GET READY FOR ‘FORWARD-LOOKING SUPERVISION'

Call it "pay now, err later"

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Hold onto your hats! Forward-looking supervision by the bank regulators is coming. That is right--forward-looking supervision.

Contrast this to the type of supervision most banks have received historically and currently from both state and federal regulators. Supervision today, for the most part, is a snapshot in time as to the condition of the bank.

But In the offing for all the federal regulators and some states is a significant shift in the examination process away from the "snapshot" to "forward-looking supervision."

Defining a nebulous term

Okay. "Forward-looking supervision." Hopefully, I have grabbed your attention. What does it really mean?

Examiners will look ahead to see where the bank might get in trouble. In other words:

Your bank is not in trouble today. It is in perfect condition, but we are concerned it might be in trouble in the future. So we are going to downgrade you--today.

An example from the field

My firm had a recent experience with forward-looking supervision in connection with one of our federally supervised client community banks.

The bank had 14% Tier 1 capital; a classifications-to-capital ratio below 30%; and earnings north of 1%. We thought everything looked great.

The regulators examined the bank and rated it a Composite 3.

"A Composite 3?" we cried. "You have got to be kidding."

The response: "We are now doing forward-looking supervision and although the bank appears to be in great shape today, we think it may have problems in the future."

I am not normally a conspiracy theorist. But this appears to be such a radical shift in the examination and supervision process that I am not sure it can be attributed to anything else. Is this some kind of conspiracy by FDIC and others to make the insurance fund solvent again by downgrading healthy banks that should be rated 1 or 2, instead, a 3 or even 4?

Protecting yourself from "forward-looking supervision"

So, how do you deal with forward-looking supervision?

My understanding from inside sources is that it will primarily be a focus on concentrations of credit. The bank is going to have to assess, monitor, and manage its concentrations. This is not just dealing with concentrations in commercial real estate or acquisition, development, and construction lending.

It is also going to be dealing with concentrations in agricultural lending, medical lending, etc. Any concentration that regulators think creates additional risks is going to be the subject of forward-looking supervision.

The corollary to forward-looking supervision: Stress-testing loans and the concentrations in the loan portfolio. I had one client recently who regulators had asked to stress test its agricultural portfolio, because it has a large concentration in agriculture.

Why? Because there may be some kind of a bubble out there--land prices or commodities prices, or both. Should we downgrade the bank now, because it might get in trouble in the future?

My vote on that would be "no."

But it appears the regulators' votes are going to be "yes." Be prepared for forward-looking supervision and good luck!

No place to look it up

Besides the good luck, aren't you also going to need to know how they are going to do this?

The sad part is it does not appear there is any concerted effort to announce to the bankers that the whole process of examination and assessing the risks in the bank is going to change.

Probably the first time your bank will experience forward-looking supervision is when the examiners come in and downgrade the bank, because although it is in fabulous shape now, it may have a problem in the future.

Let's see when the regulators finally do tell their constituents about the changes.

TALK BACK! Has your bank been examined under "forward looking supervision"? Tell us about your experiences in the comment section below.

About the Author

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