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Financial Lending Notes

A Newsletter for Commercial Lenders Summer 2014

Risk Appetite and Tolerance

Have You Drafted a Risk Appetite Statement?

We are now more than five years past the financial crisis, and this summer marks four years since the passage of Dodd-Frank. But the fallout for community banks continues in terms of the increased regulatory scrutiny being faced.

In particular, regulators are now placing a strong emphasis on the creation of a risk appetite statement.

This statement — which should follow the internal capital adequacy assessment process (ICAAP) mandated by the Basel Accords — should form the foundation of a robust risk management program, and be closely integrated with bank strategy.

The risk appetite statement is a narrative that describes the bank's level of risk tolerance. In turn, risk tolerance attempts to define quantitative measures of risk and ranges of acceptable measures (e.g., asset quality ratings, non-performing assets, volatility in earnings resulting from changing interest rates).

Regulators aren't the only ones paying especially close attention to risk appetite and risk tolerance. Many external stakeholders now also expect community banks to document their risk parameters in a formal risk appetite statement, and to integrate risk management with their overall strategic plan.

The Regulators' Expectations

The Basel Committee on Banking Supervision detailed its expectations with regard to community banks' risk appetite statements in *Enhancements to the Basel II Framework*, published in 2009. This publication states that, "It is the responsibility of the board of directors and senior management to define the institution's risk appetite and to ensure that the bank's risk management framework includes detailed policies that set specific firm-wide prudential limits on the bank's activities which are consistent with its risk taking appetite and capacity."

In addition, *The Director's Book*, published by the OCC, contains specific guidelines for the board of directors when it comes to portfolio risk management. These include the following:

- Establishing the bank's risk tolerance level and approving policies that set standards for the level of risk to be undertaken.

- Ensuring that these policies are communicated and adhered to throughout the bank.

- Understanding the eight categories of risk that are inherent in bank activities and ensuring that the bank's risk management systems adequately address all relevant risks.

- Ensuring that the bank's risk management system includes mechanisms for identifying, measuring, monitoring and controlling portfolio risks.

Keep in mind that portfolio risk management should extend across all different kinds of lending, both

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The Competitive Landscape

Is Cloud Funding on Your Radar Yet?

If asked to name your biggest competitors, who comes to mind first? The large regional bank with a branch or ATM on every corner? Other community banks and credit unions trying to carve out the same niche you are? Or a non-bank lender like a captive finance or leasing company or an asset-based lender?

Most community banks have viewed one or more of these as their primary competitors for years. But a new type of competition is starting to gain traction within the realm of small business lending that many community banks aren't even yet aware of: cloud funding.

The Biggest Cloud Funding Names

Maybe you haven't heard the term "cloud funding" yet, but there's a good chance you've heard of OnDeck or Kabbage. These are two of the biggest sources of cloud funding out there right now for small businesses. Founded just seven years ago, OnDeck has already made more than $1 billion in loans to at least 20,000 companies in 725 different industries across all 50 states. This makes them one of the largest small business lenders in the country.

Most cloud lenders focus on making small business loans under $100,000. They offer a simple value proposition: quick and easy online application, fast approval and funding, and no hassle. For example, OnDeck promises a loan decision in a matter of minutes and funding by wire transfer in as little as one business day. These are true small business loans and lines of credit, not just cash advances, with loan terms typically up to 24 months.

Cloud lenders don't use traditional bank underwriting practices or ask for financial statements. Instead, they have developed proprietary credit scoring models that enable them to make fast lending decisions based on minimal business information provided by borrowers in a simple, 10-minute online loan application.

Of course, there's a cost to this fast and easy application and approval process — the interest rates on cloud loans are generally higher than rates on bank loans. But for some small businesses that need relatively small amounts of cash fast or easy access to a line of credit, this is becoming an increasingly attractive trade-off.

Formulate Your Competitive Strategy

It might be easy to dismiss cloud funding right now as just a blip on the small business lending radar. But if the rapid rise of cloud funding in just a few short years is any indication of what's to come, now is the time to start formulating a strategy for how your bank will compete with cloud lenders in the future.

It starts with reducing how much it costs you to underwrite and fund small business loans — especially loans under $100,000. To the extent possible, you also need to simplify your loan application process and shorten your loan approval time.

But perhaps most importantly, you need to emphasize your value proposition. When competing against big banks, community banks have traditionally stressed their ability to provide a high level of personalized service while serving in the role of a trusted business advisor. This same value proposition holds true when competing against cloud lenders. For example, you can:

- Provide industry and competitive information to help your borrowers benchmark their performance against their main competitors.

- Use the financial information your borrowers are required to provide to show them how they can increase efficiency and boost their profit margins.

- Provide guidance to help borrowers determine the most appropriate type of loan for their specific financing need.

- Offer other bank products and services that can help borrowers with different business and operational challenges, such as treasury management, wealth management and merchant processing services. Few (if any) cloud lenders provide these kinds of value-added services.

Start Planning Now

Don't just sit back and wait until this new competitive threat is on your doorstep before you decide to take it seriously. Take the time now to devise a strategy that will enable you to compete with cloud funding — and win. ■

Creating a Risk Appetite Statement

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consumer and commercial (e.g., C&I and CRE), as well as different types of borrowers, industries, lines of business, property types, etc. At the same time, overall risk management should extend enterprise-wide, beyond the loan portfolio across the entire organization. This includes operations, compliance, investments, tax planning, and even brand and reputation management.

