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Surviving in Today's Regulatory Environment

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At FinPro's 2007 Presidents and Directors Conference we did a presentation on top regulatory and political issues for 2007 and 2008 . . .

List from 2007 Conference

- Credit Issues – Closing the Barn Door
- BSA
- Electronic Delivery
- Examination Concerns and Pre-Emptive Downgrades
- Political Pressures Towards Consumer Activism
- Changing of the Regulatory Guard
- De Novo Applications

While today's list hasn't changed significantly, it has grown, and more importantly the focus has shifted

Surviving in Today's Regulatory Environment . . .

- Regulatory Hot Issues
 1. Credit, Asset Quality, and ALLL
 2. Regulatory Reform
 3. Consumer Protection
 4. Liquidity and Funding Sources
 5. Corporate Governance
 6. Rapid Growth
 7. Compliance
- What Bankers Need to Do
 1. CAMELS self assessment
 2. Before the Exam
 3. During the Exam
 4. After the Exam
- Final Thoughts

Don't hit many of these issues throughout his presentation, but we mention them again so that you realize the environment we are operating in is driving regulatory issues . . .

- Economy
- Institution structures
- Balance sheet – Lending
- Balance sheet – Funding
- Expenses
- Capital
- Fee Income
- Consolidation
- Management
- Political/IG Material Loss Reviews





Regulatory Hot Issues

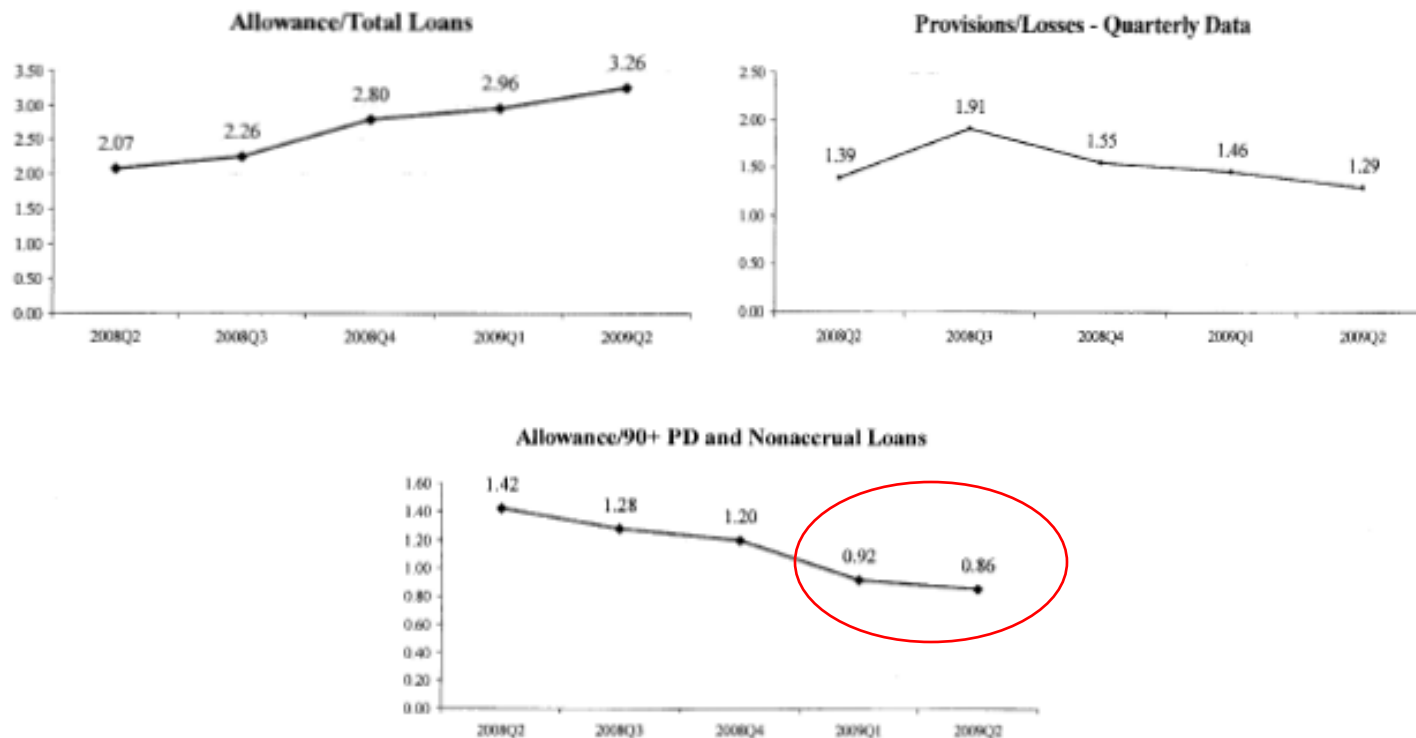
1. Without question, **credit, asset quality, and ALLL** are the #1 issues with regulators . .

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- Rising levels of delinquencies, classifications, NPL's and charge-offs
 - ALLL Adequacy
 - Coverage ratio of ALLL/NPL
 - Methodology
 - Loan **concentrations**, particularly commercial real estate (CRE) and construction concentrations
 - Predatory lending and subprime lending

