

AuditOne Advisory

From Bud Genovese, Chairman

Regulatory Crackdown on Loans

For those of you who might be new to our AuditOne Advisories, they are intended to provide useful, informative updates on a wide range of banking and internal auditing issues. We encourage you to forward relevant Advisories to the appropriate people in your bank or organization. Additionally, we view AuditOne Advisories as a service to our clients, our potential clients, and the industry as whole, so if there are any topics you'd like covered, please let me know. And as always, if you have any questions about the information presented in our AuditOne Advisories, do not hesitate to contact me directly at bud.genovese@audit-one.com. Thank you... and now on to this month's AuditOne Advisory.

In case you may have missed this, please read the following item from the 9-5-09 *Banc Investment Daily*:

Regulatory Crackdown: A tough internal critique by regulators related to bank failures should have bankers expecting to see crackdowns on lending concentrations, allowance levels compared to peers, allowance methodology, capital levels compared to peers, aggressive loan growth, reliance on volatile funding sources, a stronger regulatory response and higher overall capital requirements.

There's intensifying regulatory scrutiny out there, and prudent bankers are sensibly responding by re-examining and enhancing their Credit Review and ALLL policies. These stormy economic times demand extra due diligence. Bankers who increase the frequency and depth of analysis of their loan review and ALLL methodology will not only be safeguarding their bank's fiscal and reputational integrity, they'll also better ward off regulatory intervention ... and sleep more soundly at night.

Credit Review

Here are some steps to think about as you analyze your credit review policies and practices to meet the demands of the current environment:

- Review risk-grading policies, procedures and practices
- Conduct more frequent and rigorous credit reviews
- Conduct adjunct loan documentation reviews
- Put teeth into your covenants
- Ensure other loan policies and procedures are current and clear
- Implement stress-testing, concentration limits and other portfolio-level tools
- Upgrade portfolio data and reporting, including monitoring of loan concentrations
- Ensure appraisals are current, with reasonable assumptions and are subjected to effective review process
- Train and mentor junior lenders
- Keep the Board informed and involved

ALLL

The methodology for loss reserving must be prudent, proactive and able to pass increased regulatory scrutiny, while keeping the bank ahead of gathering storm clouds. This isn't easy in the best of times, which these clearly aren't. The challenge now comes from boosting reserves according to what instinct, common sense and experience all say is necessary, even as standard credit measures like past-due, criticized, and migration trends may have yet to manifest the full impact of growing pressures on borrowers.

The December, 2006 Interagency Guidance on the ALLL provides a roadmap for enhancing a bank's approach, though it's only a rough guide requiring considerable interpretation and supporting analysis.

Start with specific vs. general reserves. Impaired loans require specific (i.e., individualized) reserving per SFAS 114. The bank itself defines impairment (non-accruals, for example), and then a reserve amount for each such loan is calculated. There are three ways it can be calculated, with present value of cash flows typically most important for standard commercial loans and fair value of collateral for real estate. These are tools for determining impairment. But regulators expect any impairment amounts to be charged off immediately rather than parked in reserves. What you do with the remaining balance (hold it with zero reserve; create some additional specific reserve; throw it into the SFAS 5 pool) is something to discuss with both your accountants and your examiners.

The general reserve is guided by SFAS 5. Non-impaired loans should be divided into pools of similar risk -- by type of loan, by risk grade (RG), perhaps by other characteristics as well for larger, more complex portfolios. Then allocate reserves to each segment (for example: RG 5 Construction loans) by applying an appropriate loss factor to that segment's balances. The loss factors ideally reflect your bank's own experience. Otherwise, pull peer data (e.g., from the FDICs Web site) to help establish a reasonable starting point. What the regulators then want to see is a process whereby the nine Qualitative and Environmental Factors identified in the 2006 Guidance statement are used to modify the peer-adjusted historical data, at each quarter-end. The trick, of course, is quantifying what are innately subjective considerations. Rate them, weight them, and then mix in a good dose of common sense.

And finally, remember that the underlying foundation for the ALLL calculation (as it is for loan pricing, credit risk capital requirements, and other applications) is the bank's RG system. Do your RGs reliably distinguish between borrowers of different risk profiles, and do they respond to underlying changes in creditworthiness over time? Assessing this isn't all that a credit review does, but it's a very important part.

AuditOne Can Help

Many banks today are increasing the frequency of their independent credit reviews to two or more times per year, and are scheduling independent ALLL validations annually (2006 Guidance requires them "periodically"). AuditOne has the expertise to help you devise a strategy that is right for your particular bank and situation. Give me a call and we can discuss how to develop prudent Credit Review and ALLL policies and procedures that will keep your bank safe and on the right side of the regulators.

*Bud Genovese is Chairman 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 and credit review services by gathering wide-ranging, extraordinary expertise within one firm. AuditOne now serves over 160 clients throughout the Western United States, and **nationally**. Contact Bud Genovese at 408-980-8099 or bud.genovese@audit-one.com*