

Capital Preservation 2010

Essential steps to get you there...
Essential steps to keep you there.

A Live Webinar Presented by:
Austin Associates, LLC

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Webinar Agenda

- About Austin Associates
- Webinar Overview
- Credit Risk and Problem Loan Administration
- Stress Testing and Capital Implications
- Enterprise Risk Management
- Action Items
- Q&A

About Austin Associates

- 40 years serving the community banking industry
- Customized consulting specialties:
 - Investment Banking
 - Regulatory Consulting
 - Financial Management
 - Risk Management
 - Insurance & Financial Services
- For additional information:

www.austinassociates.com

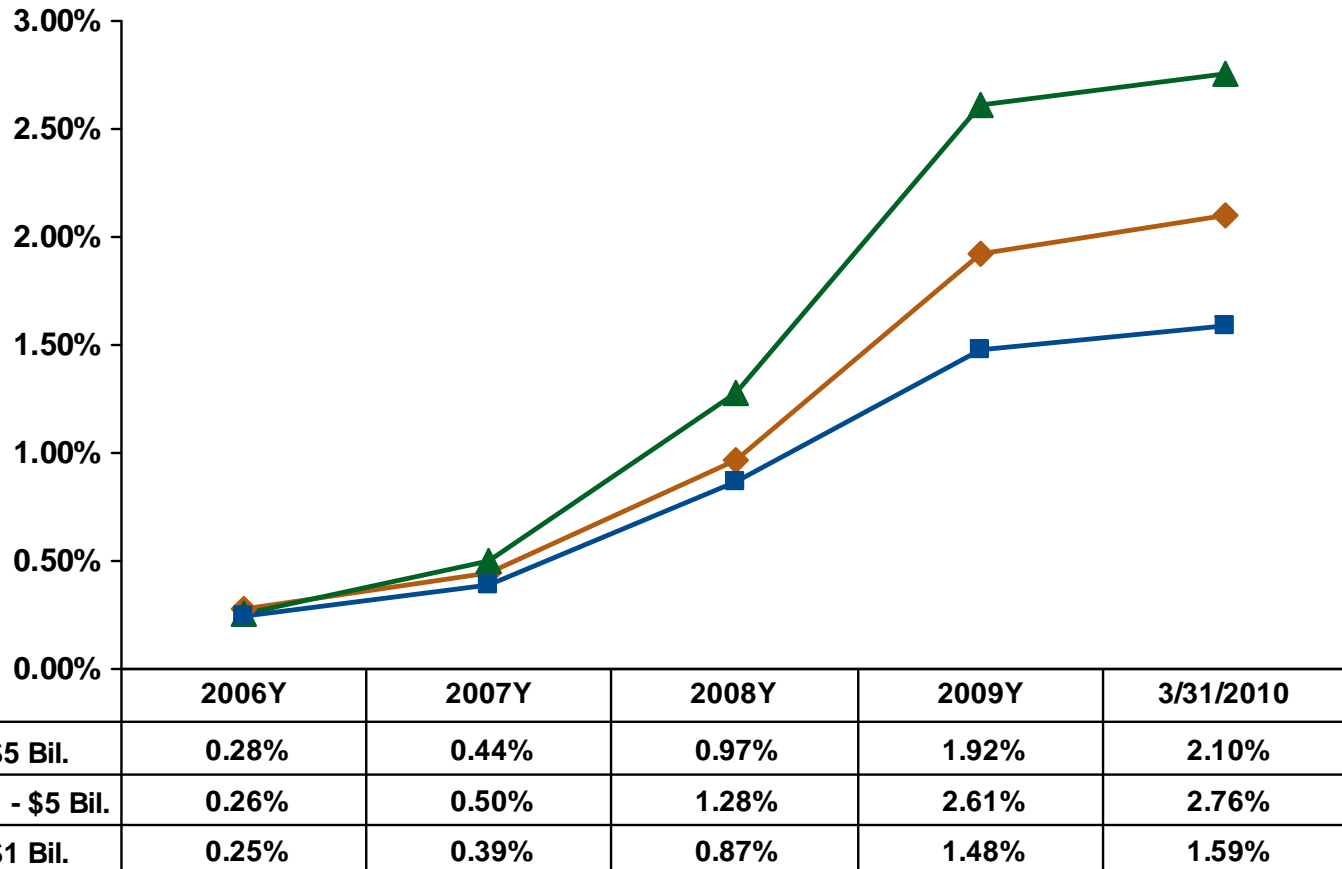
Environment Overview

Where are we today? Altered environment requires more discipline around old banking standards – credit risk administration and capital planning – but “there is nothing old school about the new expectations...”

