

Effectively Managing Regulatory Enforcement Actions

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Austin Associates, LLC

Craig J. Mancinotti
Managing Director and Principal

John R. Reisner
Managing Director

Austin Associates' Lines of Business

- **Investment Banking**
- **Strategic Consulting**
- **Financial Management**
- **Insurance and Financial Services**
- **Technology Solutions**
- **Risk Management and Compliance**

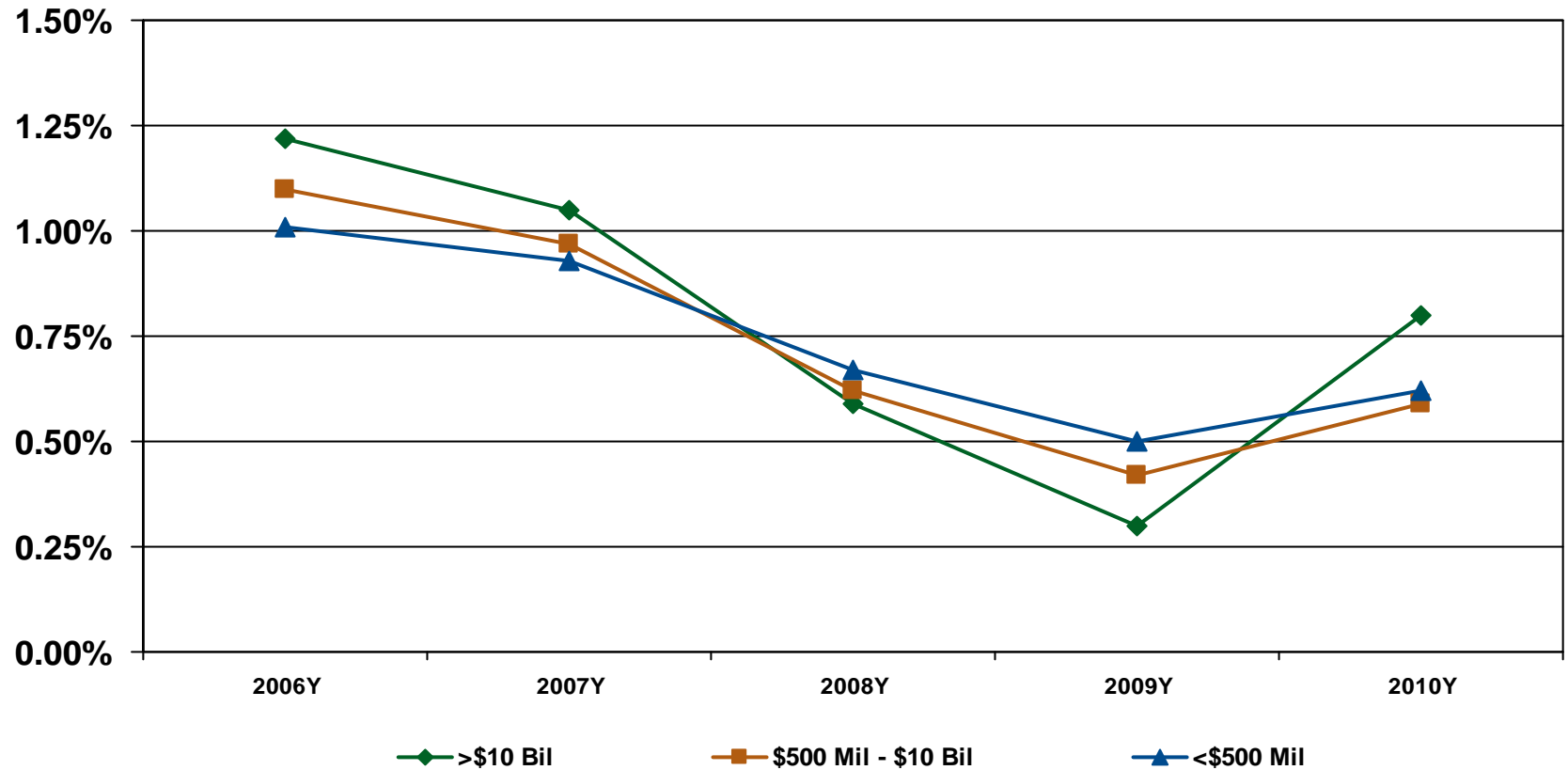
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Market Update

