Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

March 25, 2013

New Risk Management Methods Demand Better Data

Regulators want better concentration risk management from big banks – and from some smaller banks, too (see lead story). This is just one of several areas in banking in which regulators are demanding deeper, more sophisticated risk management techniques from banks. And what many banks are learning, once they are under the regulatory gun, is that more sophisticated risk management methods depend on a large, clean storehouse of quality data.

"A critical issue for banks, even smaller banks, is in having clean data," says Rick Buczynski, SVP and Chief Economist with IBISWorld, Washington, D.C. "You need it to run even simple analyses. For a lot of banks, it can take years to upgrade their data collection efforts."

Regulators, too, recognize that banks can't wring value out of reports and analyses derived from poor quality data.

Larger community banks approaching the $10 billion Dodd-Frank threshold know that they'll need to improve their data quality in anticipation of having to run more sophisticated stress tests and risk scenarios.

But examiners may consider

See Page 5

Concentration Risk Management: The Next Big Regulatory Concern?

Banks above the community banking asset tier have a new, big exam issue: concentration risk management. If examiners have little confidence in those big banks' ability to track and manage risk concentrations, they're not hesitating to demand new, better methods and policies to handle concentration risk, experts say. So, what does this have to do with community banking? Well, that regulatory focus may be sliding down into the community banking space already. Could community bank concentration risk management be the next big exam hot topic?

Banks above $10 billion in assets are hearing a lot about risk concentrations all of a sudden, says Rick Buczynski, SVP and Chief Economist with IBISWorld, Washington, D.C.

"A big issue right now with larger banks is concentration risk and risk pools," Buczynski says. "Examiners want them to be able to map those concentrations, to have an infrastructure [around those concentrations]."

This concern over concentrations isn't strictly a large bank exam issue. Smaller banks are starting to hear about concentrations – and getting criticized for concentration management – in exams, too.

(continued on page 2)

Due Diligence Standard for Fair lending and Third Party Due Diligence May be Prohibitively High

If one of your third party vendors commits a fair lending violation – guess what? Regulators will treat the violation as if it was committed by your bank. That is, they will put the blame for the violation on bank directors and senior managers.

"If a third party vendor violates consumer statutes, the responsibility for that violation shifts to the board and senior management," says John Culhane, a partner with Ballard Spahr LLP in Philadelphia. "Examiners will look into what kinds of processes took place at the highest levels of the bank."

Bankers can find proof of this third party philosophy in practice in the CFPB's very first action, a consent order against Capital One for a third-party fair lending violation. In the consent order, the agency did not address the third party's responsibility, but rather focused entirely on what Capital

(continued on page 5)

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 2013. 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

Risk Management

(continued from p. 1)

"This is more of a larger bank focus for now, but it has definitely drifted down the asset size spectrum to smaller banks," says Jeff Reynolds, Managing Director, Darling Consulting Group, Inc., Newburyport, Mass.. "Those banks are being asked to do more analysis, to do just about anything to show that they recognize their concentration risk."

Not every smaller bank with a fast approaching exam will likely hear about this, but if a bank has had or continues to have credit issues, examiners may broach concentration risk, too, says Matt Pieniazek, a bank consultant and President of Darling Consulting Group, Inc., Newburyport, Mass.

"We've seen concentration [as a regulatory concern] coming down the food chain," he says. "We've seen banks at $300 million to $500 million smacked on the head over this. Typically, it starts with a credit problem. The examiners see this and then demand that the banks put something in place. And usually what regulators are looking for is for banks to establish concentration limits relative to capital."

Examiners are broaching concentration risk in community bank exams and wanting those same banks to link concentration management to capital management, says Peter Cherpack, director of credit risk technology with Ardmore Banking Advisors, Inc., Ardmore, Pa. And it is catching banks off-guard.

"Banks are calling me up and telling me they've just been criticized for their reporting analytics – for their concentration reporting analytics – even though their examiner had never mentioned this before," Cherpack says.

For a few years now, regulators like the OCC have been signaling that concentration risk is a concern even if that concern has taken some time to show up in exams, he adds.

"Read the guidance from the OCC for the last two years," he says. "They keep weaving in these mentions of concentration management and the idea that banks should have good concentration information to share with the board, that concentration management should be tied to capital management."

This regulatory interest on the community banking side of the industry does mirror regulatory concern regulators have for larger banks. It's much less pronounced and aggressive, but it's still there, Cherpack says.

"I'd say, concentration management is what's going on right now," Cherpack says. "Regulators want banks to tie concentration management to capital planning and stress testing. But they're being much more forgiving to community banks. They understand that community bankers weren't as concerned about this before."