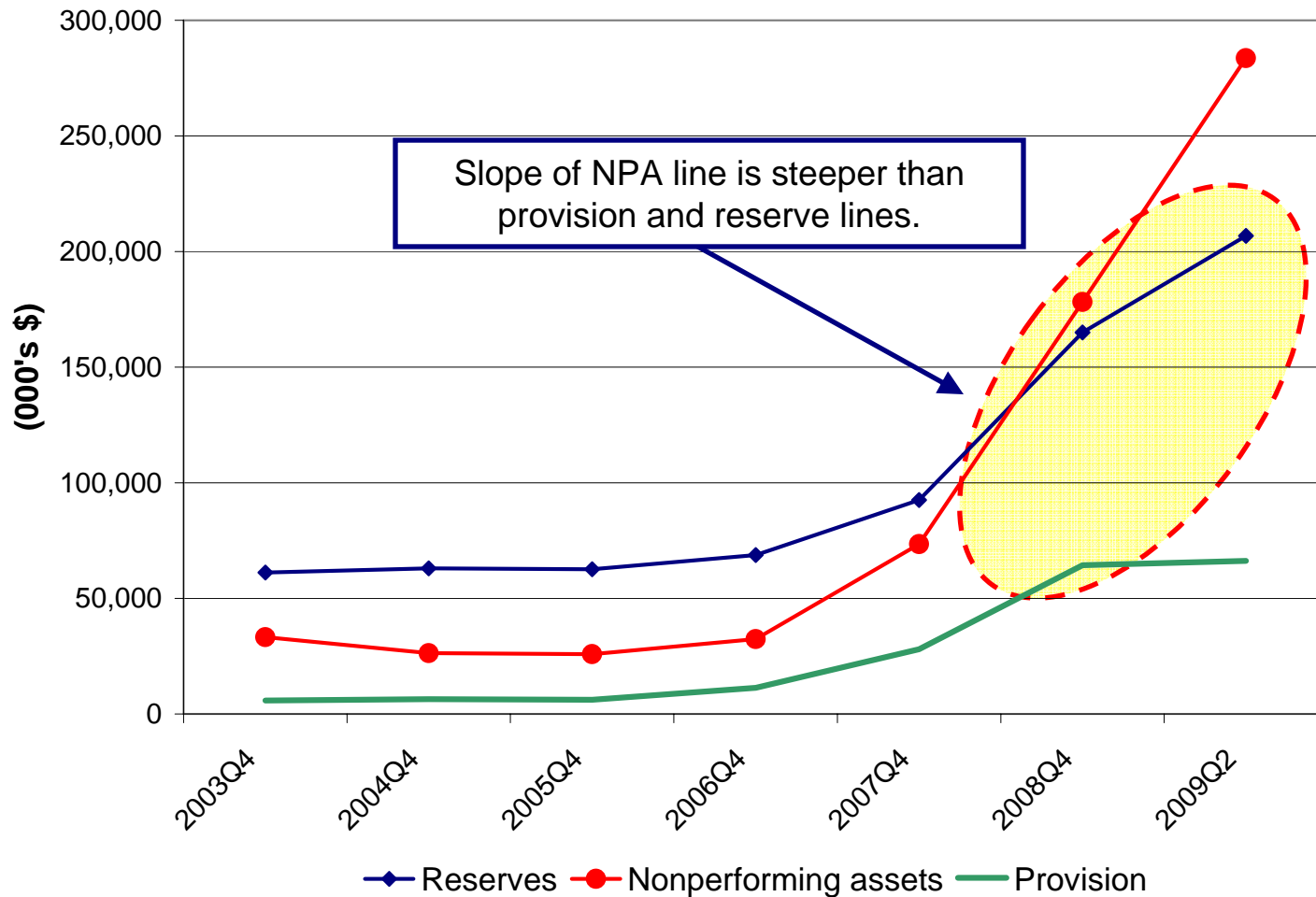
Even at the OCC Large Bank Supervision conference, ALLL was a major topic of discussion . . .



Allowance Levels



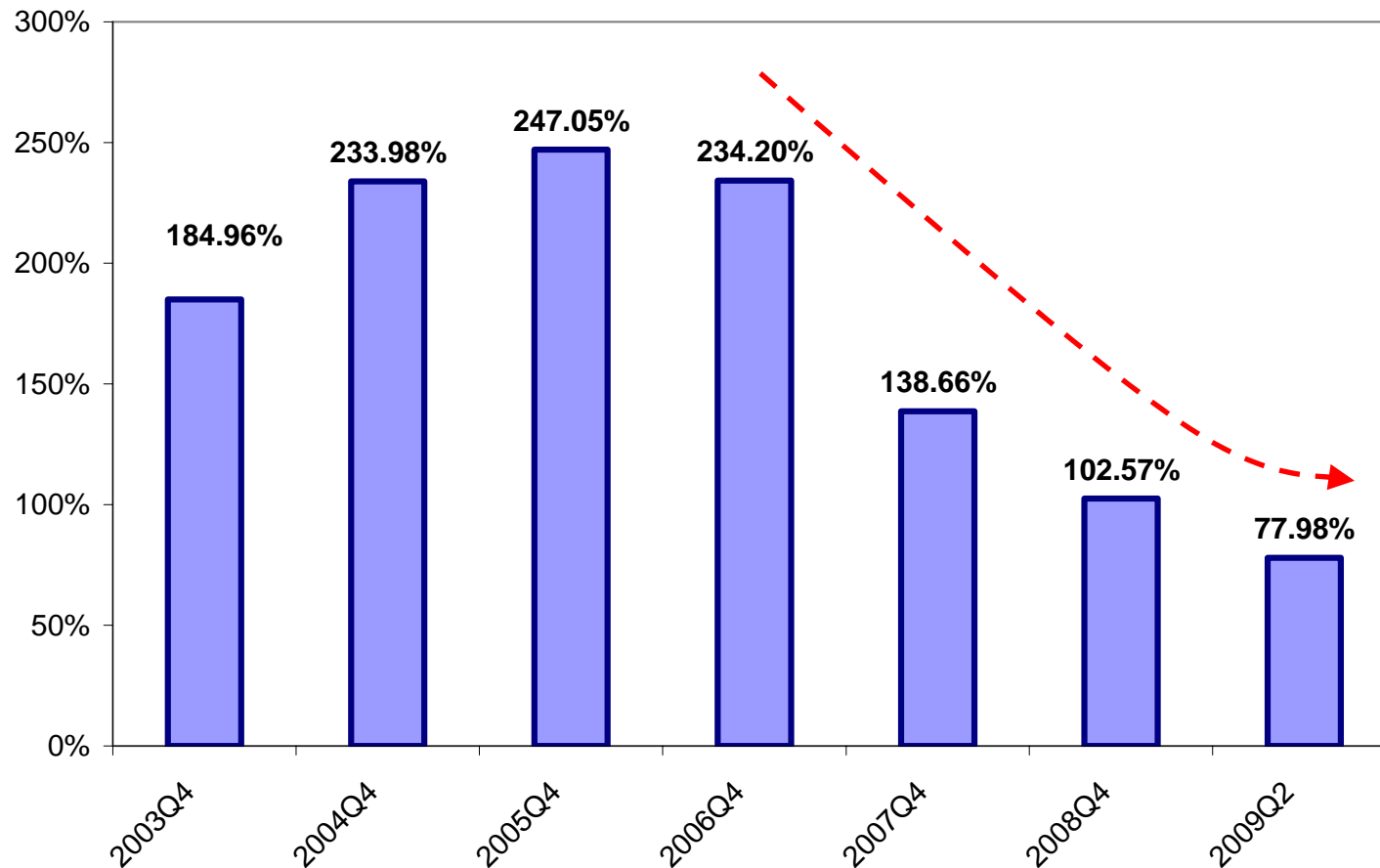
Regulators are **demanding more reserves** (and thereby higher provision expenses) due to the fact that nonperforming loans have been increasing rapidly . . .



Because nonperforming assets have been rising faster than ALLL, the coverage of ALLL to nonperforming assets has been falling. Regulators are increasingly focusing on this coverage ratio in today's environment . . .



ALLL to Adjusted Nonperforming Assets



Breaching regulatory loan thresholds causes concerns among the regulators and can result in a bank having to stop or slow loan originations, and in certain loan categories actually sell loans, in a particular loan category . . .

- Regulators have taken a hard line on the commercial real estate and construction lending guidance.
 - The regulatory threshold for **construction is 100.0% of total risk based capital**
 - The regulatory threshold for **CRE is 300.0% of total risk based capital**. Despite the guidance definitions, regulators are now sometimes **including owner occupied loans** in the calculation.
- Any loan category **greater than 30.0% or more of the loan portfolio** may draw additional scrutiny as well.