Risk ratings are a key tool for managing portfolio risk by helping ensure accurate and consistent risk exposure across your entire loan portfolio.

A big-picture enterprise-wide risk management assessment should look for risk correlations and covariance across the organization. For example:

- Are specific types of risk reinforced and amplified by being present in different areas of the bank? For instance, is mortgage risk exacerbated by a high concentration of mortgage loans in consumer lending and a high concentration of mortgage-backed securities in the investment portfolio?

- Are risks in the loan portfolio being amplified by going long in the investment portfolio?

- Are extended durations in the investment portfolio to maximize yield increasing enterprise risk when combined with a high concentration of long-term fixed-rate mortgages?

The Role of Risk Ratings

Risk ratings are a key tool for managing portfolio risk by helping ensure accurate and consistent risk exposure across your entire loan portfolio. These ratings will quantitatively define your bank's risk tolerance and, just as important, demonstrate how it is changing over time.

While every bank's risk rating system will be slightly different, all systems should include at least one broad "pass" category for low- and acceptable-risk loans, along with the four standard regulatory categories of special mention, substandard, doubtful and loss for weak and potentially weak loans. But the more granularity within your asset quality ratings (AQRs), the better, since the limited granularity of a five-category AQR system doesn't allow you to distinguish between credits that are substantially risk-free and those that are marginal, or worse.

The best way to add granularity to your risk rating system is to break the broad "pass" category into sub-categories that further define each loan's risk level. This will enable you to categorize and monitor loans based on their probability of default, and the potential loss given default.

For example, a 1-rated credit would be an exceptional loan that is substantially risk-free, while a 5-rated credit would represent a loan with above-average risk that requires close monitoring and control. In between would be loans rated 2, 3 or 4 representing minimal, modest and average risk, while below these would be loans rated special mention (6), substandard (7), doubtful (8) and loss (9).

With an effective risk rating system in place, you can now determine your overall portfolio risk tolerance level by specifying your desired distribution of AQRs. If your level of risk tolerance is low, for example, your portfolio should include mostly 1-, 2- and 3-rated loans. A quick glance at your distribution of AQRs will show you the aggregation of risk across your portfolio.

Just as important, you can see how your portfolio's risk level shifts over time by gauging the migration of your AQR distribution. In other words, is your portfolio becoming more or less risky over time?

Integrating Your Risk Appetite Statement and Strategic Plan

Your risk appetite statement should be formulated as part of your bank's overall strategic plan. What's the difference?

- Your strategic plan details your bank's mission, values, priorities and guiding principles in a formal, written document. It describes your risk management philosophy from a big-picture perspective, and explains the measures you have put in place to balance risk against performance. It should also detail significant initiatives like growth and expansion plans and large-scale projects, while explaining your guiding philosophies in such areas as hiring, corporate philanthropy and community involvement.

- Your risk appetite statement is a formal recitation of the bank's overall level of risk tolerance across the entire enterprise. It should form the foundation of a robust risk management program and be linked to your overall risk management philosophy. Your risk appetite statement should be accompanied by a risk appetite framework, and both of these should be approved by your board and included in your annual report. ■

Communicate with Your Lenders

Clearly communicating your bank's risk appetite to your line lenders is just as important as drafting a risk appetite statement. Without guidance and reinforcement of your bank's risk tolerance level, lenders tend to default to the behavior that is most incentivized for them — which may or may not correspond with the bank's stated risk appetite. ■

Contact our office if you have more questions about risk appetite statements.

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What's Your Post-Reg Q Strategy?

Three years ago, a banking regulation from the early 20th century that many considered antiquated and counterproductive was finally wiped off the books. The repeal of Reg Q, which prohibited banks from paying interest on commercial demand deposit accounts, was mandated by Dodd-Frank, which passed one year earlier.

So far, Reg Q's repeal has been met mostly with a big yawn by both community banks and small business customers. With interest rates hovering near zero and inflation not an issue, it has essentially been a non-event. But this could change in the very near future.

First, of course, is the inevitable rise in interest rates from their current historic lows. This is certain to change the equation when it comes to paying interest on small business deposits, which constitute up to half of the demand deposit base for many community banks. While most small business owners aren't likely to move their deposits for a quarter of a percent interest, they will think more seriously about it for 1 or 2 percent.

Equally important is the funding pressure many community banks are feeling as more deposits are moving out of banks and into the stock market, and loan demand is starting to pick up again. The regulators have said they are not going to allow banks to rely too heavily on the non-core deposits they've traditionally turned to when facing liquidity shortfalls.

This will make it more tempting to start paying interest on business deposits to help ease funding pressures. But at what cost?

One strategy is to pay interest only on balances above a certain amount. This will reward your biggest depositors and help preserve these relationships. Also keep an eye on what your competitors are doing and watch for signs of depletion in your deposit base. Be prepared to act quickly in response to competitive pressures if the situation dictates it. ■

If you would like to discuss competitive strategy in more detail, please call to schedule an appointment.