Old news or new trend?

Is this regulatory concern about concentrations really a new way of talking about an old problem? To some extent, yes, says Francis Grady, a partner with Grady & Associates, Rocky River, Ohio.

Bank regulators interest in concentrations is an interest in credit – CRE specifically – and that interest

Are You a CRE Growth Outlier?

As banks know by now, if they bust the thresholds from the interagency guidance on CRE concentrations, they can expect to hear about it from their examiner – and likely be expected to adopt a new, more sophisticated CRE concentration risk tracking method. What some bankers may not know is that banks with CRE portfolios growing much faster than peer banks can expect regulatory demands for enhanced risk management methods, too, whether they're near those CRE concentration ratios or not.

How can you tell if your portfolio is growing much faster than the average? Look at the FDIC's state-by-state quarterly bank reports, says Francis Grady, a partner with Grady & Associates, Rocky River, Ohio.

"This is the easy way to check," he says.

The FDIC issues state-by-state quarterly reports that include data from all banks – not just the FDIC-regulated banks. Banks can look at the reports and compare their CRE growth rate with the rest of the state banks.

"If you're growing at 10% and the rest of the state is growing at 2%, you know you'll stand out when regulators look at your risk profile," Grady says. "This is a crude, easy proxy way to figure out if your bank might get saddled with higher risk management expectations by regulators."

"It's surprising that not all community banks think to check this simple tool," Grady adds. ■

dates back to the 2006 interagency guidance on CRE, Grady says. That interest may not be new, but raised expectations for CRE concentrations are relatively new, he says.

"If a bank's total CRE is at or above 300 percent, their regulator will expect enhanced risk management," he says. "They'll expect that the bank can stratify it's CRE lending, that it can say that X percent is in multi-family, Y percent is in strip mall shopping centers, Z percent is in nursing homes. They'll expect that they can go through your portfolio and see that the different risk characteristics are there. That's the kind of thing they'll expect from a bank at or near that threshold."

This doesn't apply only to banks at or over the CRE thresholds. Banks with quickly growing portfolios can expect the same interest and expectation, too, whether they've approached those thresholds or not, Grady adds.

And of all the regulators, the OCC has most clearly communicated expectations for enhanced risk management.

"Remember, the OCC recently put out guidance on the bank capital planning process and that is a great roadmap that any bank would be wise to follow," Grady says. "If a bank with a 325% CRE-to-capital ratio, you can bet your last dollar that that bank will be expected to have an enhanced process like the one described by the OCC, but you won't find a process like this in many community banks. They'll say, instead, that they're well capitalized, but the bank hasn't done a risk assessment of capital adequacy. They haven't set their own capital goals."

It isn't just credit

Regulators have been and will certainly continue to talk about credit concentrations and credit concentration management, but lately, examiners have turned their attention to other forms of risk concentration, too. Community bankers are used to talking about credit concentrations, but they may find themselves talking about interest rate risk or, in particular, liquidity risk, says Bill McGuire, president of McGuire Performance Solutions, Scottsdale, Ariz.

"The traditional focus on credit risk by lending type or sector is still topic number one but liquidity risk concentrations – in the form of a single sources of wholesale funds, large balance depositors, geographic area or web-based concentration, etc. – are also getting almost equal scrutiny," he says. "Interest rate risk-related concentrations are also being assessed. Credit unions are being drilled down on hard if they hold even moderate concentrations of mortgages of any kind. The NCUA is very touchy about the whole topic. Meanwhile, for banks, the regulatory concern is mostly long-term fixed-rate mortgages and held in context with other longer term investments that can create exposures if interest rates rise."

Liquidity risk management has been coming up in community bank exams and when it does come up, it's frequently cast as a concentration management issue, Pieniazek says. Regulators clearly want banks to see liquidity risk management as a form of concentration risk management and to handle it accordingly.

"We're seeing banks being

(continued on page 4)

Risk Management

(continued from p. 3)

asked questions under the guise of concentrations and concentration risk that involve liquidity," he says. "We've seen a number of examples of community banks anywhere from $500 million to $5 billion that have been asked to modify their policies to incorporate concentration limits on funding sources."

Pieniazek notes that both OCC and FDIC examiners have requested this of banks.

"Examiners are asking banks to look in the mirror. Where you have above average concentrations with characteristics that are similar or share similar threats to you in terms of access to [liquidity] markets, you need to learn to factor this into your thought process."

"We're not seeing this a lot, but we are seeing an uptick," Pieniazek adds.

Concentration policy

So, what does that mean when examiners expand their concentration concerns from credit out to liquidity and interest rate risk? The creation of new policies and the establishment of risk limits, McGuire says.

