
EXAMS: 9 basics--and not so basics--for better ones

Ready for your next
safety-and-soundness visit?

By Kevin Johnson,
Sageworks Vice President of Financial Markets. For more about Johnson, see the
end of this article. Regan Camp, risk management consultant, contributed to the article.

Examiners tend to have a way of finding the six loans in
your portfolio that don't have up-to-date information.

That's probably the banker's version of Murphy's Law.

But even when you've had weeks to prep, seeing examiners
walk through your financial institution's door is often a cause for fear, or at
least apprehension. They cause your institution to divert time and resources
toward compliance. But they serve a purpose and we've found the following steps
to be of help to our banking clients.

1. Keep files up-to-date and organized.

Seems like a basic, but all it takes is a few client
handoffs, an illness, or some other interruption, and something critical isn't
where it ought to be when the examiner looks for it.

One of the easiest ways to make your examination process
easier is to make sure you have up-to-date information (i.e.; appraisals,
guarantor information, and financial statements dated within the parameters
established in your financial institution's policies and procedures).

In the same vein, it is important that your files are
correctly added to your banking software. Merely dropping a client's latest

tax-return into his or her file will not satisfy examiners and may lead to data inconsistency. Instead, you must make sure that the data contained within these documents are input into your financial analysis software and thereby incorporated into portfolio assessments. Only then will your up-to-date data actually prove useful in risk rating.

Generally, the size and delinquency of an account positively correlates with the likelihood of that particular account attracting examiner attention and scrutiny. Consequently, particular attention should be given to larger and more delinquent accounts when ensuring information is up-to-date.

2. Review your risk ratings

Risk ratings should be reviewed and updated regularly to ensure changes in loan or borrowing conditions are reflected appropriately. Risk rating software may prove especially helpful in identifying those changes and ensuring directional consistency. Examiners will look for that directional consistency as they review the history of risk rating changes for each loan.

Further, a written review of the risk rating process should be provided to your board of directors on a consistent basis, so as to ensure board members are well informed about the level of risk in the portfolio.

3. Review your process for setting the allowance for loan and lease losses.

As the number of insolvent institutions rises, due to lack of adequate capital reserves, so also does the focus and time examiners put into ensuring the appropriateness of an institution's allowance. Consequently, the following steps should be considered in demonstrating compliance with ALLL regulatory guidance:

First, begin by ensuring all your loss rates are up-to-date. Then, look at your weights (if you use weighted averaging) to ensure each of your segment weights reflects current risk conditions.

Next, ensure that your qualitative factor adjustments are updated with reasonable and adequately supported drivers. The utilization of methodologies such as back testing may assist you in this area. You can look

for relationships between certain market activities and your own institution's loss rates and then conduct correlation analysis on those factors to assess their strength. Running such an analysis will add solid, quantitative backing to your assumptions.

Finally, it's important to have proper documentation for your ALLL. This includes documentation on the aforementioned qualitative factors process as well as adjustments to collateral value. Further, documentation should show that you've made adjustments to your ALLL components both now and in the past.

4. Keep the board informed.

A financial institution's board members should always be cognizant of all problem areas in the portfolio and should oversee the management and workout of troubled debts where appropriate. Keeping documentation that demonstrates the board's oversight should be a priority. Further, there should be written action plans for all problem loans that are updated during a quarterly review, if not at a more frequent rate.

5. Know your guarantor.

Loan guarantors are often forgotten as potentially viable sources of loan recovery. It's important you are well informed about loan guarantors since they act as a safety net on loans. Accordingly, make sure to have the following financial information on all guarantors in your portfolio:

Current financial information, including tax returns and personal financial statements.

A recently updated debt service coverage ratio.

Strong covenants--review your institution's covenants to ensure that, in the event of a default by the primary lien holder, you have the proper legal standing to ensure payment by the guarantor.

6. Take extra time to inspect common problem areas.

Here are two; there are others:

Loan participations:

A common issue many institutions face in regards to loan participations is the fact that, with other institution(s) involved, sometimes the integrity of loan data suffers. Consequently, it is critical that lines of communication be open and active with participants, in order to ensure that you have up-to-date loan information before an examination.

Mergers and acquisitions:

Mergers and acquisitions often require that special attention be given to an affected portfolio, as the merging of loan portfolios can often be daunting. During an exam, it's important that your institution show that it has adequately assessed any new loans acquired in the merger or acquisition and that these loans are being handled appropriately.

7. Be honest during the process.

One would be hard-pressed to find a portfolio without imperfections; documentation may be lacking, or so also may adequate oversight on a particular loan. Consequently, if exceptions to policies and/or procedures are discovered, it is imperative that, rather than attempting to hide or excuse away the issue, you demonstrate to examiners that you are cognizant of the situation and that you are actively engaged in identifying a remedy.

If you aren't honest, the examiner will be left wondering what else you are hiding. This will only lead to more headaches. A proactive stance will help your institution earn the trust of the examiner and prevent additional, time-consuming investigations.

8. Emotions don't win arguments, facts do.

Examiners won't be won over by your candor or other emotions while conducting their assessment. Rather, they want to see documentation on your processes and methodologies, proof that they are based on well-formed assumptions, consistent implementation, and regular reviews.

9. Be prepared for changes.

The reality is that the requirements of an exam are ever changing, especially with the likely implementation of Basel III requirements over the next five-to-ten years. Therefore, it is always important that you have someone in your bank assessing the latest in regulatory requirements. Keeping a pulse on the latest regulations will allow your institution to adapt before the regulations go into force, or plan for a smoother change of process and examination.

About the author

Kevin

Johnson is vice-president of financial markets at Sageworks, where he focuses on the Sageworks/Fiserv partnership. Before joining Sageworks in 2008, Kevin was vice-president of sales and marketing at ECS, LLC. Prior to that, Kevin was with Morgan Stanley for over nine years. He served in branch management positions and rose to vice president in the New Jersey and New York area.

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