Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

June 18, 2012

OCC Keys Risk Management Requirements to Complexity, Not Size

The sophistication of a policy/program/plan should be scaled to the size and complexity of the bank. In the world of guidance and regulation, it's a ubiquitous phrase, one that suggests that examiners will have different standards – tougher, higher standards – for larger banks. Bankers may be so accustomed to the phrase and its many variants that they might not have noticed the small, albeit significant change the OCC made to its wording recently. In its capital planning and advocacy guidance, released last week, the agency instructs banks to scale its risk management and capital adequacy program to complexity, yes, but the agency makes no mention of size.

"The key principles are the same for all banks, including small banks," says Carolyn DuChene, the OCC's Deputy Comptroller for Operational Risk. "Every bank, regardless of size, is expected to have an effective internal process to assess its capital adequacy in relation to its overall

See Page 5

OCC Mandates Enterprise-Wide Risk Management

For years, consultants and regulators have touted Enterprise Risk Management as a worthy best practice for progressive banks. For some banks, it's no longer optional. According to the OCC's new capital planning and advocacy guidance, banks can no longer show that they're adequately capitalized until they adopt some form of firm-wide risk management process and measure the impact of overall risk on capital. The guidance doesn't mention ERM by name, but there may be no other method for banks to meet the new requirements, experts say.

"I don't think this is a matter of the OCC coming close [to requiring ERM], it's an explicit requirement," says Marcus Faust, Director with RP Financial, Arlington, Va. "The level of sophistication required will depend on the size and complexity of the institution, but they're clearly saying that it's no longer sufficient to rely on well-capitalized ratios. Banks need to determine their risk profile and they need to track the risk their strategy would pose in different operating environments. I just don't see how a bank can do this except through ERM."

(continued on page 2)

Simple Credit Stress Testing Possible, Preferable for Small Banks, FDIC Says

You can do it. It can be simple. It's a really good idea. That was the message behind the FDIC's recent article on small bank credit stress testing, a document that finally provides small banks with some long-awaited regulatory guidance on the practice.

As banking regulators flooded the industry with big-bank-specific stress testing guidance, signaling that stress testing had indeed become a big regulatory priority, smaller banks wondered when those same regulators might offer them stress testing guidance scaled to small bank needs and uses. For credit-specific stress testing, it finally arrived last week, though through an unexpected route. The FDIC bypassed the guidance pipeline entirely and opted instead to publish its views on small bank credit stress testing in a thorough, example-packed article tucked inside

(continued on page 4)

BSSA will not be published next week.
Please look for your next issue dated July 2nd.

SUBSCRIBER SERVICES

MISSION:

Bank Safety & Soundness Advisor provides independent, executive intelligence on bank exams, enforcement and risk management.

EDITORIAL:

Need us to investigate a topic? Want to express your opinion? Please call or e-mail us.

Publisher:

Aaron Steinberg
800-929-4824 ext 2471
asteinberg@banksoundness.com

Group Publisher:

Hugh Kennedy
800-929-4824 ext 2213
hkennedy@banksoundness.com

SUBSCRIPTIONS:

Direct questions about subscriptions to:

Phone: 1-877-320-7147;
Fax: 301-287-2945;
or send an **e-mail** to Customer@banksoundness.com.

Published weekly (48 times a year).
Copyright 2012. Price: $595/yr.

EDITORIAL CONCERNS:

Our goal is to provide you with the most accurate and balanced information available anywhere. If you ever feel we're not living up to this standard, I want to know about it. Please call me, Hugh Kennedy, Group Publisher, direct at 1-800-929-4824 ext. 2213.

ADDRESS:

Bank Safety & Soundness Advisor
Two Washingtonian Center
9737 Washingtonian Blvd., Ste. 200
Gaithersburg, MD 20878-7364

OCC Mandates ERM

(continued from p. 1)

"This is a game-changer for all OCC-regulated institutions," he adds. "Banks won't all be expected to comply in the same way or at the same level of sophistication, but OCC banks no longer have the option to ignore enterprise-wide risk management programs."

The guidance stops short of calling for ERM outright, but it's clear that the agency wants OCC-regulated banks to adopt some form of forward-looking method for tracking and quantifying a full-spectrum of risk.

"Like a lot of the regulators, it appears as though they are taking more of a results oriented approach, meaning, they described what they want, but how you get there is up to you," says Tony Ferris, an ERM consultant and partner with The Rochdale Group, Overland Park, Kan. "But what they describe is very much in line with ERM. Whether you call it that or find some alternative naming convention, the fact remains that institutions will be required to increase the interconnectivity and proactive nature of their risk reporting processes."

