

ABABANK DIRECTORS BRIEFING

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THE DIRECTOR'S JOB

UNDERSTANDING THE ROLE OF EXAMINERS IN HOW YOUR BANK WEATHERS THE STORMS

Doing business as a bank director over the next five years is not going to be the way it was these past five," Philip Smith warns. "I may be wrong. But with the economic cycle I'm seeing, we're going through a time of choppy weather, and I'm cautioning boards that your next examination will not be as friendly as your past one."

Smith, leading the annual director peer meeting that this newsletter sponsors at ABA's National Conference for Community Bankers, told directors and trustees that examiners' attitudes will be different this time around. "That doesn't mean you're going to become a four-rated bank," the Memphis attorney explained. But things will be tougher. "You will see somewhat more banks in regulatory trouble," he warned, and more banks and boards will be under formal and informal supervisory actions.

Smith, president of Gerrish McCreary Smith, PC, gave a wide-ranging presentation entitled "The Directors' Survival Kit." In it, he made eight points about examiners.

1. Examiners are not auditors. "For outside directors that's often a revelation," he said. "But they are not there to look at financial statements and make sure this is in this box and this adds to this. That's not their job."

2. Nor are examiners there to perform the function of management—though they will have ideas on how managers should be acting. Tongue in cheek, Smith narrated a typical examiner-CEO conversation:

Examiner: We're seeing some softening of asset quality.

CEO: We noticed that too.

Examiner: And because of that, we're concerned that your allowance for loan loss

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DEAR DIRECTOR:

Tougher Times For Many Banks Focus Attention On Board's Duty To Monitor Loan Loss Allowance

All new bells and whistles aside, the essential function of most community banks is "intermediation." That is, banks take in deposits and other monies, put much of that out at interest, collect the principal and interest, take a profit, and start the whole cycle again.

That's the idea. Of course, as times like today's underscore, loans aren't always repaid on schedule, or with all principal and interest due, or, sometimes, at all. Sometimes—real estate is coming to be an unfortunate living example—collateral values don't hold, and the performance hoped for at the outset of the loan isn't always present. And so banks must take protective steps.

ALLL: Key banking concept

One of key protection is capital, and a critical element of capital, in this regard, is the Allowance for Loan and Lease Losses.

The allowance—

ALLL for short—is a component of supplementary (or Tier 2) capital, and is a cushion between losses and the bank's core (or Tier 1) capital. The allowance is a balance sheet item that regulators pay close attention to, and examiners will be looking even more closely at this number, and how the bank has set it, as the economy deteriorates.

The allowance, very simply put, consists of the setaside made for losses inherent in the loan portfolio, some of which have not been specifically identified. It is supposed to be reviewed, and if necessary, adjusted, regularly, but at least at the end of

each quarter. Additions to the allowance are made quarterly, if necessary, by increasing both the ALLL (on the balance sheet) and the Provision for Loan and Lease Losses, an expense item on the income statement. Additions to the ALLL therefore reduce current earnings, just as putting money into savings reduces your immediate disposable income. When loan and lease losses are charged off, both the loan balance and the ALLL are reduced—removed from the balance sheet. (Recoveries are credited to ALLL, increasing it.)

The ALLL is not designed to absorb all risk in the loan portfolio, but to deal with probable credit losses that have already been incurred, according to the regulators' "Interagency Policy Statement

on the Allowance for Loan and Lease Losses," issued in 2006.

Until recently, the banking industry, especially community banks, have experi-

enced relatively low historical losses in the near-term past. But, clearly, things have been changing.

"Events have occurred that have moved us into a recession, if we are not already there," according to Robert F. Storch, FDIC chief accountant. So more attention than many banks have seen in recent years is being placed on ALLL.

Storch and other experts spoke about this important banking concept during an ABA telephone briefing presented on March 26, "Allowance for Loan and Lease Losses (ALLL): Documentation for

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"Judgment is replete through the whole discussion of the allowance"

Community Banks.”

Judgment in times of trouble

As speakers pointed out, setting the ALLL isn't an exact science.

“Judgment is replete through the whole discussion of the allowance,” said Storch.

Much consideration goes into ALLL decisions and measurements. However, “gut feel” and “flying by the seat of the pants” aren't supposed to be ingredients of the decision. Instead, banks must adhere to a combination of rules and practices set out by management, with board oversight, and these must be set up in keeping with “generally accepted accounting principles” (GAAP) as set forth by the Financial Accounting Standards Board, a quasi-public entity that sets GAAP. In addition, regulators' policy statements and other guidance play a critical role in setting the decision framework.

