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Publications & Resources

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Focus: Directors Issues



Seven Key Questions Directors Must Ask their Bank Executives

By *Jeremy D. Taylor and Len Filppu*

As the banking industry continues to evolve in this era of economic and regulatory flux, it is more important than ever that bank directors pay close attention to the ever-widening array of Safety & Soundness concerns and threats. To help you get your arms around it all, here are seven key questions directors should ask their bank executives.

1. Is Your Capital Adequate and Safe?

Can you ever have too much capital? The reality is that in the eyes of examiners, a healthy capital cushion can diminish the importance of other CAMELS deficiencies. Are you replenishing capital as you replenish your loan loss allowance? Do you have a contingency plan for the possibility of loan quality problems or other unknown events causing capital to fall below comfortable levels? Track your capital ratios relative to peers. Recognize that yesterday's minimum ratios have long since passed...especially if you're grappling with credit or other problems.

2. Do You Have Enough Liquidity?

The liquidity issue is not just a matter of covering short-term liabilities with liquid assets, and avoiding (or minimizing) the volatile, wholesale liabilities on the examiners' warpath. It's also ensuring/verifying that you've got enough liquidity for when loan demand eventually recovers, and for the deposit withdrawals that may coincide. It's also the liquidity to cover stress scenarios, and recognizing that your off-balance sheet (contingent) liquidity may not all be there when you really need it.

3. Is Your Loan Quality Under Control?

Do you have your hands around your loan portfolio, the individual problems within it, and the correlated credit risk across it? Are your loan officers doing timely monitoring and review of all loans? Have you upped the frequency and depth of independent credit review? Examiners are citing a variety of credit underwriting and administration weaknesses including incomplete cash flow analysis; weak assessment of sources of repayment and guarantor support; violations of real estate lending standards; poor loan to value exception tracking; and weak controls over loan boarding. Signs that additional action needs to be taken include increasing trends in OREO and in nonperforming loans; adverse comparisons against UBPR and/or local peers; low or declining ratio of ALLL to non-accruals or non-performings; higher haircuts on FHLB or FRB pledged loans; credit staff turnover; and of course, material criticism in examination reports.

4. Are your Interest Rate Risk Models Prepared for Change?

When rates do start to rise, do you know how you'll be affected? Your IRR modeling results may suggest (beneficial) asset-sensitivity, but suppose the yield curve doesn't rise in a nice parallel shift? How much of an interest expense kick will the Regulation Q repeal bring? Will you be able to restrain deposit rate increases as much as your modeling assumptions state? How much will higher rates stress your already stressed borrowers? Throw all this into the pot and rising rates may not result in the benign outcome you're presuming – especially if rates were to rocket rather than ramp. Do your back-testing, do those 400 basis point shifts, review/revise your assumptions, and ask lots of questions.

5. Is Your Compliance Up-to-Date?

Can your bank meet the new, higher compliance standards and the continually shifting focus of this regulatory environment? Here are some hot topics we're finding out in the field.

- RESPA: Is your monitoring process in place to ensure required tolerance levels are not exceeded? Are you aware that the zero tolerance "transfer taxes" vary by state? Make sure your estimate is exact to avoid

paying the difference between actual and estimated.

- TISA: Do your checking account statements now reflect total fees for the payment of overdrafts and returned items unpaid, both for the statement period and year to date?
- Privacy: Are you using the new model privacy notice form to mitigate risk via safe harbor?
- Expedited Funds Availability Act: Are you prepared for the new (7/21/11) requirement to release \$200 the first business day after the day of deposit?
- Interest on Deposits (Regulation Q): Are you ready for the demise of Reg. Q and able to offer interest on demand deposit commercial checking accounts (effective 7/21/11)?
- FCRA: Are procedures in place for Model Forms for Risk-Based Pricing and Credit Score Disclosure Exception Notices?
- TILA: Have you amended the "Fed Box" on closed-end mortgage disclosures to reflect interest rate and payment summary (effective 1/31/11)?
- SAFE Act: Will you meet the 7/29/11 deadline for mortgage loan originators employed by regulated institutions to register with the SAFE Act registry

6. Is Your Risk Management System Prepared for Scrutiny?

Recent regulatory actions signal that banks should be employing more robust, enterprise-wide risk management models for their financial, risk and other management needs. Will you be ready for the next wave of examiner scrutiny of your various models and how you're managing them? Have you taken an inventory of all models being used across the bank? Have you validated their accuracy? Do you have a policy to control their access, ensure correct input, review and validate the output, and appropriately govern other components of the model management process?

7. Are Your IT Systems Secure?

Information technology moves fast, and it's critical to make sure your bank's IT department stays in compliance with regulations... and ahead of hackers. Today's prudent technology risk management program should include an annual risk assessment; an information security review; an independent IT audit; review of bank-wide business continuity and disaster recovery plans; internal and external network penetration tests with social engineering analysis; and an assessment of the Information Security Program (federal GLBA and applicable state laws).

Additionally, new mobile/remote technologies, the rise of online banking, interactive websites and social networking, and increasingly creative criminal activities such as phishing demand that new risks are quickly identified, managed and controlled. Be sure the information security reviews are current and mapped to these new technologies and the risks they introduce.

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