In fact, the guidance's title is something of a misnomer, suggests Scott Polikoff, executive managing director at FinPro, Liberty Corner, N.J. and a former official with the OCC and FDIC. The OCC titled it "Guidance for Evaluating Capital Planning and Adequacy," but regulators have been talking about capital planning for some time. What's new is the insistence that capital planning must follow from a functional firm-wide risk program.

"This guidance should have been titled: 'Implementing efficient ERM,'" Polikoff says. "It appears to be focused on capital adequacy and capital planning, but it clearly lays out the proper approach for ERM. The identification of risk, setting risk thresholds, stress testing, these are all in the guidance and they're all foundational parts of an ERM program."

How steeped in ERM is this guidance? For banks that run solid ERM programs, there's little new here, Polikoff says. It's a different story for everyone else.

"To those banks on the fence about whether or not to focus on ERM, I think the OCC just fired a shot across the bow as to what the new expectations are," he says. "All banks, including community banks, have to realize that ERM is now a foundational aspect of daily operations."

Banks can consider alternative methods to meet the OCC's new requirements, but the guidance essentially asks for banks to do what ERM does: assess risk across the institution and quantify the current and plausible future impact of key risks on earnings and capital.

"It's clear they're looking for quantitative analysis of material risks – they want you to quantify the impact of your bank's risk on earnings and capital," says Faust. "They also want you to run stress tests. It's explicit here that a firm-wide risk assessment should be the foundation of your bank's capital and strategic planning. They also want you to consider qualitative factors, such as the quality of management overall in executing the strategy and the independence and effectiveness of your risk governance."

A new method for capital assessment

Since the recession, regulators have repeatedly argued that regulatory capital minimums are not enough and that banks should expect to hold levels well above those minimums. In practice, what this often meant was examiners visiting banks and dictating capital levels. With this new guidance the OCC now wants banks to get much more involved in the capital assessment process. The agency insists that banks use firm-wide risk management to assess their own capital needs.

"The 2008 economic downturn and the ensuing increase in problem banks underscored the need for all banks to build and maintain sufficient capital to weather stressed environments when raising capital may be difficult," the guidance notes. "Capital planning helps to ensure a bank's on-going safety and soundness. The OCC expects every bank, regardless of size or charter type, to have an effective internal process to (1) assess its capital adequacy in relation to its overall risks and (2) plan for maintaining appropriate capital levels."

As the guidance makes clear, the OCC will be looking for banks to assess their own unique risk profile, run adverse planning scenarios, and run stress tests to evaluate whether or not, after a stress event, your bank will still meet regulatory well-capitalized minimums.

"Banks know that they really should have capital levels higher than the regulatory well capitalized minimum," Faust says. "In my view, they'll need to have capital targets well above the minimum well capitalized level. And, post-stress, they should still meet regulatory minimums. The OCC wants institutions to build up capital during expansionary periods so that they can still be well-capitalized even after running a stress test."

Enforcement

The OCC also wants banks to understand that examiners won't take poor compliance lightly. As the guidance insists, examiners will be assessing banks' risk management and capital assessment programs, and banks found lacking could quickly find themselves on the wrong side of an enforcement order.

"A bank's failure to have an effective capital planning process may be an unsafe and unsound banking practice," the guidance notes. "If a bank does not have an effective capital planning process that is commensurate with its overall risks, the OCC may require immediate corrective action."

Oh, and then they'll also dictate your new capital levels to you, too.

"An ineffective or weak capital planning process may invalidate the bank's internal capital assessment and necessitate that examiners determine the appropriate capital level is necessary based in part on judgment grounded in agency experience," the guidance states.

"What is telling is that the agency refers to banks without effective capital planning as operating with an 'unsafe and unsound' banking practice," Faust says. "These are strong terms. If you look at enforcement actions by regulatory agencies, they always start by saying that a bank is engaged in 'unsafe and unsound' banking practices."

FDIC, Federal Reserve to follow?

Will the FDIC and Federal Reserve follow the OCC's lead and require enterprise-wide risk management? According to spokesman Greg Hernandez, the FDIC is looking at the OCC's document, but currently has no plans for similar guidance. The Federal Reserve did not respond to questions about similar guidance as of press time.

(continued on p. 3)

Why Doesn't the OCC Say "ERM"?

The risk management expectations in the OCC's new guidane on capital management dovetail neatly with ERM methodologies like COSO. So why doesn't the OCC use the phrase "Enterprise Risk Management"?

It's because the term is too nebulous, the agency says. Call it ERM or not, but the agency is clear that it still wants banks to run a risk management program that accounts for all bank risk.