- Industry-wide NPAs increased over SIX fold since 2006
- LLR levels have not kept pace – capital under pressure
- Texas Ratios – increased 500% to 900% since ‘06
- 691 Enforcement Actions in 2009 – 309 added by June 11, 2010
- FDIC’s problem bank list up to 775 with \$431 billion of assets 1Q10
- 140 failed banks in 2009; 83 as of mid-June 2010

Nonperforming Assets as a % of Total Assets

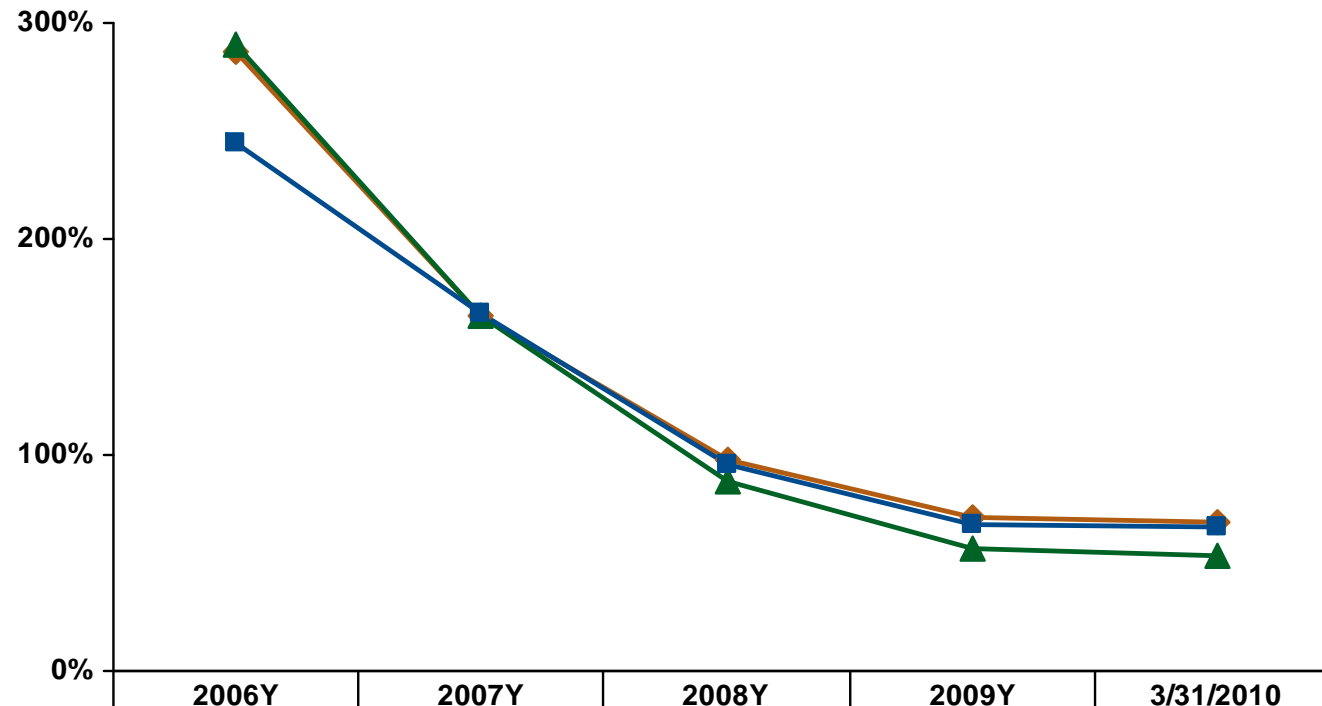
Median U.S. Bank & Thrift Data



Note: Nonperforming Assets = Loans 90 Days Past Due + Nonaccrual Loans & Assets + OREO + Restructured Loans