- **Industry Financial Performance**
- **Asset Quality**
- **Problem Bank Statistics**
- **Formal Enforcement Actions**

Banking Industry Earnings

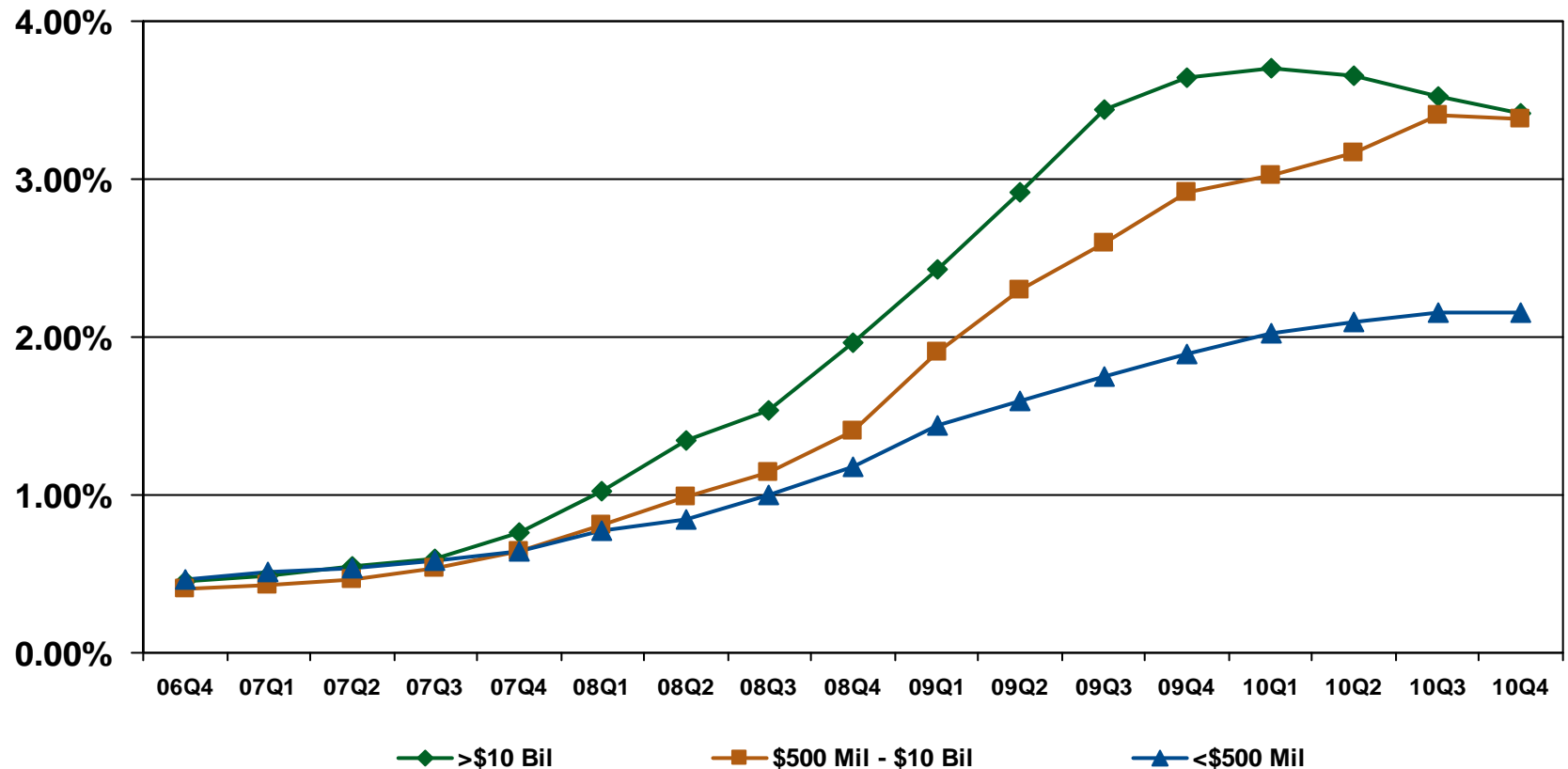
Median Return on Average Assets



Note: ROAA based on net income divided by average assets for each period.
S-Corporations have not been adjusted to C-Corporation status.
Based on the median results of all commercial banks, savings banks & savings institutions reporting 12/31/2010 assets.
Source: SNL Financial

