Bank Safety & Soundness Advisor

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Small Institutions Should Also Pursue Risk Management, OTS Says

When pushing risk assessments, and their connection to setting capital levels, the OTS doesn't exempt smaller financial institutions. Those smaller institutions may not need a big, sophisticated program, but they should talk through and assess institutional risk, the regulator argues. Here are a few "what if" scenarios the agency suggests to smaller institutions looking to assess institutional risk:

• A decline in local or regional house prices or an increase in the unemployment rate in the local area.

• A decline in commercial real estate prices or rents, or an increase in vacancy rates.

• Over-development or a decreased demand for new homes or other newly developed real estate (e.g. condominium projects) in the institution's lending area.

• A downturn in the national or regional economy and resulting increases in delinquency or charge-off rates.

• A sudden, unexpected increase in market interest rates.

• The closing of a local business

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Risk Mitigation Key to Capital Levels, OTS Says

With only months left to live, the OTS surprised the industry last week with the most definitive risk monitoring and mitigation guidance from any regulator yet. The guidance, a memorandum on capital planning signed by OTS deputy director of exams Thomas Barnes, comes very close to calling for Enterprise Risk Management outright, experts say, though the guidance doesn't mention the risk methodology by name.

"This is the strongest regulatory statement regarding ERM I have seen made by the OTS to date," says Marcus Faust, an SVP and ERM consultant with RP Financial, Arlington, Va. "The OTS may as well have come out and said: You need to implement ERM. They're defining it without using the term."

The memorandum deals explicitly with capital management, but makes clear that capital management must be tied to risk management.

"Capital planning should generally begin with a meaningful assessment of capital adequacy relative to an institution's own unique risk profile and business plan," the memorandum states. "… Savings associations should have a robust process for setting internal capital target that are commensurate with their individual risk profiles and strategic plans, and adequate to withstand periods of economic stress," the memorandum states.

Why is the OTS putting this guidance out now, just months prior to its planned merger with the OCC? The agency saw a need for better capital management best practices, says OTS spokesman Bill Ruberry. "We're looking at guidance to be helpful and user friendly," he says. "We just put together in one document, what we regard as best practices for capital management. We saw some problems [with some financial institutions] during the financial crisis and we think institutions need to do a better job with capital planning."

The guidance argues that each bank has a unique individual risk profile and that established, public regulatory capital standards may not be adequate capital benchmarks – especially when the economy crumbles. Instead, banks should think of those capital standards as minimums. Risk mitigation and monitoring programs can then tell a bank if it needs to hold a larger capital cushion. As the memorandum

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makes clear, the OTS will expect thrifts to stress test and conduct scenario analyses. Thrifts can expect examiners to broach the subject at a future exam.

Banks under other regulators should definitely pay attention, argues Dave Sidon, an ERM consultant with The Navis Group in Gloucester, Mass.

"All banks should look at this," he says. Banks tend only to look at guidance from their own regualator, but "as a practical matter, these pieces of guidance eventually merge," he adds.

It makes perfect sense that regulators would relate capital to ERM because their ultimate concern is that capital is properly aligned with a savings association's individual risk profile" Faust says.

"This CEO memorandum is geared towards capital," Faust says. "All of ERM relates to capital adequacy from the regulatory standpoint. That's the Holy Grail. Capital protects the FDIC insurance fund and what the OTS is saying is that it's no longer sufficient to adhere to minimum regulatory capital requirements alone. Banks need to look at their own situation, unique from any other bank, and determine a risk profile. They need to figure out what levels of capital they need in relation to their unique risk profile"

Here's what the OTS suggests to banks thinking about capital targets:

• Risk-based regulatory capital requirements do not take into account certain risks, both specific to individual savings associations and more generally to the economy at large, including concentration risk, interest rate risk, liquidity risk, and business cycle risk.

• The economic value of capital often falls in times of stress. A savings association should have sufficient capital to weather both normal business fluctuations as well as stressed economic conditions.

• In times of stress, particularly during unfavorable market conditions, associations often find it difficult and costly to replace depleted capital.

The OTS memorandum and regulators' increased interest in ERM are all part of a larger shift in regulatory thinking, suggests Faust. Regulators are increasingly less content with historical analysis alone.

Historically "The regulatory approach has been backward-looking, like an audit," he says. "Regulators were looking at what was already there. [Guidance] like this CEO memorandum emphasizes capital planning is forward-looking and risk focused. They're saying: You need to look at the risk in your institution today, but also the risk in your strategy and your business plan going forward."

And examiners will expect to see that risk reflected in new, higher capital levels, adds Sidon. "What jumped out, for me, was this: The industry has been considering [standard regulatory] capital ratios to tell if banks are well capitalized, but that may not be the case anymore," he says. "The regulators are now looking to you to provide your own assessment. Also, I think capital standards just went up." ■

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and resulting unemployment in the local economy, including estimates of loan defaults and losses.

• Increase in delinquencies or defaults on adjustable rate loans from a sudden, unexpected increase in interest rates.

• Changes in an institution's mortgage origination pipeline with increases or decreases in interest rates.

• Increases in servicing costs on mortgage loans, due to unexpected levels of defaults and foreclosures, or changes in foreclosure costs.

• A local natural disaster such as flooding, including resulting loan defaults and possible changes in property values, or damage to agriculture in the area.

• Slower or faster prepayments as compared to projections.

• Core deposit outflow faster than projected.

• Losses on REO higher than projected.

"Management should use the information derived from the stress tests to develop action plans appropriate to the stress scenarios identified," the guidance states. "In many cases, holding an increased level of capital against the risk may be sufficient. Other action plans might include restrictions on capital distributions. A savings association should establish a dividend policy that clearly articulates the institution's objectives and approaches for maintaining a strong capital position throughout the economic cycle."

The list isn't designed to be proscriptive or definitive, the agency notes. Risk is unique to the institution. ■

Risk Assessments Include Holding Companies, Too, OTS Says

The OTS isn't just pushing banks to look at risk on the bank level alone. As the OCC has been saying, too, the OTS wants banks to expand their consideration of risk to the holding company level, says Marcus Faust, an SVP and ERM consultant with RP Financial, Arlington, Va.

"According to the guidance, more complex savings institutions should assess material risk and quality of cap in greater depth and detail," Faust says. "This chimes with what the OCC is saying: You have to look at the entire holding company. Think about how many holding companies are dependent on dividends being up-streamed from subsidiaries." ■