

Preparing for Your Next Regulatory Examination

**A Live Webinar Presented by:
Austin Associates, LLC**

Presenters:

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Webinar Agenda

- About Austin Associates
- Webinar Overview
- Credit Risk Management – John Reisner
- Liquidity Management – Bob Morgan
- Capital Planning – Rick Maroney
- 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 & Compliance
 - Insurance & Financial Services
- For additional information:

www.austinassociates.com

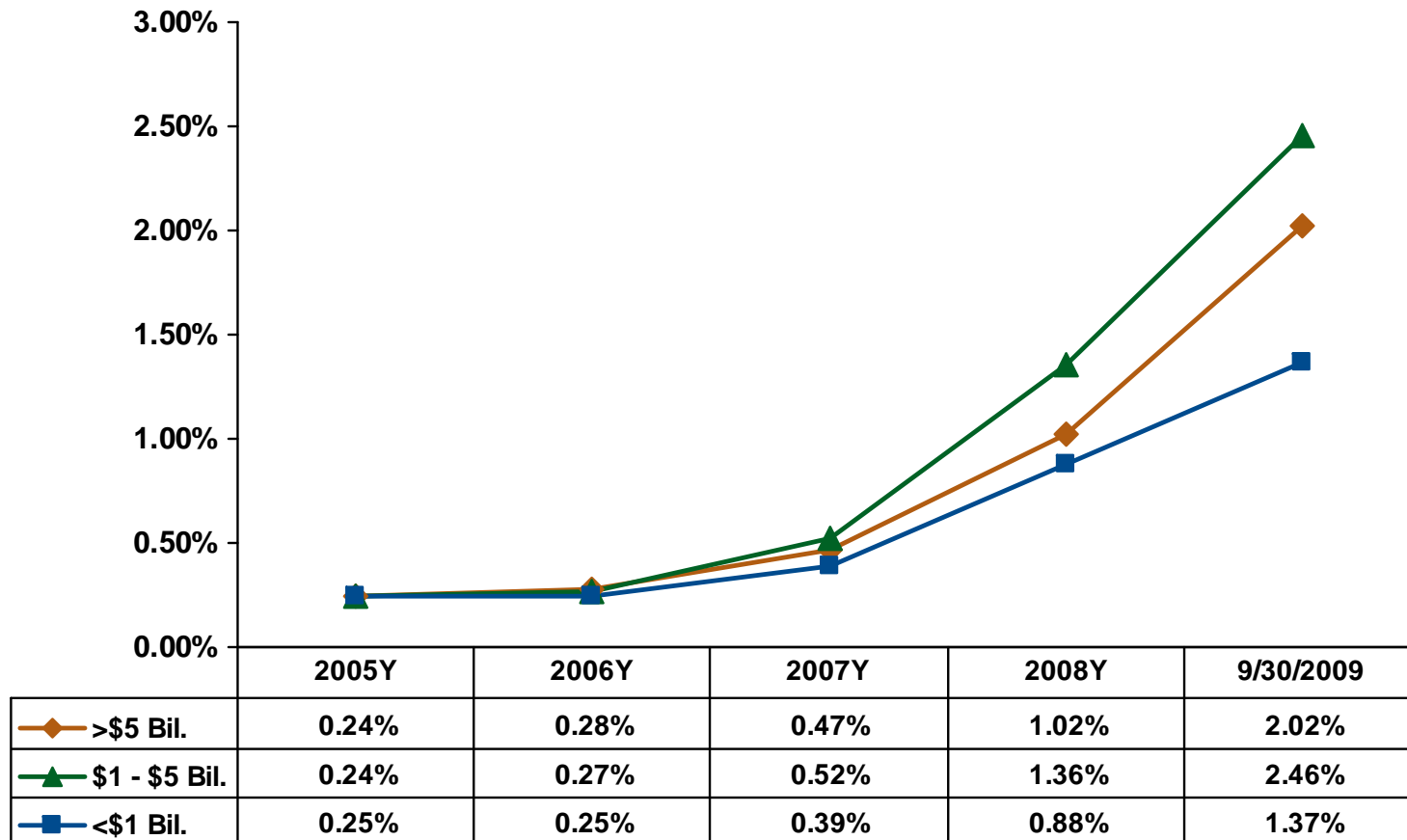
Webinar Overview

Why has the regulatory exam process intensified?

- Industry-wide nonperforming asset levels have increased nearly FIVE fold since 2006
- LLR levels have not kept pace and profits and capital ratios are under severe pressure
- 668 banks & thrifts are under a formal regulatory enforcement action (C&D or Written Agreement)
- FDIC's problem bank list at 9.30.09 was 552 with assets of \$346 billion
- The Deposit Insurance Fund has a deficit balance of \$8.2 billion at 9.30.09 or -0.16% of insured deposits

