

# ***Will Your Risk Management Program Pass the Casablanca Test?***

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# Session Goals

- **Acknowledging regulatory expectations**
- **Five vital elements of an effective risk management program**
- **Risk assessment model**
- **Stress testing model**
- **Interdependence: risk management and capital preservation**

# The Handwriting on the Wall – Part One

- **Market's Fall Deepens as Concerns Mount on Banks – WSJ 112108**
- **Job Losses are Worst Since '74 – WSJ 120608**
- **Recession Turns Malls into Ghost Towns – WSJ 052209**
- **Banks Ramp Up Foreclosures – WSJ 041509**
- **Pope Tells World Not To Lose Hope – WSJ 122608**

# Risk Assessment Matrix

## Any Bank or Thrift - Risk Assessment

As of May 31, 2009

TYPE OF RISK	DATE OF LAST RISK ASSESSMENT	INHERENT RISK	ADEQUACY OF RISK MANAGEMENT	COMPOSITE RISK	TREND
Credit	Jan 14, 2009	High	Weak	High	Increasing
Market	Jan 14, 2009	High	Marginally Weak	High	Increasing
Liquidity	Jan 14, 2009	High	Marginally Acceptable	High	Increasing
Operational	July 16, 2008	Moderate	Acceptable	Moderate	Increasing
Legal	April 15, 2009	Moderate	Acceptable	Moderate	Increasing
Reputational	April 15, 2009	High	Marginally Acceptable	High	Increasing

# Foundational Components of an Effective Risk Management Program

- **Continuous risk identification**
- **Accurate and timely measurement of risk**
- **Controls to limit and mitigate risk**
- **Monitoring to ensure effective management of risks**
- **Accurate and timely reporting of risks at the management and board levels**

# The Handwriting on the Wall – Part Two

- **Banks Await Stress Test Results - WSJ 041509**
- **Fed Sees Up to \$599 Billion in Bank Losses - WSJ 050809**
- **Small Banks Face Hits on Commercial Real Estate - WSJ 050509**
- **Banks Won Concessions on Tests - WSJ 050909**
- **Local Banks Face Big Losses - WSJ 051909**

## Agency Guidance: Institutions Potentially Exposed to CRE Concentration Risk

- Rapid growth in CRE lending
- Construction/land development loans approach/exceed 100% of total risk based capital
- Total CRE loans approach/exceed 300% of total risk based capital and o/s balance of total CRE loans has increased 50% or more during prior 36 months

## Key Elements in Risk Management of CRE Concentration Risk

- Board and management oversight
- Portfolio management
- MIS
- Credit underwriting standards
- Portfolio stress testing and sensitivity analysis
- Credit risk review function

# Stress Testing

- Quantify the impact of changing economic conditions on asset quality, earnings and capital
- Practices should be consistent with the size, complexity and risk characteristics of the loan portfolio
- May be as simple as analyzing the potential effect of stressed loss rates on the CRE portfolio, capital and earnings

# Regulatory Expectations Going Forward

- **Stress testing – more than recommended – EXPECTED**
- **Direct senior management and the board to maintain strong risk management practices**
- **Heightened vigilance on the part of supervisors to assure standards are met in the areas of**
  - **Capital adequacy**
  - **Liquidity planning**
  - **Risk management**

# Shot over the bow or direct hit?

- Will the increased scrutiny and expectations reach the community bank level?
- With regard to stress testing?
- With regard to risk management and capital and liquidity planning?

**“The past was about finding the rock stars and heavy hitters. The future is about managing the risks and expenses.”**

**Barclays Global Investors April 30, 2009, WSJ**

# Five Vital Action Items for an Effective Risk Management Program

- 1. Take a formal inventory of the key risks/risk factors at the product and functional activity level. Quantify the level and direction of the risks.**

# Five Vital Action Items for an Effective Risk Management Program

**2. Take a formal inventory of your mitigating controls and assess their effectiveness.**

# Five Vital Action Items for an Effective Risk Management Program

**3. Identify the under-mitigated risks and develop an action plan.**

# Five Vital Action Items for an Effective Risk Management Program

**4. Independently test assumptions and conclusions.**

# Five Vital Action Items for an Effective Risk Management Program

**5. Include and inform your board every step of the way.**

## **Five Vital Action Items for an Effective Risk Management Program**

- 1. Inventory and quantify key risks**
- 2. Inventory and assess mitigating controls**
- 3. Develop action plan on under-mitigated risks**
- 4. Challenge/test assumptions independently**
- 5. Include/inform Board throughout process**