"One of the challenges is that the term ERM has different interpretations and implementation methods across institutions," says Deputy Comptroller for Operational Risk Carolyn DuChene. "An effective risk management program is based on the effective identification, measurement, monitoring, and control of all risks across an enterprise or institution; which has been a longstanding supervisory expectation." ■

OCC Mandates ERM

(continued from p. 3)

Nevertheless, Federal Reserve and FDIC banks, too, are catching heat over ERM program or the lack thereof in exams, says Mark McCollom, senior managing director with Griffin Financial Group, Reading, Pa., and a former CFO with Sovereign Bank.

"It's what we're seeing in community banks," he says. "I've seen cases in banks as small as $300 million, where regulators come in and criticize them on ERM. This bank happened to hear this from their FDIC examiners."

That's why he recommends that banks take the OCC's hint and work towards building an ERM program to power their capital planning even if they don't have to.

"We say, 'hey, even if you're doing fine, you have lots of tangible equity and are a decent earner in a tough economy, you should still shoot for stress testing your capital, still shoot for an ERM program,'" he says. "Banks should do this so that when regulators come in, they have no objections."

This guidance wasn't interagency guidance, but it easily could have been, Polikoff adds.

"Every regulator has their own focus and not all guidance comes out on an interagency basis, but there's nothing here that the Fed or the FDIC would object to," he says. "There's nothing here they'd say is new or wrong. So, what should a state-chartered member or non-member bank do with this guidance? The answer is, they should read it, absorb it and implement it." ■

Simple Credit Stress

(continued from p. 1)

the summer issue of *Supervisory Insights*.

The article, which discusses several stress testing examples in detail and counsels bankers on how to use stress testing results, makes the case that stress testing can help community banks manage risk, but that they don't have to use expensive and/or dizzyingly complex tests to reap the benefits. Valuable stress tests can be devised with little more than a spreadsheet, your portfolio data and some historical or peer loss rates, the agency notes.

"Clearly, institutions with total assets of less than $1 billion tend to have less complex credit portfolios and a particularly intimate understanding of their borrowers and local economic conditions," the article notes. "Therefore when an institution is subject to a supervisory expectation to conduct stress test (as with the 2006 CRE guidance) or otherwise wishes to conduct stress test, it may be sufficient for such institutions to analyze the portfolio in a simple spreadsheet to simulate base-case and severe–case scenarios."

"The FDIC's emphasis here is that stress testing is simple – that it's not a hard process for community banks to follow, but it is an important one," says Peter Cherpack, director of credit risk technology with Ardmore Banking Advisors, Inc., Ardmore, Pa.

Especially for banks new to stress testing, basic tests built from historical data work best, agrees Bill Nayda, principal with Second Pillar Consulting, Glen Allen, Va.

"When moving to quantitative measures we recommend simple historical loss analysis and if an institution does not have a long or rich loss data history to supplement that with industry loss information," he says. "The FDIC article recommends the same."

The article not only offers methods for small bankers to run simple tests, but it also touches on the role stress testing has played in banking throughout the recession. Examiners see a clear correlation between stress testing and resiliency, the agency insists.

"They're saying, this is something that helped banks manage through the storm," Cherpack says. "The survivors are doing it."

The FDIC also urges bankers to consider credit-risk stress testing more than just a rainy-day activity.

"The strategic value of stress testing may be greatest during the expansionary phase of business cycles," the FDIC notes. "During times when losses are minimal and property values are rising, stress-testing assessments of riskier assets and concentrated positions can help management anticipate potential risks arising from lower-than-expected cash flows, deteriorating local or regional economic circumstances, or declining real estate values. Directorates can use stress-test results as part of establishing risk tolerances and ensuring that remedial or mitigating action is taken when elevated risks become evident."

"This is the first time I've seen regulators stating that this practice is not just for troubled times, but that banks should use it even when things improve," Cherpack says. "It

can help them analyze potential risk in new markets, for example. It's not just something banks use just to put out fires."

The article may also signal exam priorities, suggests William McGuire, President of McGuire Performance Solutions, Scottsdale, Ariz.

"While interest rate risk and liquidity risk issue-related concentrations are noted, the emphasis is on credit risk here," says McGuire. "To me, that is a clear signal to community banks that their major efforts need to be directed to stress testing loan portfolio outcomes."

"I can say that from my recent experiences with clients, the FDIC is not joking about stress testing all concentrations of credit, interest rate, and liquidity risk," he adds. "It's better to get a process in place, create supporting policy text, and do at least some preliminary examinations now." ■

FDIC-Recommended Stress Tests

Transactional Sensitivity Analysis – Before making a commitment for financing a commercial property or project, an institution can analyze financial and market assumptions provided by the borrower or through the appraisal process to determine the degree to which the cash flows generated by the property or project can withstand market fluctuations and service the loan per contractual terms. For example, a bank could assume the departure of a key tenant in a commercial real estate project and measure the resulting effect on loan performance. The results of such stress analyses can help an institution determine whether to make a loan and if so, formulate a more appropriate loan structure, pricing, or other prudential terms to mitigate credit risk. Further, individual stress tests can be aggregated and studied to assess the impact on the portfolio.

