

# Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

June 13, 2011

## OCC Enforcement Orders Hammer Banks on Strategic Planning

Recent OCC consent orders are drilling down into strategic planning and doing so at a level of detail and scrutiny previously reserved for larger banks, experts say. Many community banks think of the strategic plan as little more than a regulatory requirement, but that way of thinking may be coming to an end for OCC-examined banks.

Several consent orders from the OCC hammer banks for insufficient strategic planning, liquidity planning and capital planning. Many of those same consent orders demand that banks draft new plans, that the board reviews those plans regularly and compare bank actions to what the bank sets out in the new plan.

“[The OCC] is clearly raising the bar in terms of how corporate governance is properly executed on a daily basis,” says Orlando Hanselman, the education programs director for Fiserv Risk & Compliance in Johnstown, Pa. “They’re basically saying, without a well-developed strategic plan and capital plan you are de facto unsafe and unsound.”

Another important detail: regulators are applying this new standard to smaller banks. Community banks may no longer be able to argue that they’re too small for this kind of scrutiny, Hanselman adds. They’re now having to live with standards that used to apply only to the biggest banks.

“These standards have been required for as long as I can remember, but with a different measuring stick, one based on size,” Hanselman says. “Historically, the larger the institution, the higher the bar has been set. But, it’s clear that this degree of enforcement has filtered down to community bank-sized banks.”

Regulators are clearly going more deeply into bank operations with administrative action, and exams can’t be far behind, he suggests.

**“The regulators are leading the industry towards an expressed need to consider risk management as part of the strategic planning process.”**

“I think that this is an early warning precursor for how high the exam bar will be for community banks,” Hanselman says. “I thought that this would be the result at the field exam level, once new policy, direction and best practices were embraced. This is

the end result: more definitive exams.”

A senior examination official with the OCC denied that strategic planning – or liquidity and capital planning – were new areas of special focus for the OCC. “We’ve been including strategic plans in enforcement documents for years,” he says. Nevertheless, he did admit that OCC examiners have been seeing cases where banks created strategic plans for exams and subsequently ignored them.

“We did see a lot of cases like this,” he says. “It’s an OCC requirement for banks to have them, but we did see instances where they were collecting dust. They weren’t being used. They might have been developed for an exam and then gradually, they go by the wayside.”

The agency stresses the importance of a functional strategic plan because it forces management and the board to consider the whole of banking operations and that makes it a pivotal piece of any bank’s risk management program, the official says.

“Strategic planning is the start of risk management,” he says. “You have to plan for the product lines, the risk controls, the costs. Bank management

*(continued on page 2)*

## SUBSCRIBER SERVICES

### MISSION:

**Bank Safety & Soundness Advisor** provides independent, executive intelligence on bank exams, enforcement and risk management.

### EDITORIAL:

Need us to investigate a topic?  
Want to express your opinion?  
Please call or e-mail us.

### Publisher:

**Aaron Steinberg**  
800-929-4824 ext 2471  
asteinberg@banksoundness.com

### Group Publisher:

**Hugh Kennedy**  
800-929-4824 ext 2213  
hkennedy@banksoundness.com

### SUBSCRIPTIONS:

Direct questions about subscriptions to:

**Phone:** 1-877-320-7147;  
**Fax:** 301-287-2945;  
or send an **e-mail** to  
Customer@banksoundness.com.

Published weekly (48 times a year).  
Copyright 2011. Price: \$595/yr.

### EDITORIAL CONCERNS:

Our goal is to provide you with the most accurate and balanced information available anywhere. If you ever feel we're not living up to this standard, I want to know about it. Please call me, Hugh Kennedy, Group Publisher, direct at 1-800-929-4824 ext. 2213.

### ADDRESS:

**Bank Safety & Soundness Advisor**  
Two Washingtonian Center  
9737 Washingtonian Blvd., Ste. 100  
Gaithersburg, MD 20878-7364

## OCC Enforcement

*(continued from p. 1)*

has to translate that into budgets and forecasts the board can follow. Adjustments always need to be made."

