

# ABABANK DIRECTORS BRIEFING

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## THE DIRECTOR'S JOB

### PLAYING YOUR PART, YET NOT GOING PAST THAT PART, IN "ALCO" OVERSIGHT ROLE

Often bankers complain that nowadays federal regulators seem to want board members to *run* their institutions, encouraging them, through regulations and otherwise, to micromanage.

Consultant George Darling agrees with this beef. But he believes it is not a recent development, but rather a continuation of what he's been watching unfold for years.

"Back in the 1990s, when we had the New England banking crisis, regulators rushed in and tried to tell bankers that they needed more 'hands on' from directors," said Darling.

Darling believes board members need to keep in mind that directors direct, and managers manage. Look up the term "director" in any good dictionary, he said, and you'll find that "there's nothing in there that talks about *managing* the corporation."

However, this doesn't leave board members off the hook when it comes to duties in some technical areas. One is asset-liability management. Regulators have been discussing the roles of bankers and board members in interest-rate risk and related areas (see the main article). In a December 2009 director telephone briefing sponsored by ABA's America's Community Bankers Council, "The New Basics of Asset-Liability Management for Directors," Darling, a bank director, and a community bank asset-liability manager discussed the board's role. (CDs can be purchased at [www.aba.com/teleweb/tb120909.htm](http://www.aba.com/teleweb/tb120909.htm))

#### SCOPING THE JOB RIGHT

Darling, head of Darling Consulting Group,

THE DIRECTOR'S JOB continues on p. 3

## DEAR DIRECTOR:

### Agencies' Rate-Risk Advisory And Pending Liquidity Guidance Underscore ALCO Issues

While the turmoil in Washington over the major pending banking legislation turns the heads of board members and bank management alike, there's no shortage of concerns right at home.

As one community banker recently told us, "I thought about Washington affairs for about five minutes this morning." The rest of day was taken up with blocking and tackling in a troublesome time.

#### Rate risk and liquidity concerns

Federal regulators have some essential banking functions on their radar. Besides credit quality, there are two more: interest rate risk and the liquidity and funding challenge.

Regarding the first, an article in the winter edition of FDIC's *Supervisory Insights* newsletter, "Nowhere to Go But Up: Managing Interest Rate Risk In A Low-Rate Environment," opened this way:

"Understandably, many bank managers and boards of directors are focusing efforts on areas of immediate concern, such as liquidity and deteriorating asset quality. However, evidence suggests that more financial institutions currently are taking on higher levels of interest rate risk at a time when short-term rates are near historic lows, which could leave them significantly exposed to changes in interest rates."

Almost simultaneously with the

### FDIC Draws Assessment Bead On Bank Compensation

Washington has been focusing hard on pay.

This is especially so for executive bonuses in very large banks and investment banks. But it's also seen more broadly. There are pay issues in the pending financial reform legislation; hearings galore; special compensation issues for TARP institutions; new compensation disclosure rules, for larger companies, from the Securities and Exchange Commission that relate compensation of all employees to risk management; and the Federal Reserve's pending compensation proposal—subject of last November's "Director's Job."

**Now there's a new wrinkle: compensation issues and deposit insurance assessments.**

On Jan. 12 FDIC's board approved for 30 days comment an "advanced notice of proposed rulemaking" that could result in a system in which a bank's compensation program could affect how much it pays for deposit insurance.

**The notice includes a proposed compensation model, for discussion purposes:**

- *Pay in restricted stock.* A significant portion of compensation for employees whose activities can present significant risk to the bank would be paid in restricted, non-discounted stock.
- *Clawbacks and vesting.* Significant awards of company stock would only be vested over multi-

year periods, subject to potential "clawback" to account for risks assumed in earlier periods.

- *Board oversight.* The compensation program would be administered by independent directors with input from independent experts.

**The concept is that programs following this outline would be "voluntary"—but that insurance assessments would be adjusted based on meeting or not meeting the three factors.**

"Studies almost universally find that poorly designed employee compensation programs provide incentives to take risks that can significantly and adversely affect a firm beyond a period when compensation is earned or awarded," a staff memorandum held.

FDIC noted that compensation programs were cited as a factor in 35% of the staff reports prepared last year in cases where failed banks caused losses to the Deposit Insurance Fund.