Threshold Analysis

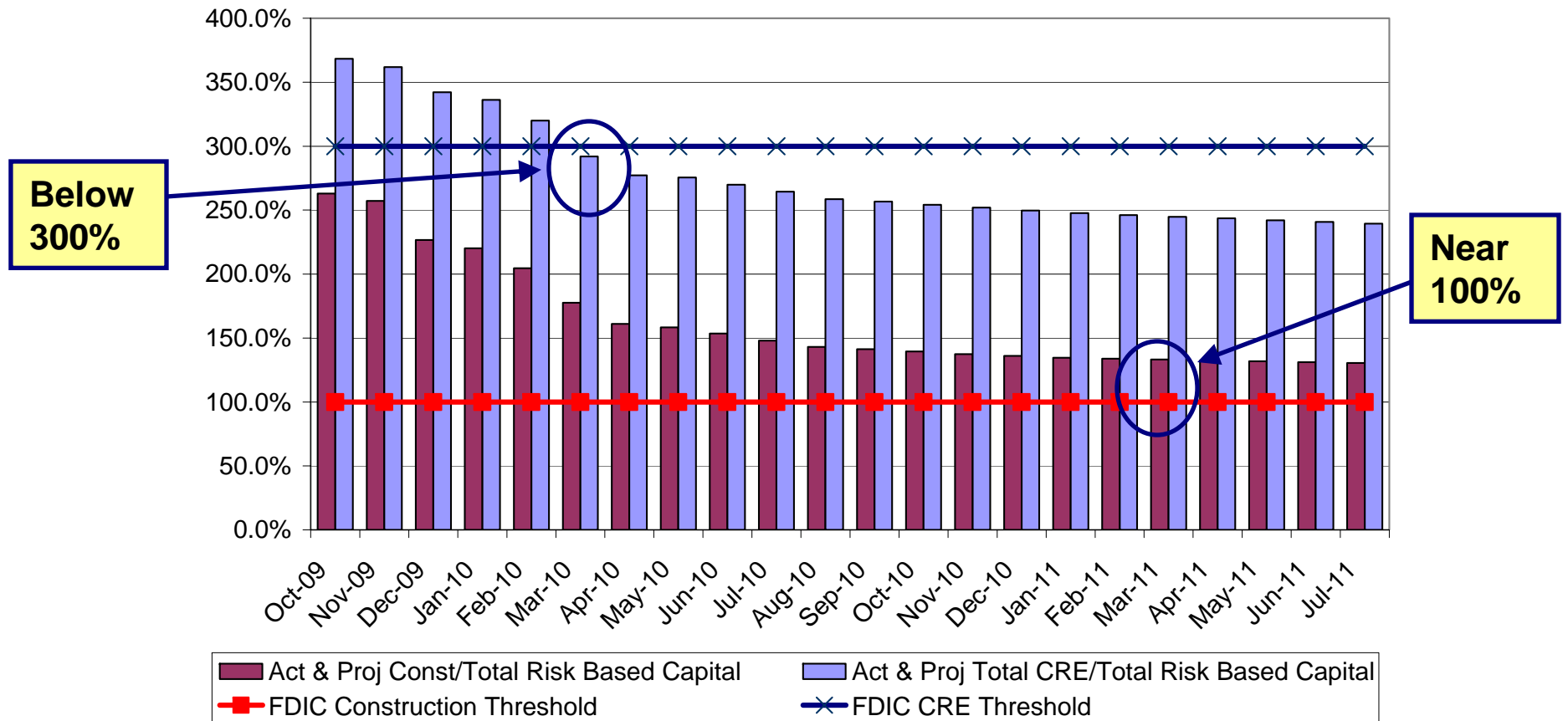
Total reporting institutions in data set:	7,362	
(Institutions reporting construction or CRE "NA", excluded from data set)		
	# of institutions	% of institutions
Institutions over 100% threshold:	1,656	22.49%
Institutions over 300% threshold: *	2,522	34.26%

How to survive credit, asset quality, and ALLL issues . . .

- **Proactive analysis** of loan concentrations
 - Both as a percent of capital and as a percent of the loan portfolio
 - Demonstrate loan concentrations are being managed (includes stress testing)
 - Report and analyze
- Very **detailed work out schedule** for classified and nonperforming assets
 - Show the regulators there is a plan and equally importantly that the bank is monitoring and achieving the plan
- Proactive work on reserves levels
 - Review qualitative factors in reserve methodology calculations. Are they reflective of today's environment in the marketplace?
 - Watch the **coverage ratio of ALLL/NPL**. Be prepared to justify any declines or low coverage ratios.
- Effective **credit monitoring and administration**
- Board needs to set direction and provide adequate oversight

Demonstrate to the regulators declining loan concentrations. A similar chart should be created for nonperforming assets to demonstrate loan workout schedules, with [detailed schedules](#) supporting the summary output . . .

Loan Concentration to FDIC Thresholds



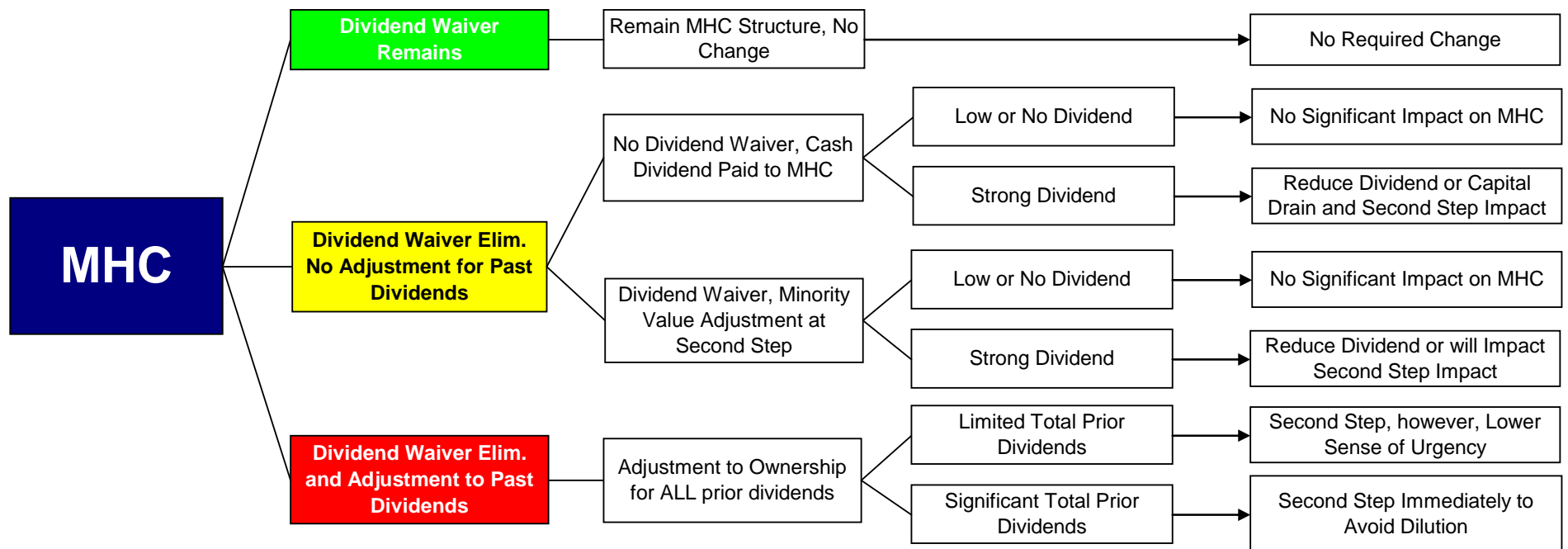
2. More regulation is coming and **regulatory reform**, of some kind, is at hand . . .

