

Exams, CAMELS and Change: Is Your Board Prepared?

By Koya M. Bakare

As a record number of financial institutions encounter fiscal problems, good corporate governance is no longer good enough. Now more than ever, it is critical for bank boards to maintain dialogue with management and remain abreast of what is occurring at their specific institutions and in the industry as a whole.

For instance, given the current regulatory environment, your bank's board could be subject to a more in-depth examination process. Is your board prepared for the next examination? "Right now, this is probably the most difficult regulatory environment I have ever seen," said Pat Rohan, managing director for Liberty Corner, N.J.-based FinPro. "The examiners are coming in with bigger crews. They are digging deeper than normally into the banks' records, particularly into the loan portfolio."

Before joining FinPro, Rohan served as regional director for the FDIC's Boston region after working for the agency almost three decades. Based on his extensive regulatory experience, Rohan underscored the need for bank directors to have a good

loan portfolio," Rohan said. "It is key that board members have a good understanding of any asset quality problems. They should know everything [that's] going on as far as earnings, liquidity, rate sensitivity and capital position." Rohan also

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understanding of their banks' financial position prior to an exam.

"Board members in this environment need to have a good handle on what issues they may be dealing with as far as any kind of credit quality problem in the

suggested the following best practices for bank boards:

- Keep thorough board reports.
- Ask questions of management.
- Probe beyond the numbers presented at board meetings.
- Be aware of industry hot topics.
- Participate in educational opportunities.
- Maintain open communication with your regulatory agency.

He emphasized that it is the responsibility of bank boards to possess a working knowledge of the examination process. Every board member should be aware of the basics of the process. If they are not, a plan should be implemented to educate and inform them.

According to Rohan, a particular area of concern for bank boards should be the regulators' overall assessment of an institution's condition as determined by the CAMELS rating system. It is vital for the board to know and understand the basic

Regulatory Response and the CAMELS Rating System

Here's a quick guide to use with your board to explain this aspect of the examination process.

Composite Rating 1 -2: Letter asking for corrective action on any criticized areas.

Composite Rating 3: An informal corrective program—board resolution or memorandum of understanding.

Composite Rating 4: Formal corrective program—written agreement, cease and desist order.

Composite Rating 5: Formal corrective program—written agreement, cease and desist order, termination of deposit insurance.

Source: FinPro PowerPoint Presentation for ABA Telephone Briefing

components that make up the composite rating: capital, assets, management, earnings, liquidity and sensitivity.

“Typically the bank’s composite CAMELS rating will be a good indicator of what the regulator’s response will be in dealing with the bank,” Rohan said. The composite rating also determines the level of follow-up to be expected from the regulators following an examination (See sidebar).

Rohan observed that some banks that have historically received ratings of 1 or 2 have received ratings of 3 or 4 on their most recent exams. “What may have passed muster at a prior examination isn’t necessarily going to pass muster at this exam,” he said.

Rohan identified “new and tougher application of regulatory guidelines, greater demands for documentation, downgrades on bank’s current risk ratings and challenges to the bank’s reserve loan-loss rate methodology” as critical influences on

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the shift in ratings received by banks – specifically institutions that in the past received stellar results.

“Typically a bank that is going to get a rating of 3, 4 or 5 will have a pretty good idea at the exit meeting of the examination of the rating and regulatory action,” Rohan said. At this point, he believes it is advantageous for banks to become proactive and respond to regulators’ criticisms even prior to receiving the formal exam report. He suggested that following exams, banks and their boards should maintain communication with regulators before receiving the corrective program and address issues and render feedback as soon as possible.

In the current regulatory climate, good corporate governance incorporates not just good but exceptional insight, preparation and strategic application. As the industry moves toward recovery, preparation for your next examination begins today. **5**

Pat Rohan was one of the speakers for the America’s Community Bankers Council’s recent telephone briefing, Directors and Regulators: Understanding the Exam and Enforcement Process. To purchase a recording of the telephone briefing, visit www.aba.com or call (800) BANKERS.