Weathering the Storm:

A Guide to Banking in Uncertain Times

A Jones Walker Webinar Series
December 15, 2009

Introduction and Overview

- First of six sessions that will address issues for bankers navigating a difficult banking environment.
- This session will focus on the current banking environment and its implications for your next exam, as well as advice for preparing for your next exam.
- Future sessions will cover:
  - regulatory enforcement
  - raising capital
  - management and disposition of problem assets
  - regulatory reform
  - management and board issues

The Current Banking Environment

State of the Economy

- Unemployment rate currently at 10% nationally; more than double the rate at year-end 2007 (4.9%).
- Foreclosures expected to reach a record level for 2nd straight year (3.9 million in 2009 vs. 3.2 million in 2008); NV, FL, and CA have most foreclosures as a percentage of households.
- Economy may be showing signs of picking up:
  - ❖ Slight increase in GDP during 3rd Quarter.
  - ❖ Unemployment edged down in November.
  - ❖ Home sales have strengthened somewhat over the course 2009, and prices have begun to stabilize.
  - ❖ Consumer spending has been rising since the middle of the year but is likely to remain weak.

The Current Banking Environment

Condition of the Banking Industry (FDIC's Quarterly Banking Profile)

- Deteriorating balance sheets have resulted in more conservative lending practices.
  - ❖ Total loans and leases dropped 2.8% during the 3rd quarter—the largest percentage drop since reporting began in 1984.
  - ❖ Declines in the 3rd quarter were reported in C&I loans (6.5%), residential mortgage loans (4.2%), construction & development loans (8.1%), and credit card loans (1.3%).
- While the overall banking industry turned a profit of $2.8 billion in the 3rd quarter, 26.4% of banks were unprofitable.
- NIM stood at a 4-year high of 3.51% in the 3rd quarter.

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The Current Banking Environment

Condition of the Banking Industry (Cont'd)

- Asset Quality
  - ❖ Net charge-offs continued to rise in the 3rd quarter, up 80.5% over the 3rd quarter 2008; annualized net charge-off rate climbed to 2.71% (highest rate since recording began in 1984).
  - ❖ Loan-loss provisions in the 3rd quarter exceeded $60 billion for the 4th consecutive quarter and were 22.2% higher than 3rd quarter 2008.
  - ❖ Nonperformers increased 10.5% from 2nd quarter to 3rd quarter, and are 95.7% higher than 3rd quarter 2008.
- Average capital ratios are at the highest levels since current risk-based capital standards were enacted 19 years ago.

The Current Banking Environment

Condition of the Banking Industry (Cont'd)

- Bigger Picture
  - ❖ 133 bank failures so far in 2009 (the highest number in one year since 1992); there were 25 in 2008, but only 3 between 2005–2007.
  - ❖ FDIC's problem bank list has increased to 552 banks (highest number in 17 years) from 252 banks in 2008.
  - ❖ In 3rd quarter, DIF reserve ratio dropped to -.16%, the first time it has been negative since 1991; DIF has declined by nearly $25 billion this year.
  - ❖ To support DIF, banks are being required to prepay assessments, and a $500-billion line from Treasury is in place.

The Current Regulatory Posture

The business of state and federal regulators is largely to ensure the safety and soundness of the banking industry. The significant deterioration in large segments of the industry weighs heavily on their minds and is motivating them to do what they can to turn the tide. A far less lenient attitude is frequently the result.

There are a variety of other factors that exert meaningful influence on the regulatory process.

- Material Loss Reviews (MLRs)
  - ❖ Bankers are not the only ones being second-guessed by a "higher power."
  - ❖ Section 38 of the FDI Act requires that, following a bank failure, a material loss review be conducted by the OIG of the bank's primary federal regulator if, as a result of the failure, the DIF incurs a material loss (a loss equal to the greater of $25 million or 2% of the bank's assets).