Asset Quality Trends

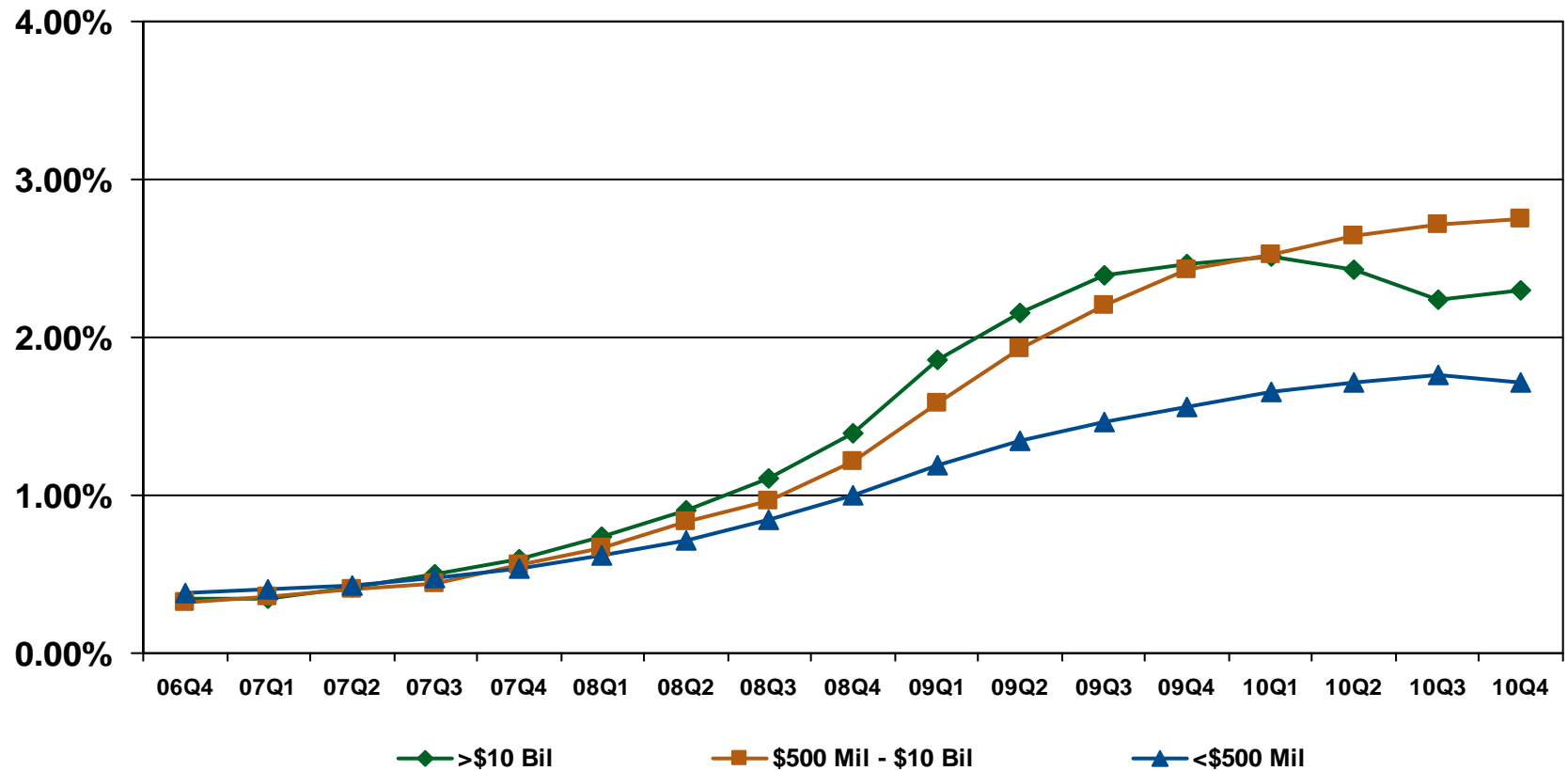
Median Nonperforming Loans / Total Loans



Note: Nonperforming Loans ("NPLs") equal to the sum of loans 90+ days past due, nonaccrual loans, and restructured loans less the guaranteed portion of 90+ days past due loans and nonaccrual loans wholly or partially guaranteed by the U.S. government. Based on the median results of all commercial banks, savings banks & savings institutions reporting 12/31/2010 assets. Source: SNL Financial