The OCC's interest in strategic planning – and its connection to risk management – makes sense, since the agency has been ahead of its regulatory peers in pushing enterprise-wide risk management, says Marcus Faust, SVP and ERM consultant with RP Financial, Arlington, Va.

"The regulators are leading the industry towards an expressed need to consider risk management as part of the strategic planning process," Faust says. "There is strong evidence of this in the regulators' view: You can't just put together a strategic plan or a business plan and include goals, people and products, but [omit] all the risks you'd subject the company to in the execution of that plan."

Pairing strategic planning with risk mitigation in administrative orders is a new trend, says Faust, who first started seeing it pop up in early 2011. It also makes sense, he adds.

"The two concepts, strategic planning and ERM, go hand-in-hand," Faust says. "It's consistent with the guidance in the OCC examination handbooks in 2010, both for large banks and community banks."

Nevertheless, forcing troubled banks to put in a ton of effort drafting a new strategic plan may not make much sense, suggests Peter Weinstock, a partner with Hunton & Williams LLP, Dallas, Texas.

"This tends to be another one of those issues," he says. "When a bank is in troubled condition, the

regulators pile on. They demand a kitchen sink document. What would be better is [to demand] a document that's much more tailored to the bank in question. Throwing a strategic plan paragraph into the order makes the document thicker and more impressive, but it doesn't get to the heart of the document's purpose."

"Requiring strategic plans is key for regulators, but I haven't seen it be a key driver for the success of banks," he adds. "A lot of successful banks have strategic plans they don't follow. They have them because the regulators make them have one."

### Planning Ahead

Banks who haven't been using strategic plans should start making them part of their regular operations, especially in light of this recent administrative activity, says Hanselman.

"It's clear that banks and the board should be cognizant of the fact that they can't just write a weighty [strategic planning] document and then ignore it as soon as they submit it," he says. "Management and the board should be referring to it in the daily operations of the bank, with follow-up and action. Strategic planning documents should guide a financial institution. It shouldn't be a compliance checklist."

In light of this, what should banks do?

**1. Hit the basics.** "The requirement to have a sound, board-approved strategic and capital plan isn't new," Hanselman says. "It's been fundamental to safe and sound banking operations for as long as

I can remember. But the prevalence of robust and comprehensive strategic planning [in administrative actions] shows that there are a lot of financial institutions out there not doing this.”

In the past, strategic planning at a lot of financial institutions has been largely for the benefit of examiners, Hanselman says. Actions like this suggest that regulators won't settle for that anymore.

“Even banks with robust strategic plans have been in the habit of writing one every three years and then setting it on a shelf to collect dust,” he says. “In the past it's been more of a checkbox. ‘Do we have one?’ If yes, then check the box. It hasn't been a living, breathing document.”

**2. Create an ERM corporate governance structure.** There are no surefire antidotes for administrative action, but banks can plan ahead and buy themselves some credibility should an issue evolve into admin-

istrative action, Faust says. A good first step for proactive banks would be to set up an ERM corporate governance structure.

Banks should “think about incorporating risk management in planning and, at the very least, set up an ERM corporate governance

**“A lot of successful banks have strategic plans they don't follow. They have them because the regulators make them have one.”**

structure,” he says. “A lot of banks don't have ERM committees at the board level or even at the management level.”

If you establish an ERM committee at the management level or even the board level, it will be an easier sell to convince examiners that you, too, see the link between strategic planning and risk management and you're acting on it, Faust adds.