Loan Loss Reserve as a % of Nonperforming Loans

Median U.S. Bank & Thrift Data

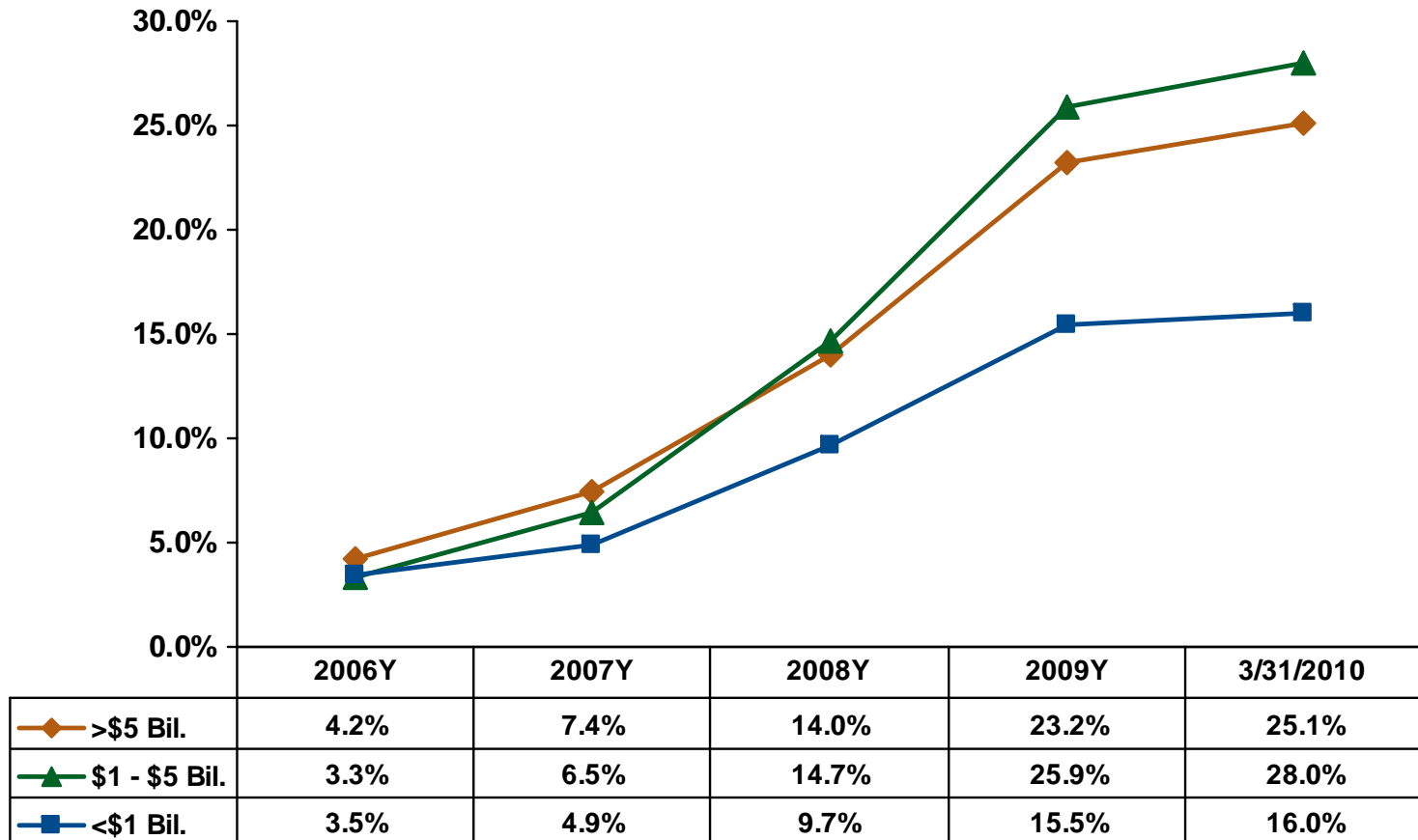


>\$5 Bil.	287%	165%	98%	71%	69%
\$1 - \$5 Bil.	290%	164%	88%	57%	53%
<\$1 Bil.	244%	166%	96%	68%	67%

Note: Nonperforming Loans = Nonaccrual Loans + Restructured Loans.

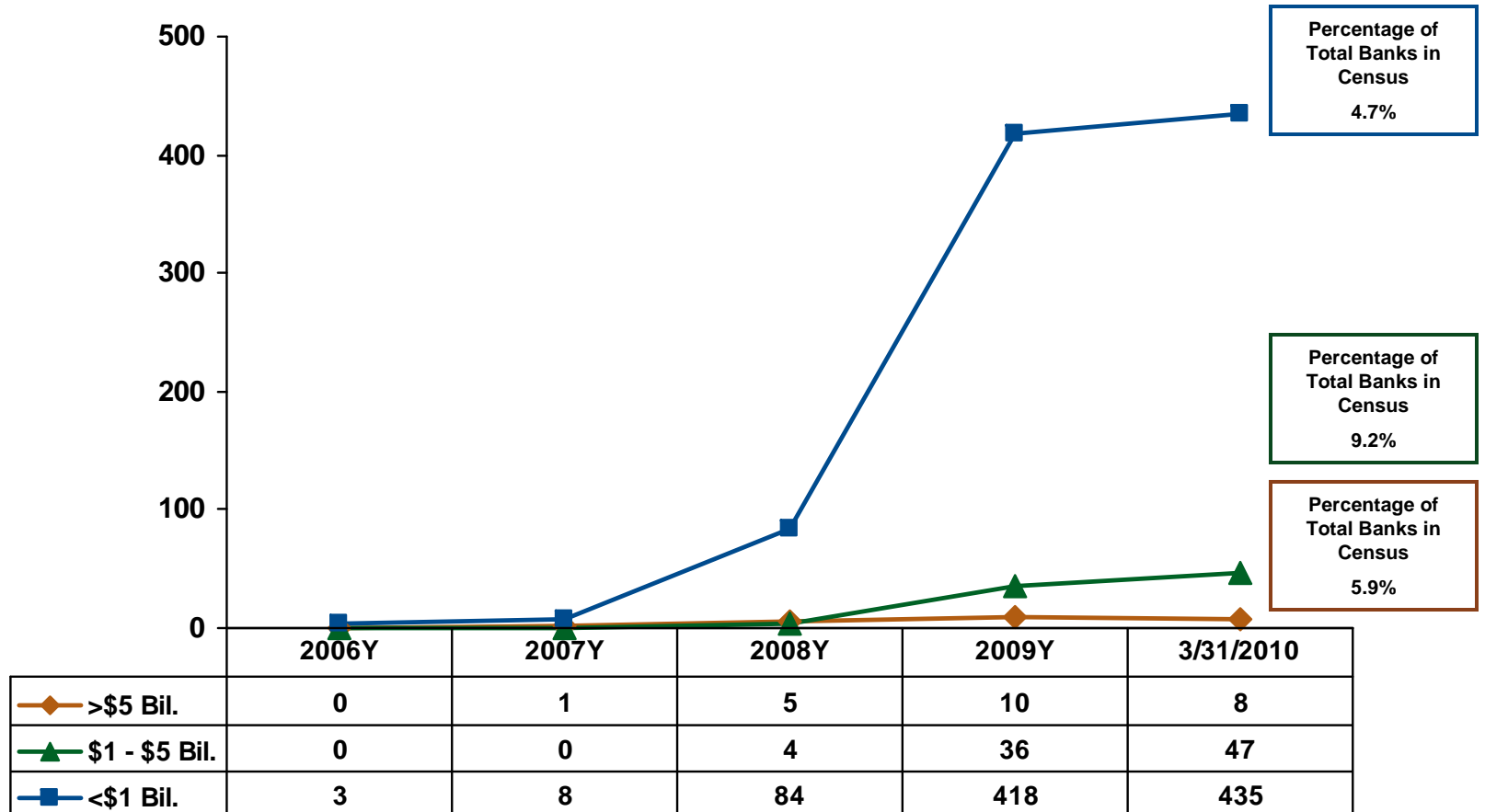
Texas Ratio: Nonperforming Assets / Capital (Tangible Equity + Loan Loss Reserve)