Nonperforming Assets as a % of Total Assets

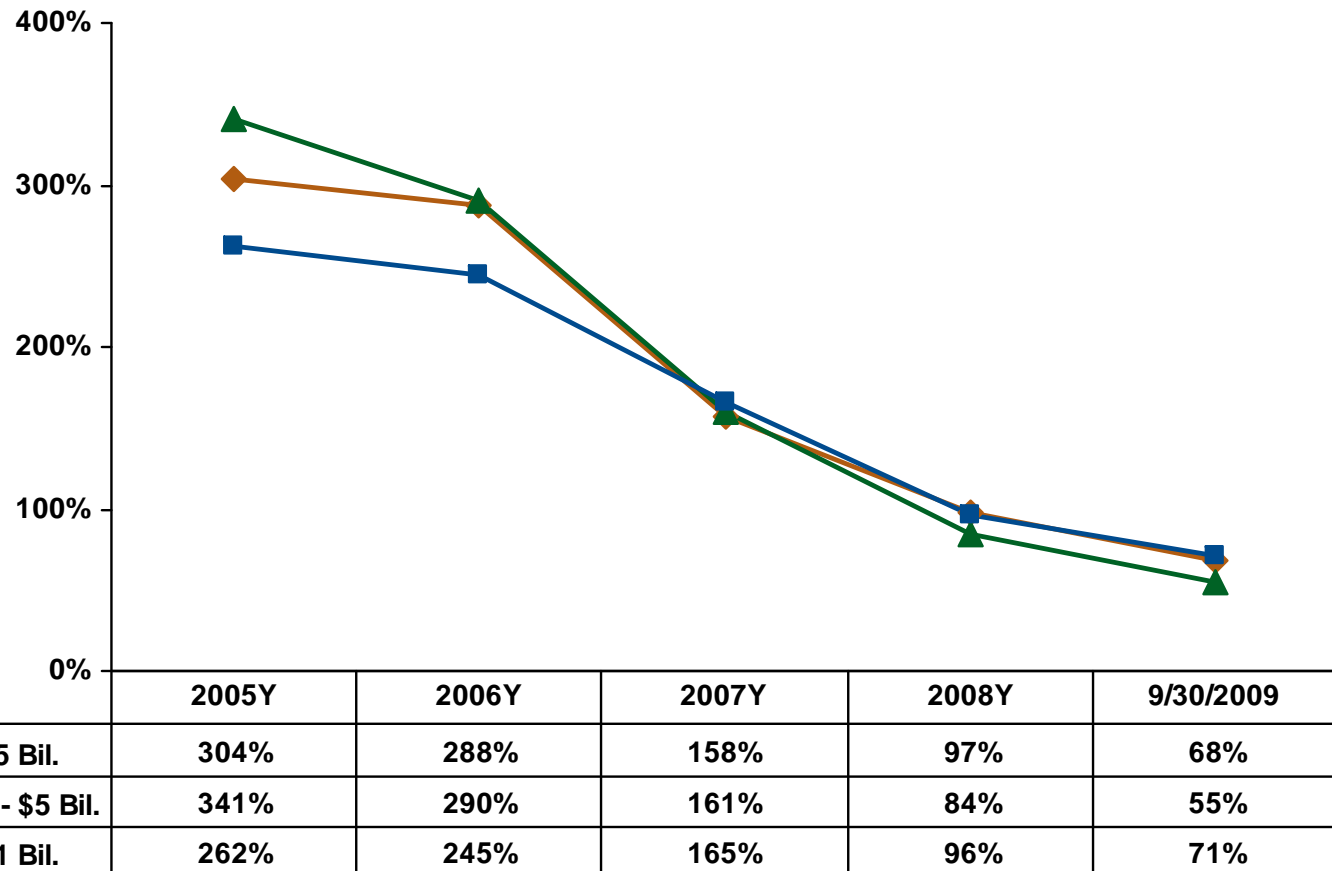
Median U.S. Bank & Thrift Data by Asset Size



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

Loan Loss Reserve as a % of Nonperforming Loans

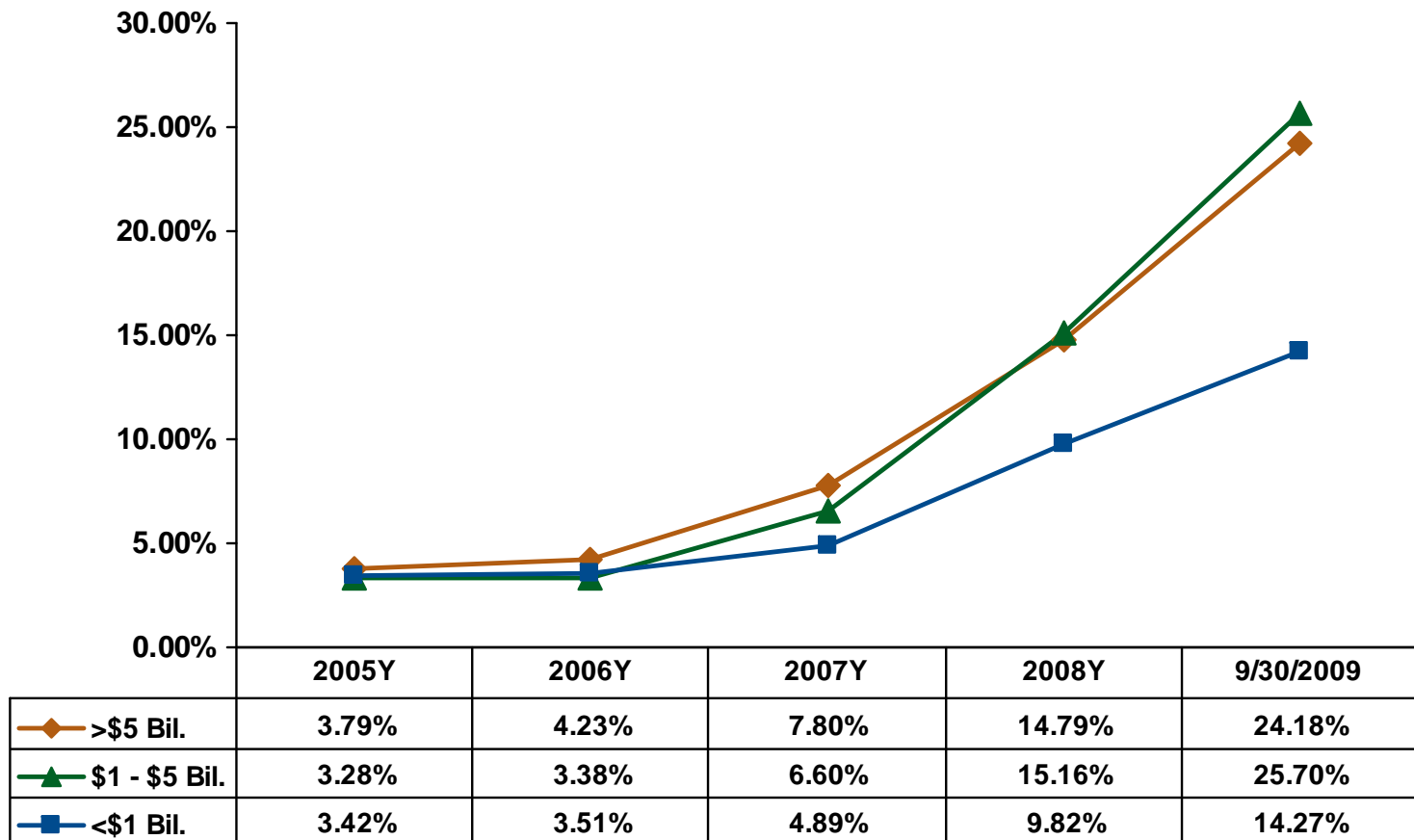
Median U.S. Bank & Thrift Data by Asset Size



