

How ERM Can Aid Capital Planning

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Banking regulators may have been content with industry standard capital levels prior to the recession, but now they're not so sanguine. Those same regulators are now pushing for capital standards tailored to a bank's risk profile, experts say, and Enterprise Risk Management (ERM) can give banks a comprehensive way to set those standards.

Stress testing has become a "hot button issue" in all banks, even community banks, argues Marcus Faust., the SVP of ERM with RP Financial, Arlington, Va. Regulators want to see if banks are testing their capital levels and if they're setting capital targets based on those levels.

But unless the bank has a good understanding of its own risk profile, capital stress testing won't make much sense. The regulators have made this connection already, he argues.

"We're seeing the regulators pushing the concept for community banks," he says. "Even the OTS, in a CEO memo put out in its last few months [touched on the issue](#). It argued that just being well-capitalized or relying on risk-based capital levels was not enough in this crisis. We went on our merry way for a decade and a half and now, in this crisis, risk-based capital didn't work to prevent banks from falling below well-capitalized status."

The one-size-fits-all status won't fly for regulators anymore – nor should it, Faust argues. That's why banks would do well to set their capital standards with a capital stress testing program tucked within an ERM assessment.

"Regulators are now saying, each bank is different, even if bank A and bank B happen to have the same asset mix," he says. "Those banks are in different markets with different unemployment mixes and different industries. Banks need to look at their own profile, assess their own risk and then design a capital stress testing program."

In fact, the two activities, capital stress testing and an ERM assessment, dovetail, argues Faust. Banks need to understand their risk profile first. Only after the bank finishes an ERM assessment should it engage in capital stress testing, Faust says.

"Banks should be looking at moderate or severe stress scenarios that they envision as a possibility," he says. "If they occur, they could have a dire impact on capital. Banks should manage themselves in a way to be able to weather these potential crises. In other words, they need to understand the risk before they determine the appropriate level of capital."

Banks that understand capital and capital-at-risk within an ERM framework are much better prepared to plan and set capital levels, agrees Tony Ferris, an ERM consultant and partner with The Rochdale Group in Madison, Wis.

“I believe that fundamentally, capital – that is, the efficient use of capital – is part and parcel of an ERM program,” Ferris says. “The focus [of ERM] ultimately is on whether an organization can effectively use and deploy capital.”

In Ferris’s conception, ERM engages with capital in three broad ways.

1. Capital stress. Financial institutions need to know how much capital they would need in a worst-case or near-worst-case scenario, Ferris says. Banks can test those levels with capital stress testing. Ferris recommends running two tests: one based on Basel guidelines and a second, derived from the unique risk the bank has identified in itself. Both tests are designed to track economic capital.

For his credit union clients, Ferris recommends a net worth to economic capital ratio of 1.5% to 2%. For banks, that ratio should be lower – since credit unions can’t raise capital as quickly or efficiently as banks – but not much lower.

Once a bank understands, roughly speaking, how its economic capital relates to its net worth, the discussion shifts back to risk appetites, Ferris says. That is, whatever specific net worth to economic capital ratio a bank sets will depend on the bank’s risk appetite.

“How willing are you to generate retained earnings and how capable are you of doing this?” Ferris asks. “Some community banks are in a bad position and can’t keep going back to the well [for more capital]. They may choose something closer to a typical credit union capital level.”

2. Capital planning. Once the bank has a good handle on the potential risk wrapped up in its operations – and in the capital it’s risking given its profile – it’s time to talk about the bank’s long-range, risk-informed plans. Banks should, at that point, start a conversation “from a capital standpoint, about strategy going forward,” Ferris says. “What large scale risk might be emerging? What impact might that have, long-term, on the bank’s capital position?”

3. Loss testing. With both stress testing and capital planning, banks spend a lot of time thinking about future risk. In loss testing, banks look backwards at actual losses to better determine and better quantify the relationship between risk and loss. And this, in turn, can make discussions on future risk more concrete and better supported by data.

“The point here is to teach financial institutions to calculate actual losses and track them on an ongoing basis,” Ferris says. “This activity can provide more information and insight into risk going forward.”

Banks may be able to guess which future scenario will pound their bank, but the point of an ERM program – and the capital measurement and planning that goes along with it – is to better position the bank’s capital, and therefore the bank, too, Ferris says.

“If we think that the economic situation is going to be bleak over the next year, if we’re expecting, as a result of our risk assessment, that fraud, loan losses and interest rate risk will double, we’ll double our economic capital calculation to find out how much capital we’ll have remaining, should those events occur,” he says. “What we do with that information is educate ourselves and help us prepare for strategic direction. If these events come to pass, many banks will just take the losses. [For banks that adjust capital levels using an ERM methodology], we can reposition ourselves rather than just take the losses.”