"FDIC does not seek to impose a ceiling on the level of compensation that institutions may pay their employees," the proposal stated. "Rather, the criteria should focus on whether an employee compensation system is likely to be successful in aligning employee performance with the long-term interests of the firm and its stakeholders, including FDIC."

BY THE EDITORS OF ABA BANKING JOURNAL

**ABA urges directors to attend March GR Summit**

ABA is strongly encouraging all bankers and bank directors to "defend the industry against unfair, costly, and debilitating new regulations" by attending the ABA Government Relations Summit, March 16-18, Washington, D.C.

Registration is free. For more information, go to [www.aba.com/Events/GRS.htm](http://www.aba.com/Events/GRS.htm)

publication of that article, the interagency Federal Financial Institutions Examination Council issued, on Jan. 6, "Advisory on Interest Rate Risk Management." It was published, the preamble states, "to remind institutions of supervisory expectations regarding sound practices for managing interest rate risk."

In addition to these documents, since June the united regulators have had pending a proposed interagency guidance, "Funding and Liquidity Risk Management," which sources say is close to being finalized.

Both of these factors—rate risk and liquidity—play their own roles in the "CAMELS" system used by banking regulators (CAMELS stands for Capital, Assets, Management, Earnings, Liquidity, and Sensitivity to market risks.)

Virtually every factor in CAMELS is affected these days, but rate risk and liquidity are two that are reflected in *multiple* categories.

"Management" ability, for instance, must be measured against many performance factors, including both rate risk and liquidity.

And "Sensitivity" brings several aspects of risk together. In the words of the 1995 announcement adding the "S" to the system, this factor addresses "changes in interest rates, foreign exchange rates, commodity prices, or equity prices [that] can adversely affect a financial institution's earnings or capital."

**Interest-rate risk statement**

It's hard to read an issue of *The Wall Street Journal* without coming

across an article concerning when and how the Federal Reserve will hike rates. Regulators define interest rate risk as "the potential for changes in interest rates to reduce a bank's earnings or economic value."

The recent FDIC article notes that while interest-rate risk is built into banking, too much unprotected risk carries dangers. Earnings can be affected by changing net interest income, for example. Capital can be affected by changing the "net present value of a bank's future cash flows, and the cash flows themselves, as rates change."

*For banks, a significant source of interest rate risk is the issue of funding longer-term assets—loans and investments—with shorter-term liabilities—notably, deposits, according to the new guidance.*

The FDIC article identifies four types of interest-rate risk:

1. *Repricing risk*—another way of describing the facet of risk just addressed—comes about when the rate on the source of funding, such as a short-term deposit, rises more quickly than the rate being earned on the loan or investment it is funding.

2. *Basis risk*—Not all financial instruments are pegged to the same index, and such indexes don't always move in synch. Floating-rate instruments may be pegged to the national prime rate, or some other prime rate, while others may be tied to the "London Interbank Offered Rate."

3. *Yield curve risk*—The range of interest rates from very short-term to very long-term are plotted on a graph by financial types. In some periods the rates on money don't fluctuate much from one extreme to the other; that is referred to as a "flat yield curve." At other times, the difference can be drastic; that is referred to as a "steep yield curve." Or conditions may be somewhere in between. But, again, the difference between short-term funding and long-term assets may be extreme,

depending on the curve. Currently the industry faces a yield curve that has steepened significantly.

4. *Option risk*—This risk arises when changes in the rate environment cause other parties to make a decision affecting the bank.

**Regulatory worries over shifts**

What has regulators concerned is a shift in banks' asset holdings, brought about by disruptions to the mortgage and commercial real estate markets. FDIC noted that for nearly 20% of banks, longer-term assets make up more than half of their assets now. By contrast, in 2006, longer-term assets made up that share of assets at only 11% of banks.

"The shift in the asset mix increases the interest rate exposure of many institutions, especially those with less than \$10 billion in total assets," stated FDIC.

"Mortgage-related assets present unique risks because of borrowers' ability to prepay the mortgages before the contractual term. Because prepayment rates slow when rates rise, the duration of lower-coupon, fixed-rate mortgages will extend, and financial institutions will be locked into these lower-yielding assets for longer periods."

**Regulators' view on board role**

Regulators have been worried about banks taking on funding from less-stable sources, ranging from brokered deposits to other forms of "hot" money, such as deposits raised through the internet. Some institutions have been rationed, and regulators have been discouraging many institutions from using wholesale sources of funding.