Median U.S. Bank & Thrift Data



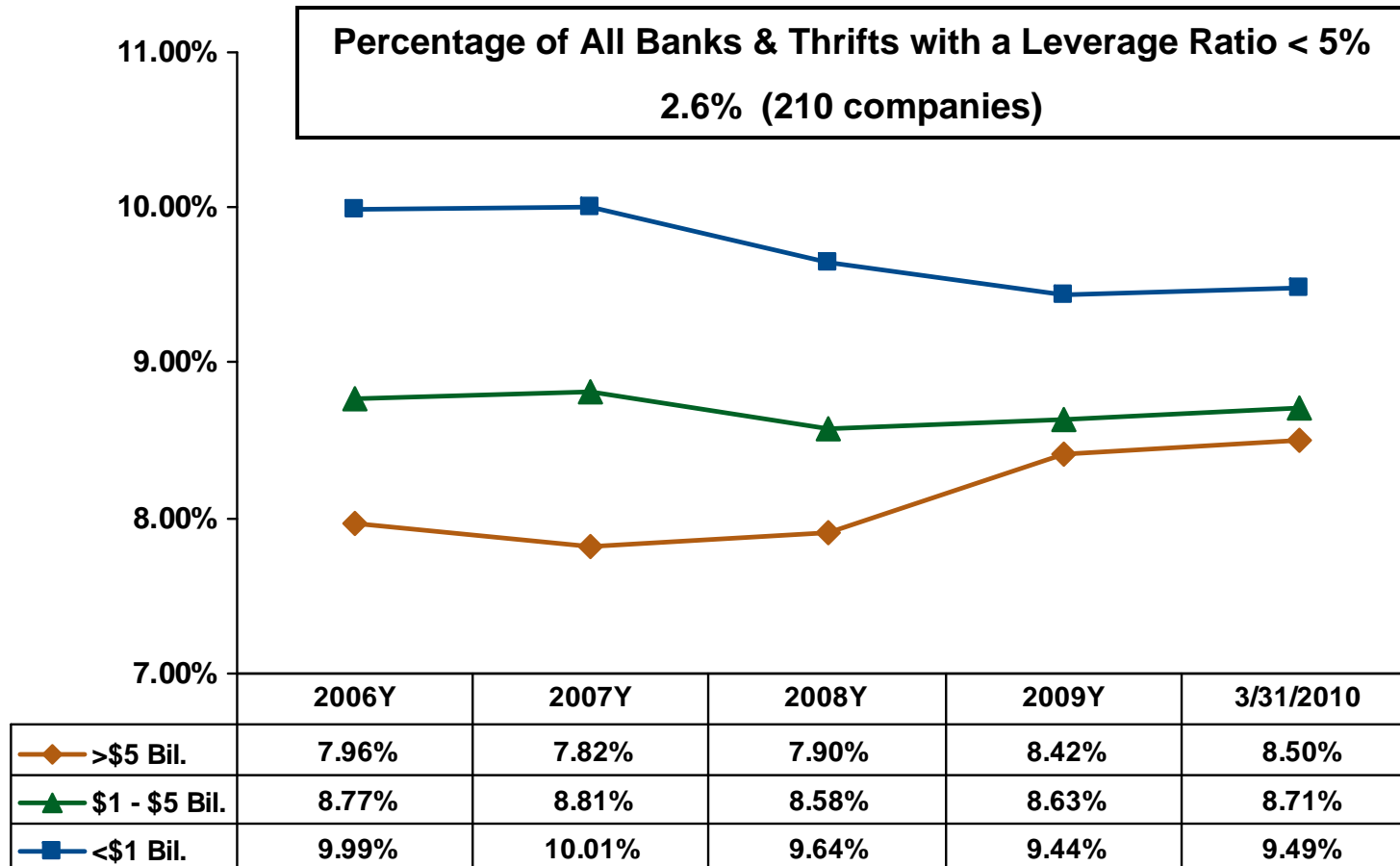
of Banks with a Texas Ratio Greater Than 100%

