

Get Ready Now for Your Safety and Soundness Examination

The old adage that the best defense is a good offense comes to mind in this turbulent and hostile banking environment. Now is the time to implement a risk-adjusted strategy that will strengthen your institution and prepare it for significant third party scrutiny and oversight. That scrutiny and oversight may take the form of a more aggressive Regulatory Safety and Soundness Examination and potentially an Enforcement Action. An updated, anticipatory and realistic risk management strategy with targeted action steps will strengthen internal focus and serve to buffer changing market and regulatory conditions. In sum, having a plan and actively implementing self-identified corrective action steps will build credibility with your regulators and auditors. With that credibility you can influence third party review from a position of strength and lay the foundation for a prosperous future and shareholder value creation.

Financial institution directors and officers are well aware of the serious problems facing the financial services industry. A less than robust economy, shrinking earnings power, the need for fresh capital, mounting asset quality problems, heavy real estate concentrations, waning depositor confidence and individual firm failure plague the sector. The U.S. government is debating a massive intervention strategy to stabilize our financial system and has taken over Fannie Mae, Freddie Mac and AIG. Washington Mutual is the largest bank failure in history. Billionaire Wilbur Ross, well known for his business acumen and insight, has predicted that 1,000 banks will fail. Many factors led to the current situation and these factors will unfortunately continue to impact future operating results for the foreseeable future.

Today's problems are uncannily similar to those of the late 80's and early 90's. Based on that similarity and taking a close look at that period's regulatory examination approach, the following three key steps are critical to a risk adjusted management strategy that addresses current challenges:

- Identify the bank's current position with complete transparency
- Formulate and implement a plan
- Effectively manage regulatory relationships

These steps may seem like common sense day-to-day risk management and they are. The real trick is making sure that each step is grounded in facts and sound, supportable judgment that can withstand close third party scrutiny.

Step One — Identify The Bank's Current Position With Complete Transparency

It is important to objectively determine and document the financial condition of your institution. It can be difficult to prepare an unbiased review that reveals internal weaknesses, but it is critical to step back and analyze the situation like an outsider. Doing so will provide a valuable assessment of existing risk and regulatory gaps. There are many key success factors that contribute to an institution's strength; however, at a minimum a review should include the following:

- Capital Plan and Dividend Policy. The linchpin of institutional soundness, the capital position, should be reviewed, updated, and documented as part of the strategic planning process. The plan should clearly support the capital and dividends position and be consistent with the institution's size, complexity, balance sheet risk, off balance sheet exposure, and operational soundness. If capital challenged, address both realistic capital raising options and immediate tactical actions like shrinking the balance sheet, restricting dividends, and shifting the assets mix to lower risk assets. These tactical actions should contemplate regulatory capital requirements as well as activities that have limits governed by capital levels.
- Asset quality. Overwhelmingly asset quality is the largest problem financial institutions have today. Assess the quality of your loans, investments, and other assets to be sure that valuations are clearly, logically and concisely supported, and are consistent with regulatory and GAAP guidance. Understand that secondary sources of repayment such as collateral and guarantors will be reviewed and critiqued by skeptical examiners and auditors. Therefore, it is imperative that your bank demonstrate a strong and independent collateral appraisal process. The process must be consistent with regulatory requirements and reflect a disciplined collateral valuation program that includes risk sensitive re-evaluation and re-documentation of values based on market conditions. Fully document guarantor strength by maintaining current financial information and a complete analysis of income, liquidity, liabilities and contingent liabilities. For Acquisition, Development, and Construction loans in particular, collateral values and guarantor support should be updated and documented almost on a continuous basis or at a minimum quarterly.
- Concentrations. Asset concentrations, geographic concentrations, and deposit and funding concentrations should all be identified. With recent market disruptions and increased regulatory interest, special attention to residential and commercial real estate concentrations is required.
- Allowance for Loan and Lease Losses (ALLL). Methodology and analysis must address and consistently apply GAAP and recent regulatory guidance, be well documented, be reasonable, and be directionally consistent with loan portfolio trends.
- Earnings Position. From where are your earnings derived? What factors threaten future earnings and are those factors addressed in the capital plan? What steps must be taken to ensure earnings growth? Are expense levels consistent with revenue generating capacity?

- Quality of Risk Management. Is the risk management framework appropriate given balance sheet size, complexity and level of risk? Are key risks properly addressed by Board and management committees? Are the credit approval, loan review, and audit functions sufficiently independent?

