

WHAT ARE YOUR RISK LIMITS?

The uncertainty of our economy continues to roll on and on. Sub-prime problems and the fallout continues to taint other areas of the U. S. and global economies. The news ebbs and flows. Losses in amounts that I never imagined in my 35 year securities career are announced, discounted, and then re-considered it seems over and over. These continuing revelations and concerns move prices of investment portfolio holdings up and down like a yoyo. Where do we go from here?

Many of us who work in banking have some sort of a rate bias. While we have our opinion and probably some logical rationale for that position, we may well be **WRONG** as history has proven us many times. For many reasons, markets have become more volatile as have the instruments that are often used in our investment portfolios. Recognizing this, regulators issued and implemented the FFIEC Supervisory Policy Statement on Securities Activities in 1992 which provided, among other things, a testing process to inform the banker of the characteristics of securities considered for purchase. While some elements of that statement have been revised over the years, a valuable process of pre-purchase testing was quantified and introduced formally as a necessary and important process in acquiring issues for the investment account. In times of uncertainty such as today, some of this same pre-purchase analysis can quantify what our losses may be if the wrong things happen. The point here is that by using this pre-purchase analysis, or at least some parts of it, we can quantify the risks in dollars to our banks in purchasing bonds with various characteristics. While the risks are not eliminated, the consequences are quantified, and we obtain information that is valuable in these times of uncertainty.

We are required to set risk parameters for our banks concerning losses that can be tolerated in the course of our doing business. This level of risk also applies to the investment portfolio and specific securities of course are parts of the whole. Bond analytics of today are a wonderful thing. Through computers and complex mathematical calculations, we can project how a bond will perform in a variety of interest rate scenarios. Price movement and cash flow in the case of imbedded optionality are critical elements of the information provided.

As you may be aware, Bloomberg data is widely used in the securities industry and consequently, most of the bond analysis you receive concerning potential purchases is generated from their system. Here is a list of a few reports and the pertinent information usually provided in each concerning three types of securities often used in bank investment portfolios. Perhaps you are already using these screens or some other source of similar information, but if not, consider requesting these from your bond provider in order to help you determine whether you can stand the level of risk that you purchase with a particular security issue.

History has a way of repeating itself. It may be helpful at this point in time to step back to a direct quote from an OCC Bulletin on the subject of Unsafe and Unsound Investment Practices dated May 22, 2002:

“As banks contemplate investment strategies, they should carefully consider their risk tolerance. Given the long-term risks to earnings and capital from investment decisions made now, banks should not make strategic and policy changes to permit more aggressive risk profiles without careful consideration of their risk management capabilities. The Board of Directors should review the bank’s risk management framework for investment risks and confirm that it provides appropriate controls over the current level of risk. The Board should also formally approve changes to policies and practices that permit increased risk tolerance. It is understandably difficult to reinvest cash flows from called or prepaid high yielding assets at today’s low yields. However, for many banks it may be more prudent to accept somewhat lower than expected earnings for the near term in order to increase the likelihood of more favorable earnings for the long term. Banks should focus on long-term performance.”

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