“How can you argue that you're incorporating [risk management] into strategic planning without any official body – at the management or board level – charged with that responsibility?” Faust asks. “Being proactive and using a portfolio-level point of view to manage will buy you some credibility with the examiners.” ■

## CRE Stress Testing

(continued from p. 1)

### CRE Stress Testing Expectations Nebulous; Use Your Judgment, Experts Say

The recent GAO report on CRE regulation, guidance and exams only reaffirms general banker sentiment: The regulators haven't been clear enough on expectations for CRE. One aspect of CRE guidance that bankers – and BSSA readers – have been asking about is CRE stress testing, which is required by regulators for CRE portfolios of a certain size. Nevertheless, that 2006 guidance only devotes a few paragraphs to the subject.

What does an examiner-acceptable CRE stress testing program look like? According to the guidance, that depends not only on the size of the CRE portfolio, but also on the contents.

The 2006 guidance leaves it up to banks to determine just how dangerous the contents of their CRE portfolio can be and scale their stress testing plans accordingly. “The sophistication of stress testing practices and sensitivity analysis should be consistent with the size, complexity, and risk characteristics of its CRE loan portfolio,” the guidance states. “For example, well-margined and seasoned performing loans on multifamily housing normally would require significantly less robust stress testing than most acquisition, development, and construction loans.”

As regulators also suggest, it doesn't have to be complicated either. “The final guidance notes that portfolio stress testing does not require the use of sophisticated portfolio models,” wrote the regulators in a Financial Institutions Letter accompanying the final version of the guidance. “Depending on the institution, stress testing may be as simple as analyzing the potential effect of stressed loss rates on the institu-

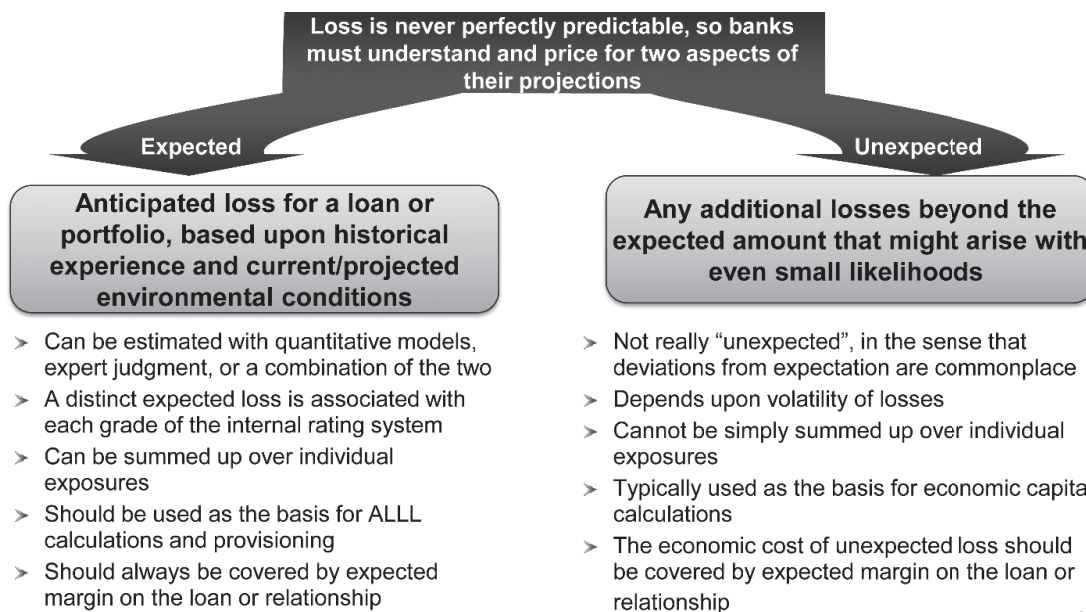
tion's CRE portfolio, capital, and earnings. The important objective is that an institution should have the information necessary to assess the potential effect of market changes on its CRE portfolio and lending strategy.”

Banks should begin by focusing on the thought process, which is more important than the models themselves, suggests a Federal Reserve presentation on CRE and stress testing produced by the Federal Reserve's credit risk department.

