The Regulatory Focus

Ohio Department of Commerce
Division of Financial Institutions

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John Kasich Governor | **David Goodman** Director | **Charles Dolezal** Superintendent | **Kevin Allard** Deputy Superintendent

Credit Risk Management Strategies That Work

The Division is pleased to note that many institutions have improved their asset quality portfolio. Some credit can be attributed to an improved economy; however, stronger risk management practices have been the key factor. The Division asked several bankers who managed the most significant progress to share their ideas on risk management practices and strategies that work best. Below are strategies that worked for Ohio institutions:

- Vigorous underwriting is the foundation. Curtail individual approval limits and use a committee of lenders. The lenders should use historical experience about the borrower or particular type of lending. Most importantly, ensure the borrower has "skin" in the deal and establish and enforce rigorous covenants.
- Talent acquisition is needed to assemble the quantity and quality of staff to manage a high volume of workouts. Knowledgeable credit analysts can recognize deteriorating credit early. Delinquency is a behavioral issue, and when it occurs it is probably too late. Lenders must be held accountable. Sometimes the originating lender is too close to the situation to recognize and react swiftly.

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"These bankers also stressed one common theme: diversify your risk, stay within your market area, and *stick to the business types you know!*"

Participation Agreements with Optionality Provisions

The Division has become aware that "optionality" provisions in loan participation agreements providing the selling institution the right to repurchase the portion of the loan sold are likely prevalent in Ohio banks.

Ohio institutions are reminded that newer accounting guidance and Call Report instructions require that loan participations that contain such language should be treated as a "secured borrowing" and not as a loan participation sold.

With regard to the Ohio legal lending limit, Ohio institutions will also need to review the participation agreement closely to ensure that the risks of ownership have transferred with the sale.

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- A culture change is required. Clear direction and expectation need to come from board and senior management that these workouts are the #1 priority. Personnel need education and authority so borrowers recognize they are working directly with the decision maker so no time is wasted. Establish scheduled progress monitoring meetings to apply pressure towards your goal.

- If the action plan is rehabilitation, pursue a restructure quickly and appropriately. Ensure a value exchange for the institution, whether it is a structural enhancement or additional protection. When negotiating, be aggressive but allow for compromise.

- If the action plan is to terminate the credit relationship, encourage the borrower to seek a solution and offer favorable terms for any deficiency balance or charge-off forgiveness. Consider use of a third-party for liquidation since often a mediator can work out a solution quicker between parties and have attorneys file appropriate paperwork expeditiously.

These bankers also stressed one common theme: diversify your risk, stay within your market area, and ***stick to the business types you know!***

Real Estate Appraisal Requirements for Other Real Estate Owned (OREO)

Questions about the documentation necessary for the disposal of Other Real Estate Owned (OREO) have recently arisen during examinations. The regulatory requirements are addressed in guidance issued by the Federal Reserve in March 1995: http://www.federalreserve.gov/boarddocs/srletters/1995/sr9516.htm

Real estate acquired through foreclosure qualifies for an exemption to the appraisal regulation for existing extensions of credit. Therefore an appraisal is not required, but an evaluation of the collateral is required.

The **disposal** of OREO is not related to the previous extension of credit and does not qualify for the same exemption. As a result, institutions must have a valid appraisal (or evaluation if the sales price of the OREO is less than $250,000) to support the transaction. If the institution already has an appraisal and it is determined to be valid, then a new appraisal is not required. To be considered valid, an institution should be able to document that there is no material change in the market value of the collateral. This determination must be made by someone with appropriate real estate expertise and market knowledge.

2012 Regional Bankers' Roundtables

Regional Roundtables have been scheduled to provide senior bank management and directors an opportunity to discuss current issues and hot topics with Division staff. Roundtables were recently held in Findlay and North Canton. The December events will be:

Athens – Tuesday, Dec. 11 - Ohio University Inn

Mason – Thursday, Dec. 13 - Kings Island Resort

Reynoldsburg – Tuesday, Dec. 18 - State Fire Marshal's Office

All Roundtable sessions begin at 8:30 a.m. and conclude by 10:30 a.m.

For more information or to register, please contact Sean Kesler at (614) 644-7547 or call our main number (614) 728-8400 and ask for Phyllis Humphrey.

From the Director ...

Director

David Goodman

As I write this, the new Financial Institutions Tax is headed towards passage in the Ohio Senate. The bill will then go back to the House for expected concurrence on Senate amendments. The "Financial Institutions Tax" – also referred to ask the "FIT"-- is the last major component of the Governor's mid-biennial budget review package.

