Robot Problem Early Warning System

by Steve Brown

We've always been fascinated with robots, beginning with Rosie the Robot who greeted George Jetson at the door with his favorite cocktail. Technology may not yet have achieved that, but we are all aware of the robot vacuum cleaner called the Roomba that propels itself around the house. To us it looks a bit like a dinner plate-sized hockey puck that slides around sweeping up dirt, debris and dog hair. This is a great idea, except it appears that a certain Roomba wasn't asked its opinion about doing such chores. This particular Roomba which was turned off at the time, decided to self activate, went across the kitchen counter scooping up leftover cheerios, rolled onto the hot stove, pushed a cook pot out of the way, sat on the hot surface and blew up. You may wonder what a Roomba was doing on a kitchen counter in the first place, but that isn't the point of this story. No, instead this appears to be the first documented case of robot implosion.

This story brings to mind the steps that community banks should undertake to ensure capital adequacy. Instead of activating capital planning when times are troubled as with the robot above, the most effective way is to make capital planning an embedded part of sound ongoing risk management practices. Many banks think primarily in terms of minimum regulatory capital requirements, but the level of capital in a bank should be far more personalized and related to both the risk profile and the risk management strategy. If your bank has a higher risk profile due to concentrations/geography, loan types, etc. it can make sense to hold more capital.

When doing any capital planning, primary banking risks should be assessed (credit, market, interest rate, liquidity, operational, reputational and legal), as well as regional and macroeconomic risks, vendor and third party risks and a host of others.

Looking back at the difficulties that banks had during the credit crisis, many did not see the problems coming and did not have adequate risk management processes to alert management and ultimately did not hold enough capital. The key with capital planning is to be sure enough is maintained so there are still options available to react to changes around you. In order to have an effective process, banks must be able to take action in the present to avoid future problems, so it must also be forward-looking and tested under stress scenarios.

What are some simple steps banks should take here? First, stress testing is an important component because the bank goes through a set of hypothetical extremes. This gives the management team time to think about how to protect the bank against unforeseen negativities that surface. That process pushes management teams to consider possible effects on earnings and capital and determine whether strategic changes to the business model are in order. Next, consider using two approaches - sensitivity analysis (which measures the sensitivity of a bank's balance sheet based on assumptions) and scenario analysis (which looks at external events like a recession or a natural disaster).

Banks with lower risk profiles may not need outside help with stress tests, but there are best practice guidelines. Stress tests should be customized and include the bank's historical experience if relevant. Next, results and assumptions should be discussed and documented in board meetings to show that the board understands the potential risks. Early warning thresholds for key measures should assist management in knowing when to proactively take action.

Capital planning can't solve every future mishap, just like the family could not have known its Roomba was about to melt down. However, the smart bank pays close attention to warning signs and may even have a robot dog standing by to warn of potential issues as they arise. Have a solid capital plan in place and listen for the barking to make sure your bank is safe.

BANK NEWS

Rate & Funding Risk

Regulators are warning banks to analyze and understand the risk for non-maturity deposit runoff of so called "surge" deposits that came in as a result of the actions the Fed took during the crisis. According to Fed research, the "pre-surge" average of non-maturity deposits to total assets for banks nationwide was about 43%, so banks should carefully analyze anything above that as outflows are likely once rates begin to rise again.

Home Equity

The Fed reports $221B of home equity loans will hit their 10Y mark soon & might begin to default. The number is about 40% of all home equity lines currently outstanding.

Loan Limits

The regulator for FNMA and FHLMC said it will hold the limit on size of mortgages that the agencies can guarantee at $417,000 in most areas of the US for 2014.

Video Marketing

For banks working to ramp up video to boost marketing efforts in 2014, consider a new survey by Brightcove. It finds 75% of respondents won't watch a video if they experience buffering and freezing issues and 62% are more likely to have a negative perception of a brand that uses low-quality video. Another 23% said they would hesitate to purchase from a brand because of low quality video.

Worrisome

The Labor Department reports worker productivity has increased 1.0% annually over the past 4Ys vs. 2.2% average since 1983.