Note: Nonperforming Loans = Nonaccrual Loans + Restructured Loans.

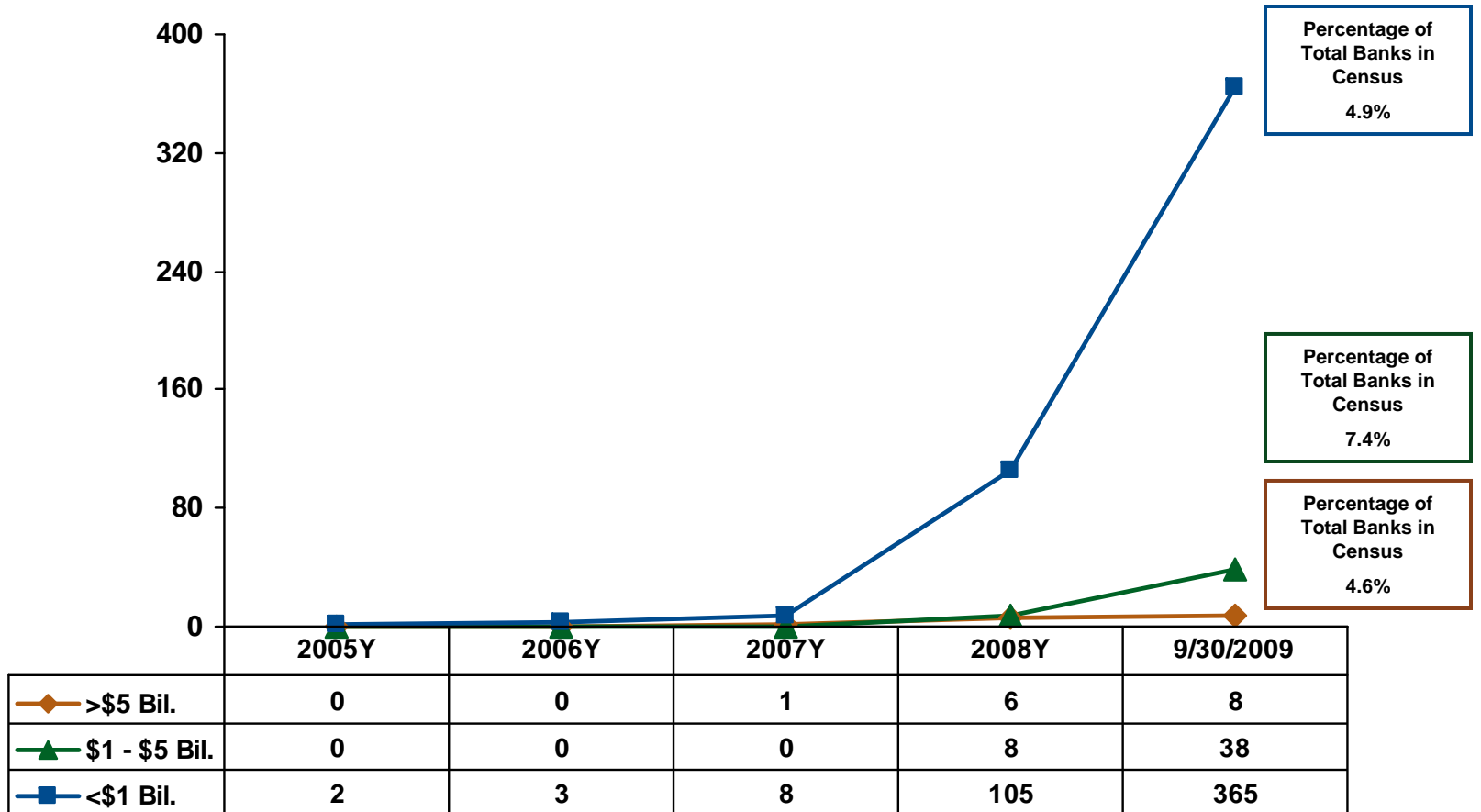
Texas Ratio: Nonperforming Assets / Capital (Tangible Equity + Loan Loss Reserve)

