What Banking Regulators Want
A Guide to Bracing For Your Next Examination

By: Catherine A. Ghiglieri
Ghiglieri & Company

2300 Cypress Point West
Austin, Texas 78746

Tel: (512) 329-5101
Email Catherine A. Ghiglieri
Website: www.ghiglieri.com

Listing on Experts.com

Bankers are hearing horror stories about examiners' demands and are confused as to how to plan for their next examination. What should they focus on? And will those things be the wrong things when the examiners come into their bank?

Here is a guide to preparing for your next examination and to know what the regulators want, so that you can have the best examination results possible. It is especially important because regulators want you to identify your problems before they come into your bank for an examination. This is not always easy since oftentimes what regulators view as problems, bankers do not. If the examiners identify problems that you don't, they will come down harder on you. They will rate your bank more harshly, rate management more harshly, and take a harsher enforcement action against the bank.

Understanding what the regulators view as problems and looking at your bank objectively so you can identify the problems before the examiners arrive will allow you to prepare for your next examination for the best possible outcome.

Here is a formula that you can utilize to brace for your next examination:

1. Prepare
2. Repair
3. Share
4. And take care…

1. Prepare

In order to do prepare for your next examination, you must first know what hot spots the examiners are focusing on during examinations. You have heard of flavor of the month when you go to the ice cream shop. That is how the examiners examine banks. They scrutinize the current hot topics. And if you have those topics in your bank, you will get an extra special examination!

Flavors of the Month

Here is a list of the hot topics that examiners are focusing on during examinations:

- Commercial real estate
- Appraisals
- Performing loans
- Loan participations
- Reserve for Loan Losses
- Capital
- Federal Home Loan Bank advances
- Preferred stock ownership in Freddie Mac and Fannie Mae
- Internal Controls
- Anti-money laundering programs and Bank Secrecy Act

Now that you know the topics, what do you do about them? The best plan of attack is to perform a pre-examination review, so you will know where you stand on these issues before the examiners come into your bank. All of these items may not be germane to your bank, so identify which areas in this list could expose your bank to criticism by the examiners.

Take the list of topics and decide how you are going to perform a pre-examination of them. Does your audit or internal loan review staff have sufficient knowledge and bandwidth to perform a pre-examination? Do you need to outsource the pre-examination review in one or more areas? You need to be tough and objective during this pre-examination review; otherwise, it will be of no value.

Here are a few ideas regarding the hot topics for you to consider when planning a pre-examination review:

Commercial Real Estate:
Many bankers tell me that they don't have a concentration in commercial real estate. This does not mean they can rest easy, in my opinion. Remember that the examiners are looking at commercial real estate in other community banks or in the larger banks they examine, and are bringing that focus to your bank. So if you have some large real estate loans, you should conduct a similar review to ensure that the examiners are not going to criticize those credits. Instructive in this process is the OCC's suggested steps for monitoring commercial real estate. Take them and apply them to your largest real estate loans:

A. Aggressively identify problem loans.
Make sure whoever is reviewing the loan portfolio, whether it is your internal loan review person, or your outsourced loan review company, that they are taking a hard, objective look at your loan portfolio.

B. Divide loans into those borrowers who can survive a downturn and those who can't.
Apply this to your large real estate loans. You can do some shock testing of your borrowers to determine what changes in interest rates or reductions in collateral values would do to their ability to repay.

C. Develop workout strategies for those who can survive the downturn.
Formulate written workout strategies and measure progress against them.

D. Pursue an exit strategy with borrowers who can't survive the downturn. Formulating an exit strategy sooner rather than later may help minimize loss to the bank.

E. Reward lenders who bring problem loans to management's attention sooner rather than later. Don't kill the messenger. Have a process that rewards those who identify their problem loans and penalizes those who fail to identify their problem loans. Also review the compensation plans for your lenders and make sure that loan quality is factored into the lenders' compensation. They should not just be compensated for increasing the loan portfolio, but also for building it with good loans.

F. Accurately identify losses, non-accruals, and loan classifications. This is usually the hardest part for the banks. It requires that you must be objective when reviewing the loan portfolio and make the hard calls to classify problem loans, place them on non-accrual, and take charge-offs.

Remember, just because you don't have a concentration in commercial real estate, you should still be reviewing your large real estate loans in the context of the OCC's guidelines. This is good guidance even if you are a state chartered bank or thrift. You can also apply these guidelines to your large commercial loans.

Appraisals:
Appraisals need to be reviewed even if you don't have a large concentration in commercial real estate. Examiners are downgrading real estate loans where the appraisals are perceived as outdated. Depending on whether or not real estate values have fallen dramatically in your area, appraisals even 6 months old may be perceived as outdated. Obtaining a new appraisal might save you a write-down or a classified loan. However, if the appraisal comes back identifying a write-down is necessary, promptly take the write-down and document your actions in the file.

Performing Loans:
Examiners are criticizing and writing-down performing loans because of concerns that the borrowers will not be able to continue to making payments or otherwise service the loans. One way to combat this is to update the borrowers' financial information to demonstrate that they have the capacity to continue making payments. If the financial information shows they may not be able to continue making payments, then downgrade the loan yourself before the examiners come into the bank. Remember be objective and unemotional when making these determinations.