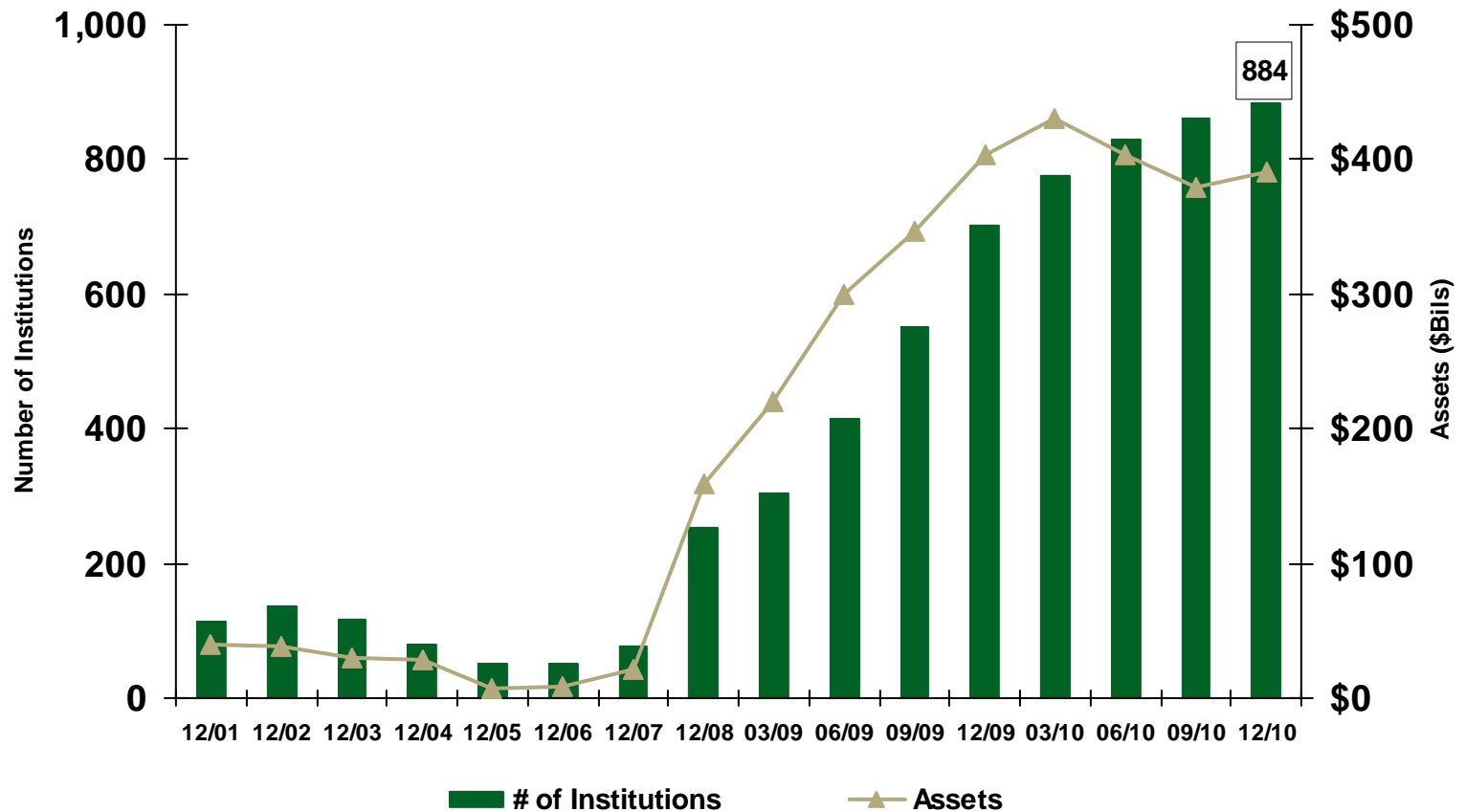
Asset Quality Trends

Median Nonperforming Assets / Total Assets



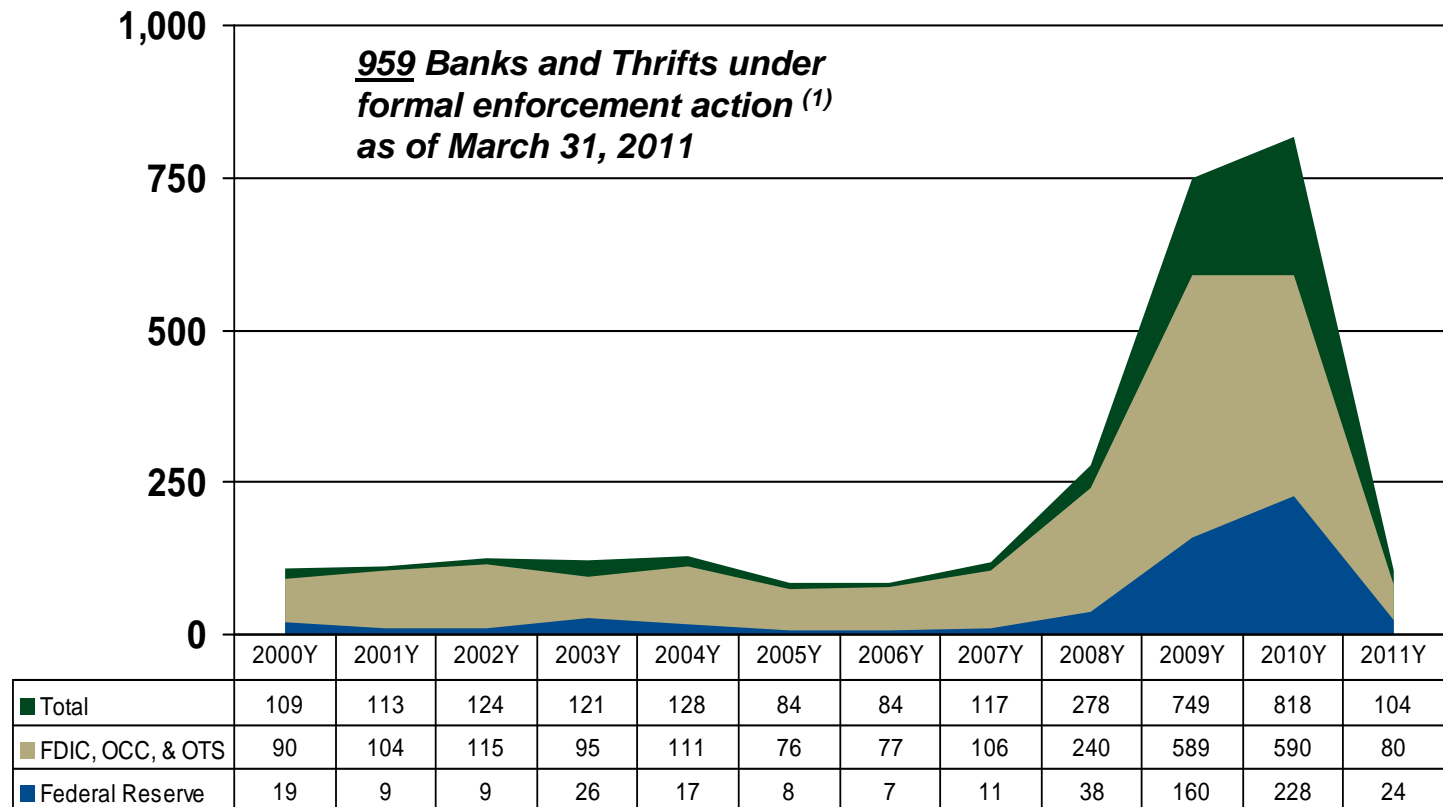
Note: Nonperforming Assets ("NPAs") equal to the sum of loans 90+ days past due, nonaccrual loans, debt securities and other assets, and restructured loans less the guaranteed portion of 90+ days past due loans and nonaccrual loans wholly or partially guaranteed by the U.S. government and other real estate owned covered by loss-sharing agreements with the FDIC. Based on the median results of all commercial banks, savings banks & savings institutions reporting 12/31/2010 assets. Source: SNL Financial

Number of Problem Institutions



Source: FDIC.gov

Regulatory Enforcement Actions



Note: Total number of orders issued in each period. Total may include modified orders.

