Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

June 11, 2012

Regulators to Adopt Basel III Capital Rules

Basel III capital standards have arrived. Last week, the Federal Reserve Board approved new, Basel III-based capital standards for all banks with assets of at least $500 million. The FDIC and OCC are expected to follow suit shortly. The FDIC has already announced that it, too, plans to consider a similar regulation this week – with standards that will likely apply to banks of all sizes – not just the country's largest.

Last week, FDIC regulators downplayed the impact of the regulation, suggesting that most community banks will already meet the new standards and likely won't need to raise more capital. But the true cost to community banks won't necessarily be in meeting the capital standards themselves. The new standards will demand much more sophisticated analytical and technical capabilities, too, and many community banks just aren't equipped to handle it now, experts say.

"I believe that the regulators may be somewhat guilty of underestimating the rigorous work and change in approach and measurement that Basel III will impose on community banks," says Orlando Hanselman, the education programs director for Fiserv Risk & Compliance.

In drafting its new regulation, the FDIC and Fed looked to the Basel III framework for minimum capital requirements and capital buffers –

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Op Risk Framework: A Short How-to

Very quickly, operational risk has moved to the top of regulatory concerns. In fact, last month the Comptroller of the Currency Thomas Curry called it his agency's new, number one concern. When agency heads start talking about a new top risk, you know examiner scrutiny can't be far behind. So, the question is, how can community banks better manage their operational risk *and* convince examiners that they're doing so successfully?

Consider the operational risk framework. Community banks can use the method for managing operational risk and it's something examiners will eventually want to see, experts say. A framework includes a catalogue of any bank's people, processes and technology and then wraps it in a policy designed to formalize the way the bank tracks

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6 Tips for Better Exams

It's a familiar narrative: Post recession, once collegial relationships between bankers and examiners soured. Examiners stopped listening to bankers and started issuing terse exam reports full of sharply worded criticism. Regulators now seem receptive to the criticism. They're not planning on going easier on banks any time soon, but many regulators have worked to improve examiner communication and comportment skills.

For better exam outcomes, good communication runs both ways, the FDIC reminds bankers. In the summer issue of *Supervisory Insights*, released last week, the regulator reminds bankers that they could help to improve their exam outcomes with better communication skills and exam strategies of their own.

"Although making these determinations is ultimately the FDIC's responsibility, a constructive dialogue between examiners and bankers can enhance the FDIC's understanding of an institution's policies, business strategies, risk management programs, and financial position," the agency notes.

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Basel III

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which was drafted by the bank for international settlements in 2010 and revised in 2011 – according to George French, the FDIC's Deputy Director of Policy in the Division of Risk Management Supervision.

The regulation would apply to banks of all asset sizes, he says. "As it applies to community banks, it's simple conceptually," he noted. The regulation would "strengthen the definition of regulatory capital and increase the level of minimum capital requirements for the various risk-based capital levels."

The FDIC attempted to head off industry concern over the new capital standards. Most community banks won't need to worry about meeting the new capital standards since they traditionally and still today tend to hold more capital than their larger sister institutions, said James Watkins, the FDIC's Deputy Director for Supervisory Examinations. Both French and Watkins addressed the new rule at the FDIC's Future of Community Banking Forum last week.

According to FDIC analyses, "community banks are on good footing today," he said. "They consistently maintain a higher level of capital than non-community banks. There's substantially more leverage for community banks."

Watkins pointed to end-of-first-quarter data, which shows banks at $1 billion in assets and below holding a leverage capital ratio of nearly 10.25% and a total risk-based capital ratio of around 16.75%, as compared to 9% leverage and 15.38% risked-based capital at banks over the $1 billon asset threshold.

The challenge for community banks won't be in meeting the capital standards, the FDIC says, but rather in understanding the regulation, he says.

"These are big documents," he said. "When [FDIC Acting Chairman Martin Gruenberg] asked us to implement Basel III, he requested that we not produce a tome, but we've come perilously close to a tome here. The main challenge for community banks will be in understanding and identifying the parts of the document that will be most important to them."

