

AuditOne Advisory

From Bud Genovese, Chariman

Regulators Scrutinizing Lending

As internal auditors for more than 150 banks, AuditOne reads numerous regulatory examination reports as part of our audit planning process. This information is a valuable indicator of regulatory trends that we use to make adjustments to our audit models and programs and to help bank management make proactive adjustments to their practices.

Over the past ten years, major waves such as BSA, Information Security and flood insurance have hit the banking industry. But the most recent --loan quality-- is more like a tidal wave. Following are lending-related regulatory hot spots we see from our ongoing survey of examination reports and public consent orders for 2009. Since the regulators are looking closely at these issues, it's prudent that bank management do the same.

Loan Quality

It's common knowledge in banking circles that the hurricane force loan quality issues developed first in subprime, then in residential, then in residential development and construction, and now into commercial real estate. The next shoe to drop will be Commercial & Industrial, and we are already seeing this with SBA loans. For the large banks, major problems in credit card debt have also surfaced.

Liquidity

The catch-22 is that when a bank really needs liquidity from depositors, correspondent lenders or potential shareholders, it very likely won't be available. The same is true for consumers since banks are loathe to lend money to borrowers with weak cash flows. Examiners are asking banks to have a Liquidity Contingency Plan in place as well as a cash flow forecast in the form of a projected Sources and Uses statement.

Allowance for Loan and Lease Losses (ALLL)

Since aggressive recognition of loan quality problems could manifest itself in capital shortfalls, bank managers are often slow to make necessary ALLL provisions. At the same time, examiners are expecting larger ALLL balances than in the past due to the general climate of the banking industry and concerns about the spread of credit problems into commercial real estate and C&I loans. Additionally, examiners are scrutinizing non-compliance with the 2006 Interagency Guidelines on the ALLL. Generally, the examination findings have noted poor documentation of the relationship between loss reserve factors and historical charge-off rates.

Appraisals

As might be expected with collateral values falling as they have, examiners are criticizing appraisal practices, often citing Part 323 of the FDIC Regulations and also the Interagency Appraisal Guidelines. Specific criticisms target the independent ordering of appraisals and also the quality of the appraisals themselves.

Lending Practices

In addition to loan quality, ALLL and appraisals, examiners have been citing a variety of credit underwriting and administration weaknesses. Some of these include incomplete cash flow analysis, weak assessment of guarantor support as well as sources of repayment, violations of real estate lending standards, poor loan to value exception tracking, and weak controls over loan boarding.

AuditOne would be honored to discuss in greater depth steps you and your bank can take to avoid lending-related regulatory action. Please contact me or AuditOne CEO Kevin Watson (kevin.watson@audit-one.com) or AuditOne President Jeremy Taylor (jeremy.taylor@audit-one.com).
Thank you.--Bud

Bud Genovese is founder and CEO of AuditOne LLC, a California-based internal audit firm that focuses only on banks and their service providers. Mr. Genovese pioneered the concept of providing comprehensive, affordable, independent internal audit services by gathering wide-ranging, extraordinary expertise within one firm. AuditOne now serves over 140 clients throughout the Western United States, and nationally. Contact Bud Genovese at 408-980-8099 or bud.genovese@audit-one.com