Also underscoring the importance of the ALLL is the fact, pointed out by speakers, that troubled debt restructurings are subject to particular rules that must be observed.

One significant instance concerns restructurings of single-family residential mortgages. Typically, mortgages and other types of consumer

credit are evaluated for loan loss purposes in groups of loans, rather than singly.

However, under Statement of Financial Accounting Standards No. 114, when a loan, say, a mortgage, is restructured, it is moved out of the pool it otherwise would have been considered in. Instead, it is considered an impaired loan, to be considered individually, said Storch.

Storch pointed out that several typical measures to assist such borrowers trigger classification of the loan as impaired, among them forgiveness of principal or of interest.

An overall test for ALLL is “does your allowance make sense?” said speaker Kathy Murphy, deputy chief accountant at the Comptroller's Office's Office of the Chief Accountant. The direction of the ALLL should jibe, she said, with what the bank has been experiencing. When asked if it could still be appropriate for a bank with good credit experience to have no allowance for loan and lease losses, Murphy said that in today's environment, she'd be surprised if a bank could justify not having any ALLL.

Key board duties

Before getting into further specifics (box on p.4), it's important to under-

stand board duties in this context.

In general, boards are not expected to be conducting calculations and other nitty-gritty details. Instead, “boards of directors should be challenging the allowance, often,” said Todd Sprang, partner and Midwest Financial Institutions Practice leader at Grant Thornton, LLP, Chicago. As so much of its setting involves judgment, it is important for the board to be certain it is comfortable with where ALLL

is coming out. The accountant added that, “I think they are doing so, but that discussion may not be documented. You must make sure the bank documents those discussions.” This is so auditors and examiners see that debate is going on.

This emphasis on documentation came up often during the ABA briefing. Banks are expected to maintain sufficient files, worksheets, and other records to demonstrate that they have followed a formal and consistent process. Further, speakers pointed out that a good practice for banks is to periodically compare the ALLL decisions made, side-by-side, with their relevant policy and pro-

CDs of the ABA briefing can be ordered at www.aba.com/teleweb/tb032608.htm

WATCHING WASHINGTON

FDIC warns heavy commercial real estate lenders

In mid-March FDIC issued Financial Institution Letter 22-2008, “Managing Commercial Real Estate Concentrations in a Challenging Environment.” The agency warned banks under its authority that have heavy commercial real estate loan concentrations to step up activity in five areas:

- 1. *Increase or maintain strong capital levels.* “Institutions with significant construction and development and commercial real estate exposures may require more capital because of uncertainty about market conditions, causing an elevated risk of unexpected losses.”
- 2. *Ensure that loan loss allowances are appropriately strong.* FDIC covered many of the same points discussed in this issue's main article.

- 3. *Manage C&D and CRE loan portfolios closely.* FDIC stressed the importance of adequate policies and systems for managing concentrations.
- 4. *Maintain updated financial and analytical information.* The importance of valid, timely appraisals was also stressed.
- 5. *Bolster the loan workout infrastructure.* Institutions should make sure they have the staff and other resources to manage rising troubled loans and workout situations.

Administration unveils revamped regulatory scheme

The Treasury Department has proposed a massive, multi-stage reworking of the way the U.S. regulates financial services businesses.

The March 31 proposal—running hundreds of

pages—comes at a time when other proposals, mostly tied to the housing crisis, are also being floated. These come not only from Capitol Hill, but also from the presidential campaigns.

The Treasury proposal comes late in the Bush Administration's term, but nevertheless stirred early controversy. Among its points: eventual elimination of the federal savings institution charter and the merger of the Office of Thrift Supervision into the Comptroller's Office.

The proposal calls for a major reworking, in the long-term, of the regulatory apparatus into three superagencies, one devoted to market stability; one to safety and soundness of firms that have federal guarantees, such as deposit insurance; and one devoted to “business conduct,” including consumer borrower and investor protection.

cedure documents.

Given the need for oversight that ensures the bank has a systematic approach, the approach to oversight must also be systematic. FDIC's Storch reviewed key duties of boards:

1. Overseeing management's significant judgments and estimates relating to an appropriate ALLL.
2. Reviewing and approving the institution's written ALLL policies and procedures at least annually.
3. Reviewing management's assessment and justification that the loan review system is sound and appropriate for that particular institution.
4. Reviewing management's assessment and justification for the allowance for losses and the quarterly provision.
5. Requiring management to periodically validate and, when appropriate, revise, ALLL methodology.