- There are various Regulatory restructuring proposals being formulated by the Administration and Congress.
 - One consolidated bank regulator
 - One consolidated financial services industry regulator
 - OTS/OCC combination
 - End of Dual Banking System?
- Consumer Financial Protection Agency (CFPA)
 - Rule making and primary enforcement powers for:
 - All financial service providers
 - Only non-bank financial service providers
 - Rule making for all financial service providers but:
 - Primary enforcement powers only for non-bank financial entities and secondary (back-up) enforcement powers for banking institutions.
 - Primary enforcement powers only for non-bank financial service providers banks over \$10 billion in assets and secondary (back-up) enforcement powers for all other banking institutions.

How to survive regulatory reform . . .

- **Plan ahead for different paths** depending on various alternative scenarios for regulatory reform.
- What will the ramifications be for your institution:
 - If all the banking agencies are combined into one superagency
 - If OTS is merged into the OCC
 - If the FRB becomes regulator for all holding companies
 - This is especially a critical issue if you are an MHC with a thrift holding company and rely on using the dividend waiver
 - If the dual banking system begins to disappear
 - If the CFPB becomes your primary regulator for all consumer issues
- Need to determine **decision points and action items associated with different outcomes.**

FinPro conducted a webinar for public MHCs several weeks ago on various potential paths for the MHC structure, including decision points and action items that varied dependent upon an MHC's utilization of the dividend waiver . . .



3. Political pressure is causing renewed emphasis on [consumer protection](#) . . .

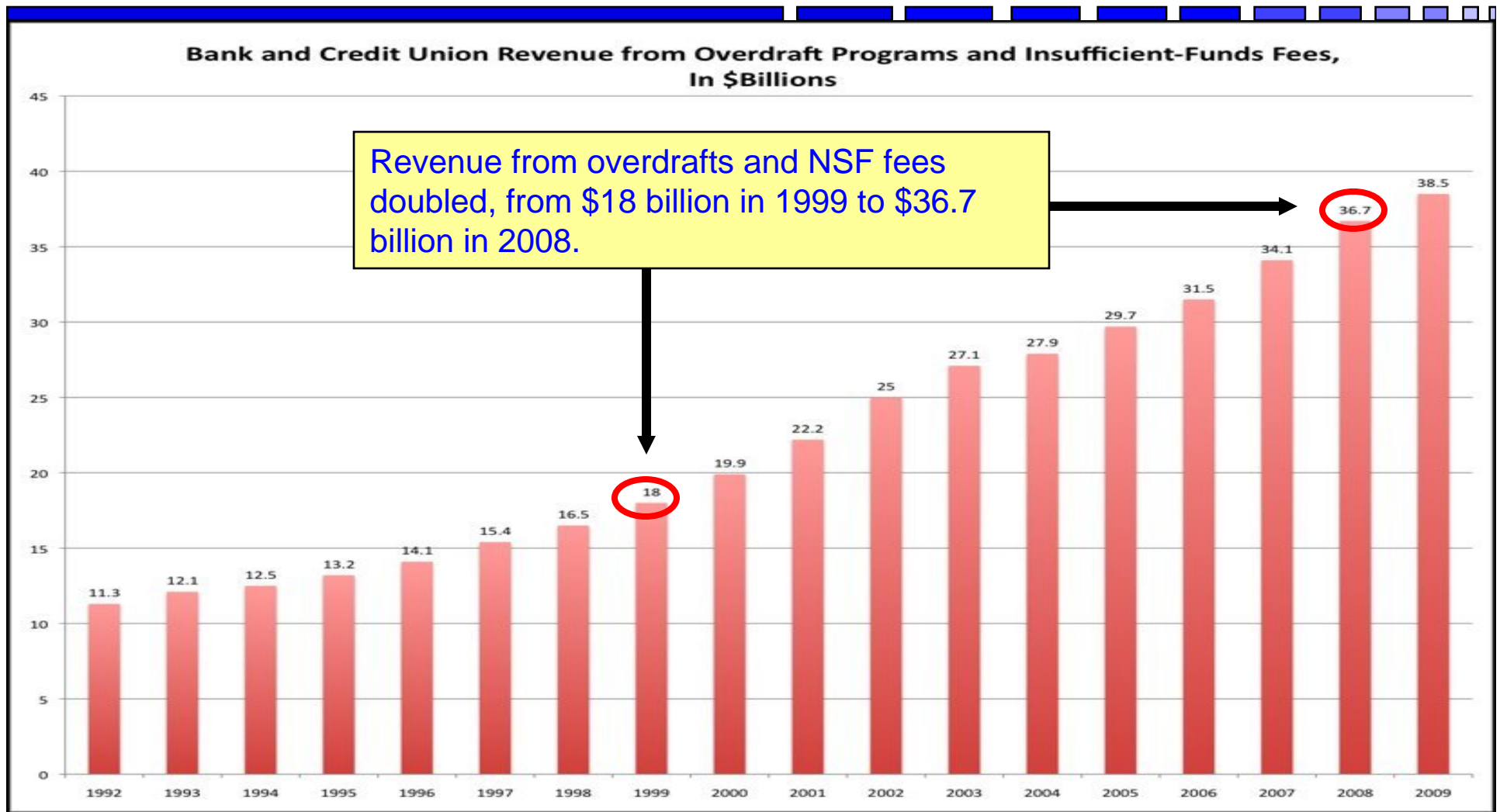
- Overdraft Protection Programs
- Federal Preemption
- Identity Theft
- IT Security
- Privacy
- Vendor Management
- Credit Card programs



This increased pressure and emphasis on consumer protection is impacting financial institutions . . .

- "Families across central New York are being involuntarily placed in these overdraft loan programs and getting ripped off by excessive fees. It's time to stop them dead in their tracks." – Senator Charles Schumer
- How will the proposed **limits on overdraft protection program fees** affect your budgets and plans if they are enacted?
- What adjustments will need to be made to your overdraft program?
 - How are you **displaying available balances on ATMs** to customers?
 - How are you **ordering transactions** processed?
 - What are you doing about **“habitual”** or overdraft **“abusers”**?
- Are you in sync with all regulatory guidances and recommended best practices (including those out for comment or proposed) with regard to consumer related practices?
 - Some agencies and examiners are **applying proposed rules** at examinations and factoring the results of that into their conclusions.