Median U.S. Bank & Thrift Data



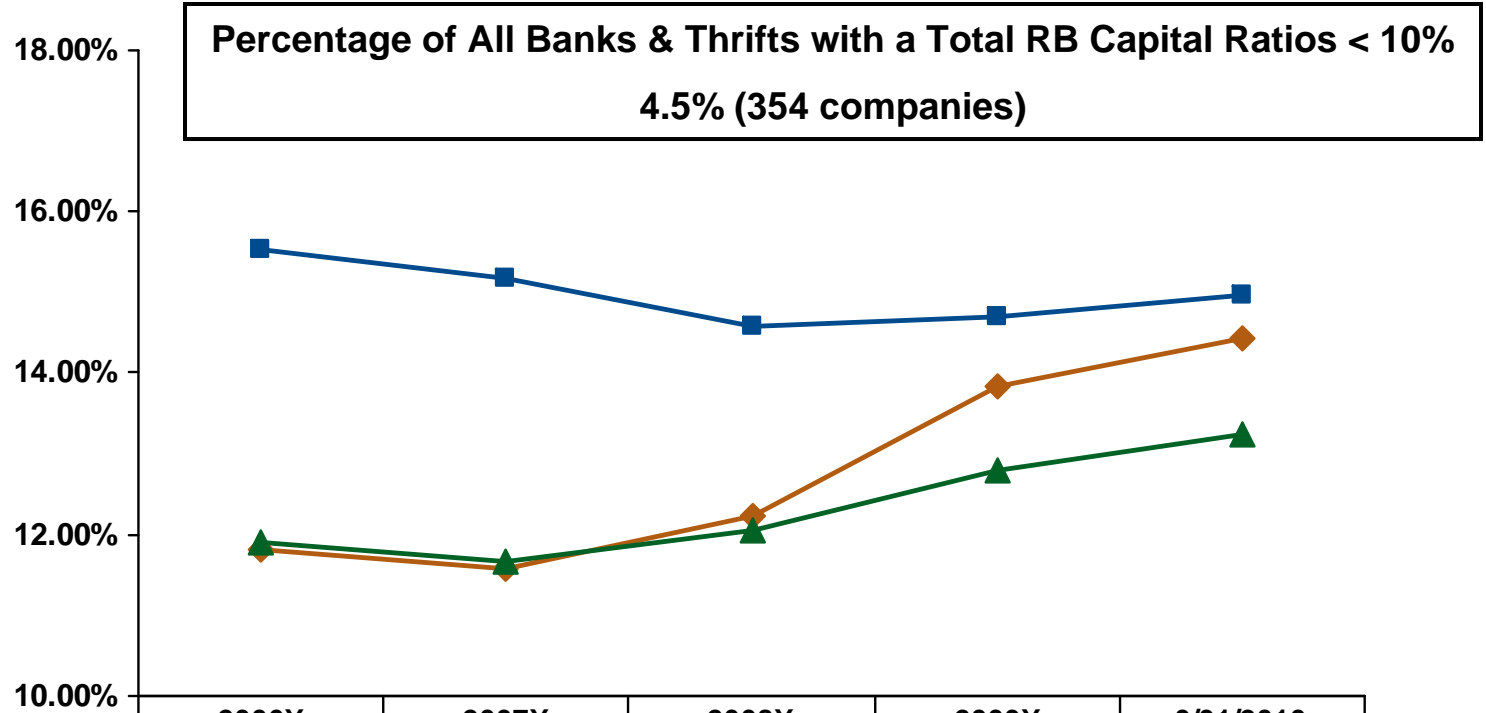
Leverage Ratio

Median U.S. Bank & Thrift Data



Total Risk-Based Capital Ratio

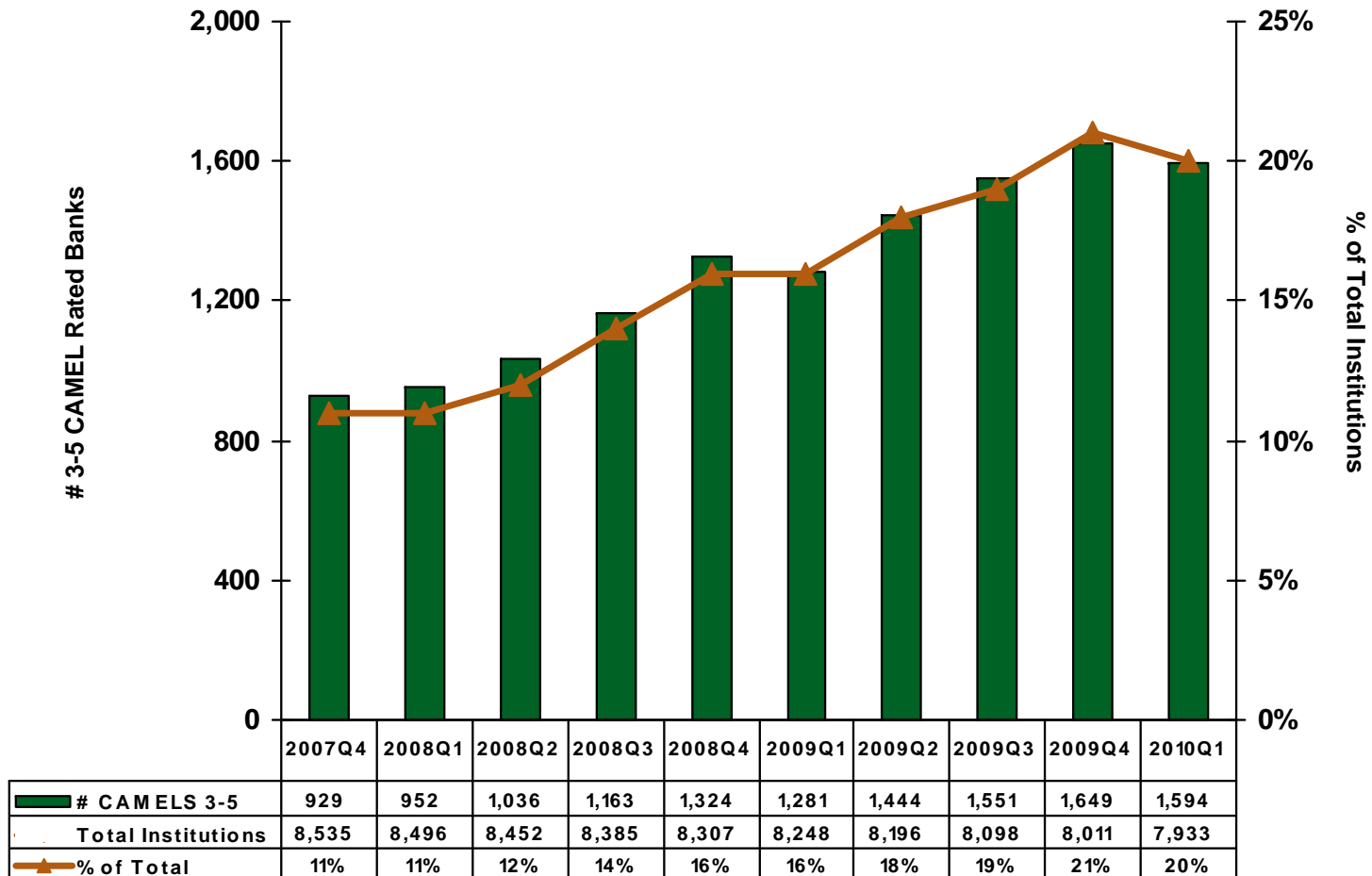
Median U.S. Bank & Thrift Data



	2006Y	2007Y	2008Y	2009Y	3/31/2010
◆ >\$5 Bil.	11.82%	11.57%	12.22%	13.83%	14.42%
