



Reducing the Risks of Banking Your Customers

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Full Disclosure

- Guy R. Henshaw
 - 23 Years in Banking
 - Investment Management
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 - President Bank Holding Company
 - Domestic Asset/Liability Manager
 - 24 Years on Boards of Public Companies
 - 30 Years as Chair or member of various investment committees
 - 9 Years Investment Advisor Series 65
 - 16 Years Owner/CEO/Consultant Payroll Companies



The Facts

- This is the most difficult financial market in the last 75 years
- Companies which do not control their risks will fail
- Credit Risk Management and Treasury Management are Mandatory



The Markets

- Poor government policies, lax regulation, arrogance and greed, and the lack of understanding of market principles have resulted in:
 - Illiquid markets
 - Insufficient capital
 - Distrust
 - Failures and bankruptcies



Trust Will Take Time To Rebuild

years



You Have a Company to Run

- What are the risks and how do you
 - Reduce
 - Manage
 - Eliminate them



Risks

- Systemic Risk
- Bank Risk
- Investment Risk
- Customer Credit Risk
- Your Internal Risk



Systemic Risk

- Markets Shut Down
- Government
 - Inaction
 - Action
 - Over Reaction
- Your Actions May Be
 - Shut down of funds transfer systems
 - Change payment systems



What Henry Could See in Systemic Risk

- 1933
 - At one point all banks were closed
 - More than 30% of banks failed
- No Interbank Lending
- No Interbank Clearing
- Commerce Slowing
- Massive Unemployment



Bank Risk

- Banks lend long and borrow short
- Banks depend on trust
- Banks lend money on character, collateral, and cash flow
- Banks are highly regulated in all their activities



Your Bank Risk

- Funds Transfers
 - Your Customer ACH
 - Sweep Accounts
- Depository
- Custodianship
- Working Capital Lines of Credit
- Referral Source



Managing Bank Risk

- Talk to your banker – regularly
- Build a credit file on your bank
 - Quarterly Reports
 - Annual Reports
 - Analysis Reports
 - Regulatory Reports
 - Your local newspaper



Managing Bank Risk

- How to judge a bank
 - Capital
 - Asset Quality
 - Management
 - Earnings
 - Liquidity
 - Sensitivity to Market Risk



Managing Bank Risk

- Capital
 - Return on Equity
 - Net Interest Margin
 - Overhead Costs
- Asset Quality
 - Non-Performing Assets
 - Loss Reserve
 - Loan Yield
 - Asset Growth Rate



Managing Bank Risk

- Management
- Earnings
 - Net Worth/Assets
 - Regulatory Capital
- Liquidity
 - Balance Sheet
 - Purchased Liabilities



Managing Bank Risk

- www.fdic.gov
- Bank Rating Services
 - Bankrate
- Call & Thrift Financial Reports
- www.edgar-online.com



Bankrate

- 5 Star Rating System

- 5 best
- 4 good
- 3 OK Examiners visit
- 2 issues Examiners see Board
- 1 lots of issues Examiners on site



Examiner Reports

- Examiners in my experience are fair
- Reports
 - Call Reports -- issued by banks
 - Examinations Reports – Private
 - Memorandum of Understanding
 - Cease and Desist Order



Investment Risk

- Credit Risk
- Marketability Risk
- Liquidity Risk
- In Mutual Funds
 - Management Risk
 - “Breaking the Buck”



Managing Investment Risk

- Know what you are buying
- Know if there is an active market for the instruments you are buying
- Brokers and Money Market Fund Managers Must Re-earn Your Trust



Managing Investment Risk

- Repos, Commercial Paper, Notes, Bonds are loans to people/institutions, even over night
- Insured paper is weaker than it looks
- Creative cash flow demands, derivatives are loans and you need to know the credit of the borrower, the value of the collateral, and the credit of the counterparty
- If you are going to lend other peoples' money you need to understand the credit and keep very good credit files.



Managing Investment Risk

- Anything safe today?
 - U S Government paper for US citizens
 - Maybe debt of our countries only 5 AAA rated firms
 - Credits you have researched and assessed the risk
 - Banks you have researched, scored, and continue to monitor



Customer Credit Risk

- At Risk
 - Funds Transfers – company and individual employees
 - Payroll
 - Tax Deposits
 - Other Funds Transfers
 - Fraud
- Policies
 - Deal in collected funds only
- Credit Risk Underwriting
 - Credit History, FICO
 - Bank Reference – check accounts and history
 - Monitor



Managing Customer Credit Risk

- Qualify All Customers
 - Contract
 - Bank Reference – history and av balances equal to or greater than transfer balances
 - Credit and Fraud Scores
 - Monitor Credit Standing
 - Maintain a Credit File on All Customers
- No Over Drafts
- Monitor Funds Transfers



Your Internal Risk

- Customer File
- Credit Policies
- Funds Transfer Procedures
- Investment Policies
- Investment Procedures
- Staffing
- Staff Training
- Audits



Managing Your Internal Risk

- Customer File
 - Bank Account and Average Balance Code
 - Credit History
 - Current Credit and Fraud Scores
- Credit Policies
 - Who can approve extension of credit, how much, how long, what rate
- Funds Transfer Procedures
 - Who computes, who verifies, who authorizes, who can make transfers



Managing Your Internal Risk

- Investment Policies
 - Define the level of risk which can be taken
 - Define instruments which can be used
 - Define underwriting required and files
 - Define brokers used, custodians used
 - Define staff authorized to transact business
- Investment Procedures
 - Underwriting
 - Monitoring
 - Valuation
 - Staffing, Training, Supervision



Managing Your Internal Risk

- Staffing
 - Tax Department
 - Finance Department
 - ACH Transfers
 - Investment Department
- Staff Training
 - Define the qualifications needed for each function
 - Training
 - Continuing Education



Managing Your Internal Risk

- Audits
 - SAS 70
 - Beyond SAS 70 for Best Practice
 - **Daily Bank Recon**
 - Monthly Review of the Investment Accounts
 - Annual Review at least



Conclusions

- We have been let down by people and institutions, and governments we trusted
- They must regain our trust
- We must help ourselves by improving our credit and treasury best practices



Conclusions

- Back to the Old Time Religion
 - Know Your Banker
 - Underwrite All Extensions of Credit
 - Build Credit Files
 - Monitor
- Trust but Verify



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