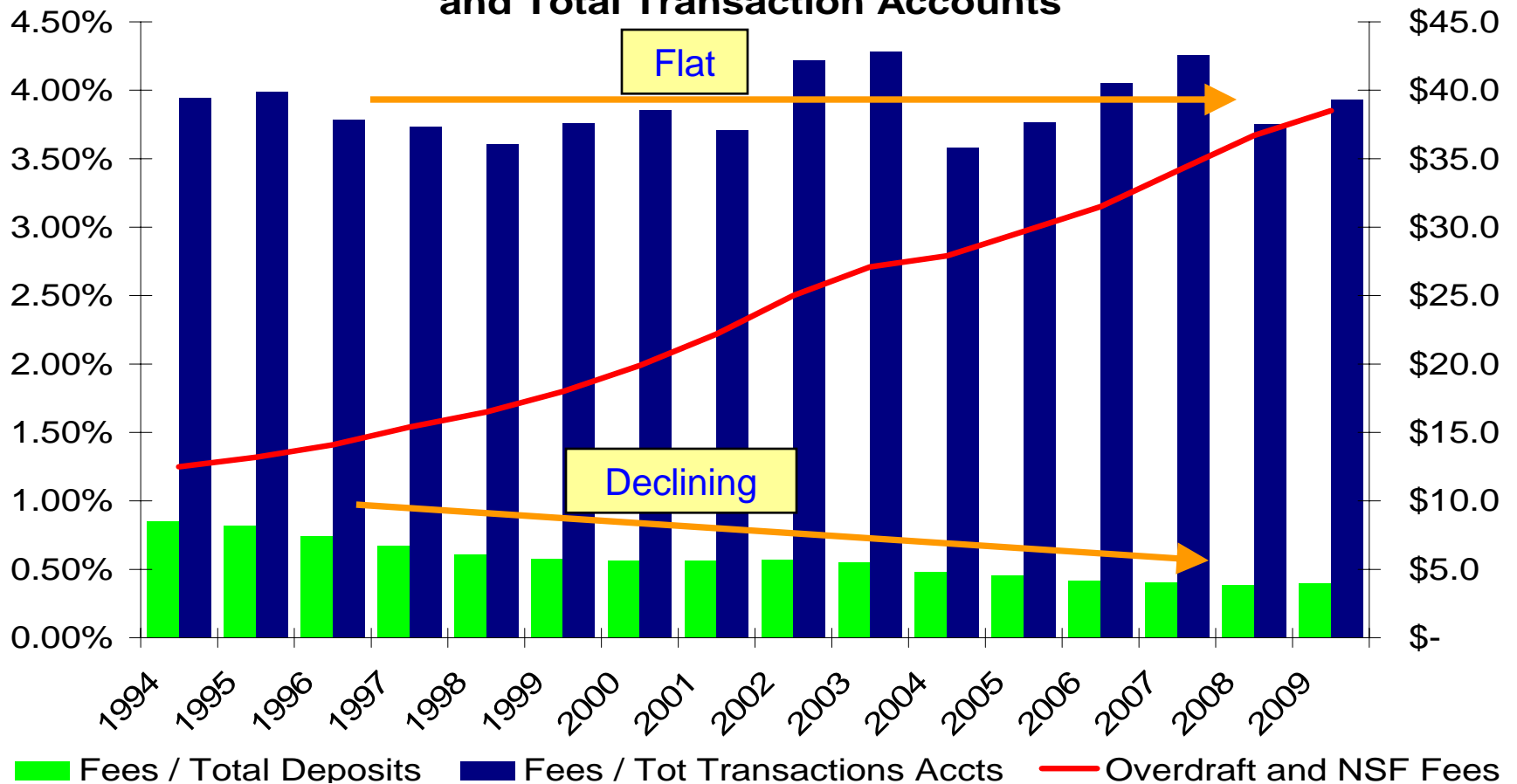
Overdraft and NSF fees have been increasing and are projected to increase another \$1.8 billion in 2009 when compared to 2008 . . .



Although overdraft and NSF fees have been increasing steadily in dollar value, fees as a percentage of total deposits has been declining and fees as a percentage of total transaction accounts has generally been flat . . .



Overdraft and NSF Fees as a Percentage of Total Deposits and Total Transaction Accounts



Overdraft statistics . . .

- 44.5% of all banks and credit unions have **OD income greater than net income**.
- Higher OD fees were led by Wall Street banks, which charged a median price of \$35 per overdraft vs. all financial institutions, which charged a median price of \$26 per overdraft.
- 45 percent of Wall Street banks tier OD prices, vs. 2 percent of Main Street banks and credit unions. The OD charges range from a first-time charge of \$25 up to a \$35 charge per incident.
- 86 percent of all financial institutions that offer OD services **allow the consumer to opt-out at any time**.
- **Less than 20 percent of all financial institutions pay checks in the order from large to small**, with the vast majority paying checks in the order of presentment to the financial institution.
- **35 percent of all financial institutions allow consumers to overdraw their accounts at an ATM or with a debit card**, charging a median of \$26 for this service.

How to survive consumer protection . . .

- Ensure that you are aware of “best practices” regarding overdraft programs and that programs are tailored to meet or exceed them
 - Ensure that **ATM available balances do not include overdraft balance**
 - Customers should be able to make a **decision at point-of-sale** terminals
 - “Habitual” or overdraft “**abusers**” **removed** from overdraft programs
 - Provide **education** on overdraft programs
 - Permit customers to **opt-out** of the program
- Ensure that you have satisfactorily **addressed any consumer protection criticisms** in past exams, audits and/or compliance reviews.
- Review your vendor management policies. If you don’t have one, you probably should get started.

4. As a result of the liquidity related failures and near failures of financial institutions during the fall of 2008, regulatory scrutiny of **liquidity and funding sources** has been significantly elevated. They will be particularly looking for in depth and enhanced . . .

- Liquidity policy
- Liquidity planning and analysis
 - **Cash flow** liquidity analysis
 - **Stress testing** assumptions
 - **Multiple** liquidity **sources**
- **Contingency funding** policy
- **Strong Asset-Liability Management**



Regulators have been denying or significantly delaying approving business plans that rely on wholesale funding or brokered deposits . . .

-
- The new FDIC insurance premium structure illustrates the regulatory concern in regards to wholesale funding.
 - An institution will incur additional FDIC assessment fees if:
 - Borrowings are above 25.00% of total deposits.
 - Brokered deposits are above 10.00% of total deposits, for non-risk category I institutions.
 - Measured use of borrowings or brokered deposits can enhance an institution's profitability, but it should be used in moderation.
 - Do a cost analysis based on borrowing costs and where assets can be pledged.
 - Every institution should know where the value of its collateral is highest and where the cheapest funding source is.