All this takes time, wading through detail. "The board has to oversee the process that management has gone through by getting appropriate reports presented to the directors, and by making sure they are sound and appropriate," said Storch.

And it is important for the board to understand that, while standards apply, setting the ALLL is no formulaic exercise. The process, according to Storch, "is an institution-specific review of the portfolio that will assist the bank to set its allowance." He said it is critical to ask questions.

Key management duties

You may have noticed the frequent use of the word "appropriate." Storch noted that "adequate" isn't the word used because it is considered too open to interpretation. Appropriateness is demonstrated to examiners and auditors by documentation that explains the supporting analyses and rationale used for arriving at the ALLL.

Management, naturally, is responsible for things at a finer level, such as:

1. Maintaining the ALLL at an appropriate level, based on current judg-

is not adequately funded.

CEO: Well, we've had a bit of a concern about that, too. We've been thinking about modifying our methodology to account for this new environment we're in. ["See, you're playing the regulatory game here," said Smith.]

Examiner: We'd really like to see you modify the way you calculate your allowance for loan loss in order to meet the additional risk.

[**Smith:** What do you think most bankers would say? "We're not going to do that?" No. They'd say something like, "That's a good point. How would you suggest that we modify the way we do this, to meet what you think?"]

Examiner: We can't tell you. That's management's job.

CEO: Well, we kind of like it as it is.

Examiner: Well, no, you can't do it that way. You've got to change it.

CEO: Okay, how would you like for us to change it?

Examiner: I can't tell you. That's management's job.

While he was being satirical, Smith said, that's how conversations tend to go, with examiners declining, at least at early stages, to be direct.

3. Examiners do make "recommendations." Examiners may say, "We think your loan loss reserve is underfunded by \$150,000. Please fully fund it."

"Do you *have* to do that?" Smith said. "Actually, you *don't*. It's still America. I know it's hard to believe, in a regulatory environment, sometimes. But that's a 'recommendation,' because they've got some gigantic hammers in their back pockets, if you don't want to do what they say."

4. Examiners judge the quality of the bank's assets. And quality, said Smith, is a subjective measurement. While banker and board may know a customer, even one with some troubles, and believe it is a reliable credit in the end, examiners look at things coldly and objectively. "Their argument is that 'You guys are wishful thinking,'" said Smith, "that you are hoping on a wing and a prayer this is going to pay off, that the stars and planets will align and that it will be a good credit."

5. Examiners set CAMELS ratings. Smith warned listeners that the regulatory ratings are not simply an exercise in math, with the overall CAMELS rat-

ing being an average of the individual ratings on capital, asset quality, management quality, earnings, liquidity, and sensitivity to risk categories.

"Management is the key component, and that includes the board members," said Smith.

Difficulties in any of the other CAMELS categories have a tendency to pull down others, and all of those downward pulls tend to bring down the view of management, and therefore, its rating and the overall rating.

6. Examiners expect honesty and a realistic perspective. "The regulators want to see that the directors are on top of things. That will go a long way toward keeping you out of hot water," said Smith.

He recommended, "If you are going to have a bad year, *have* a bad year. Don't have three bad years. Take your hits, charge them off, move on."

7. Examiners have leeway. Regulatory teams have more flexibility than many bankers and board members realize, Smith said. A board and management team that have given examiners reason to think they are in control may get an informal enforcement action, while a bank with leadership that does not inspire examiner confidence may get a more-severe formal action.

"If they come in to examine you," said Smith, "and you've got tons of asset quality problems, and you haven't identified them and you haven't charged them off, they aren't going to have any confidence that you know what you are doing."

8. Examiners can be wrong. "There are some really good board members, there are some really bad ones," said Smith, "and there are some really good examiners, and some really bad ones. If you get somebody you think is just absolutely wrong, there is an appeals process you can go through with your examination findings. Don't be afraid to take advantage of that."

April 16 marks first ABA director phone briefing

ABA, in cooperation with *ABA Bank Directors Briefing*, presents "Directors and The Bank's Portfolios: Understanding Bank Investments and Asset/Liability Management," on April 16, 2-3:30 PM Eastern time.

For more information about the briefing, or CDs available after the air date, go to: www.aba.com/teleweb/tb041608.htm

ments about the loan portfolio's credit quality.