The Jan. 6 interagency interest-rate-risk advisory addresses many aspects of what banking institutions are expected to do to avoid and address this risk.

While not expected to be financial managers, the advisory stated,

board members are seen as having “the ultimate responsibility for the risk undertaken by an institution—including interest rate risk.”

This, the agencies state, means that boards must have a clear picture regarding the bank's rate exposure:

“The board of directors or its delegated committee of board members should oversee the establishment, approval, implementation, and annual review of interest rate risk management strategies, policies, procedures, and limits (or risk tolerances).”

Management, on the other hand, is responsible for carrying this out, and for systems that measure, track, and report it in a form and frequency that allows for timely adjustment.

The announcement points out that these roles apply not only to a bank's current affairs, but also to any new strategies, products, and business lines that the institution may move into.

Both the Jan. 6 guidance and the FDIC article go into considerable detail regarding methods and means of measuring and monitoring rate risk. There is recognition that institutions with straightforward business plans may be able to use simpler techniques.

### Stress on stress tests

However, bank size is not considered an excuse for giving the matter short shrift. Take the concept of “stress testing” for rate risk: “Non-complex institutions ... may be able to justify running fewer or less-intricate scenarios, depending on their interest-rate-risk profile. However, interest rate shocks of sufficient magnitude should be run, regardless of the institution's size or complexity.”

“Shocks” in this context refers to the practice of looking at the bank's potential financial shape in the event of a rate rise or drop of a given amount across the entire yield curve. FDIC's article points out that stress testing is not for predicting rates, but

**DEAR DIRECTOR** continues on p. 4

an asset-liability management advisor to banks, based in Newburyport, Mass., presented an extensive combination of basics and detailed guidance. Some fundamentals:

- *Remember your role.* In spite of some of what the regulators say, “don't let yourself become a manager of the bank,” said Darling. “If you look at the overall process for asset-liability management, the key is that the board approves policy statements, and then it basically monitors adherence to the policy. Management basically runs the bank within the policy guidelines that are established by the board, with the expectation that they will report to the board as soon as possible if they fall outside of any type of policy guideline.”

- *Remember the essentials.* While handling asset-liability management details is not the board member's job, Darling said that doesn't mean that lack of understanding is acceptable.

“It's so easy to get confused in these particular times, in these stressful times,” said Darling. In most institutions, 80%-90% of income comes from net interest income. That makes net interest income “the most meaningful reference, in terms of risk management, and how bankers run their business,” he said.

Put simply, he added, “If you don't make money on the net interest income line, you don't make money.”

- *Remember every bank is unique.* Every bank board's decisions regarding risk guidelines and constraints will be different because every bank represents a different risk-return mix.

“As bank directors you will need to make sure that you are able to balance the managed risk and the bank's earnings levels with the requirement for safe and sound operation from the regulators,” Darling said.

Having set out those basics, Darling had a warning for board members beyond the avoidance of micromanagement. This was to avoid, to the extent possible, regulatory “advice” that works against the bank's long-term interests.

“Regulators want high capital,” said Darling, ticking off their demands. “They want no growth, or

even contraction. They want no credit risk. They want high liquidity levels—which they define as cash. And they want very low interest rate risk.”

“If you follow that formula,” he said, “you can do nothing as a bank other than produce minimal income.”

Darling held out a sobering thought: “If I manage to a minimal risk perspective, I will in fact eventually be liquidated, because I won't have enough income to cover overhead.”

These are challenging times. “In today's world,” said Darling, “setting and understanding risk guidelines, for directors, is very difficult. The problem, more than anything else, is making sure that any measurements you set within the organization are meaningful to the bank, and not just conforming to regulatory guidance.”

### A DIRECTOR'S PERSPECTIVE

Bank director Tom Chandler takes asset-liability management oversight quite seriously, and presently, he takes oversight of liquidity most seriously of all.

“A bank can fail over time with bad loans or other balance sheet problems,” said Chandler, a founding director of Syringa Bank, Boise, Idaho, “but a bank can fail in a matter of days because of liquidity problems.”

Chandler, also a partner at Boise's Hawley Troxell Ennis & Hawley LLP, said directors need to make sure that their institution has not only a liquidity contingency plan, but a backup plan, and a “backup to the backup plan.”