"We have been seeing interest in concentration risk policies lately," he says. "Financial institutions are now being held to account on that source of risk. Board understanding of the many facets of concentrations – interest rate risk, credit, and liquidity risk – reasonable limits by concentration type, and monitoring solutions are what we [suggest] as enhancements to concentration policies."

Regulators aren't as hard on community banks when it comes to this kind of risk awareness and management, but it is coming up in smaller financial institution exams, he says.

"Concentration risk awareness, including the need for a policy or at least recognition of the issue in separate policies (IRR, credit, and liquidity) has already arrived in community-size (e.g., $1 billion and above) banks as far as I can tell," he says. "In credit unions it goes down much lower – even as far as $250 million, if mortgage holdings are notable. The intensity of scrutiny, and level of measurement systems expected is less intense in community size (e.g., $1 billion and above) institutions than in large banks, of course, but it is a topic on the regulatory radar."

"Concentration risk awareness, including the need for a policy, has already arrived in community-size banks."

In some cases, examiners have been very prescriptive about what they want from banks to fix perceived liquidity concentration problems.

"They've been very definitive," Pieniazek says. "In one case I know of, they wanted the bank to set limits by liquidity source type and they wanted them to set limits in terms of maturity schedules. They said that credit problems with the bank could force it into undue concentrations. If a source dwindled or disappeared, or if there's a pick-up, a large spike in maturities, those would be deemed a funding concentration, not just by source but by volume."

DIY Liquidity Concentration Policy

Don't wait until your examiner demands a liquidity concentration policy from you, Pieniazek counsels. It's always better to anticipate an examiner's concern before the examiner gets a chance to voice it. But also, designing and drafting risk limits for liquidity sources is not hard, he adds.

Pieniazek asks bankers if they would be comfortable drawing any amount of funding from outside their core, back-yard deposit sources, or if there's a limit beyond which they start to get uncomfortable. Bankers inevitably agree that there is a limit, but what the regulators are saying is that bank policy is typically silent on this, he says.

"What I'm suggesting is that if you have a limit – if in your gut you feel that yes, there's a point at which you'd feel uncomfortable, then write it down. This is a constructive exercise. Regulators won't view it negatively," he says.

As a starting point, a bank might choose something like 40%, he says. After that, bankers should look at their various sources of liquidity. A bank may be using a Federal Home Loan Bank line, brokered deposits, a national listing service and/or a basic bulletin.

"All of these sources could become funding concentrations," Pieniazek says. "Banks should decide how much they are comfortable taking from each source before they say uncle. You could say you won't go above 10% for national listing services, or above 15% for municipal funds or above 25% from the FHLB. Once you set that down, you have the makings of what regulators are asking about. Now if certain things happen in your organization, if those funds are suddenly at-risk, you have a limit in place."

EWRM

This concentration risk discussion – whether applied to liquidity or credit – may just be a way for regulators to get banks thinking about enterprise-wide risk. Bankers can't assume that actions in one area of the bank won't have repercussions in another area, he says, and regulators are increasingly, under the cover of concentration discussions, pushing banks to consider the risk that comes along with decisions the bank makes – no matter where that risk manifests.

"Risk flows. It's dynamic. And this – liquidity and concentrations – is just a piece of it and regulators are starting to expand it," Pieniazek says. ■

Fair Lending

(continued from p. 1)

One did and did not do, notes Anthony Sharette, a partner with Bricker & Eckler LLP, Columbus, Ohio.

"In this case, the CFPB faulted the bank for failure to conduct due diligence, and the result was harsh," Sharette says.

Banks looking to ensure that they don't befall the same fate as Capital One can take several steps to protect themselves, including by looking at recent bulletins on fair lending issued by the CFPB, Sharette says.

Bulletin 2012-03 expands the responsibilities of institutions to ensure that third-party vendors do not present "unwarranted risks to consumers." Bulletin 2012-06 requires institutions to "take necessary steps to ensure credit card add-on products are properly marketed to protect consumers," Sharette says.

Here are a few things you need to know about the bulletins:

- Banks need to be aware of third party vendors' policies and procedures. "Banks have to make sure their own policies and procedures are proper, but the CFPB has also put the burden on financial institutions to review the policies and procedures of third parties providing fair lending consultation," Sharette says. "This means going beyond merely interviewing representatives of the company. Bankers have to look at the company's policies and procedures to make sure they go with the bank's strategic plan."
- And banks may need to investigate the third party vendors' operations, too. Bankers need to know "what technologies the vendor has in place, what does the IT department look like, and what kind of expertise the company's employees have," Sharette says.
- Banks can't expect to match due diligence efforts to risk. Other bank regulators, such as the OCC have said in the past that bank efforts to vet vendors should be at least commensurate with the level of risk posed by that vendor, but the CFPB does not accept that standard, Sharett says. "There are third-party vendors that provide substantially more risk to the bank than a third party fair lending consultant, but banks hiring these companies will have to go through all these steps," he adds.