For the FDIC, OCC and OTS, only Formal Agreements/Consent Orders and Cease & Desist Orders are included. (Source: SNL Financial)
Federal Reserve data based on Written Agreements – www.federalreserve.gov.

(1) Includes Formal Agreements/Consent Orders/Cease & Desist Orders for commercial banks, savings banks and savings institutions.
Data through March 31, 2011.

Regulatory Enforcement Action Statistics

Indexed Deposit Disintermediation

Based on reported total deposits 1-quarter prior to enforcement action⁽¹⁾ compared to deposit totals 1, 2, and 3 quarters after enforcement action was announced. Data is for all companies that reported total assets less than \$2 billion at year-end 2009.

<u>1Q Prior</u>	<u>1Q After</u>	<u>2Q After</u>	<u>3Q After</u>
100.0	98.6	97.3	95.9

(1) Includes commercial banks, savings banks, and savings institutions that received an enforcement action in 2009. Enforcement actions included are: Formal Agreements/Consent Orders, Cease & Desist Orders, and Prompt Corrective Actions.

A Case Study in Public Relations

Northwest Herald, Crystal Lake, IL

May 27, 2010

{Excerpt}

HOME STATE BOOSTS CAPITAL

An agreement between Home State Bank and its regulator has led to improved Tier 1 capital and total risk-based capital at the bank. A Report of Examination, issued in October, spurred the bank to raise capital during the fourth quarter.

“Home State’s been the community bank in this community forever, and we’ve invested in the local economy. We’ve been the largest small business lender, the largest lender to local contractors, roofers and builders in real estate, and those people have been hardest hit by the recession”...

Basic Strategy: Regulatory Enforcement Action 101

- Might debate the magnitude but the not the existence of the problem
- Establish Regulatory Confidence in Management (including the Board of Directors)
- This will buy you time and a longer leash, both of which are needed
- Active Board involvement also protects directors in “worst case” scenario
- Treat regulators with respect and deference

“We appreciate the counsel and guidance that your office provides to the Bank and we are committed to addressing deficiencies noted in the Report of Examination.”

Your NEW Strategic Plan

- Recognize that you are in the “Penalty Box”
- The Bank’s primary strategic objective is to achieve full compliance with the Enforcement Action
- Goal: Termination of the Enforcement Action
- Timing: Plan on a minimum of 2 examination cycles if everything goes right

Forms of Enforcement Actions

- The names of the enforcement actions vary by regulator (FRB, OCC, FDIC, OTS, States)
- Two basic forms: Informal and Formal
- Informal:
 - Memorandum of Understanding
- Formal:
 - Consent Order
 - Formal/Written Agreement
 - Cease and Desist Order (“C&D”)
- Prompt Corrective Action (“PCA”) directives

Specific Enforcement Action Provisions

- Increased Board Involvement
- Credit Administration
- Credit Quality
- Compliance/BSA/Fair Lending Plans
- Capital Plan and/or Individual Minimum Capital Ratios (“IMCR”)
- Management Study and Management Plan
- Liquidity and/or Contingency Funding Plans
- Strategic Plan/Profit Plan
- Violations of Law
- Requirement to submit Quarterly Progress Reports
- Key provisions include mandatory timeframes

Negotiating Enforcement Action Provisions

- Capital: “Bank shall maintain a Tier 1 leverage ratio of 8.0% and a total risk-based capital ratio of 12.0% by [Date]”
- Classified Asset Reduction: amount and timeframe
- Management Study: Case Study

Draft provision required the Bank to complete management study internally; negotiated elimination of the provision

- Timeframe to file Quarterly Progress Report: extend from 30 days after end of quarter to 45 days
- “Advocacy” Letter: an opportunity to make a case to mitigate severity/terms of enforcement action

Compliance Process

- Establish Board Compliance Committee
- Make decision to manage process internally or retain consultant
- Key considerations:
 - Executive management “time allocation”
 - The need for “independent” perspectives
 - Protect Directors: the issue is not about “trust” but rather “reasonable care” and “prudent business judgment”
 - “Best Practices”

Effective Action Strategies

- Determine key management individuals that will have responsibilities in the process
- Develop Exam Response Checklist
- Develop Action Plan Checklist (this is the key tracking document to monitor Enforcement Action compliance status)

Exam Response Checklist

- Line by line review of Report of Examination
- List all noted deficiencies, issues and criticisms
- Assign individual responsibility
- Prepare/assemble written documentation to support compliance
- Board Compliance Committee review process
- Submit to regulators
- Post-implementation validation

