its ability to liquidate assets quickly and with minimal loss due to market fluctuations. The Handbook notes an increase in complexity in managing liquidity risk, due to off-balance sheet retail products and other factors.

Price risk comes from changes in the value of a bank's trading portfolios. This doesn't usually impact community banks, but it does if any portfolios are subject to daily price movements or accounted for on a mark-to-market basis. Price risk can arise from lending pipelines, OREO and mortgage servicing rights.

Operational risk comes from inadequate or failed internal processes, human errors, misconduct or external events. The quality and effectiveness of a bank's system of internal control is a key factor in managing operational risk, as well as the due diligence process and business continuity planning.

Compliance risk arises from violations of laws, rules or regulations or from non-conformance with prescribed practices, internal policies and procedures, or ethical standards.

In addition to these categories of risk, the Handbook prompts examiners to be alert to concentrations which can increase risk in any or all areas. Regulators are asked to focus on concentrations in

business lines or related to geographic areas. Since the community bank business model by its nature is usually in a concentrated geographical area, with concentrated expertise, this is an additional concern. The rules don't mean a bank can't have concentrations, it just means you need to be able to adeptly demonstrate you can identify, measure, monitor and control risks within that context. If not, expect a demand for additional capital to perhaps follow.

As you do your best to slurp up the regulatory changes, focus on documenting better and thoroughly discussing things that appear to be outliers to avoid issues. As with our snail example yesterday, moving slowly so you fully understand regulatory changes/updates is critical to stay out of trouble.

BANK NEWS

Competition

In an effort to retain more clients and deepen relationships, Huntington Bank (\$56B, OH) said it will once again offer MasterCard credit cards to its commercial customers, after exiting this line of business in 1999.

S&P

Research by Deloitte finds companies that make it onto the S&P 500 list used to be on that list for an average of 75Ys back in the 1930's, but that has declined to less than 15Ys today due to extreme global competition.

Small Biz

The Census Bureau reports small businesses operated by a single person represent more than 70% of all companies in the US.

Fined

The Financial Industry Regulatory Authority (FINRA) has censured and fined brokerage firm Raymond James for municipal securities rule violations after buying municipal securities for its own account from customers and/or selling municipal securities for its own account to customers at a price that was not fair and reasonable, according to FINRA.

Marketing

A study by Aite Group finds 80% of financial marketers say they have trouble measuring marketing return on investment.

Down Payment

Ellie Mae indicates mortgage payments including taxes and insurance should be no more than 28% of gross income for a borrower.

ROA Down

Research by Deloitte finds that over the last 40Ys ROA for all public companies in the US has fallen 75%. Technological advances and global competition are key drivers for this decline.

Mobility

Research by comScore finds in the past year, nearly 30% more Americans have purchased and are using a smartphone (as of Feb., 133.7mm Americans had smartphones vs. 104.0mm at the same time last year).

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