Stressed Portfolio Loss Rates – Applying a set of portfolio or portfolio-segment loss rates that might be expected during downturn conditions can help community banks identify the extent to which capital might be at risk given the bank's balance-sheet structure and loan mix. For example, a bank could use portfolio loss rates from a previous economic recession and apply those to their current portfolio.

Scenario Analysis – An institution may want to evaluate how a certain portfolio or portfolio segment (e.g., second lien mortgages) may respond to different levels in a key performance metric (e.g., housing prices or interest rates).

Loan Migration Analysis – Institutions with larger portfolios and more comprehensive internal databases can evaluate how a downward migration in internal loan ratings, consistent with migrations that might be expected during adverse financial conditions, would impact asset quality and capital. This analysis would also assist institutions in determining possible actions to address potential migration or deterioration in the portfolio. ■

Source: FDIC

Complexity Not Size

(continued from p. 1)

risk and to plan for maintaining appropriate capital levels."

"Regulators almost always say this or that guidance applies to banks at a certain complexity and a certain size, but in this guidance, the OCC removed the reference to size," says Scott Polikoff, executive managing director at FinPro, Liberty Corner, N.J. and a former official with the OCC and FDIC. "They're saying that the sophistication of the program should be tied to complexity. It has nothing to do with asset size."

In other words, asset size isn't a factor. If smaller banks run bigger risks, they can expect OCC examiners to press them for more sophisticated risk management programs.

"The expected level of program sophistication will depend on the risk profile," says Marcus Faust, a director and ERM consultant with RP Financial, Arlington, Va. "A simple organization doing nothing to elevate its risk profile may be over $1 billion, but that bank won't have to have a program in place as sophisticated as a $500 million bank that's complex and growing quickly. Complexity, risk profiles and growth – that's what regulators will be looking at."

Do ERM requirements make sense for the smallest banks? It depends on how sophisticated a program regulators push them to adopt, says Mark McCollom, senior managing director with Griffin Financial Group, Reading, Pa., and a former CFO with Sovereign Bank.

Smaller banks just don't have the wide, complicated range of significant risk that the larger banks do and they probably cover a great deal

(continued on p. 6)

Complexity Not Size

(continued from p. 5)

of their risk already with a credit risk committee (sometimes called the loan committee) and an ALCO committee.

"Credit risk, interest rate risk, operational risk – that's 98% of potential risk right there," he says. "Clearly there's less material impact of risks like currency, market or reputation to private organizations that don't have swaps or derivatives on the balance sheets."

An ERM program tailored to those banks' smaller universe of risks may make sense. A more expensive program built to track a fuller, less-representative range of risk may not, he adds.

"It's unfair to those banks to go through a papering exercise, to establish a risk committee separate from the credit risk committee if it's not necessary," he says. "The expense required to hire a separate staff member to cover that ERM program when the industry is already stressed already? That puts an additional layer of burden on smaller banks."

Nevertheless, ERM can be done at smaller banks on a small-scale basis, Faust says. "A $50 million bank could implement ERM less formally – by getting the heads of business lines and the chief lending officer together with senior management, thinking through the bank's risk factors and writing up a narrative about how they're impacted. Internally, they could discuss adverse risk scenarios – or what-ifs – to see how outcomes might impact their earnings and capital."

For more on small bank ERM, see "How Ready Are You for ERM?" *BSSA*, October 10, 2011, "The Risk List Method: How to Jump-Start an ERM Program Fast," *BSSA*, December 5, 2011 and "ERM, Jr. - How to Design a Scaled-Down ERM Program and How to Know If It's Right for You," *BSSA*, March 14, 2011 ■

Presented by *Bank Safety & Soundness Advisor*

COMMUNITY BANK

Enterprise Risk Management

How to manage your bank's risk for regulatory and financial success

OCTOBER 22-23, 2012 | WASHINGTON MARRIOTT | WASHINGTON D.C.

Save $200
Register by
Sept. 1, 2012

Sign up at www.ERM4Banking.com
or call 877-320-7147

Copyright© 2012 UCG. No portion of this publication may be reproduced or distributed without the written permission of the publisher. Bank Safety & Soundness Advisor shares 10% of the net proceeds of settlements or jury awards with individuals who provide essential evidence of illegal photocopying or electronic distribution. To report violations contact: Roger Klein, Esq., Howrey LLP, 1299 Pennsylvania Ave. NW, Washington, D.C. 20004-2402. Confidential line: 202-383-6846. For photocopying and electronic redistribution permission, please call Aaron Steinberg at 301-287-2471 or asteinberg@banksoundness.com.