Higher analytical standards

The challenge for community banks will go well beyond rule comprehension, Hanselman says.

"Moving to a Basel III risk adjusted approach for capital adequacy will be a sharp departure from current practices," he adds. "It will require a much more rigorous level of analytics, a much more granular risk analytic and a much more integrated risk assessment than most community banks that I've worked with are pursuing."

"Just to get to a final measurement will require a new thought process, a new approach and more robust technology," he adds.

The new standards may push many community banks into firm-wide capital stress testing, despite the fact that regulators have excused all community banks from running such tests. Capital stress testing is, in fact, baked into the very methodology behind the Basel III standards, Hanselman argues.

"Basel III is based on the premise that the only true way to know if you have adequate capital or not is by stress testing cap for all risks over the full probability spectrum," he says. "That definitely has an inherent requirement that you have a robust stress testing program, that you are stressing for all risk over all probabilities, and that you're tying stress testing outcomes back to capital. That is a hurdle that is far greater than what most community banks are doing. Or what a large number are presently capable of doing, with current reporting systems and technology."

Community bankers can adapt without too much sweat if they look to upstream correspondent services for help, suggests Tom Day, managing director of risk and policy at SunGard Ambit, Parsippany, N.J., and a former policy advisor and bank supervisor for the OCC, Federal Reserve and Treasury.

"It's a solvable problem," he says. "Many community banks use upstream correspondent services for asset/liability services. Banks can look to them. But the new regulation will require plenty of education and training, too."

More emphasis on capital plans

Another big implication for community banks: the new capital standards will place even more emphasis on the capital plan.

The FDIC may very well be right that most community banks will already meet the new capital standards. But, Hanselman adds, they'll still have to prove that they meet the standard and that won't be easy.

"The challenge for most Tier 2 and Tier 3 banks will likely be proving their capital adequacy case and not actually meeting the new required capital level," he says.

Additionally, the new standards will likely bring not only a higher set of minimum capital levels, but also an additional percentage of capital required over and above the minimum – a shock absorber that will be left

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up to regulatory discretion, says Jeff Reynolds, Managing Director, Darling Consulting Group, Inc., Newburyport, Mass.

"There will be the expectation that banks will need to build countercyclical capital as well, so when times are good, banks will squirrel away capital for the bad times," he says. "The idea is that when you have bad times, there won't be a mad scramble for capital. Banks will instead eat into their shock-absorber capital."

Regulators will expect banks to manage that additional capital shock absorber, and they'll expect them to do so with the capital plan, Reynolds adds.

"Here's where the capital plan really kicks in," he says. "Banks will have to develop some sort of restoration plan to build the shock absorber back up if it goes down."

Community banks may have to consider firm-wide capital stress testing just to keep up with the increased emphasis on capital plan requirements.

"No one believes that capital stress testing won't eventually apply to smaller banks," Reynolds says. "It may not be required, but will be viewed as a best practice."

Banks can use a capital stress testing program to help them with capital plans, he adds.

"Banks that have a capital plan should look at their profile and be able to say, if something goes wrong, here's what it might look like," he says. "This is what it would do to our capital balance and here's how long it would take to refill that hole."

TruPS legacy truncated?

With the new capital standards comes a much stronger emphasis on capital, Day says. Banks still holding trust preferred securities already know that they can't keep it forever, but this new regulation forces the issue.

"This regulation means a redefinition of capital itself," he says. "Community banks will need to figure out how they'll replace their TruPS if they're reliant on it as a component of their Tier 1 capital. All banks will need to do a better job at capital management, and that means thinking about real tangible common equity." ■

Op Risk

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operational risk and identify those within the bank tasked with tracking and managing that risk.

Larger banks have used operational risk frameworks to formalize their operational risk management and this is precisely the kind of tool – scaled down to bank size and need – that community bankers should consider when planning to formalize their own process, says Edward DeMarco, Director of Operational Risk Management and Regulatory Compliance for RMA, Philadelphia.

"Regulators are pushing banks to look for more sophisticated, more robust operational risk practices across the institution regardless of the size, scale and complexity of the bank," DeMarco says. "Banks need to be good at [managing operational risk] and they don't get good by happenstance."

