Banking in the Ninth

March 2013

Ninth District Highlights

Confusion on Complexity

All essential truths are ultimately defined by their contradictions. The best strategy is to let a competitor come to you. Except when you must take the action to the competitor. The virtues of simplicity in bank management and bank supervision and regulation have been extolled of late. Observers of banking and regulation advise us to avoid the complex. I concur. In many cases, community banks and supervisors do not need formal statistical models, to choose one example, to be successful in identifying and responding to risk.

But that concurrence is hardly a vote against complexity. Complexity is often required, for both banks and supervisors. Indeed, what is purported to be basic or simple risk identification or management actually requires a fairly sophisticated approach. The complexity of the analytical modeling, or lack thereof, does not define the sophistication of the underlying thinking. I offer a few examples across several major types of risk to make this point.

Credit Risk

Very few banks need a credit risk management system that measures the probability that an obligor will default and the likely loss given default. Indeed, for commercial credits, most community banks do not typically need an econometrically derived measure of credit risk. Credit risk management systems based on accounting data and basic descriptive information typically are sufficient.

Ron Feldman

At least one major credit risk facing community banks, however, requires a sophisticated approach even if not a highly mathematical one. A concentration of credit risk can pose a significant potential risk to bank earnings and even to viability if a large enough "hit" to that risk arises. Many community banks cannot avoid concentrations given the economic locale in which they operate. However, they must manage that concentration to avoid the worst potential outcomes. When funds become available, bank

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SAFETY and SOUNDNESS UPDATE

Information Technology and Data Security Management

Creating an effective IT management framework can be very challenging for community bank management. This article suggests key areas of focus that should assist bank management. In many cases, taking care of these basics will address some of the most important IT-related threats. Consider the following questions:

Where is your data? What are your data security requirements? Banks seek to secure confidential data wherever it is; but achieving that goal is not easy. Bank data no longer sits under one roof. But banks still remain responsible for ensuring that they have effective control over it, whether it moves over a network or is stored at a third-party service provider.

Is your software updated promptly and consistently? Widely used software applications such as Java and Adobe are prime targets for hackers. Last year, Java surpassed Adobe's Reader software as the most frequently attacked piece of software. Bank management must make sure that the most recent versions of software are in use.

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Is your system ready for personal mobile devices? Using smart phones or tablets to access bank email or reports is gaining momentum. However, banks need well-thought-out controls for these “bring your own device” practices so that additional data risks are identified and controlled.

Do you have a framework? An effective framework for IT risk management includes a data classification method (private, public, internal, external) and knowing where data is (in motion, at rest, in use). The details of this framework can vary, and there are many resources to provide options for management. The key is finding a framework that works for an institution and having board and senior management support that framework.

Are you getting good feedback? Bank management needs feedback on its IT risk practices. Obtaining effective feedback requires that bank management provide details to explain its framework. An audit process of that framework driven by a data-centric risk assessment is one important source of that feedback.

Ninth District Highlights continued

management must decide if the bank should make another loan that would add to concentration, offset the concentration risk by buying a security not tied to the area of concentration, hold additional capital or reserves against the concentration or sell loan participations. Regardless, management and the board of directors must perform some kind of risk analysis to determine how much risk to accept and/or what steps to take to manage that risk.

The appropriate level of concentration cannot be determined without considering the major events that could make a concentration a major source of loss. Management must ask: Are the major potential sources of loss a fall in value of collateral or a fall in the income of the industry to which a bank is exposed? The bank must then determine how it will manage those potential losses. Bank management can and does carry out this type of analysis routinely. However, such analytics are hardly simple and, if taken seriously, this necessary process requires complex thinking.

The same points apply to supervisors as well. We must take care not to push down empirical analysis required of the largest institutions—that must use automated and empirical means to oversee their vast portfolios—to smaller institutions that can provide oversight without the same infrastructure. That cascading approach will not make the smaller banks safer. At the same time, we must ensure that the key analysis of the risk of concentrations occurs in a sufficiently robust manner at all institutions. For community banks, this means examiners must conduct in-depth discussions with management and the board of directors regarding the thought process behind their decision-making and review materials such as board minutes that are descriptive of the analysis rather than assessing complex models.

Strategic Risk

Community banks almost by definition have a strong sense for business opportunities in their areas of operation, and even in potential areas of operation. For many such banks, expansion into new products or new geographies does not require reams of data gathered by surveys, mapping software or focus groups. Banks often get timely observations directly from customers and potential customers on potential gaps in the market that the bank might fill. And most community banks know what they do well and do not do well.

At the same time, understanding the comparative advantages of a bank relative to potential competitors and the competitive dynamics of a new market is not so easy. How will competitors respond to the entry of a new bank into a market? How will the strategies that a bank uses with its current set of products serve it when it offers a new product? Do the dynamics of the new market differ from the market in which the bank currently operates? What appears to be a step to diversification can end up being a costly expansion followed by a costly retrenchment.

Again, my message is hardly that the analysis needed to expand is somehow beyond the ability of a typical community bank. Certainly, there are hundreds of contrary examples across the Ninth District. Rather, what may sound simple—expand by building on what a bank already does well—requires analysis at a sophisticated level to serve a bank well.