2. Documenting ALLL analysis by standards set by the Financial Accounting Standard Board and the regulators.
3. Evaluating the ALLL reported and handling the provision to bring the ALLL to the appropriate level for each current period.
4. Adopting and adhering to ALLL policies and procedures that are appropriate to the institution.
5. Maintaining internal controls to ensure ALLL process meets accounting and regulatory expectations.
6. Promptly charging off uncollectible loans.

Management is responsible for who determines

ALLL decisions and who, being responsible but being outside of that process, reviews them. In addition, management must establish and maintain the loan review process that handles the grading of loans.

Grant Thornton's Sprang pointed out that, though consistency remains important, a bank's approach to ALLL computation is not supposed to be cast in stone.

Sincerely,
Steve Cocheo
for *ABA Banking Journal*

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Practical Application: How ALLL Is Set By Banks

Speakers at ABA's event covered the basics of ALLL evaluation. Here's a summary:

First class of ALLL evaluation

The first, under Statement 114, applies to loans identified by bank processes for evaluation for impairment on an *individual*/loan basis. With the exception of troubled debt restructurings, covered in the main article, individual evaluation is meant for loans that are not smaller-balance credits that can be grouped for evaluation for impairment as a group. Group evaluation is generally reserved for mortgages and consumer loans and other credits that share many common characteristics regarding amounts, term, etc.

By contrast, loans with highly customized structure—such as business loans—typically fall under 114. Under this standard, the bank must judge whether the loan is impaired, based, first, on the borrower's performance. Only after borrower performance is assessed is the issue of collateral—if the loan is secured—examined.

Under Statement 114, a loan is considered impaired when, based on current information and events, it is probable that the borrower will be unable to collect all principal and interest payments due according to the contractual terms of the loan agreement.

Once a loan is determined to be impaired, the degree of impairment must be figured. This goes into the calculation of how the ALLL must be adjusted. For loans that will depend on collateral for repayment, the fair value in the market of that collateral is the way community banks will generally measure impairment. This methodology is permitted by the standard.

Once the bank has computed the allowance

necessary for each individual loan affected by 114, they are totaled for the overall ALLL component to be based on 114. However, there's more.

Second class of ALLL evaluation

A separate rule, Statement of Financial Accounting Standards No. 5, also comes into play. The approach here is to group loans not covered by 114. The groups are made according to common risk characteristics. There are many ways that management can break up the portfolio containing these loans. Kathy Murphy of the Comptroller's Office said the sophistication of the organization of the loans would hinge on the size and complexity of the bank. Each institution's effort would also depend on its capability to produce reports that would enable the loans to be segmented properly.

Once loans are broken up appropriately, their behavior is evaluated, in terms of a review period. For community banks, this is generally 12 months. After this historical review takes place, the bank evaluates qualitative and environmental factors that could cause credit losses to differ from the historical experience.

"Qualitative factors" include such matters as a shift in the bank's underwriting policies and other changes in practices that could affect recovery of loans. "Environmental factors" include external factors that could cause behavior to differ from historical trends. This includes changes in national, regional, and local economic and business conditions.

All these points go into adjustments to the expected loss rates for each group of loans, and, from there, into calculations of the relevant piece of the allowance for loan and lease losses

(ALLL). And every step must be documented.

Adjusting the ALLL

At the end of the process, the two elements—the calculations under Statement 114 and Statement 5—are joined, and the allowance is adjusted accordingly.

But that's not quite the end. There is also the "unallocated" amount. One way of defining this piece of the ALLL is to consider it an amount management is unable to match to a particular group of loans or individual loans, but that reflects its judgment of risks.

As Question 13 of the regulators' 2006 "Questions and Answers on Accounting for Loan and Lease Losses," states, in part: "Economic developments that surface between the time management estimates credit losses and the date of the financial statements, as well as certain other factors such as natural disasters that occur before the date of the financial statements, are examples of environmental factors that may cause losses that apply to the portfolio as a whole and are difficult to attribute to individual impaired loans or to specific groups of loans and, as a consequence, result in an 'unallocated' amount."

Where history is lacking

In some cases, a bank may not have historical experience to go by. It may be a relatively new bank. Or it may have only recently started doing a particular type of lending. In such cases, said Todd Sprang of Grant Thornton, the institution can draw on peer group figures. However, even there, the bank must document why the peer group was appropriate.

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