▲ \$1 - \$5 Bil.	11.90%	11.66%	12.04%	12.80%	13.25%
■ <\$1 Bil.	15.53%	15.18%	14.59%	14.71%	14.96%

Estimated Banks with CAMELS 3-5 Ratings

Estimated CAMELS Scores of 3-5 Represent Moderate to Severe Degree of Regulatory Concern

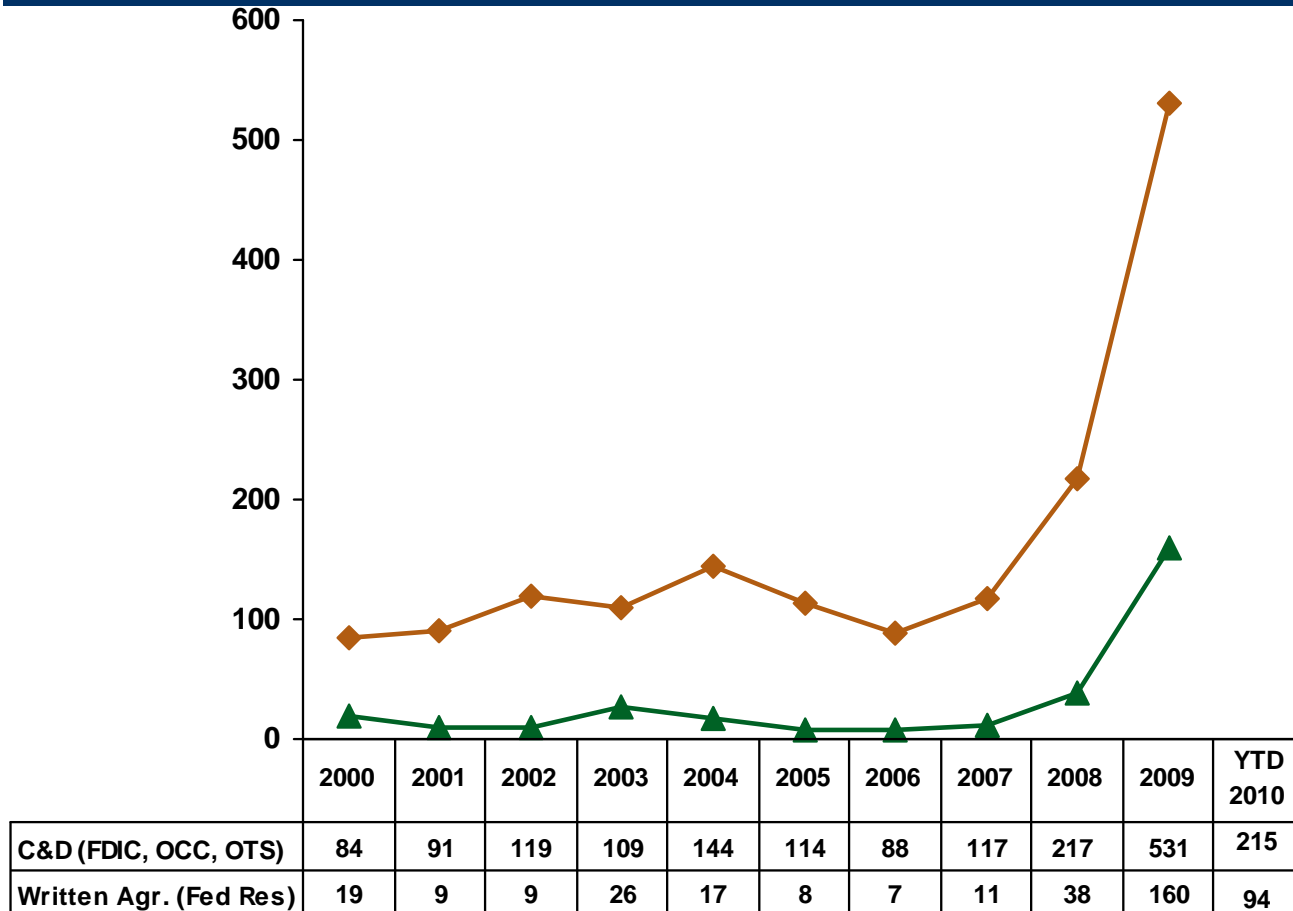


Note: Includes Commercial Banks, Savings Banks & Savings Institutions.