Operational risk frameworks do not need to be nearly as complicated as what larger banks design, but the tool can be simplified and smaller banks should use it, he adds.

"Smaller community banks may not end up buying the latest tool, but they will go to roundtables and conferences. They can learn and institute something," he says. "There are different ways to go about it, but you don't need to be an operational risk expert to do it. You just have to understand it and right-size it."

Drafting an op risk framework

Here, according to John Drew, a former CRO and current President of ErmsCo, Houston, is one method community banks can use to draft an operational risk framework.

1. Catalogue processes. The first step is to build a catalog of all the bank's processes, Drew says. Make sure to organize them in a way that makes sense to management.

"Where are the people? Where are the processes? Inventory these and organize them in a way that reflects the way they operate," Drew says.

"Banks need to be good at [managing operational risk] and they don't get good by happenstance."

2. Identify risk. Once you've catalogued your processes, investigate those processes and try to identify the risks within them, he says. Internal audit can help with this step. Management can look through self-assessment work audit staff has already completed. Internal audit could also disseminate risk surveys.

A tip: Before you start identifying risk, make sure to develop a standard reporting method for risk. Managing operational risk is a lot easier if you use a standardized method, Drew says.

3. Collect policies and procedures. Your bank should already have a long list of policies and procedures in place designed to manage bank processes. Gather them all together and assess them as a group. You may find that some policies are too old and need to be enhanced or updated. You may also find that you don't have policies where you might need them.

4. Draft a master policy. In enterprise risk management, the risk appetite statement established a master set of rules and policies for governing risk. Accordingly, your operational risk framework will need a master policy, too.

Name names, Drew says. This document should not only define what operational risk is for your bank, but it should also identify bank staff responsible for tracking and managing that risk.

If you've started an ERM program or plan to, make sure to harmonize your operational risk master policy with your risk appetite statement, Drew adds. Operational risk controls are part and parcel of an ERM process.

"The two documents really need to be drafted at the same time," he says. "Some organizations choose not to do it that way – to do it independently. It can be done that way, but it's not a best practice."

"For community banks, the process is not so complex that they can't do it themselves," he adds. "The challenge is to make the catalog of processes and subprocesses, to identify all the risk and to draft the controls that go along with that risk"

An easier first step?

Banks that want to manage their operational risk probably should build operational risk frameworks –

and examiners will eventually want to see them in place – but a thorough operational risk framework can take a lot of time and effort to complete and it may not be the best first step for a community bank looking to formalize its operational risk process, says Bill Popp, CEO of Popp Risk Group, Boston.

"Yes, examiners will at some point want to see a framework, but if banks don't start with something that adds value to the management team right away, the whole process could be stillborn," he says.

To community banks new to the formal operational risk process, Popp recommends setting aside the bottom-up, data-and-reporting heavy framework project for now and instead beginning with a more conversational method, one focused on unexpected risk. Here's what he suggests.

1. Get the gang together. Assemble a group of executives, typically key members of senior management, who have a good view of various forms of operational risk.

2. Go make some lists. Rather than meeting right away, have each member go off by him or herself and draft a short list of unexpected operational risks. Here is where this method really diverges from the operational risk framework project, Popp says. Participants shouldn't be focusing on the relatively small-dollar operational risks that get cataloged in a framework, but should instead try to think about and list the kinds of big, unexpected operational risks that could wreck a quarter. Or a year. Participants need not restrict their list to areas of expertise. All risks in all areas of bank operations could and should be considered.

3. Make it specific, think through a solution. No one should be simply writing down: "IT risk," Popp says. The idea is to force participants to be specific with their perceived risks. Have them identify the risk with detail, explain what they think the consequence of the risk would be and have them propose a solution.

4. Talk about the risk. Once everyone has their lists, assemble the group to talk through the risks.

> **"Ideally, bankers will want to have someone come in and facilitate the discussion."**

The idea, Popp says, is to really dig into everyone's list and try to figure out where risk perception and information may be asymmetrical within the group. It's a chance for bankers to challenge one another on perceived risk. If someone considers a risk as being a much bigger concern than you think it is, find out if there's something they know that you don't.