Step Two — Formulate & Implement a Plan

Once an objective review is completed, it's time to prepare an action plan. The plan need not be unduly detailed but it should thoroughly address weaknesses/problems surfaced during the analysis. For example, if credit analyses or collateral valuations for real estate credit exposures are not well documented, the plan should detail what must be done, who will do it and within what time frame it will be completed.

The key is to not only set forth a plan, but to make sure, via periodic monitoring, that planned actions are properly implemented.

Step Three — Effectively Manage Regulatory Relationships

It is critical to gain and maintain regulatory credibility. The best way to do so is to proactively self-identify and address risk management weaknesses. After years of focus on compliance and community development issues, regulators are concentrating on safety and soundness of the financial system, i.e., capital adequacy, asset quality, reserve levels, and earnings sufficiency. This means it is imperative that the institution have its house in order before the regulators visit.

What to Do Prior to a Regulatory Safety and Soundness Examination

Never leave it in the hands of a regulator to “guess” what capital and reserve levels should be or what asset valuations are appropriate. Always support those levels and values by facts that are readily available. A regulator may disagree with the institution's conclusions, but disagreement is much more difficult with careful preparation, up-to-date facts, and solid documentation.

Here is a real example from the early 1990's that illustrates the danger of not being prepared for a regulatory credit examination:

A bank had a large office building loan where a federal government entity was the tenant under a 25 year lease. There was no analysis in the credit file. As such, a bank examiner arbitrarily used a 16% capitalization rate, which put the loan under water and resulted in a loss that accelerated the bank's failure. A proper file analysis would have indicated that US government risk should require a cap rate equal to a 25 year US government security yield - much less than the 16% actually utilized. Instead, the bank left it to the examiner to determine the cap rate and as a result suffered a large and unnecessary write down.

In preparation for a Regulatory Safety and Soundness Examination, the bank should consider the following, much of which was accomplished in Step One above:

- Make sure impaired investments and loans are valued consistent with GAAP and that all loans are risk rated and documented as required regulatory classification definitions.
- Ensure that the quarterly ALLL methodology meets regulatory directives and clearly identifies the rationale for the level of the loan loss allowance. Simply saying, for example, that the reserve covers non-performing assets is not sufficient.
- Identify all possible risk concentrations and either the basis for the concentration or a plan to reduce same. Real estate concentrations, either residential or commercial, should be clearly identified.
- Put loan and asset files in order. This means preparing reviews on major exposures and obtaining up-to-date financial, project, and appraisal/valuation information. If the exposures are collateral dependent or rely on a guarantor, make sure the file information includes a current analysis of each. Organize files and documentation so that at a glance a review will know precisely the amount exposure, the terms, the collateral, the payment history, etc. Make sure all information sources are consistent. For example, if a loan is rated a “7” on the problem loan list, make sure the credit file reflects the same rating. The easier it is for the examiners to understand the asset, the better the institution will fare during the exam.
- Update investment and lending policies and be sure that exceptions are noted. A certain number of policy exceptions are expected. However, it is also expected that any exceptions be noted, aggregated, and monitored.

What to Do After a Regulatory Safety and Soundness Examination

Now that the examination is completed, the regulators may require a response or request that certain actions be taken. If examination findings are not favorable this might entail a substantial list of items, the failure of which to address adequately may lead to an Enforcement Action. Regardless of the severity of examination conclusions, care the forethought is required for any response to the regulators. Do not over or under commit. If there are actionable items, for example, a request that the policy for the Allowance for Loan and Lease Losses be modified, a thoughtful response is required. Sometimes this can be difficult, as most Boards and management teams no doubt already feel their current policy to be sufficient. Bear in mind that while regulators are not always right, they do see many banks, giving them industry information that an individual institution may not possess. Thus, it is important to set aside those biases and formulate an objective and reasonable response without over committing.

Summary

Financial institutions have a unique and vital place in both the local community and the overall financial system. As such, directors of financial institutions are not only responsible to their shareholders and communities but also to the larger financial system. Without a well functioning credit supply mechanism our economy falters. A responsible and well-prepared director is one that is fulfilling his or her duty to ensure a sound, well functioning institution. These are difficult times for many financial intermediaries. However, with proper attention, strong internal focus, and committed management, banks can emerge from these troubled times stronger than ever. A proactive Board and management will enhance the institution's credibility with depositors, shareholders, regulators, employees and other constituents. And at this point in the credit cycle it's all about credibility, risk management focus, and the pace and effort behind that focus. An objective, well documented financial condition review, a comprehensive plan addressing the risks unique to your institution, and the effective management of regulatory relationships will lead to a safe harbor.

Get ready NOW.

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