O'LEARY'S ESSENTIALS: THE SAFETY AND SOUNDNESS EXAM PROCESS—AN UNFINISHED TASK

Part one of two: How exam methods evolved into today's model

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The process of examining banking companies has evolved over the years, not only in what examiners look at and for, to how they do it. Overall, there was a shift from asset identification and valuation to judgment of the adequacy of policies and internal controls. Even with examiners' detailed attention to certain assets, they still tend to take a very "top down" view.

The collective and generally unhappy experiences of the last few years--and various news events of the last few years--suggest that perfecting the process is not yet complete. In this blog and the next, I'll review where we were, where we are, and explore where we may need to go.

A process almost quaint today

When I started in banking in the 1960s at The Bank of New York, examinations began at the close of business on a Friday. Examiners swarmed in and went behind the teller lines. They sealed the drawers; went into the vault and sealed the compartments containing negotiable collateral; and then they dug in for a long evening. As each teller was balanced out, he or she was permitted to leave.

The stories that circulated around about the process were probably a combination of fact and fiction. But there was, no doubt, a rigor to the process that participants recalled like combat veterans. The exam process was very labor intensive, especially initially, as the examiners went about their verification of the existence of bank assets by physically counting them.

Structural change lead to new examination philosophy

By the early 1970s, the barriers to "unit" banking were tumbling, though there were still many state jurisdictions where branching was prohibited or significantly limited. In the years that followed, barriers to branching tumbled down.

Both state and federal regulators conducted exams more or less the same way as I described above--The Bank of New York was a state-chartered Federal Reserve member and examined by the Fed. It was the Comptroller's Office that led the way to changes in the examination process. In 1975 it commissioned a study by Haskins and Sells, at that time one of the "big eight" accounting firms, to investigate and recommend more efficient and effective exam practices suitable to an age of permissive branching.

One of the first and most significant conclusions that H&S reached was that the emphasis was being placed on selected bank assets without any discrimination on materiality of a bank's assets in their entirety. How material could a shortage be in the cash drawers of a few tellers or just how much in negotiable securities value could any employee likely steal or embezzle? was the thinking.

The most significant conclusion was the idea that a bank examination should evaluate both lending standards and the concrete results of those standards as existed in the loan portfolios of the banks. Thus was born the era of formalized lending policies.

Age of formal lending policies--and their examination--arrives

Most banks, especially the large ones, had credit policies.

As a Stonier student in my first year of the Stonier program I remember the chief lending officer of Manufacturer's Hanover Trust, then one of the country's largest banks, describing the lending process at his bank. He distributed copies of his bank's lending policy-a single-page document that was essentially as I recall "do good and avoid evil" kind of statement.

It was very general and spoke of the bank's making "productive loans," without attempting to define what productive meant. I had occasion to learn firsthand over the next several years that the credit extension process at any large bank was typically a lot more formal than what existed at small ones and that was almost certainly true at Manufacturer's Hanover.

I also learned that lending policies at small banks were often quite specific but often did not exist in a formal, written way.

The degree of formality among banks of different sizes is an important point. In the mid-70s, there were lots of banks but only a handful of really large ones. Senior lenders of most banks knew personally and individually all, or nearly all, of the bank's officers who exercised delegated lending authority from the board of directors.

Today in the large lending institutions, it's impossible to know or even meet all of the lenders. Not very many years ago the top lender at all but the largest institutions could look up from his desk and see the back of the heads of most everyone who had credit authority, The Haskins and Sells model that came out of the study adopted in 1976 by the Comptroller was to examine the bank's lending policy for adequacy, completeness, and reasonableness. Once the examiners were satisfied that the standards were appropriate for the bank's market and customer base, it could go about examining a sample of the actual loans made to see if they were underwritten to those standards.

Not only was performance of individual credits an examination metric but compliance to policy became one as well.

With the existence of a detailed policy, examiners went about the work of measuring compliance with the policy. An outsized number of exceptions meant that no matter how good the policy appeared to be, it was not followed if the loans examined were riddled with exceptions.

The other bank supervisory agencies saw the merit in the approach and followed pretty quickly with similar requirements that encompassed ultimately all banks. For two or three years, lenders were talking about little else but loan policies. There was a veritable cottage industry of consultants and trade associations that offered courses, seminars, and booklets on how to write a credit policy.

"Checking the checkers" comes into vogue

After about two years of very concerted effort to gain acceptance of formalized credit policies by national banks, the Comptroller's Office turned its attention to the next part of its overall plan: loan review.

H&S recognized that the exam process couldn't cover 100% of the credit asset exposure of any bank. The objective was to build an internal control mechanism that would oversee the credit risk exposure of a large percentage of total credit assets.

Loan review shifted the main cost burden of the process from the examiners to the banks.

Bank managements understood what an effective internal control loan review could be in the pursuit of acceptable credit quality. Although loan review represented a new level of overhead, boards of directors understood that this was a better process for maintaining asset quality and willingly enough complied. In hindsight it seems to me that loan review was an easier "sell" than was the formalization of credit policies.

So, what happened?

But here we are more than 35 years later.

We've been through a terrible recession and the credit policies and loan review processes at many banks did not prove adequate to preserve an appropriate level of asset quality or prevent widespread bank failures.

How should we understand what happened? What needs to be done now?

In a subsequent column we'll discuss what needs to happen to restore confidence that we are capable of managing credit risk reasonably well for the years to come.

In his follow-up blog next week, Ed will make a case for:

- • Ruthless application of internal controls.
- • Back offices that won't let exceptions get through without heroic effort.
- • A quality process that is uncompromising.
- • Enough staff in the right places to have a true separation of duties.

About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions, working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and has been a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear free audio interviews with Ed about workouts here. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.

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