

Beat the Odds

By Eliot Stark and Tad Gage

Much has been said and written about regulators' increasing focus on risk management issues. What are some ways for community banks to prepare for and minimize the negative impact of tougher exams and increasingly stringent risk management directives? Be proactive, anticipate problems and be prepared.

First, make sure your asset, lending, underwriting and capital policies (including liquidity) are seamless and completely spelled out. Even if you are confident in your policies and risk management, make sure these procedures and practices are committed to paper and memory in a cogent, clear fashion. This internal exam should also highlight gaps in your risk management profile that need to be addressed.

Examiners are intensively reviewing banks' plans for preserving capital. This enterprise risk management includes operational and strategic issues that may have received cursory review in the past: board members' credentials and their involvement in credit and strategic decisions; the skills that management and underwriters have demonstrated navigating a difficult banking and economic environment; the decision-making process in making loans and determining limits; and, risk profiles of the loan and deposit portfolio mix.

The board is a particularly salient issue for community banks, whose directors tend to be dominated by key investors and community business leaders. There is nothing wrong with that, of course, but make sure they are active, engaged and involved in strategic decision-making. Examiners are sure to have less tolerance for boards dominated by hands-off figureheads.

Just as all successful salespeople have well-prepared "elevator speeches" about their companies, products and services, be ready to deliver your risk management "elevator speech" to regulators. Keep it clear, organized and detailed. More than ever, banks will be required to sell themselves and their capabilities to regulators.

Although agencies are adding examiners, rest assured they will feel pressured and time-constrained because of the number and detail of exams. They will not appreciate taking the time questioning you to get a complete picture of the bank's practices. Presenting regulators with a thoughtful review of strategy won't cause examiners to overlook problems, but it could spell the difference in gaining concessions and flexibility in areas where you have solid policies and practices that are open to a certain amount of interpretation.

Second, interest rate issues will be critical. Margins will continue to be under pressure, so have detailed strategies for maximizing margins under a variety of scenarios. Banks' interest rate margins have been improving due to an extended flat-rate environment. Prepare for a potential hike in prime and new regulations limiting interest rates in excess of prime on deposits. Make sure your asset and liability committee is completely on top of things at all times.



There may be opportunities to lock in long-term CDs at attractive rates that will help protect margins if interest rates rise. Tapping the federal home loan bank system and using brokered CDs may offer other options. Be highly sensitive to local market economics, developing strategies to address business that allows your bank to maximize spreads while maintaining an acceptable risk profile.

Examiners will be looking closely at banks' strategies to maximize net interest margins. However, their risk-averse approach will likely be at odds with a banker's goal of generating profits. Once again, a well-considered, detailed argument of bank strategy in these areas may have a positive impact in a risk management review.

Third, use the increased scrutiny of risk as an opportunity to review your marketing strategy. When was the last time the board and executive team conducted a thorough analysis of the bank's served market, local economy, market trends, customer mix and new business opportunities?

This sounds obvious, but many banks do not give this kind of strategic thinking enough attention. Changing economic conditions, for instance, may call for a re-thinking of strategies. Perhaps there are underserved specialty markets worth considering. Small businesses are being shunned by larger banks. Are you reaching these disenfranchised potential customers with a proposition for high levels of service and value? These could be borrowing customers, but also liquid customers who could be net lenders to the bank by carrying higher average balances.

Have you honed your pricing strategies to maximize banking relationships? This might, for example, include offering discounts for service packages in exchange for higher minimum balances in DDAs. Has your bank fully capitalized on customer runoff related to bank failures or service degradation in your market?

This kind of thinking directly and positively impacts risk management if it results in higher capital levels, margin preservation and winning or retaining customers who are less rate-sensitive. Of course, it's also an effective way to grow your business. It's worth discussing these strategies with examiners — at least, enough to demonstrate it has been given careful consideration.

Finally, don't assume policies that breezed through previous exams will do so in the future. Examiners

have little incentive to be flexible or interpretive in light of more rules, tougher exam standards and pressure to follow formulae for risk-related issues. Historical trends in loan losses and non-performing loans, even if they're low, are no guarantee of a free pass.

Preparation is the key. Being able to discuss current credits, customers, market conditions and your bank's plans to address any potentially negative trends should help assuage concerns. Being ready to communicate a well-defined analysis and strategy is the best defense. In preparing for battle, there is no such thing as too much ammunition.

Without a doubt, compliance will cost more and be more time consuming. Challenges to hitting fluctuating standards for capital and liquidity will be significant. It's a safe bet yesterday's CAMELS rating of two will be tomorrow's three. Concessions will be tougher to come by. In the risk management review process, a bank's best defense will be a good offense. It may not make a profound difference, especially for a bank with challenges, but it could win at least a few valuable points and concessions.

Eliot Stark is managing director, investment banking and Tad Gage is executive vice president, communications strategies for Capital Insight Partners, a Chicago-based firm specializing in community banks.

Copyright © March 2010 BankNews Media