How to survive new liquidity realities . . .

- Stress test liquidity assumptions
 - Deposit shocks
 - Losing brokered or other wholesale sources
 - Decline in collateral values
- Conduct **cash flow based liquidity** analysis
 - Recent Fed and interagency pronouncements focus on this
 - Clients that have had recent examinations have attested to regulatory focus on this
- **Diversification** of liquidity sources
 - **Correspondent concentration FIL** is just one way regulators are enforcing this
 - Need to have multiple sources to be prepared
- **Contingency funding plans** are a must

Maintaining a liquidity plan that addresses contingency funding needs is a necessity for any institution . . .

- Liquidity management is all about **managing cash flow and understanding your liquidity sources** and capacity.
 - Cash flows are often drastically different in different interest rate environments.

As of: Mar-09	Cash Flow Liquidity Analysis											
	Static Balance Sheet - Flat Rates											
	Apr-09	May-09	Jun-09	Jul-09	Aug-09	Sep-09	Oct-09	Nov-09	Dec-09	Jan-10	Feb-10	Mar-10
Scheduled Cash Flow:												
Assets												
MBS	1,541,782	1,534,523	1,393,330	1,311,190	1,234,493	1,162,856	1,095,923	1,033,365	974,875	920,169	862,943	759,989
Investments	2,347,000	2,450,000	6,291,000	2,136,000	6,191,000	645,000	1,799,000	1,099,000	99,000	2,475,000	(0)	990,000
Total MBS & Investments	3,888,782	3,984,523	7,684,330	3,447,190	7,425,493	1,807,856	2,894,923	2,132,365	1,073,875	3,395,169	862,943	1,749,989
1-4 Family and Mixed Use Mortgages	1,247,838	862,706	843,072	823,923	805,248	787,034	769,269	751,940	735,038	718,551	702,468	686,779
Commercial Mortgages (Owner Occupied)	5,923,959	3,119,871	2,819,566	2,784,421	2,051,105	1,985,657	1,739,241	1,736,079	1,681,364	1,491,544	1,488,388	1,485,271
Construction, Land and Other Mortgages	16,007,310	7,460,741	3,580,592	1,923,960	1,419,078	1,299,146	1,156,243	769,951	451,799	453,588	376,315	344,997
Home Equity Loans	184,838	183,454	182,084	180,728	179,386	178,058	176,744	175,443	174,156	172,881	171,620	170,372
Consumer Loans	73,242	14,192	14,112	14,035	13,923	13,601	13,528	13,457	13,387	13,235	12,937	12,648
Commercial Loans	13,450,104	7,213,026	5,180,399	5,555,576	2,581,698	2,289,867	1,889,382	1,656,796	958,857	3,740,098	2,903,637	1,803,202
Loans, gross	36,887,291	18,853,989	12,619,825	11,282,643	7,050,439	6,553,364	5,744,407	5,103,667	4,014,601	6,589,897	5,655,366	4,503,269
Other Assets	-	-	-	-	-	-	-	-	-	-	-	-
Total Assets	40,776,073	22,838,512	20,304,155	14,729,833	14,475,932	8,361,220	8,639,330	7,236,032	5,088,476	9,985,066	6,518,309	6,253,258
Liabilities												
Certificates of Deposit	(24,683,111)	(30,082,590)	(10,172,048)	(4,684,023)	(13,159,913)	(11,371,181)	(1,575,463)	(2,994,000)	(1,948,092)	(6,129,137)	(10,819,966)	(8,031,472)
Brokered Deposits and CDARs	-	-	-	-	-	-	-	-	-	-	-	-
Total Deposits	(24,683,111)	(30,082,590)	(10,172,048)	(4,684,023)	(13,159,913)	(11,371,181)	(1,575,463)	(2,994,000)	(1,948,092)	(6,129,137)	(10,819,966)	(8,031,472)
Borrowings	(30,003,676)	0	0	0	0	0	0	0	0	0	0	0
Other Liabilities	-	-	-	-	-	-	-	-	-	-	-	-
Total Liabilities	(54,686,787)	(30,082,590)	(10,172,048)	(4,684,023)	(13,159,913)	(11,371,181)	(1,575,463)	(2,994,000)	(1,948,092)	(6,129,137)	(10,819,966)	(8,031,472)
Net Scheduled Inflows (Outflows)	(13,910,714)	(7,244,077)	10,132,107	10,045,811	1,316,019	(3,009,961)	7,063,867	4,242,032	3,140,384	3,855,929	(4,301,656)	(1,778,214)

Stress tests are needed!

5. Additional regulatory scrutiny will force enhanced **corporate governance** . . .

- Compensation issues
 - Obama's Compensation Czar
 - FRB Guidance
 - Financial Stability Board
 - Section 39 of FDIC Act
- Management Succession Plans
- Strategic Plans
 - Stress testing
 - Various scenarios
- Risk Management Practices
- Board Policies, Practices and Involvement



Section 39 of FDIC Act . . .

Compensation Standards – Each appropriate Federal banking agency shall, for all insured depository institutions, prescribe -

- (1) standards prohibiting as an unsafe and unsound practice any employment contract, compensation or benefit agreement, fee arrangement, perquisite, stock option plan, postemployment benefit, or other compensatory arrangement that -
 - A) would provide any executive officer, employee, director, or principal shareholder of the institution with excessive compensation, fees or benefits; or
 - (B) could lead to material financial loss to the institution;

Section 39 of FDIC Act continued . . .