The Current Regulatory Posture

- Material Loss Reviews (Cont'd)
  - ❖ Section 38 requires that every MLR include a review of the agency's supervision of the institution, ascertain why a material loss was incurred, and make recommendations aimed at preventing future losses.
  - ❖ OIGs are regularly critical of the oversight by regulators. A recurring theme in MLRs is the failure of the regulator to take a sufficiently aggressive approach in dealing with noted weaknesses.
- Media reports and the frequent focus on regulatory shortcomings have an impact on the posture of the regulators.
- Proposed legislative action has their attention.
  - ❖ Proposals aimed at eliminating OTS, consolidating regulators, and establishing CFPA, as well as attacks on Chairman Bernanke and the Fed, have gained regulators' attention.

The Current Regulatory Posture

- State regulators are not insulated from the fallout. Pressure felt by state regulators (frequently exerted by their political overseers) as targets of criticism for failing to carry out their responsibilities effectively can be intense.

The Current Regulatory Posture

Countervailing Forces

- There is some legislative and other political pressure for regulators to take a more measured approach to community banks.
    - ❖ Letter from Barney Frank and Walt Minnick to the banking agencies, pointing out that current problems largely resulted from gaps and regulatory shortcomings pertaining to non-banks and asking regulators to show temperance in their regulation of traditional banks.
- Stress on the Deposit Insurance Fund and Other Regulatory Resources—Is the FDIC "kicking the can" down the road in the same way banks have been accused of doing (because of DIF deficiency and increase in number of problem banks)?
- Are these countervailing forces having an effect (for example, CRE workout guidance, proposal by FASB Chairman to decouple GAAP from RAP)?

Implications For Your Next Exam

Primary Areas of Focus For Examiners

- Asset Quality
  - ❖ This area will receive the most scrutiny with ADC loans and non-owner-occupied CRE receiving the most attention.
  - ❖ Examiners will look closely at loans where payments are made from interest reserves.
  - ❖ Examiners will evaluate appraisals to determine if collateral values are overstated.
  - ❖ Examiners will focus on whether bankers are promptly identifying problem loans and taking steps to mitigate losses, and whether they are promptly recognizing losses.

Implications For Your Next Exam

Primary Areas of Focus For Examiners (Cont'd)

- Loan Loss Reserve
  - ❖ After scrubbing the portfolio, examiners will closely review ALLL to determine if additional provisioning is necessary.
  - ❖ Examiners will focus on whether ALLL assumptions are realistic (for example, do historical loss rates reflect current environment?).
  - ❖ Substantially inadequate ALLL will have consequences throughout the exam, and may lead to downgrades of management and other CAMELS components.
- Loan Concentrations
  - ❖ If ADC and CRE loans are approaching or exceed the 100%/300% thresholds in the Interagency Guidance expect examiners to require reductions; concentration will play significant role in evaluation of ALLL and capital.

Implications For Your Next Exam

Primary Areas of Focus for Examiners (Cont'd)

- Liquidity
  - ❖ Significant emphasis being placed on liquidity.
  - ❖ Expect criticism of significant reliance on brokered deposits and FHLB advances and attention to the net non-core funding dependence ratio.
  - ❖ Because of liquidity issues at failed banks, examiners will focus on liquidity risk management, especially contingency funding plans (whether plans are realistic and tested regularly).
- Capital
  - ❖ If bank has significant concentration of ADC and/or CRE loans it can expect examiners to insist on higher capital ratios.
  - ❖ Recent administrative enforcement actions have generally required leverage ratios of 8% to 9% and sometimes higher.

Implications For Your Next Exam

Primary Areas of Focus For Examiners (Cont'd)

- Compliance
  - ❖ Because of media and congressional attention on consumer protection, expect examiners to focus on compliance.
- Interest-Rate Risk
  - ❖ Regulators have recently noted that some banks have begun loading up on short-term liabilities and long-term assets to maximize spread.
  - ❖ As economy recovers, rates will rise, which could lead to mismatches and a rapid contraction in interest rate spread.