Chandler also advised:

- *ALCO documents for the board.* Today's economic conditions will significantly influence the types of asset-liability management reports that you get, and the content. “The focus of ALCO is dynamic. You need a dynamic reporting process,” said Chandler.

- *Avoid “silo” thinking.* While the Loan Committee oversees lending, the Asset-Liability Management Committee and the directors who work with it cannot ignore lending. Lending issues and borrower performance serve as economic indicators that the board must consider with its

**DIRECTOR'S JOB** continues on p. 4

for identifying risk.

The article notes that 1996 guidance suggested using a shift of plus or minus 200 basis points as a means of testing the bank.

However, the Jan. 6 guidance calls for more intensive testing. The article puts that in perspective: "... 30% of one-year periods between 1955 and 2008 have experienced changes in interest rates of more than 200 basis points."

*And the article also states something to keep in mind before exam teams next arrive:*

"Examiners have observed that financial institutions with the strongest interest rate risk identification and risk management programs have used interest rate shocks of plus or minus 400 basis points or more as a benchmark ..."

Finally, the Jan. 6 guidance concludes by warning that "material weaknesses in risk management processes or high levels of interest rate risk exposure relative to capital will require corrective action."

Such corrective measures could include "recommendations or directives" for additional capital; reduction of rate-risk exposure; beefing up rate-risk management expertise; and improvement to rate-risk monitoring and measurement systems.

### Funding and liquidity proposal

A major concern these days is liquidity. It's defined by regulators as a "financial institution's capacity to meet its cash and collateral obligations at a reasonable cost. Maintaining an adequate level of liquidity depends on the institution's ability to efficiently meet both expected and unexpected cash flows and collateral needs without adversely affecting either daily oper-

## ABA comments on regulators' liquidity proposal

ABA sent the financial regulatory agencies an extensive comment letter last August concerning the liquidity proposal described in the main article. A few points made by ABA, to watch for in the final document:

- *"One size doesn't fit all."* Expectations for liquidity management processes and systems should be tailored to the size and complexity of the bank—and examiner training should reinforce those expectations.
- *Buffer the "buffer."* While ABA agreed with the agencies' concept that banks should establish and maintain a cushion of very liquid, unencumbered assets that could be held as a buffer for various liquidity stress scenarios, the association emphasized the need to avoid any "one-size-fits-all" mentality here, as well.
- *"Some examiners appear to have a 'rule of thumb' or standard metric that they apply in assessing the adequacy of a bank's liquid assets,"* ABA wrote.
- *Flexible liquidity contingency planning.* ABA urged regulators to consider a range of approaches here, too, to address situations of differing severity.

ations or the financial condition of the institution."

There is a saying: "Credit maims, liquidity kills," meaning that bad loans could cripple the bank, but prolonged lack of liquidity will sink it.

Back in June, the federal regulatory agencies proposed "Funding and Liquidity Risk Management," giving the industry until early September to comment (see some ABA comments above). At the time, regulators said that "liquidity risk management at many financial institutions is in need of improvement."

Three overall risks seen in exams were listed:

- Insufficient holdings of liquid assets
- Funding risky or illiquid asset portfolios with potentially volatile short-term liabilities
- Lack of meaningful cash flow projections and liquidity contingency plans.

Sincerely,

**Steve Cocheo**

for ABA Banking Journal

"ALCO head." The work of the two functions, and the committees overseeing them, complement each other.

• *Get a reality check.* "Is your bank earning money if we subtract the impact of all the current bad assets?" asked Chandler. "You can easily hide bad operations or money-losing operations if you get too absorbed in loan write-offs and solely what appears on the financial statements."

To avoid this, some banks run a provisional second set of books, excluding the effect of bad loans, to determine if

the bank otherwise would be earning well, or has less-obvious problems embedded in its operation. This isn't official—just an analytical tool.

### ALCO IN THE TRENCHES

"The ongoing financial crisis has turned into a game changer for ALCO," said Mark Wild, executive vice-president and CFO at United Bank of Michigan, Grand Rapids, Mich. One of the most notable shifts, he said, is how ALCO has grown more complicated.

"Community bank managers and board members should be aware that more and more large-bank complexities are creeping into our operations," said Wild.

A good case in point is "stress testing." Last year major stress tests were conducted under regulatory orders at the nation's largest banks. Wild said expectations are spreading that similar stressing of institutions' liquidity, and, potentially, the overall balance sheet, are being "encouraged, if not expected."

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