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Advisory Alert: Three types of banking regulations that keep regulators up at night

Recent foreseeable events in the Puerto Rican economy, such as the increasingly likely default on its $72 billion public debt, have raised concerns among lenders and credit facilities, especially in the banking industry. Last September, the Commonwealth released a five-year recovery plan that said even significant spending cuts would leave the island billions of dollars short of the amount needed to pay bondholders in the next five years. On January 1st, the Commonwealth missed about $37 million in payments which attracted the attention of several bond insurers.

As the island's economy continues to struggle with high unemployment rates and declining population, local banking and credit industry regulators, such as the Office of the Commissioner of Financial Institutions (OCFI) and the Puerto Rico Credit Unions Supervision and Insurance Corporation (PRCUSIC), recognize the public's concern and are on the lookout for inherent risks to the sector.

The vigorous regulatory response to the financial crisis, coupled with innovation in IT, has placed risk management at the forefront of bankers' concerns. As institutions strive to strengthen their risk cultures, regulators work to limit exposures that threaten the financial system. Three major risk themes — strategic, revenue growth and operational — have emerged as the focus of regulatory scrutiny.

Strategic risk

Gone are the days when banks could sketch out a strategic plan once a year, put it on a shelf, and feel confident they had fulfilled regulators' expectations. Regulatory agencies now demand robust strategic plans and call on boards of directors and management to follow them.

The financial crisis and its aftermath have brought many new challenges for banks. Regulators must ensure that bankers are prepared for the risks associated with them. For example, slow economic growth and continued low interest rates have led to diminishing margins and reduced profitability. Banks can be trapped into locking in longer loan terms and taking on higher levels of risk while they search for higher yields. Also, as

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they compete with other banks and lenders for higher-yielding assets, there can be pressure to reduce interest rates to stay competitive. Often the risk pricing on new loans disappears.

Contending with tightening margins, managers and directors frequently turn to new, expanded or modified product offerings and service lines to improve performance. The regulators' concern is that many banks — particularly smaller community banks — have not performed the upfront risk analysis required for such a strategy. These banks may lack the necessary controls, the required expertise and, the appropriate information systems and risk management processes to effectively monitor and develop these new products and services. Instead of posting higher profits, banks can suffer credit losses, compliance issues and damaged reputations.

Faced with depressed earnings and capital challenges, some banks are shifting their focus to reducing noninterest expenses. While many institutions have successfully slashed operating expenses, the savings from these reductions has, in many cases, been offset by continued loan resolution costs (such as continued losses related to foreclosed assets), as well as increased expenses for regulatory compliance. Regulators are also concerned that the emphasis on reducing noninterest expenses will contribute to risks — such as diminished internal controls and increased personnel turnover — that may not surface immediately but could have a significant impact over time.

Revenue growth risk

Although the recession supposedly ended in mid-2009, slow growth in the economy continues to put great pressure on bank profitability. Banks are reporting some slow-paced loan expansion, but most observers believe significant revenue growth requires stronger Gross Domestic Product (GDP). At the same time, heightened competition for "bread and butter" loans in the commercial and industrial sectors (where the bulk of the banks' business loans typically reside) has also affected earnings.

With banks competing intensely on rates, regulators are increasingly concerned that risk pricing of loans has evaporated. They fear future loan losses will surface, and banks will not have been compensated for the risk they have assumed.

A large portion of the earnings across the banking industry in 2010 and 2011 resulted from reductions in provisions for loan losses in the face of an improving economy. But the current regulatory concern is that those provisions have stabilized, and continued reliance on reduced provisions will cause banks to fall short of their profit goals — once again pressuring institutions to seek revenues and earnings elsewhere.

Operational risk

Banks have increasingly turned to outsourcing, process re-engineering and investments in technology, such as applications for mobile banking, in search for opportunities to reduce operating costs. But in the eyes of regulators, these improvements are often accompanied by increased risk stemming from reductions in internal audit activity and weaker internal controls.

For regulators, outsourcing increases the risk of excessive reliance on third-party vendors. Banks must therefore be diligent in negotiating and monitoring contract terms and other vendor management issues. At the same time, as more banks roll out mobile capabilities, they also must contend with vastly greater cybersecurity risks, which in turn require even more investment of capital. Banks will have to shore up their firewalls against identity theft, fraud and theft of their proprietary information to protect their customers, their reputation, and their capital.

Regulatory compliance, particularly the myriad consumer compliance requirements, has been an increasing exposure for banks in the last three years since the approval and implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act. In some cases, banks were so focused on managing credit risk during the crisis that insufficient attention was paid to training, auditing and processes surrounding compliance. Efforts to reduce costs, heightened turnover and reductions in personnel compounded the problem, leading regulators to conclude that risk was expanding in the compliance area. The increasing sophistication of money launderers and other criminal participants only added to this view.

The result has been greater regulatory scrutiny and mandatory compliance examinations for nearly all banks as part of safety and soundness. It is not unusual for noncompliant banks to be subject to severe penalties, including fines, regulatory orders/agreements, and requirements for additional training, auditing and reporting.

Bibliography

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