Interest Rate and Market Risk

The world of interest rate and market risk has built complexities on top of complexities. There is hardly a path of future rates that quants will not offer up for modeling. The likelihood that a given path may actually occur or that the path will actually matter for the portfolio of a bank does not always alter the opportunity to quantify its potential. And once the modeling has occurred, the risks associated with the modeling exercise itself arise. Yet more room for complexity.

I can easily see how the discipline of interest and market risk management may seem a sideline to some in banking, delegated to a vendor and checked in a rather cursory way. This approach, however, would be a big mistake.

Experience shows that interest rate and market risks are real and have led to many financial institution failures. Most community banks are heavily reliant on deposit funding. Management must consider the behavior of depositors in the face of a change in rates, particularly when the direction of rates changes relatively quickly and by a decent amount. Determining depositor response requires both data and analysis, which may be direct but still complex in some respects. The need for sophisticated analysis grows if a bank decides to buy a security whose value could change in possibly unexpected ways with a change in rate.

The lesson applies to supervisors as well when it comes to market risks. In the face of a crisis caused by credit risk, we appear to have an excuse for not putting rate risk at the top of our list. However, continued deprioritization of risk associated with a change in rates—particularly given the state of rates today relative to where they may be in the future—would not serve us well.

Conclusion

There has been some backlash against complexity in banking regulation. Some of the concern is valid, and supervisors need to be alert to situations where complexity is being imposed needlessly. However, that should not obscure the fact that risk management at community banks needs to be highly analytical and requires what can fairly be called "deep thinking," even if it is not captured by formulas.

–Ron Feldman
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Change to Reserves Reports

Are you aware that effective June 27, 2013, with the implementation of Reserves Central—Reserve Account Administration, Reserve Reports (Report of Required Reserves, Reserve Position Reports, Required Reserves in Pass-Through Accounts and Interest on Reserves Advices) will no longer be available via FedMail (email and/or fax)?

Institutions that are FedMail users and do not currently have access to the FedLine web access solution will need to set up access for subscribers to use Reserves Central—Reserve Account Administration in order to maintain access to Reserves information.

All current ReserveCalc Subscribers will automatically be given access to the new Reserves Central—Reserve Account Administration.

If you have questions regarding these changes, please contact the Credit/PSR/Reserves area at 1-877-837-8815.

CONSUMER AFFAIRS UPDATE

Federal regulators receive and investigate thousands of consumer complaints against financial institutions annually. The majority of complaints involve checking accounts, credit cards and real estate loans. We discuss the most common complaints and steps that banks can take to reduce their prevalence.

Based on data collected, we can identify common consumer complaints, which we summarize below. (While this information is from publicly available Consumer Financial Protection Bureau data, we find these complaints generally similar to our experience.)

- **Checking accounts**. Typical complaints concern insufficient funds, overdraft charges and unauthorized transactions. Consumers are frustrated when banks process larger account withdrawals before smaller ones, which may cause an overdraft and resulting fee.

- **Credit cards**. Most commonly, consumers complain about credit card billing error disputes. Generally, consumers express confusion with and frustration about processes and limitations they encounter when challenging inaccuracies on their billing statements. Consumers are often unaware that in most cases they have 60 days to notify a bank of an account error; they may learn of this limitation after the bank denies an error request because the deadline has passed. Consumers also express concern about inaccurate credit reporting and fraudulent activity, such as potential identity theft.

- **Real estate loans**. Not surprising, many real estate loan complaints concern problems surrounding delinquent accounts, including collection, loan modification and foreclosure processes. Confusion exists regarding the process and requirements for obtaining a loan modification as well as frustration over the lack of alternatives to help a consumer avoid foreclosure.

What can banks do to help limit these types of complaints? We recognize that banks already take many steps to anticipate potential concerns of consumers. Bank management understands the many costs associated with dissatisfied consumers. That said, we receive and follow up on relevant consumer complaints as part of our key consumer responsibilities. Based on that experience, we highlight the following steps we believe would reduce the number of complaints.

First, banks should examine the consumer complaints they receive. Banks are in the best position to identify steps they can take to avoid future complaints, recognizing that some complaints may arise given the types of decisions (e.g., denying loans or charging fees) that banks must make.

Second and more generally, banks should evaluate their products, services and practices from the consumer's perspective. Compliance with consumer protection laws and regulations is no longer just about having accurate disclosures and technically following the rules. Rather, it is also being able to see products and services from the consumer's perspective to help ensure the bank engages in fair and non-deceptive practices.

Third, we find that many complaints arise out of confusion or misunderstood communication. Again, while some of these complaints may prove unavoidable, banks should ensure they explain fees, terms, rates and billing error practices as clearly as possible. Bank staff should clearly explain product terms and bank processes to consumers at account opening or during loan application processing or loan closing.

Finally, banks should have procedures that ensure bank staff responds to consumer questions and concerns promptly and thoroughly, particularly for serious matters such as foreclosure, billing errors or possible identify theft or fraud. We find that consumers are more likely to lodge a complaint when they believe banks do not take their concerns seriously and respond promptly.

For a more comprehensive discussion of complaints, we suggest a recent *Consumer Compliance Outlook* article related to complaints and compliance management. (http://www.philadelphiafed.org/bank-resources/publications/consumer-compliance-outlook/2012/second-quarter/enhancing-compliance-mgmnt-program.cfm).