Median U.S. Bank & Thrift Data by Asset Size



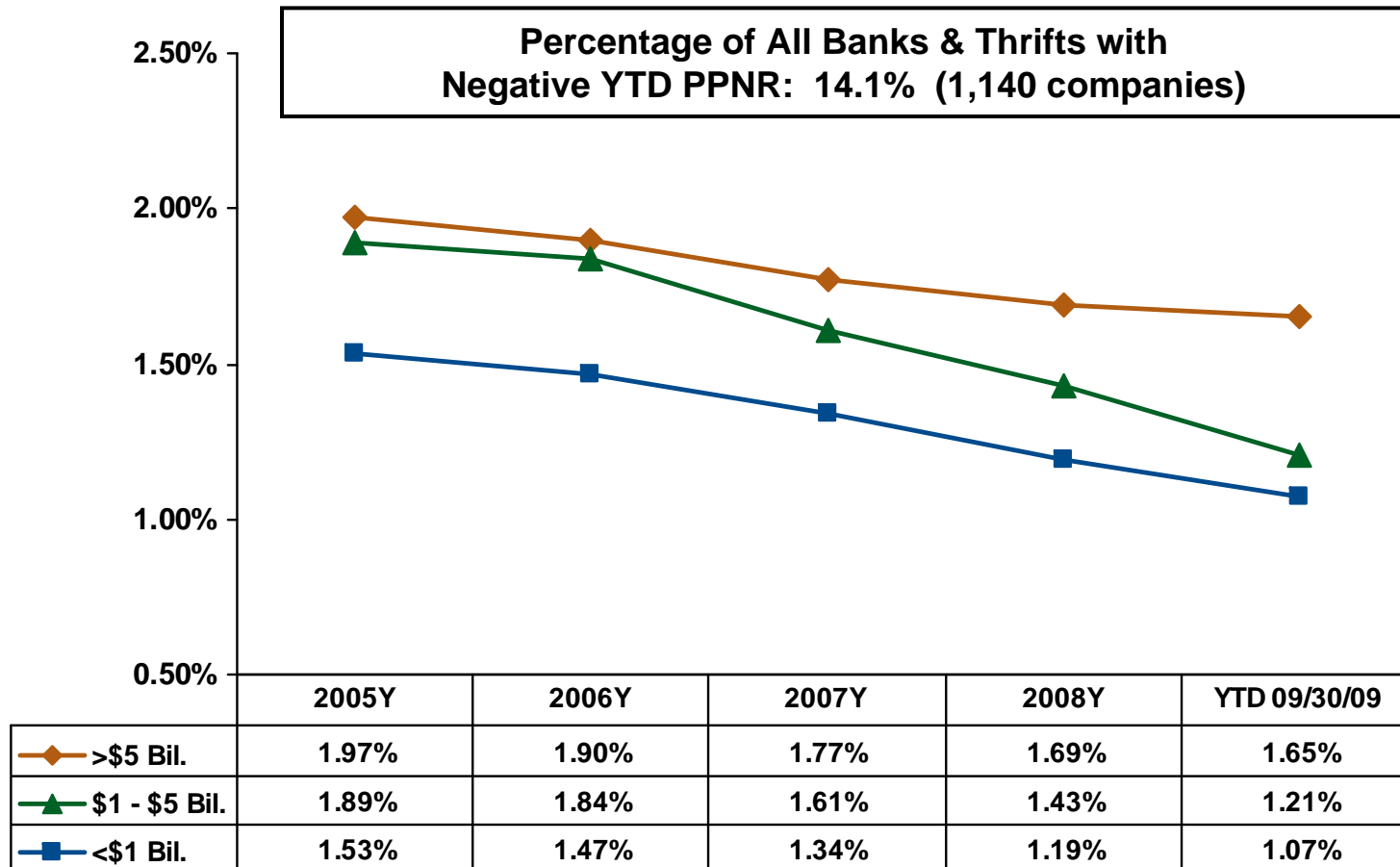
of Banks with a Texas Ratio Greater Than 100%

Median U.S. Bank & Thrift Data by Asset Size



Pre-Provision Net Revenue / Average Assets

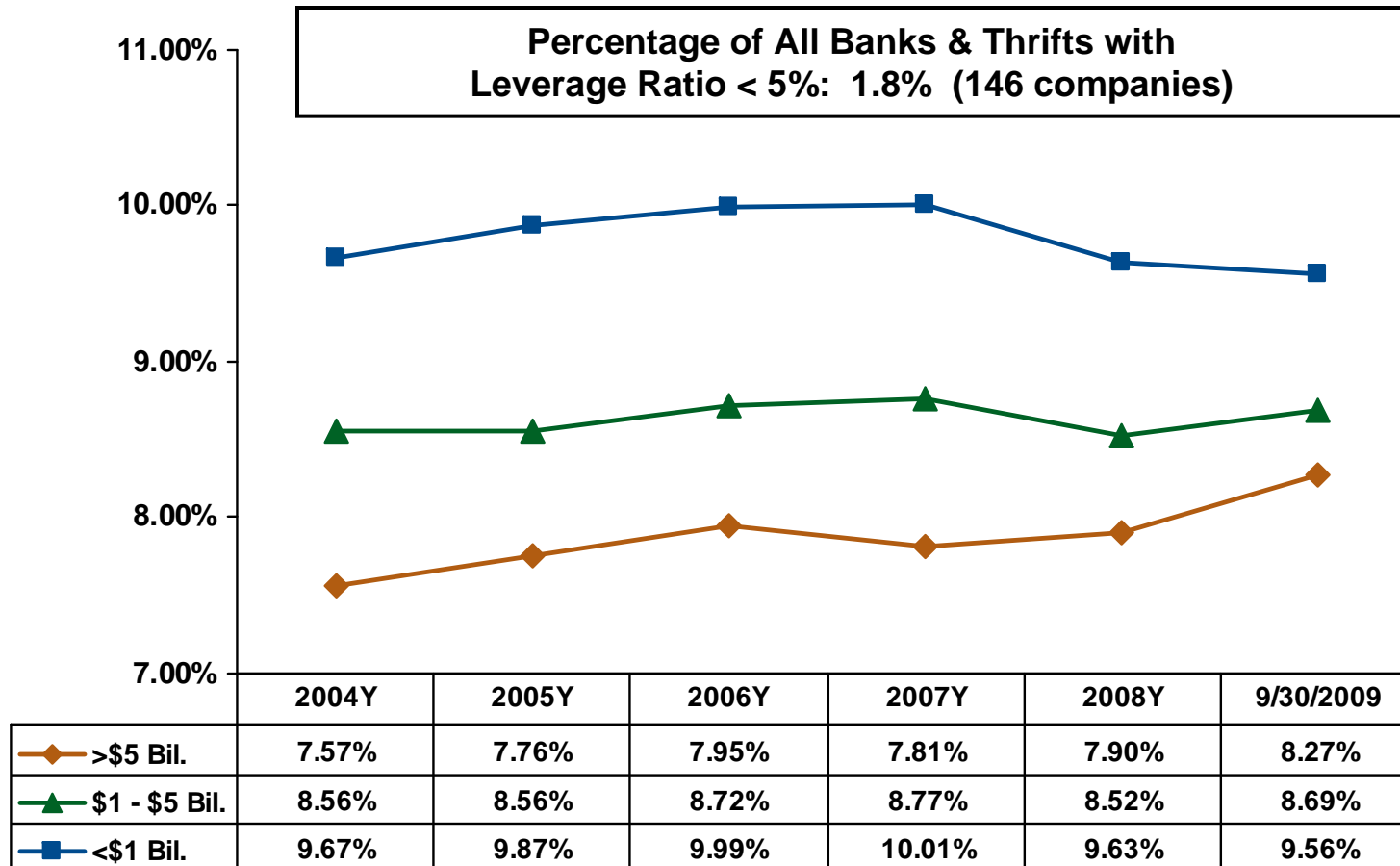
Median U.S. Bank & Thrift Data by Asset Size