Action Plan Checklist

- Key document to systematically monitor progress towards compliance with Enforcement Action
- List each provision in the Enforcement Action
- Individual responsibility for each provision
- Deadline for completion
- Develop written documentation to demonstrate compliance with each provision
- Continually update with “current status”
- Review at periodic Board Compliance Committee meetings
- Submit to regulators with Quarterly Progress Report
- Post-implementation validation

Case Study: Credit Administration

- MOU “upgraded” to Formal Agreement by OCC
- Terms of Formal Agreement limited to credit administration – remaining MOU issues satisfied
 1. Credit Risk Rating
 2. Credit and Collateral Information
 3. Annual Credit Reviews
 4. Appraisal Review Program
- Regulators remain laser-focused on “Best Practices”

Post-Enforcement Action Best Practices: Enterprise Risk Management (“ERM”)

- Establish Board Risk Management Committee
- Comprehensive Risk Management Strategy

Regulatory Expectations – Ask the following questions...

- How does the bank identify risks?
- How does it quantify the risks?
- How does it manage/mitigate the risks?
- How effective is the mitigation?
- Where are the gaps?
- What is the plan to manage the gaps?
- How are the risks/controls monitored?
- What is the Board's understanding of the risk profile of the bank?
- What risk limits has the Board established?

Foundational Components: ERM Program

- Continuous risk identification
- Accurate and timely measurement of risk
- Controls to limit and mitigate risk
- Monitoring to ensure effective management of risks
- Accurate and timely Reporting of Risks at the Management and Board levels

Risk Management Program Overview: Risk Matrix

TYPE OF RISK	DATE OF LAST RISK ASSESSMENT	INHERENT RISK	ADEQUACY OF RISK MANAGEMENT	COMPOSITE RISK	TREND
Credit	January 2011	High	Acceptable	High	Stable
Interest Rate	April 2011	High	Strong	Moderate	Increasing
Liquidity	April 2011	Moderate	Strong	Moderate	Stable
Price	April 2011	Moderate	Acceptable	Moderate	Stable
Foreign Currency Translation	April 2011	Low	Acceptable	Low	Stable
Transaction	June 2011	High	Acceptable	High	Stable
Strategic	June 2011	Moderate	Acceptable	Moderate	Stable
Compliance	September 2011	High	Acceptable	High	Increasing
Reputation	September 2011	Moderate	Strong	Moderate	Stable

EXHIBIT A

Capital Plan Case Study

- \$800 million bank
- Required to maintain IMCR of 8.25% Tier 1 Leverage and 11.00% Total Risk-Based Capital
- Adopted Capital Plan in December 2009

Capital Plan Case Study

Table of Contents

1. Executive Summary
2. Regulatory Capital Guidelines and Current Capital Position
3. Financial Performance History and Peer Group Analysis
4. Parent Company Overview
5. Bank-level Financial Projections
6. Parent Company Cash Flow Projections
7. Capital Stress Test
8. Planned and Strategic Growth
9. Capital Contingency Plan
10. Dividends
11. Levels and Trends in Problem Assets

Capital Plan Case Study

1. Executive Summary

- Establish board policies and directives related to capital
- Key observations: capital ratios, asset quality and earnings
- IMCR (“Individual Minimum Capital Ratio”):
 - 8.25% Tier 1 leverage and 11.00% Total RBC ratio
- Current capital deficiency of \$4 million
- Capital Stress test shows no capital shortfall

Action Items:

- ✓ Issue \$12 million in Subordinated Debentures; \$10 million downstreamed to Bank
- ✓ Balance sheet reduction target of \$75 million
- ✓ Increase ALLL from \$9 million to \$17 million
- ✓ No dividends until return to acceptable performance

Capital Plan Case Study

2. Current Capital Position

- Calculate current capital ratios
- Calculate surplus/deficiency relative to “well capitalized” and IMCR requirements
- Bank had \$4 million deficiency relative to Tier 1 IMCR
- Bank had \$10 million surplus relative to Total RBC ratio IMCR