Examiner expectations in regards to CRE stress testing – much like stress testing expectations in general – have not been standardized or made explicit. Banks should know if examiners will expect them to stress the CRE portfolio, but there's no way to know, with certainty, exactly what your examiner will expect, says Bill Nayda, principle with Second Pillar Consulting, Glen Allen, Va.

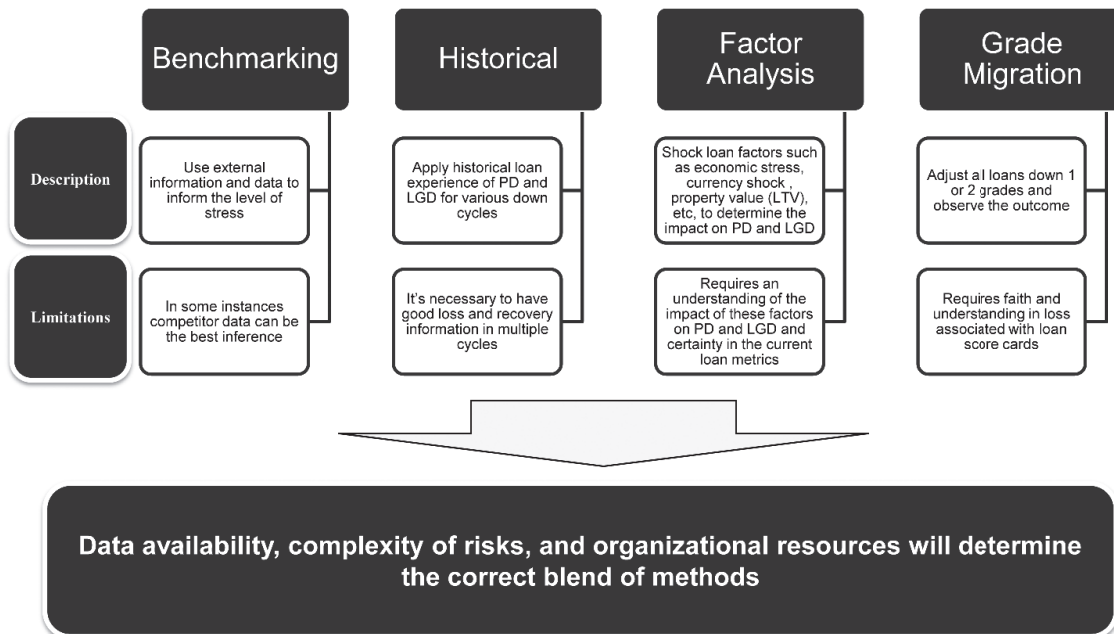
“Basically, if you fall under the guidance of SR 07-1, [examiners] will ask if you have conducted a

### Expected vs. Unexpected Credit Loss



*Source: Second Pillar Consulting*

## CRE stress testing is a hot topic: several methods can be used to stress CRE credit resiliency and to determine capital need



Source: Second Pillar Consulting

stress test and will want to see the results," Nayda says. "It goes from there, depending upon the examiner and there are thousands of those so there is no cookie cutter answer."

Nayda does point to some general expectations that banks can use as a guide, however. Examiners will expect banks to conduct some form of scenario analysis regarding potential losses in the portfolio and how those losses will impact the balance sheet and earnings.

"The intent is to be able to inform management of the inherent risk in the bank and to own the risk," Nayda says. "Portfolio-level stress tests would be the most basic starting point. Again, the sophistication and complexity of the stress will depend upon the size and complexity of the institution. Larger banks with high concentrations of CRE may have to conduct both portfolio and loan level stress tests to get an accurate

picture of risk."

Nayda recommends one relatively new, and examiner friendly method: using SCAP parameters to stress your CRE portfolio. No stress testing method will work perfectly right out of the box, however, and with this method, too, banks need to make sure that they've tailored it to their bank and its unique portfolio. A regulator-designed test like SCAP may impress examiners, but banks still need to get on top of the technical details, Nayda adds.