Some performing loans do not have collateral that has been perfected, causing examiner criticisms. Take the time now to review your loan files to ensure that the collateral documentation is in order. Have you filed your UCC's? Verify the lien status on your larger pieces of real estate collateral. Ensure that there are no mechanics liens filed on your collateral. Check to make sure that you have flood insurance. All of these things will go a long way to minimizing examiner criticisms.

Loan Participations:
Many banks have purchased loan participations to augment poor local loan demand. Horror stories abound lately about loan participations, such as the one where banks purchased a participation secured by a building that was constructed so poorly that it

is leaning like the Leaning Tower of Pisa. There may be nothing that can be done now but tear it down and the banks are being forced to take large write-downs.

Examiners want to see that banks are buying loan participations based on a review of the loan documents and financial information prior to the purchase, instead of relying on the lead bank to do the due diligence. Review your loan policy which should call for obtaining loan documents prior to approving the participations. If it does not, make a change in your loan policy.

Review the files to make sure you have complete loan documentation as well as financial information. Depending on the collateral, you may want to request a current collateral inspection from the lead bank.

Reserve for Loan Losses:
The examiners are closely scrutinizing banks' reserves for loan losses and requiring extra provisions to achieve adequate levels.

Take a close look at your Reserve after your reviews of appraisals, financial information on performing loans, and collateral, and determine whether any of the results might require an additional provision. If so, document it in the files for examiners' review.

Capital:
The most important thing to remember about capital is that you want to maintain well-capitalized ratios. Regulatory scrutiny increases if your bank falls below well-capitalized levels. Analyze your capital adequacy in light of your pre-examination review and formulate a plan to stay well-capitalized. It takes longer to obtain capital these days and the sooner you start, the less harsh the criticisms will be from the examiners if you are teetering on the brink of well-capitalized levels. Look at cutting dividends, reducing assets, and any other alternatives that would allow you to remain well-capitalized.

Federal Home Loan Bank Advances:
Examiners are criticizing banks which have advances from the Federal Home Loan Banks. If you have advances, review this source of funds in the context of your overall funding sources. You may want to reduce your dependence on Federal Home Loan Bank advances by slowing asset growth rates or increasing other funding sources. Any plans to reduce this funding source should be reduced to writing and progress measured periodically.

Internal Controls:
You might be surprised that examiners are reviewing internal controls with renewed energy. If you haven't thought about your internal controls for awhile, now is the time for a fresh look. Look at the controls over the lending and deposit functions. Have you begun offering new products and services since the last time you looked at your internal controls? Have you opened new branches or acquired branches and personnel since your last review? This is also an area that can help you catch fraud taking place in the bank, can help you prevent fraud from within and outside of the bank, and can reduce your litigation risks.

Anti-Money Laundering and Bank Secrecy Act:
Bank Secrecy Act and the U.S. Patriot Act are a continuing examination focus.

Review your Anti-Money Laundering program to ensure that everything is in order and that this won't be the focus of regulatory criticisms.

2. Repair.

The next step in preparing for your upcoming examination is to repair the problems you found in the pre-examination review. Analyze the results objectively and determine what you need to do. You may want to contact your banking attorney or consultant for input on correction action.

The examiners will be impressed that you took corrective action prior to them making you take it and any action they take in the way of enforcement action will be minimized because you have demonstrated an ability to assess the situation, and take corrective action on your own.

Document the corrective action that you took or are taking so the examiners can review it. This is a very important step.

3. Share.

You should be having regular communication with the examiners, but this is one phone call that should not wait. Tell the examiners what problems you found during your pre-examination review and what corrective action you are taking. Do not wait until your next examination to tell them about any problems that you have uncovered in the pre-examination process and do not wait for the examiners to call you. They will not be happy if they find out you knew about problems many months before they came in and did not inform them. And when the examiners come into the bank, demonstrate the progress you have made.

Don't forget to share the information about problems identified at the pre-examination review with your board of directors. You should then monitor these problems at the board meetings, so that the board can effectively supervise the bank.

If the problems are severe or you are in danger of falling below well-capitalized levels, prepare your board for possible enforcement actions. This is where your banking attorney comes in handy and can help you formulate an action plan to minimize the extent of any possible enforcement action.

4. Take care.

The last step is to take care of yourself. The next examination may be a marathon and not a sprint, so don't wear yourself out the first few days of the examination. Instead, view it as a marathon and pace yourself. Keep your energy levels up and your emotions down.

What should you do when the examiners discuss their findings with you?

- Stay calm in the face of criticisms.
- Don't become belligerent. Nothing can be gained by making the examiners mad.
- Don't threaten to change charters. This is a very difficult process and should only be threatened under the direst of circumstances.

- Don’t threaten to call the examiner’s boss. You may have to, but nothing good will be gained by telling them that. Most of the regulators have an ombudsman process that you can use specifically to challenge examination findings.
- Call your banking attorney or consultant to help you formulate an action plan to address the criticisms and minimize any possible enforcement action.
- Put things into perspective. Everything is cyclical including the economy, the real estate market, and the issues that the examiners focus on. This too shall pass.

Remember, in order to have the best examination outcome possible,

- Prepare
- Repair
- Share and
- Take Care.

Catherine A. Ghiglieri is the former Texas Banking Commissioner and is President of Ghiglieri & Company based in Austin, Texas. She is co-founder of The Bank Directors’ College which provides training to bank directors