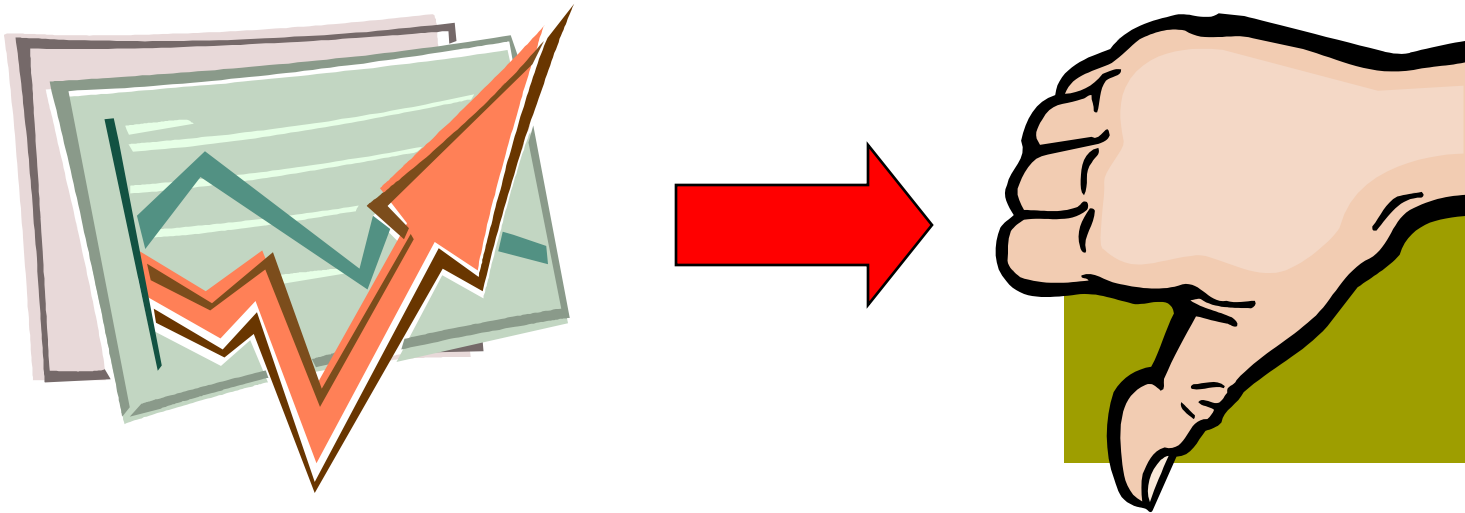
- (2) standards specifying when compensation, fees, or benefits referred to in paragraph (1) are excessive, which shall require the agency to determine whether the amounts are unreasonable or disproportionate to the services actually performed by the individual by considering -
 - (A) the combined value of all cash and noncash benefits provided to the individual;
 - (B) the compensation history of the individual and other individuals with comparable expertise at the institution;
 - (C) the financial condition of the institution;
 - (D) comparable compensation practices at comparable institutions, based upon such factors as asset size, geographic location, and the complexity of the loan portfolio or other assets;
 - (E) for postemployment benefits, the projected total cost and benefit to the institution;
 - (F) any connection between the individual and any fraudulent act or omission, breach of trust or fiduciary duty, or insider abuse with regard to the institution; and
 - (G) other factors that the agency determines to be relevant; and
- (3) such other standards relating to compensation, fees, and benefits as the agency determines to be appropriate.

How to survive corporate governance issues . . .

- Strategic and business plans must have **stress testing and risk management** and mitigation built into them.
- **Compensation rationale and justifications** will need to be made, taking into account as part of the study strengths, earnings & plans as well as national, regional, peer and size statistics.
- **Management succession plans** need to be in place, both for the short and long term.
- An **active, involved and informed Board** will help a bank survive – a rubber stamp board won't fly.
- Avoid conflicts of interest or the appearance of a conflict of interest.
- Good Board and Committee minutes are a must.

6. Regulators are clamping down on rapid growth plans . . .

- Many institutions that have failed utilized wholesale funding to fuel rapid growth.
- Rapid growth of failed institutions has also often been in areas that the bank did not have expertise.
- Ever higher capital requirements are being required for rapid growth plans.



How to survive rapid growth

- Need to demonstrate the bank has a **thorough plan to support growth**:
 - Stress testing must be incorporated into planning process
 - Adequate risk management and controls
 - Adequate management and oversight
- Growth needs to be **organic and not wholesale**.
- **Expertise** will need to be demonstrated for any projected growth areas of the bank.

7. **Compliance**, while it has currently taken a back seat, is still an important issue . . .

- BSA/AML used to be the number one hot issue. Not anymore.
- Lack of compliance with CRA will hinder institutions from growing.
- **Lack of compliance** with existing (and in some cases, proposed) consumer protection related statutes, regulations and/or best practice guidance will likely hinder approval of any applications submitted and could **result in a downgrading** of the Management component in the CAMELS rating.
- Failure to address recommendations made or deficiencies/weaknesses cited in exam reports, internal and external audit reports and/or compliance reviews may hinder approval of any applications by the regulators and could result in a downgrading of the Management component in the CAMELS rating.

How to survive compliance issues

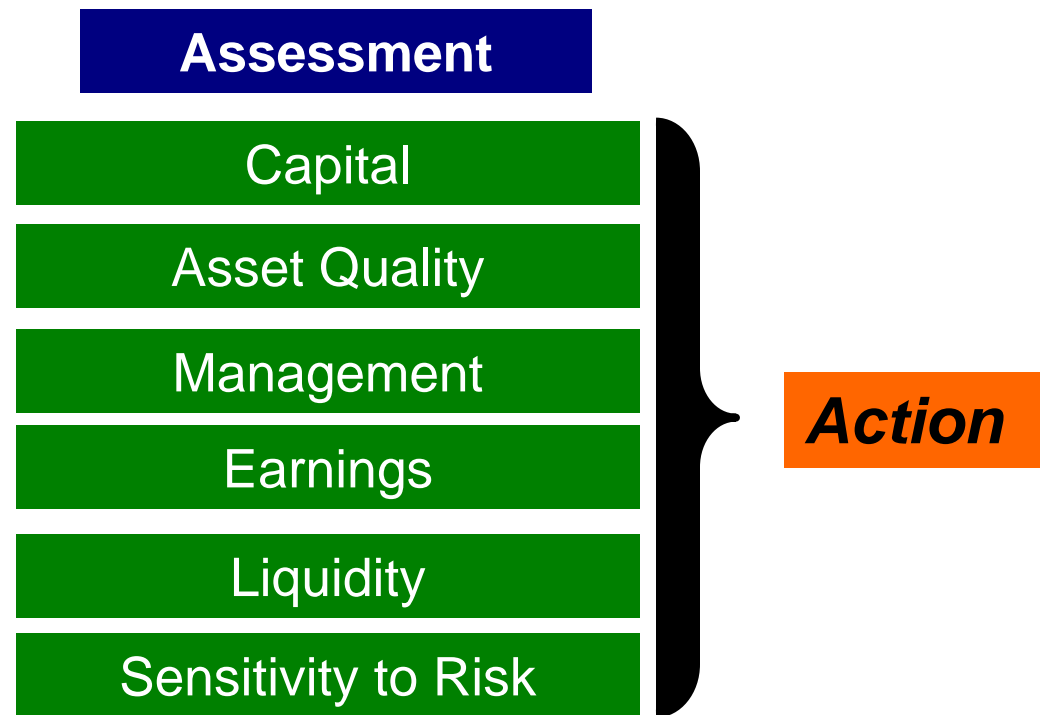
- Don't lose sight of compliance issues even though it is not the highest regulatory focus right now.
 - Regulators will come down hard on a bank if it loses sight of compliance issues.
- Zero tolerance is still the norm for program or repeat deficiencies and/or violations
- Need to stay on top of procedures with regard to BSA/AML requirements with regard to:
 - New products
 - New offices
 - New employees
 - New customers
- Be sure to address recommendations made or deficiencies/weaknesses cited in exam reports, internal and external audit reports and/or compliance reviews



What Bankers Need to Do

Boards and Management need to be doing an assessment of each of the elements of the CAMELS rating system . . .