"The important thing, which is tricky, is picking the appropriate amount of stress," Nayda says. "The SCAP had a pretty significant range. Another technical point is the amount of earnings over the next two years."

Whether you opt to go with SCAP or not, however, this process – choosing the appropriate test for your bank – is key, Nayda adds.

"Banks need to pick a stress test methodology that fits their

organization," he says. "[If] you have the data, can you do it internally. [Maybe] you need to purchase a tool from an outside vendor. However, watch out for tools from outside vendors as we have seen some that will sell you a stress test model that will test on a loan level basis, but the tests are up five percent, 10% or 20%. How do you know if it shouldn't be one percent, or 50%? That's where the bank needs to use its knowledge of the current loans and future outlook for the economy or losses to infer how much stress is appropriate."

### More Direction?

Banks have been asking for more direction from regulators on stress testing – whether for CRE or the portfolio in total – and they may have gotten it. Last week, the OCC, Federal Reserve and the FDIC released proposed guidance on stress testing for banks at \$10

(continued on page 6)

## CRE Stress Testing

(continued from p. 5)

billion in assets and up. According to the agency release, the guidance “highlights the importance of stress testing as an ongoing risk management practice that supports a banking organization’s forward-looking assessment of risk.” (Look for the low-down on the proposed stress testing guidance in a forthcoming issue of *BSSA*).

Banks may come to regret

asking for specificity in stress testing expectations, argues Orlando Hanselman, the education programs director for Fiserv Risk & Compliance in Johnstown, Pa. CRE stress testing is like any other aspect of supervision – if banks don’t develop their own methods and standards for CRE stress testing, the regulators will eventually hand them much more proscriptive guidance, he says. Regulators will design precisely what they can design: one-size-

fits-all guidance, and banks will lose the ability to tailor their program to their bank.

Once regulators give banks more CRE stress testing guidance, it will provide short term comfort, but it will also cause more pain in the long run, Hanselman says. “The banker who asks for this will end up ruing the day. They’d be giving up their judgment and experience to the regulator in exchange for mandated answers.”

Hanselman echoes Nayda’s

## Consent Orders

(continued from p. 1)

### OCC Gets Detailed with Strategic Planning in Consent Orders

For a number of troubled banks, strategic planning will become a central piece of daily operations – whether they like it or not. Recent OCC consent orders and cease-and-desist letters pound smaller troubled banks for poor strategic planning. They also demand that those banks’ boards use strategic plans to benchmark institutional action regularly.

“At least monthly, the Board shall review financial reports and earnings analyses prepared by the Bank that evaluate the Bank’s performance against the goals and objectives established in the Strategic Plan, as well as the Bank’s written explanation of significant differences between actual and

projected balance sheet, income statement, and expense accounts, including descriptions of extraordinary and/or nonrecurring items,” states one consent order for a bank with less than \$200 million in assets.

Regulators like the OCC may have saved their granular demands for larger banks in the past, but as consent orders like this one suggest, the OCC is getting granular with smaller banks, too.

In this particular consent order, the OCC wants a draft plan covering a three-year period that establishes objectives in many aspects of bank operations, including the bank’s risk profile. Here’s what the OCC wants this bank’s plan to include:

1. A mission statement that forms the framework for the establishment of strategic goals and objectives;
2. The strategic goals and

objectives to be accomplished;

3. A description of the Bank’s targeted market(s) and an assessment of the current and projected risks and competitive factors in its identified target market(s);

4. Specific actions to improve Bank earnings and accomplish the identified strategic goals and objectives;

5. Identification of Bank personnel to be responsible and accountable for achieving each goal and objective of the Strategic Plan, including specific time frames;

6. A financial forecast, to include projections for major balance sheet and income statement accounts, targeted financial ratios, and growth projections over the period covered by the Strategic Plan;

7. A description of the assumptions used to determine financial projections and growth targets;

8. An identification and risk