Note: Pre-Provision Net Revenue (PPNR) = Pre-Tax Pre-Provision Income

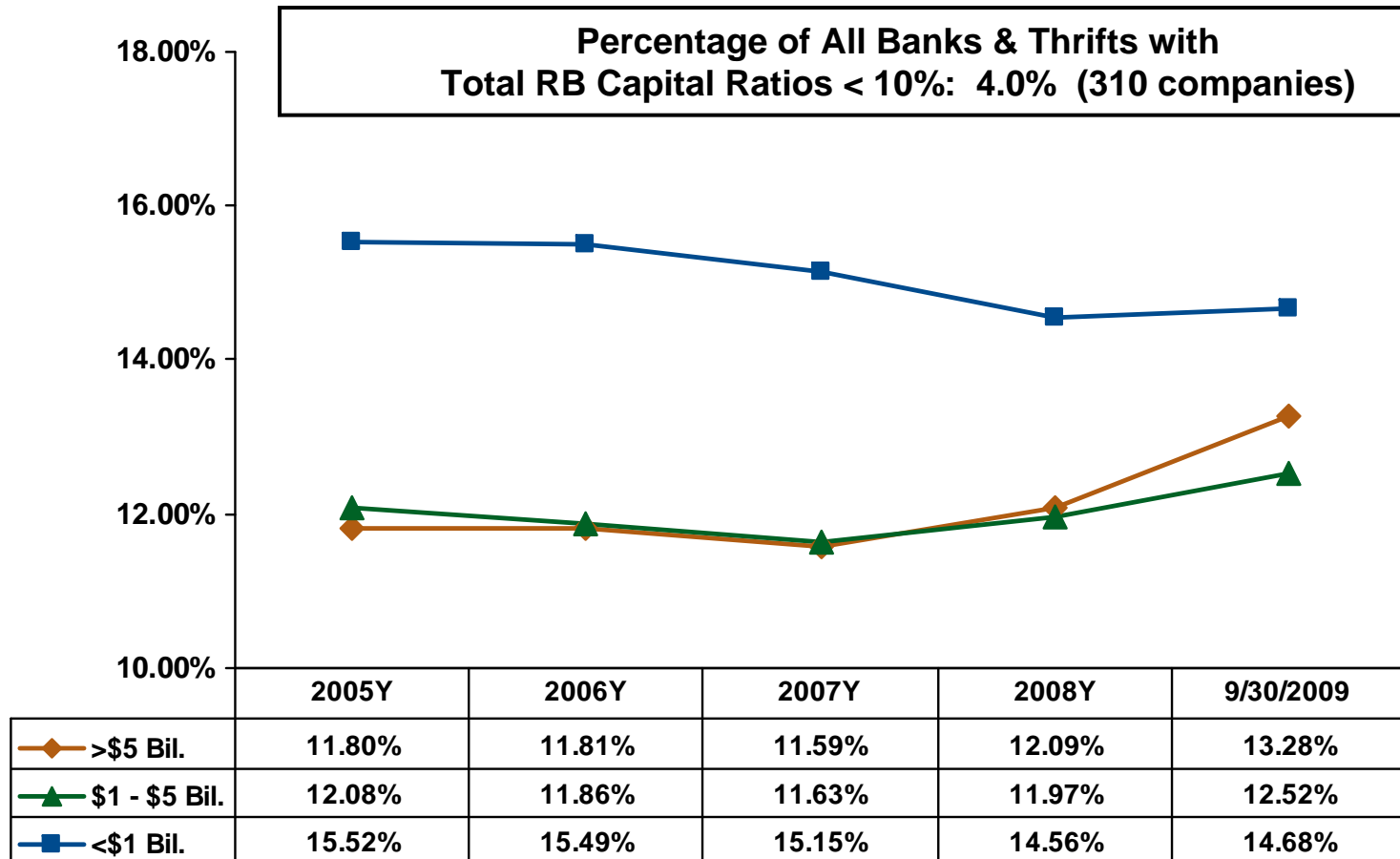
Leverage Ratio

Median U.S. Bank & Thrift Data by Asset Size



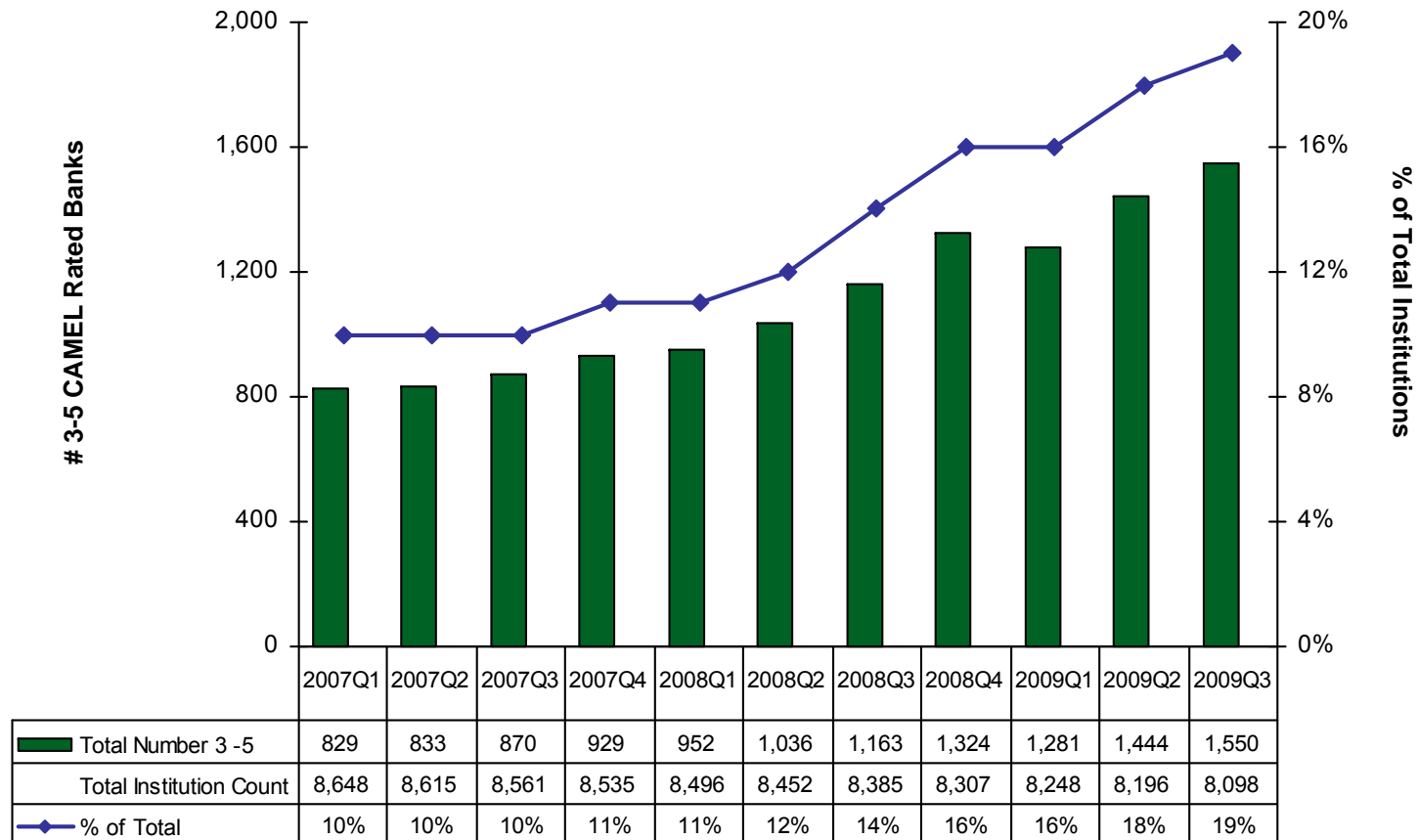
Total Risk-Based Capital Ratio

Median U.S. Bank & Thrift Data by Asset Size



Estimated Banks with CAMELS 3-5 Ratings

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

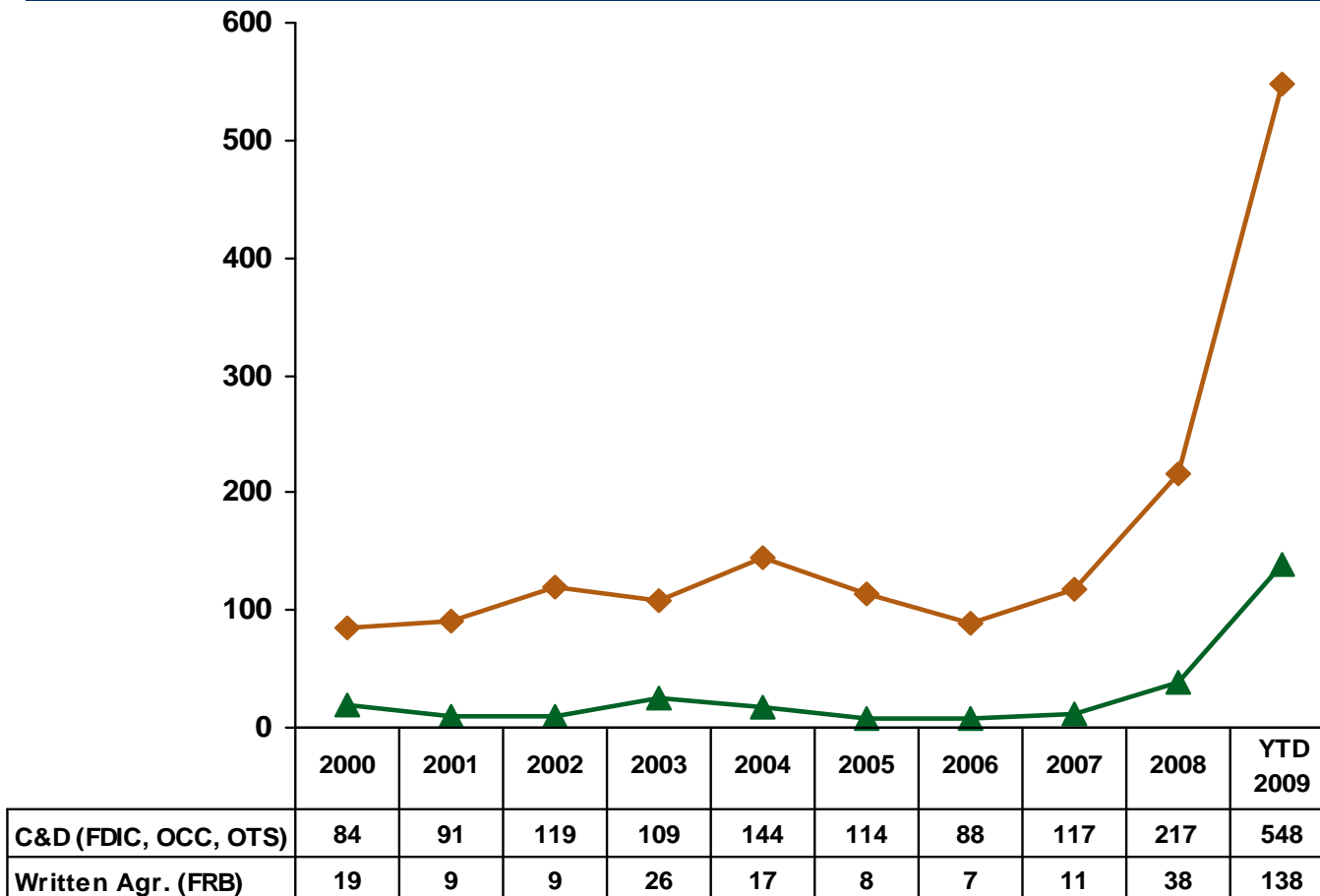


Note: Includes Commercial Banks, Savings Banks & Savings Institutions.

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 2009 for the period ending December 3, 2009. 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.

Webinar Overview

What else do we know about recent exams?

- CAMELS Ratings are more unpredictable
- Increased focus on the Asset Quality component
- The Management rating usually follows the C, A & E rating components
- Required levels of Capital are increasing
- Multiple misclassification of loans during an exam, resulting in restated call reports, must be avoided
- Proactive steps prior to an exam can mitigate the final exam outcome

Credit Risk Management

Exam Overview

- Formal enforcement actions
 - Increased 100% 2008/2007
 - Up 170% in 2009
- **Nonperforming asset trend – red flag?**
 - Over \$1B up 360% from '07, 830% from '05
 - **Under \$1B up 250% from '07, 450% from '05**
 - Effectively identifying/reserving for probable loss?
- Not about BSA, Info security or Flood violations
