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Banker's Economic & Investment ALERT

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March Madness: Turmoil in Credit and Financial Markets

March has been a very busy month for those charged with overseeing the safety and soundness of our country's financial institutions as well as proper functioning of our financial markets. Throughout the month of March, numerous speeches, testimony provided to Senate and House Banking Committees, and policy statements have been made or issued by heads of key federal regulatory bodies including FDIC chair Sheila Blair, OCC head John Dugan, Federal Reserve board members Donald Kohn and Randall Kroszner, and the President's Working Group (PWG) on Financial Markets regarding causes for the current crisis and proposals regarding how best to respond.¹ From an international banking and financial system perspective, the Senior Supervisors Group (SSG), comprised of national banking regulators from France, Germany, Switzerland, United Kingdom, and the US, issued a detailed report on March 6th highlighting the role of risk management practices in managing and mitigating loss during the current credit and financial market upheaval.²

Since this past summer, hundreds of billions of dollars have been lost and written off by the nation's larger financial institutions, with more pain and suffering impacting Wall Street than Main Street. However, the current credit crisis, sparked initially by the collapse of the sub-prime residential mortgage sector, now threatens to spread to Main Street. Both the FDIC and OCC have made statements recently warning that the number of bank failures may increase significantly over the coming months and years, especially for smaller banks with exposure to commercial real estate, as the current credit and liquidity cycle continues to play itself out.

While many smaller community banks have remained relatively untouched by the credit crisis, bearing little exposure to sub-prime lending or collateralized investments, they will be impacted surely should the nation fall into recession, in part brought about by tightened credit conditions and increased risk premiums. Moreover, given causal assessments and proposed policy recommendations as put forth by the PWG and SSG, there are important insights that would be beneficial for community banks to consider. Specifically, they fall into the areas of strengthened risk management practices and better regulatory policy making affecting both capital and liquidity management.

The PWG on Financial Markets found that the severity of financial loss absorbed by impacted institutions varied directly with the "effectiveness of certain risk management practices." Losses were particularly acute for institutions demonstrating the following weaknesses in their risk management practices:

- "Weak controls over potential balance sheet growth, including ineffective limits on the growth of business lines...";

- “Inadequate communications among senior management, business lines, and risk management functions”;
- “Dependence on a narrow range of risk measures that were based on assumptions that proved erroneous and on measurement processes that were difficult to alter once it became apparent that the underlying assumptions were wrong”; and
- “Insufficient attention to valuation issues.”³

As regards PWG recommendations to address such risk management shortcomings, many of the following would be implementable for any financial institution concerned about the effectiveness of its own risk management function. Banks should consider the importance of:

- “A strong, independent risk management function”;
- “Strategic planning with respect to balance sheet growth and utilization of capital and liquidity;;
- “Assessment of risks on an integrated basis across the enterprise”;
- “Ongoing communication among senior management, business lines, and risk management functions”; and
- “The development of, and adherence to, strong operational and financial reporting controls over valuations.”⁴

With respect to regulatory policy, the PWG report makes several important recommendations relating to capital and liquidity management. Stating unequivocally that “various regulatory policies failed to mitigate some of the risk management weaknesses that have been identified,” the PWG recommends that banks hold “capital and liquidity cushions commensurate with firm-wide exposure to severe adverse market events,” and that the Basel Committee on Banking Supervision (BCBS) issue updated guidelines relating to liquidity management, “including sound practice guidelines to be followed by regulated financial institutions.”⁵

In fact, some industry observers expect that the Basel II Capital Accords will be facing some additional changes as result of the present credit and financial market turmoil. Liquidity management issues are not addressed in the current Basel II framework. In addition to awaiting release of the final rule for the Standardized Option under Basel II, we may be seeing greater attention paid to liquidity management from an invigorated regulatory perspective over the coming months.

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¹ The President's Working Group includes representation by the following key federal agencies with responsibility for overseeing the health of the nation's financial system: the Treasury Department, the Federal Reserve Board of Governors, the Securities and Exchange Commission, and the Commodity Futures Trading Commission. See: Congressional testimony provided by FDIC Chairman Blair and Comptroller of the Currency Dugan on March 4, 2008 (<http://www.fdic.gov/news/news/speeches/chairman/spmar0408.html>, <http://www.occ.treas.gov/ftp/release/2008-28.htm>), and *Policy Statement on Financial Market Developments*, President's Working Group on Financial Markets, March 13, 2008.

² Senior Supervisors Group, *Observations on Risk Management Practices during the Recent Market Turbulence*, March 6, 2008.

³ *Policy Statement on Financial Market Developments*, The President's Working Group on Financial Markets, March 2008, page 15.

⁴ *Ibid.*, page 16.

⁵ *Ibid.*, page 17.