Capital Plan Case Study

3. Financial Condition and Performance

- Concentrations in construction and CRE
- NPAs increased from \$5 to \$45 million from 2007-09
- NCOs of \$10 million in 2008-09
- Large provision expense to build ALLL
- Net loss of \$10 plus million in 2009
- Efficiency ratio of 65%
- Pre-tax Pre-provision (“PTPP”) earnings rate of \$10 million, or 1.25% of average assets
- Summarized asset quality initiatives
- Peer comparisons indicated low capital, high NPAs, and peer “average” efficiency ratio

Capital Plan Case Study

4. Parent Company Review

- No cash prior to Sub Debt issuance
- No debt prior to Sub Debt issuance
- No operations other than ownership of the Bank

Capital Plan Case Study

5. Bank-level Financial Projections

- \$10 million capital infusion from parent
- Balance sheet reduction of \$75 million in 2010; assume flat balance sheet in 2011 and 2012
- Large public funds deposit business; with sufficient liquidity
- Reduce concentrations in construction and CRE
- Conservative underwriting; Slow loan originations
- 2010 net income forecast at \$1 million with elevated loan loss provision expense and charge-off assumptions
- 2011-2012 Core operating profitability flat; improving GAAP net income driven by decline in NPAs and charge-offs
- Dividends reinstated in 2011 to assist in servicing parent debt

Capital Plan Case Study

6. Parent Company Cash Flow Projections

- Sub Debt fixed interest rate of 8.00% for three years; then variable at 2 year Treasury plus 6.25%; 5 year maturity
- \$2 million beginning cash balance at Parent
- Parent expenses approximately \$1 million per year
- No Bank dividends to Parent in 2010
- Complete projections, including bank performance, debt service, parent level income statement and balance sheet, reconciliation of equity and cash

Capital Plan Case Study

7. Capital Stress Test

- Followed the Supervisory Capital Assessment Program (“SCAP”) framework – the Big Bank Stress Test
- Conservative, 2-year forward looking model designed to provide capital buffer against higher than expected losses
- “Base” case of \$18 million in NCOs; “More Adverse” scenario of \$27 million in NCOs

Basic SCAP Model:

1. Equity **plus** “Excess” ALLL **plus** 2-year PTPP earnings
2. Less 2-year estimated NCOs
3. Projected “Asset” and “Risk Weighted Asset” levels critical to the calculation
4. Calculate estimated capital ratios; and surplus/deficiency vs. IMCR
5. Analysis demonstrated surplus of \$2.6 million under “More Adverse” scenario

Capital Plan Case Study

8. Planned and Strategic Growth

- Affirmative statement regarding anticipated balance sheet growth during the planning period
- Would include organic growth, or growth as a result of planned or opportunistic branching or acquisitions
- Concise summary so there is no confusion among management, the board of directors and the bank's regulator

Capital Plan Case Study

9. Capital Contingency Plan

- What happens if projections are not achieved?

Contingency Plans:

1. Holding company to raise capital (form and priority)
2. Sell assets to generate gains
3. Further balance sheet deleveraging
4. Change balance sheet mix to lower risk weighted assets
5. Sell the Bank/Company

Capital Plan Case Study

10. Dividends

- Affirmative statement that dividends have been suspended
- Note the importance of holding company debt service and shareholder dividends
- Set the stage for the circumstances under which dividends could be reinstated
 - * Core earnings
 - * GAAP earnings
 - * Achievement of plan projections
 - * Reduction in NPAs
 - * Credit, Interest rate and Liquidity risk profile
- Make dividend reinstatement part of the “plan”

Capital Plan Case Study

11. Levels and Trends in Problem Assets

- Acknowledge the direct correlation between Problem Assets and “adequacy” of Capital
- Review both NPA and Classified asset metrics
- Review specific asset quality improvement initiatives
 - * independent loan review
 - * more aggressive loan collection strategies
 - * enhanced credit administration processes
 - * increased staffing
- Targeted Non-accrual and OREO balances included in financial projections

Capital Plan Case Study

Monitor Results

- Management to prepare quarterly report comparing actual performance to plan
- Board shall review and note in minutes
- Plan may be modified based on material variance

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Questions & Answers

Austin Associates Contact Information

Austin Associates, LLC

7205 West Central Avenue

Toledo, OH 43617

419.841.8521

www.austinassociates.com

Craig J. Mancinotti

Managing Director and Principal

craig.mancinotti@austinassociates.com

John R. Reisner

Managing Director

jreisner@austinassociates.com