- **Is about concentrations, ALLL and problem loan management, and earnings and capital adequacy**

Exam Overview

- **Examiners assess the effectiveness of credit risk management practices**
- Examiners determine - can institution weather the storm or will the domino effect commence?
- **Is there clear evidence that management and the board are identifying and responding to the increasing credit risk profile? Are they proactive?**
- Or has management and the board adopted a defensive posture and are waiting for a regulatory order to take action? Are they reactive?
- Tell your story – outline everything you have done

Concentration Risk Management

- **Ensure compliance with Joint Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (December 2006)**
- Provide clear examples/evidence of procedures in place to identify, measure, monitor, control and report
- Risk management processes should be appropriate to the size of the portfolio, the level and nature of concentrations and the overall risk profile of the institution – present your case
- **Level and scope of analysis and information provided to board is critical**

Credit Risk Management

- **Key elements regulators will inspect...**
 - **Board** and management **oversight** – 24/7 vs 2 hrs/month
 - Portfolio management – how and why behind the slicing
 - Management information systems – drives everything
 - **Market analysis** – often missing component
 - Credit underwriting standards – how have they changed?
 - **Portfolio stress testing** and sensitivity analysis – must do!
 - Credit risk review function – independent verification
- **Proactively document each of these elements**
- **Pre-position your examiner** on what they can expect to see in place and how all the information is utilized to manage risks in the loan portfolio

ALLL and Problem Loan Management

- Ensure compliance with **Interagency Policy Statement on Allowance for Loan/Lease Losses and Joint Q&A on ALLL**
- Comprehensive and consistently applied methodology
- Impaired loan analysis **FAS 114 specific allocations**
 - Fair value of collateral
 - Present value of expected future cash flows
 - Observable market price of loan
- **Proactive and effective problem loan management**
- **Value data must be accurate, reliable and timely**
- **Document, document, document**

ALL and Problem Loan Management

- **FAS 5 – general reserves**
- **Segment the portfolio** by similar characteristics
 - Type of loan
 - Type of collateral
 - Collateral concentration
 - Risk classification
- **Historical loss review – focus on past 12-24 months**
- **Qualitative/environmental loss factors – key focus**
- **Frequency** of factor ratification – qtrly sufficient?
- Have overall **process independently ratified**
- **Document, document, document**

Earnings, Capital Adequacy and Stress Testing

- **Sufficiency of earnings** to meet challenges of declining asset quality
- 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?”**

Any other potential exam focus?