CAMELS Scores estimated based on Veribanc safety ratings. (Source: SNL Financial)

Regulatory Enforcement Actions

C&D Orders & Written Agreements Issued by the FDIC, OCC, OTS & Federal Reserve



Note: YTD 2010 through June 11, 2010. Number of C&D Orders based on the most recent data as provided by each regulatory agency. Totals shown do not net out those orders which were terminated or modified.

Environment Overview

What else do we see in the environment today?

- **CAMELS** Ratings are more **unpredictable**
- Increased focus on **Asset Quality** component, Management rating following A, E, L, C ratings
- Capital requirements are increasing – **new “unwritten” Well-Capitalized guidelines, or are they?**
- **Credit and loan portfolio management never more critical**
- **Proactive, preventive, documented ERM practices** yield strategic and regulatory benefits
- **Piling on is evident** – starts with Credit...then flows to BSA to Information Security to Business Continuity and more

Credit Risk and Problem Loan Administration

Recent Client Feedback and What it Means

- **Asset Quality** absolutely drives exam results: A-E-L-C-M – “**the domino effect**”
- Focus is on **concentrations** and portfolio management – expectation that you **accurately identify, actively monitor, proactively manage**
- **Timely risk identification** - timely action
- **Aggressive problem loan management** – TDRs and impairment
- Ability to withstand AQ deterioration – **ALLL, earnings and capital adequacy**
- **Documentation and support, and then some...**

Credit Risk Administration

Examiners looking for...

- **Aggressive and effective risk identification** – If they downgrade, suggest N/A, allowance methodology brought under fire
- Appropriate recognition of risk level – **well-defined weakness vs. potential** for weakness – don't ignore a smoking gun
- **Concentrations...risk limits set, policy in compliance, portfolio stress testing**
- Involve the right people – **communication** is key to avoiding the “deer in headlights” look
- Ensure your **loan review provider** is keeping pace in this rapidly evolving environment

Problem Loan Management

Examiners looking for...

- Consistent and **DOCUMENTED** process for troubled debt restructures and impairment testing
- Timeliness of ratings and loss recognition – **challenge assumptions, take action**
- Ensure **independent, timely, well documented validation of collateral values** – BPOs are not cutting it
- Be well versed on **2009 Policy Statement on Prudent CRE Loan Workouts**, and prepare to **defend actions IN WRITING, IN ADVANCE OF EXAM** – Be ready!

ALLL and Problem Loan Management

Impairment testing - FAS 114

- Policy – Comply with ALLL policy statement, define **materiality threshold, parameters** for testing
- Process starts with a **2-part question**:
 - 1) **Is it impaired?** If No, loan goes back in pool for FAS 5
 - 2) **If Yes, determine loss by 1 of 3 valuation methods**
 - Fair value of collateral
 - Present value of expected future cash flows
 - Observable market price of loan
- **Reserve/charge off shortfall – may be \$0 – do not place back in pool**
- **FAS 5 considerations – documentation of qualitative factors, use of relevant historical performance**

Capital Preservation

– essential steps to get you there

Capital Preservation – bank preservation – starts and ends with robust credit risk and problem loan administration practices...

- Asset Quality drives the ratings – A-E-L-C-M
- Know your level of **Classified Assets to Capital** – over 40% is a red flag...getting close is too
- **Self-Awareness, proactive, pre-inspection** before examination
- **Challenge your processes** – underwriting, risk rating, timeliness of loss recognition, loan review
- **Sloppy process impacts** determination of **allowance adequacy**

Stress Testing and Capital Implications

Stress Testing

Examiners looking for...

- Activities/analyses to **quantify the impact of changing economic conditions on asset quality, earnings and capital**
- Practices should be **consistent with size, complexity and risk characteristics** of the loan portfolio
- May be as simple as analyzing the potential **effect of stressed loss rates on the loan portfolio, earnings and capital**

Stress Testing – The Approach

- **Stress testing at the loan level** is critical to evaluating the **current and future viability of the borrower or business.**
- **Stress testing commercial real estate loans is critical to managing concentrations** that could quickly sap capital. If the market or borrower deteriorates, collateral dependency may lead to unanticipated loss.
- **Stress testing at the portfolio level considers risk in all loan classifications,** regardless of loan type, purpose or collateral.

Supervisory Capital Assessment Program (SCAP)

- **Federal Banking Regulatory Agencies**
- 19 largest financial institutions
- **Projected baseline/more adverse losses**
- **Baseline loss** rates ranged from **4-20%**
- **More adverse loss** rates ranged from **8-25%**
- **Determine ability to withstand increased loss rates given revenue projections and capital levels**
- **Impact/application to community banks**

Modified SCAP

Model the SCAP process, but tailor to your bank

- **Bank specific** information
- **Portfolio** characteristics
- Develop **multiple loss scenarios** based on past performance, portfolio composition, origination vintage, borrower characteristics, local and national economic environment
- **Evaluate impact on earnings and capital**

Stress Testing – the essential step to continued Capital Preservation

- **Evaluate the sufficiency of earnings** to meet challenges of declining asset quality
- Identify potential **impact to capital** levels
- **Stress test the portfolio to quantify the impact of changing economic conditions on asset quality, earnings and capital – prepare for contingencies!**
- Focus on the more **vulnerable segments** of the loan portfolio in relation to the **prevailing market environment** and institution's **business strategy**
- **Results of the stress test will answer the question – “Is a capital contingency plan required?”**

Enterprise Risk Management

Enterprise Risk Management

“Our examiners have been giving us strong risk management ratings for years. How did my bank go from strong to weak ratings in risk management (and probably the CAMEL Management rating) when we didn’t do anything differently?”