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Implications For Your Next Exam

Consequences of Asset Quality Issues & CRE Concentrations

- Accelerated Examinations
  - ❖ Regulators are reviewing Call Reports and conducting off-site monitoring of banks' financial condition. If a bank is experiencing asset quality deterioration or has a significant concentration of ADC or non-owner-occupied CRE loans, it should expect its next exam to come more quickly and maybe a visitation or information request.
- CAMELS Rating Downgrades
  - ❖ Banks experiencing significant asset quality deterioration or having ADC/CRE concentrations are being subjected to CAMELS downgrades.
  - ❖ Historically 1- and 2-rated banks are now 3- and 4-rated.
  - ❖ Banks may be subject to double downgrades; examiners are erring on the side of a lower rating.

Implications For Your Next Exam

Consequences of Asset Quality Issues & CRE Concentrations (Cont'd)

- Enforcement Actions Come More Quickly and Are More Aggressive
  - ❖ Because of the current environment and criticism from material loss reviews, examiners are going to be quick on the trigger in imposing enforcement actions.
  - ❖ Examiners formerly were more likely to use moral suasion to motivate bankers to address deficiencies; now they are moving directly to enforcement actions.
  - ❖ 3-rated banks will be subject to an MOU at a minimum, and 4-rated banks will be subject to a C&D; there have been reports of 2-rated banks receiving MOUs because of the failure to address prior exam criticisms.
  - ❖ Though opportunities to negotiate the terms of an enforcement action still exist, the opportunity to negotiate whether there will be an enforcement action has diminished significantly.

Implications For Your Next Exam

Implications of a CAMELS 3, 4, or 5 Rating

- Enforcement Actions
  - ❖ 3-rated = MOU; 4-rated = C&D
- Brokered Deposits and Interest-Rate Restrictions
  - ❖ If a bank receives a formal enforcement action (such as a C&D) which contains a capital maintenance requirement (as most do), then the bank is no longer "well-capitalized" under the PCA definition, and would instead be "adequately capitalized" (assuming it otherwise would be well-capitalized).
  - ❖ Adequately capitalized banks must obtain a waiver from the FDIC in order to accept, renew or rollover brokered deposits. The FDIC is not inclined to grant these waivers.
  - ❖ If adequately capitalized, a bank is also subject to restrictions on the interest rate it can pay on any deposit (generally can only pay 75 bp above national rate).

Implications For Your Next Exam

Implications of a CAMELS 3, 4, or 5 Rating (Cont'd)

- Brokered Deposits and Interest-Rate Restrictions (Cont'd)
  - ❖ If a bank believes it is operating in a high-rate area, it can seek a determination from the FDIC, and if successful, will be restricted to paying no more than 75 bp above the local market rate as established by the FDIC.
  - ❖ The brokered deposit and interest-rate restrictions can have a significant impact on a bank's liquidity.
- Deposit Insurance Assessments
  - ❖ A bank's risk category for deposit insurance assessment purposes is primarily based on its CAMELS rating and capital.
  - ❖ If a bank is well-capitalized, the range of its assessment rate would be 7–24 bp if 1- or 2-rated; 17–43 bp if 3-rated; and 27–58 bp if 4- or 5-rated.

Implications For Your Next Exam

Implications of a CAMELS 3, 4 or 5 Rating (Cont'd)

- Loss of Financial Holding Company Status—If a BHC engages in activities permissible only for FHCs, a downgrade to a CAMELS 3, 4 or 5 rating will jeopardize its ability to continue engaging in those activities.
- Federal Reserve Discount Window—A CAMELS 4- or 5-rated bank is not eligible for primary credit, but remains eligible for more expensive secondary credit.
- Other implications for 4- or 5-rated banks: (i) prohibition on golden parachute payments; (ii) approval from regulator required to add new directors or executive officers; and (iii) no longer eligible for expedited processing for applications (also applies to 3-rated banks).