# Risk Assessment Matrix

## Annual Consolidated Risk Assessment

As of May 31, 2009

TYPE OF RISK	DATE OF LAST RISK ASSESSMENT	INHERENT RISK	ADEQUACY OF RISK MANAGEMENT	COMPOSITE RISK	TREND
Credit	Oct 14, 2008	Moderate	<i>Good</i>	Moderate	Increasing
Market	Jan 14, 2009	Moderate	<i>Acceptable</i>	Moderate	<b>Stable</b>
Liquidity	Jan 14, 2009	<u><i>Above Avg</i></u>	Acceptable	Moderate	<b>Increasing</b>
Operational	July 16, 2008	Moderate	Acceptable	Moderate	<i>Increasing</i>
Legal	April 15, 2009	Moderate	Acceptable	Moderate	Increasing
Reputational	April 15, 2009	<b>Moderate</b>	<u><b>Acceptable</b></u>	<b>Moderate</b>	<b>Increasing</b>

**NOTE:** Italicized risk ratings represent variances from ratings issued by the Federal Reserve Board and the Ohio Division of Financial Institutions. (Note that regulatory ratings are subject to confidentiality provisions contained in federal law.) Underscored ratings represent changes from the prior Annual Consolidated Risk Assessment.

# “SCAP” Stress Test Estimate

<u>(\$000)</u>	<u>Company</u> <u>3/31/09</u>	<u>% of RWA</u>	<u>Non-Performing Assets - 3/31/09</u>	
Tier 1 Capital	\$160,339	6.66%	Nonaccrual Lns	\$104,276
Tier 1 Common Capital	\$125,339	5.20%	90+ Days Lns	\$152
Tangible Average Assets	\$3,105,448		OREO	<u>\$19,336</u>
Risk-Weighted Assets	\$2,408,446		NPAs	\$123,764

# “SCAP” Stress Test Estimate

Estimated Losses	3/31/09					
	Balance	Baseline	Loss Rates	More Adverse	Loss Rates	
Construction	\$253,840	\$30,461	12.0%	\$45,691	18.0%	
Revolving 1-4 Family	\$215,894	\$12,954	6.0%	\$18,351	8.5%	
Closed End 1-4 Family First Liens	\$118,241	\$7,094	6.0%	\$10,050	8.5%	
Closed End 1-4 Family Junior Liens	\$40,102	\$8,020	20.0%	\$10,026	25.0%	
Multi-Family	\$60,867	\$3,956	6.5%	\$6,695	11.0%	
Nonfarm, Non-Residential	\$821,133	\$41,057	5.0%	\$73,902	9.0%	
C&I	\$638,965	\$25,559	4.0%	\$51,117	8.0%	
Consumer Loans	\$6,000	\$360	6.0%	\$720	12.0%	
Other Loans	\$6,210	\$248	4.0%	\$621	10.0%	
Total Loans	\$2,161,252	\$129,709	6.0%	\$217,174	10.0%	
Security Losses (AFS & HTM)		\$0	0	\$0		
Total		\$129,709	0	\$217,174		
% of RWA		5.4%	0	9.0%		

# “SCAP” Stress Test Estimate

<b>Resources Other Than Capital to Absorb Losses</b>	<b>Baseline</b>	<b>More Adverse</b>
Plus: 2009 PPNR	\$43,945	\$43,945
Plus: 2010 PPNR	\$42,092	\$42,092
Plus: Adjustment ALLL 2009 - 2010	\$3,243	\$3,243
____ Total	\$89,281	\$89,281

PPNR = pre-provision net revenue

# “SCAP” Stress Test Estimate

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	<b>3/31/09</b>				
<u>Estimated Losses</u>	<u>Balance</u>	<u>Baseline</u>	<u>Loss Rates</u>	<u>More Adverse</u>	<u>Loss Rates</u>
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<b>Resources Other Than Capital to Absorb Losses</b>					
Plus: 2009 PPN		\$43,945		\$43,945	
Plus: 2010 PPNR		\$42,09		\$42,092	
Plus: Adjustment ALLL 2009 - 2010		<u>\$3,243</u>		<u>\$3,243</u>	
Total		\$89,281		\$89,281	
PPNR = pre-provision net revenue					
			<u>% of RWA</u>		<u>% of RWA</u>
<b>Pro Forma Tier 1 Capital</b>		\$119,911	4.98%	\$32,446	1.35%
<b>Pro Forma Tier 1 Common Capital</b>		\$84,911	3.53%	(\$2,554)	-0.11%

# “SCAP” Stress Test Estimate

<u>Equity Issuance:</u>	<u>Tier 1 to RWA</u>	<u>Tier 1 CE to RWA</u>	<u>Tier 1 to RWA</u>	<u>Tier 1 CE to RWA</u>
\$50,000	7.05%	5.60%	3.42%	1.97%
\$60,000	7.47%	6.02%	3.84%	2.39%
\$70,000	7.89%	6.43%	4.25%	2.80%
\$80,000	8.30%	6.85%	4.67%	3.22%
\$90,000	8.72%	7.26%	5.08%	3.63%
\$100,000	9.13%	7.68%	5.50%	4.05%
\$110,000	9.55%	8.09%	5.91%	4.46%

**“How will we know when our program  
is appropriate for the size and  
complexity of our organization?”**

**The Casablanca Test...**

**Risk Management  
Equals  
Capital Preservation**

Questions?