Enterprise Risk Management

There's risk management, then there's effective risk management; the latter is the key to capital preservation

•Critical control activities – they're all risk management – but are they effectively identifying and mitigating risk? Challenge your assumptions.

- Credit risk management
- Loan review
- Internal/External audit
- ALCO
- Capital planning and budgeting
- Business continuity planning
- Information security
- SOx
- BSA Program
- Compliance Program

Enterprise Risk Management

Can Executive Management answer the following questions...How about your Board?

- How does our organization identify risks?
- How do we quantify the level of risks?
- How do we manage/mitigate the risks?
- How effective is the mitigation?
- Where are the gaps?
- What is our plan to manage the gaps?
- How are risks/controls monitored?
- **What is the Board's understanding of the overall risk profile?**
- **What risk limits has the Board established?**
- **How does Board hold Management accountable for managing within those risk limits?**

Foundational Components of an effective Risk Management Program

- **Continuous** risk identification
- Accurate and timely **measurement** of risk
- Controls to limit and mitigate risk
- **Monitoring effectiveness of controls** to ensure effective management of risks
- **Accurate and timely reporting** of risks at the Management and Board levels

Business Organizational By-products of an effective Risk Management Program

- Properly **evaluate** and manage **new technologies**
- Properly assess and **implement product innovation**
- Properly respond to and **navigate** swift or unexpected **market changes**
- Properly **align with** emerging **regulatory requirements** and supervisory expectations

Board Oversight By-products of an effective Risk Management Program

- Board has a clear **understanding** of the inherent **risks** of the business
- Board has a clear **understanding** of the **controls** in place to manage the risks
- Board has a clear **understanding of the effectiveness of those controls**
- Board uses the **knowledge to establish policies and risk limits**

Five Vital Action Items for an effective Risk Management Program

- Take a **formal inventory of the key risks/risk factors** at the product and functional activity level. **Quantify the level and direction** of the risks.
- Take a **formal inventory of your mitigating controls** and **assess** their **effectiveness**.
- **Identify the under-mitigated risks** and **develop an action plan**.
- Independently **test assumptions and conclusions**.
- **Include and inform your Board** every step of the way.

How to Get Started

– develop the charter, develop the framework

- **Develop the charter**
 - Establish objectives
 - Establish timeframes
 - Establish deliverables
 - Identify responsible parties
 - Document in charter and policy
- **Develop the framework**
 - Consider organizational structure
 - Identify existing control activities
 - Evaluate opportunities to leverage
 - Avoid potential for redundancies

How to “Make it Stick” – embedding risk management culture in day-to-day business

- **Thinking like an owner**
- **Everybody’s job**
- **Cross organization and departmental lines**
- **Communication and information sharing**
- **A mindset – not (just) metrics**
- **A journey – not a destination**

What it all means...

Risk Management...

**Disciplined, effective and efficient
Risk Management**

Equals

Capital Preservation

Action Items

Action Items for Capital Preservation

1. Determine and document what you are doing internally to manage credit and asset quality risk.
2. Determine and document – with timeframes – what you are doing differently (i.e., enhancements) to manage these risks as the credit deterioration snowball got rolling.
3. Determine and document – with timeframes – additional activities you will be putting in place to better manage further deterioration.

Examples include:

- Stress testing your loan portfolio
- Evaluating and enhancing overall credit risk management processes, procedures and personnel

Action Items for Capital Preservation

4. Review concentrations and ensure approach to manage fits risk profile (risk is high if *nearing* guidance limits) – Know what regulators are reviewing.
5. Evaluate your Board reporting package. Are they getting “the right stuff”? Are they adequately informed about risks in such a way they can provide guidance, limits, etc. and fulfill their oversight duties? In addition to financial analysis, think focused, summary information for credit, operational, liquidity, market, legal and reputational risk areas.
6. Don't wait for the exam request letter before starting prep. Pull out your last exam request letter, response and exam report. Engage all the right folks in the process. This is no time for the CEO to pull all the cards into his/her chest. It will take a team to get this done right. Prepare-test-prepare more. Did committed fixes work?

Action Items for Capital Preservation

7. Prepare an agenda and discussion outline for a “pre-examination” meeting with your EIC and his/her team; tell them your story – what you’ve done and how management and the board are more involved than ever before. Include information on stress test results, capital plan, and more.
8. Update policies, procedures, stress tests and capital plans
 - Validate analyses and results with third-party assessments
 - Consider board resolution on action items
 - Consider board resolution on internal capital targets (think beyond current well-capitalized guidelines)

Q & A

Q&A

- Questions not answered during the webinar can be submitted via email to info@austinassociates.com; Answers not related to a specific bank issue will be posted on our website at www.austinassociates.com
- Specific questions involving your bank will be accorded the appropriate confidentiality
- The Austin website will include a link to replay the webinar and will provide you with the ability to download all presentation slides
- Austin can prepare a customized webinar (or on-site, if preferred) for your board of directors and/or management team