Getting rid of old methods of taxing banks and creating the Financial Institutions Tax (FIT) will close loopholes to make the system fair for all, particularly community banks who do business primarily in Ohio. The change reforms and simplifies the tax code and is designed to be revenue neutral for the state.

Governor John Kasich is committed to making a more fair tax system in Ohio. Banks that operate primarily in Ohio should not be paying a larger share of the tax burden when they are local businesses fueling other local businesses in Ohio communities. The FIT is a promise of fairness that was made and is being kept without reducing the needed income to the state.

And there is a fail-safe. After the first returns are filed in 2014, rates would be adjusted if the revenue falls above or below the revenue target.

By broadening the tax base and closing the loopholes to create a simpler and fairer system which does not reduce income to the state, Ohio community banks will pay less and have more money to invest in local businesses that will be in a better position to grow and create jobs.

The new tax law would go into effect in calendar year 2013.

Finally, please continue to share your ideas for how we can be better partners in this economic recovery. Count on us to work with you; both providing conservative financial oversight and being creative problem-solvers.

Chuck Dolezal and I want to hear from you every step of the way as we work on the initiatives you read about in this newsletter. Please feel free to call me or email me any time: 614-644-7047 or

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David Goodman
Director
Ohio Department of Commerce

From the Superintendent...

Superintendent

Charles Dolezal

Welcome to ***The Regulatory Focus***. Within the pages of this newsletter, we hope you find timely information that is informative for you and your institution. Our goal is to provide a means of communicating current regulatory hot topics, provide helpful tips, and answer any questions you may have.

Our first edition features guidelines for preparing for an upcoming examination and the importance of effective communication between you, the banker, and the examination team. We address the issue of appraisals for other real estate owned, and discuss loan participation agreements and optionality provisions. And finally, helpful tips from your peers are provided on the credit risk management practices that worked for them.

Our goal is to foster open communication between the industry and the Division, and as such, we welcome your feedback on the newsletter, its contents, or any suggestions for future editions. Feel free to contact us via email at webdfi@dfi.com.state.oh.us or contact me directly at Charles.Dolezal@com.ohio.gov or (614) 644-7501.

Also, please mark your calendars for the Ohio Bankers Day Conference to be held on June 6, 2013. I'm looking forward to offering you an exciting new location and new format for this event.

Participation Agreements with Optionality Provisions continued...

Generally, if the selling bank hasn't actually repurchased the participation interest, and the buyer doesn't have a contractual right to "put" it back to the selling bank, the "risk" would remain at the buyer.

For more information on Financial Accounting Standards Board (FASB) Accounting Standards Codification 860 (fka FAS 166) and Ohio Legal Lending limit laws, see http://www.com.ohio.gov/fiin/docs/fiin_FASBAAccountingStandardsOHLegalLendingLimitLaws.pdf

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Cyber Alert

The FBI has recently reported that cyber criminals are targeting financial institution networks and employee login credentials.

Once compromised, the criminals attempt to gain access to a bank's wire transfer systems. Recent denial of service (DDOS) attacks on banking organizations may be a distraction for bank personnel to prevent them from identifying potentially fraudulent activities.

See the link below for additional information on the FBI alert and recommendations for financial institutions:

http://www.ic3.gov/media/2012/FraudAlertFinancialInstitutionEmployeeCredentialsTargeted.pdf

How to be Best Prepared for an Examination

Regulators are frequently asked for some helpful tips to aid institutions in preparing for an upcoming examination. Communication between the banker and examiners is always critical. Below are some best practices to consider when preparing for an examination:

- Consider appointing an examination liaison responsible for distributing the request list, gathering all information, and checking to confirm that all of the requested information is provided and well organized.

- Ensure corrective actions noted from previous examinations have been satisfactorily resolved.
- Ensure key personnel are available during the onsite portion of the examination.
- When the loan file request list is received, distribute to lending officers to make sure they are familiar with those loans.
- Invite and encourage outside Directors to meet with the examination team.
- Request an initial meeting at the beginning of the examination either the first day onsite or the date the requested materials are picked-up. Provide any updated information regarding changes in strategic direction; changes in personnel or roles within the institution; and significant policy or practice changes.
- Request weekly update meetings to discuss the examination process, progress and potential issues arising from the examination.
- Make certain management has a full understanding of the examination team's position on specific examination concerns and conclusions before the exam team exits the institution.