- **If capital levels and LLR are well positioned** to address current and prospective asset quality risks...
- Focus on **IT and BSA** issues continue
 - **Business continuity plan/assessment**
 - **Comprehensive IT audit plan**
 - **Vendor management program**
 - **BSA/AML/OFAC** program/risk assessment/audit
- **Enterprise risk management** programs, what is the level of **board awareness** and knowledge concerning **overall risk** within the organization?
 - **Do they understand the risk profile?**
 - **Are they establishing risk limits?**

Liquidity Management

Liquidity Management

Overview

- Asset quality and capital levels dictate liquidity measurement and management requirements
- Bank must have comprehensive measurement system that is consistent with risk profile, transparent to management and understood by the board of directors
- Balance sheets have become more complex

Liquidity Management

Overview

1. Variable rate loans with floors and collars
2. Puttable advances
3. Callable bonds
4. Pre-payment speeds
5. Decay rates for non-maturity deposits

Liquidity Management

Policy Requirements

- Specifically define the measurement of liquidity risk
- Be transparent
- Establish limits
- Assign responsibilities
- Includes stress testing
- Includes a contingency funding plan of action

Measurement of Liquidity Risk

- Liquidity gap – cash flow forecasting
- Liquidity ratios
 1. Primary
 2. Secondary
 3. On-hand
 4. Dependency
 5. Net non-core funding

Liquidity Management

Contingency Funding Plan (CFP)

- Triggers
- Define degree of risk by each trigger
- Monitor and report status of triggers
- Assign specific response for each level of risk
- Assign to individuals their role for each level of risk

Developing a Capital Plan

Capital Plan

Overview

- Typically required to cover at least three years
- Should be consistent with current Strategic Plan
- Should be consistent with, if not directly tied to, Budget and Profit Plan
- **Capital Plan should be approved by the Board and may require certain policy actions**
- **Banks will most likely be required to maintain more capital in the future AND regulators will be focusing more on Tangible Equity / Tangible Assets**

Capital Plan

Required Capital Ratios

	<u>Well-Capitalized</u>	<u>Adequately-Capitalized</u>	<u>Under-Capitalized</u>	<u>Significantly Under-Capitalized</u>	<u>Critically Under-Capitalized</u>
Tier 1 Leverage Ratio	5%	4%	< 4%	< 3%	< 2%
Tier 1 Risk-Based Capital Ratio	6%	4%	< 4%	< 3%	
Total Risk-Based Capital Ratio	10%	8%	< 8%	< 6%	

- **Regulatory enforcement actions will set forth mandated capital ratios. Typical mandates:**
 - **Tier 1 Leverage Ratios 8.0 – 9.0%**
 - **Total Risk-Based Ratios 11.5 – 13.0%**
- If no mandates, Board should establish target ratios generally consistent with above ratios

Capital Plan

Plan Objectives

Step #1: Determine capital shortfall, if any, under varying profit/growth scenarios

Step #2: Determine if shortfall is permanent or temporary

Step #3: If temporary, develop plans and timeline to reach capital targets

Step #4: If permanent, develop capital raising strategy

Capital Plan

Plan Contents

- Current capital position of bank relative to regulatory mandates or board-approved targets
- Historical and peer capital analysis
- Parent-company analysis, if applicable
- Bank and company projections (tied to profit plan)
- **Stress tested capital projections**
- Dividend policy
- **Capital contingency plans**

Capital Plan

Incorporating the Profit Plan

- **Banks must determine if capital shortfall is permanent or can be filled with future earnings...timing, amount and condition of bank will dictate**
- Banks must stress test their Profit Plan, namely for NIM and Loan Losses
- Banks must start addressing the expense side of the equation...the cost of doing business is going up!
- Revenue growth will be slow for some time. Pricing discipline will impact net interest margin

Capital Plan

Typical Capital Contingency Plans

- De-leverage – branches, lines of business, managed balance sheet
- Reduce or eliminate cash dividends to shareholders
- Sell assets for gain (e.g. investments) – decreased yields may be worth the capital impact
- Manage risk-weighted assets including off-balance sheet items (e.g. loan commitments)
- Raise capital

Capital Plan

Capital Raising Strategies - Publicly Traded Companies

- \$83.8 billion in Common Stock offering proceeds
 - 293 common stock offerings in 2009
 - Average offering price/tangible book value = 117%
- \$68.3 billion in Preferred Stock offerings (excludes TARP)
- \$32.2 billion in Trust Preferred issuances
- 346 public companies have raised capital in 2009... **Generally above average financial and asset quality**
- Institutional investors, private equity, bank funds are stepping into the market after long absence

Capital Plan

Capital Raising Strategies - Private Companies

- Limited interest from private equity firms
- Strategic investors/buyers have surfaced
- **Predominant amount of capital raised from board members, current shareholders, local investors**
- Type of instrument varies depending on **investors' interests** (dividend paying, convertible, warrants or straight common)
- **Banks must accept that a forced raise of capital will result in significant dilution**
- **Assess extended TARP program**

Capital Plan

Investor Evaluation

- Strong management team with a plan
- Detailed assessment of asset quality (adverse scenario)
- Core operating earnings before credit losses and costs (PPNR of at least 1.0%)
- Strong core deposit base
- Good markets
- Priced at a discount to book...closer to adjusted book after more adverse scenario considered
- Priced to achieve 20-25% IRR
- Exit strategy...liquidity event

Action Items and Q & A

Action Items

1. Determine what you can accomplish internally prior to your next examination with regard to:
 - Stress testing your loan portfolio
 - Evaluating overall credit risk management processes, procedures and personnel
 - Conducting a liquidity stress test
 - Preparing a capital plan and a timetable for updates
 - Identifying realistic options for raising capital

Action Items

2. Self-evaluate on the basis of the CAMELS rating system
3. Prepare an agenda and discussion outline for a “pre-examination” meeting with your EIC and his/her team; provide copies of stress test results, capital plan and updates to both, if appropriate
4. Ensure (and document) Board of Directors involvement with pre-exam preparation
 - Review all internal analytics/reports
 - Approve relevant policies, procedures, resolutions and targets incorporated into stress tests, profit and capital plans
 - Validate analyses and results with third-party assessments
 - Consider board resolution on action items

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