Preparing For Your Next Exam

Review Your Last Exam Report Closely

- Pay attention to the areas criticized by the examiners. Note the areas that were criticized and the weaknesses identified. The objective is to avoid the occurrence of repeat criticisms in the upcoming exam.

- A frequent criticism in material loss reviews is that the same problems were noted in consecutive exams with little evident improvement. Because of the sensitivity by examiners to such criticism, it's very possible that examiners will regard an institution's failure to correct prior deficiencies as appropriate grounds for an enforcement action. As referenced previously, some 2-rated banks are being subjected to enforcement actions if prior criticisms have not been addressed.

- Particular issues from prior exams to focus on: (i) repeated violations of the same laws and regulations or violations arising from the same transactions or by the same personnel; (ii) criticism of ALLL adequacy or methodology; (iii) criticism of appraisal practices; and (iv) criticism of credit-administration practices, particularly with respect to CRE.

Preparing For Your Next Exam

Review Efforts To Address Past Exam Criticisms

- Make an effort to evaluate the effectiveness of the bank's corrective measures.
- Try to anticipate the examiners' response to corrective actions taken. Be prepared to describe and justify the corrective measures taken by the bank, and if further measures are needed, be prepared to discuss what they are or will be.

Preparing For Your Next Exam

General Areas That Merit Attention

- CRE Portfolio

  ❖ Spend time reviewing the recent Policy Statement on CRE loan workouts.

  ❖ Review the December 2006 Interagency Guidance on CRE concentrations. Banks that are approaching or exceed the 100%/300% thresholds should expect a thorough review of the CRE portfolio, and should consider performing, before the exam, the kinds of risk assessments and stress tests discussed in the guidance.

  ❖ Examiners are focused on ADC and non-owner-occupied CRE, and bankers need to be prepared to justify each such loan on their books.

  ❖ If your bank exceeds the 100%/300% levels, you need to be prepared to show examiners either (i) that your capital level, your risk management practices, and the quality of the assets involved are such that the concentration does not pose a threat; or (ii) that the bank has developed, and is implementing, a realistic plan to reduce the concentrations.

Preparing For Your Next Exam

General Areas That Merit Attention (Cont'd)

- Carefully Analyze Your ALLL
  - ❖ Test the reserve assumptions and be prepared to show they are realistic.
  - ❖ Consider using a shorter and more recent review period to calculate loss experience.
  - ❖ Even if your ALLL methodology has historically been sound and blessed by your regulator, you may hear from your regulator if your ALLL is materially below peer.
- CRE Appraisal Practices—Widespread concern over CRE exposure has led to growing scrutiny of appraisal practices. If appraisals on problem credits are not current (usually meaning no more than 12 months old, but can vary by market), obtain updated appraisals.

Preparing For Your Next Exam

General Areas That Merit Attention (Cont'd)

- Interest-Rate Risk—As referenced previously, examiners are becoming increasingly concerned over interest-rate risk. Some regulators have taken the view that interest-rate shock scenarios that have historically been used (swings of 200 bp) may no longer be a realistic measure of risk, and that banks need to test their exposure against rate swings of 300 to 400 bp.
- Liquidity—Bankers should review their contingency funding plans closely and subject them to appropriate stress testing.
- Insider Loans and Affiliate Transactions—Review Reg O loans and loans to affiliates closely to ensure the files are current and complete and are compliant with applicable requirements.
- Collateral Documentation—Examiners frequently emphasize that it's essential that banks document that they have undertaken a global financial analysis of borrowers and guarantors.

Preparing For Your Next Exam

Final Thoughts

- Keep Your Ears Open
- Be Proactive and Aggressive in Identifying and Addressing Problems
- Maintain a Professional and Business-like Approach to the Examination Process

Question & Answer Session

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