Ideally, bankers will want to have someone come in and facilitate the discussion, Popp adds. Facilitators can help participants overcome biases. "Sometimes, everyone listens to someone who may be smart, but whose expertise isn't risk," he says. "Other times, people may be busy and distracted and decide just to go along with the conversation. Facilitators discourage this kind of behavior."

But bankers don't necessarily need a facilitator, he adds. They can do it well enough on their own if they want.

5. Make a master list. As the group talks through the independently sourced risk lists, they sift through the risks and begin to rank them as a group, Popp says. At the end of the process, the group ends up with a prioritized list of operational risks and now knows how to prioritize their risk mitigation efforts. The bank also has a handy working document to show examiners should operational risk come up in the next exam.

6. Work the list. Once the list is established, the bank has a game-plan for managing operational risk. As the bank works its way through the list, risks will drop down the list or off it completely. Task someone with monitoring the list and the risks on the list, Popp says.

7. Wash, rinse, repeat. At least once a year, get the group back together and start the process over again, Popp recommends.

It's a "very practical" method, Popp says. "Most banks don't have a forum for operational risk simmering right below the surface. Community banks have limited dollars, but putting operational risk in a list like this puts that risk in priority order, so the bank can start to mitigate it."

For more on operational risk, see "OCC to Banks: Op Risk Now Top Concern," *BSSA*, May 28, 2012 and "Model Risk is Operational Risk, OCC says," *BSSA*, April 9, 2012. ■

6 Tips

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To that end, two FDIC examiners, Senior Examination Specialist William R. Baxter and New York Region Field Supervisor Marianne H. Lloyd offer the following tips and strategies for a better, all-around exam.

1. Get to know your regional personnel. "Some community banks find it extremely helpful to develop productive working relationships with their field supervisors and assistant regional directors," the examiners note. "These FDIC managers lead our operational role in examinations, application reviews, and other requests. By establishing a working relationship with these individuals as well as state banking department personnel, bankers can use the regulators as a resource and gain insight into regulatory expectations and procedures."

2. Ask about your exam. Community bankers always want to know what examiners will scrutinize at their next exam. If you want to know, all you have to do is ask.

"The EIC or other staff member from the local field office typically contacts the institution 45 days before the commencement of an examination to begin planning discussions with the chief executive officer or other designated members of management," the examiners write. "CEOs should use this opportunity to discuss the scope and timeline of the review with the EIC to understand the focus of the examination."

3. Be proactive about your case. If you have risk management documentation you think will bolster your case, don't wait until the examiner shows up to flash it. Send it along with all the other documents the examiner requests before the exam.

"If a bank's risk management programs and monitoring tools extend beyond the materials requested by the EIC, CEOs should share this information with the EIC during the pre-examination process to ensure all aspects of the bank's risk management program are appropriately considered."

> **"CEOs should use this opportunity to discuss the scope and timeline of the review with the EIC to understand the focus of the examination."**

4. Your examiners are resources, too, so why not use them? Regulators visit other banks like yours and they have some ideas about what works and what doesn't. Ask them about it.

"Apart from the specific findings of an examination, some bankers report that they have benefitted from examiners' informal observations, based on experience in numerous community bank examinations, about matters such as risk management processes, banking product innovations, internal controls, and the use of technology," the examiners say.

5. Don't blow off the exit interview. Did you understand examiner findings? Are you sure? Don't wait for the exam report. Use the exit interview to talk through examiner findings before examiners decamp.

"Bank management should use this exit meeting to affirm commitments to examination recommendations and discuss any concerns with the examination conclusions," the examiners note.

6. Ask about orders. If examiners hit your bank with formal or informal enforcement orders, you may be upset about it, but you still have to deal with it. Make sure to talk through the details with your examiners right away. If you have a clear understanding of what examiners want, you'll be better positioned to meet examiner demands.

"If a formal or informal corrective program is proposed, senior management and board members are encouraged to meet with the FDIC regional office and state officials to discuss the provisions of the program and voice any questions or concerns," they add. ■