- **Where are we**, needs to be asked for each item; conduct an honest assessment
- **What are the risk factors** associated with each item, both internal and external
- **What is the strategy** to mitigate risk factors and proactively address the current situation for each item



Before the Exam

The Board and Management need to be constantly prepared and ready for an exam well before it occurs . . .

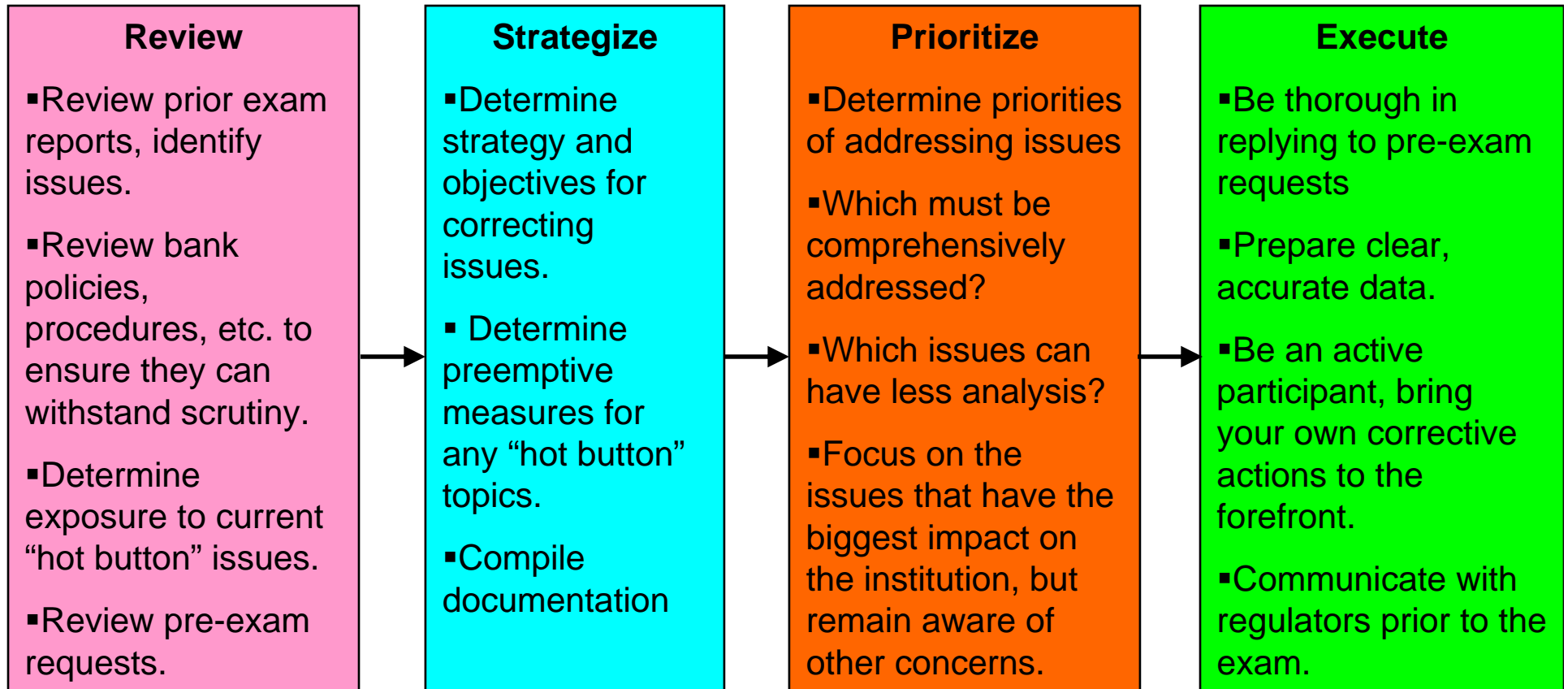
- Know what is going on in the bank
 - Have thorough board reports
 - Ask questions of management
 - Follow up on letters and reports from regulators and auditors
 - Have a strategic plan and know what it is
- Know what is going on in the industry
 - Get copies of major regulatory pronouncements
 - Review the materials for directors on the regulatory websites
 - Participate in educational opportunities
- Be vigilant in efforts
 - Document what is being done
 - Keep the lines of communication open with the regulators between examinations – proactively stay in contact, they do not like surprises

Before the Exam

Examiners do pre-examination reviews before coming into a bank, so should the Board and Management. The Board and Management should review . . .

- Prior examination reports and regulatory correspondence
- Any internal and/or external audit reports issued since the last examination
- Any internal and/or external loan review reports issued since the last examination
- Board and Committee minutes since the last examination
- Organization chart(s) and Job Responsibilities
- Policies and procedures
- Problem loan and watch list reports
- Delinquency and nonperforming asset reports
- Concentration and charge-off reports
- Financial trends and performance reports
- Allowance for Loan and Lease Losses analysis
- BSA and Compliance reports

Before the Exam



Take action before the examination.

During the Exam

Work with the examiners and make their job easy for them . . .

- Meet with the examiners regularly during the course of the exam.
- Ask questions and clarification if the examiners' conclusions are not understood.
- Express an opinion even if you do not agree with the examiners (but in a diplomatic manner).
- Be especially proactive in presenting any remedial programs in place or being developed with regard to issues or concerns expressed by examiners.
- Don't just sit there – participate in discussions .

During the Exam

Once on site, the examiners will be looking to determine . . .

- Are lending policies, procedures and risk limits adequate?
- Are the internal controls of operations adequate?
- Is the lending area subject to adequate audit and independent review functions?
- Does the bank have adequate and accurate information and communication systems for its lending operations?
- Does the bank accurately identify, monitor, measure and control risks?
- Is the quality of the loan portfolio satisfactory?
- Is there appropriate Board and senior management supervision?
- Is the Bank's systems and organization structure adequate for the size and complexity of the institution?
- Are the bank's practices in compliance with State and Federal banking laws, regulations, policy statements and guidances?

After the Exam

Follow up after the exam can often be as important as the exam itself . . .

- Typically, the bank will have a pretty good idea what is coming from the exit meetings with management and the board .
- Address the issues identified as quickly as possible.
- Let the regulators know what the bank has done and plan to do before they send the report and/or any corrective program.
- If it becomes apparent that an enforcement action is being contemplated or recommended, get professional help from those (consultants, lawyers) with experience in the regulatory arena.
- Review notes from exit conferences as well as all commitments made to examiners for corrective or remedial actions. Follow-up to insure they are done and report it to regulators on a timely basis.
- Review and address any remaining outstanding issues as soon as the report is received and respond back to regulators as to actions taken.
- Stay abreast of changing economic, industry and regulatory environments and communicate them to personnel.

Final Points . . .

- Work with the regulators, not against them, but don't acquiesce on everything.
- Be proactive in identifying, measuring, monitoring, and controlling risk.
- Focus on issues and risks that will have the biggest impact on your institution, but don't take your eye off other risks and issues.
- Take action before, during, and after your exam.
- Regulatory environment is changing rapidly, stay abreast of emerging issues.