The new CFPB due diligence standard is very high – so high, in fact, that many banks may find themselves having to develop in-house expertise in an area they wanted to outsource, but that's where the new standards are, Sharette says.

"Really, in order to effectively hire and manage third party lending consult, the bank needs to have a certain, baseline level of expertise," he says. "Someone in the institution has to properly manage the company. That's what's concerning with this."

Sharette and Culhane spoke about disparate impact and fair lending in the recent *BSSA* webinar, *Disparate Impact and Fair Lending Enforcement: What You Need to Know to Protect Yourself.* ■

Better Data

(continued from p. 1)

data collection a mark of quality management, even for banks nowhere near that Dodd-Frank threshold.

"I'm seeing bigger banks being pressed to clean up their data and make sure it has been coded properly, but it's clear that the number one issue for smaller banks continues to be data quality, too," Buczynski says. "If you can't get a handle on data, you don't have a handle on your business. How can

(continued on page 6)

Fair Lending

(continued from p. 5)

you expect to do a concentration pool analysis or run a stress test if you don't know your own data?"

As banks grow, regulatory requirements for more sophisticated risk management methods will grow, too. It can help to plan ahead for those requirements. And that means planning for data collection, Buczynski says.

"What I tell people, first thing, is to have a business plan and that part of that plan has to be about how to collect data down the road."

That is, Buczynski suggests, banks can anticipate that they will be asked to run more sophisticated risk management studies eventually, and it would help to make sure they're collecting a good, wide swath of relevant data right now.

"You need to build an infrastructure for the future," Buczynski says. "You can try to correct a field you've miscoded, but it's hard to start collecting something you've never collected in the past. You painted yourself into a corner."

For many community banks, the issue is not only the breadth of data collected, but the quality. Some banks have not planned out or prioritized data collection only to discover the poor quality of their data once they've committed – or been required – to dig into more sophisticated forms of risk modeling.

A lot of times, bankers rely on data without understanding how that data gets collected, about who, within the bank, keys the data and the processes those employee use to record the data. That's a recipe for poor quality data, says Peter Cherpack, director of credit risk for Ardmore Banking Advisors, Inc., Ardmore, Pa..

"When regulators come in and criticize a bank's concentration reporting, they won't come out and say, 'Oh, the accuracy and the coding behind your data stinks.' Instead, they'll say, 'You just have to do better with this,'" says Cherpack. "But often, I'm amazed with banks. I'll talk to the credit people, and they have no idea how things get coded, where the data comes from."

Cherpack recalls working with one bank where the coding the bank used to track concentrations was captured on loan approval forms. The form had been designed by a lending assistant who had no idea about the structure of the codes and little reason to learn.

"The bank got crazy data," he says. "And it was because the lending department had no incentive to code properly. Eventually, the credit people asked, 'Where is this coming from?' It was coming from the loan officers, who only wanted to start the loan process. There was no incentive to make the data right. That's how you end up with problems."

There are thee fairly common reasons banks fail to build a storehouse of quality data, Cherpack says.

1. The notion that the core system can't accommodate the coding the bank should be doing all along. Sometimes, there's some truth to this, Cherpack says. Core systems do have limited places to put data. But, in most cases, bankers just don't know what's available to collect. That, and not the limitations of the core system, keep them from getting more and better data.

2. Banks don't update their data with fresh information. Banks will review financial information for the large credits every year, but often, that updated information doesn't go back into the core system. No one is updating the core data because no one is sending the new information to data entry to update the core. "It's a shame because that's a treasure trove of information that can support a concentration analysis or a stress testing program, but it doesn't get leveraged – all because of the data entry lapses," Cherpack says.

3. No dates. If banks don't date their data it can be almost useless, Cherpack says. Analysts will have to assume that the data dates back to origination. "You just can't know how old the appraisals are," he says.

Collecting data is only the initial step, Buczynski says. Regulators want to see that you're doing something with it.

"Regulators complain that banks collect data, use it to put together a report and hand the report over to examiners," he says. "They want to know, what are you learning from the process? Does this data change behavior or policy? Even bigger banks get this criticism. Regulators want to know that the data effects policy, that it changes the behavior of the bank." ■