



## **A Time for Vigilance**

News headlines continue to focus, as they have for several months, on the depth and breadth of the current recession. Corporate icons Bear Stearns, AIG, Fanny Mae, GM, Countrywide, Citigroup, and Chase, as well as President Bush, are some of the most newsworthy casualties. Government bailouts, un-thought-of until recently, have become the norm.

As all of us know, it's not just the large institutions that are feeling the impact of the current recession. The effects can be felt in virtually every community in Missouri...and in every community bank.

Many are looking to Washington for a quick cure. Despite \$100's of billions in economic stimulus programs, no one can be sure when or how fast we will recover. Moreover, smaller communities, further from the effects of the stimulus programs, may be slower to rebound.

Fortunately, community bankers are conservative by nature and experience, and skeptical of risky new loan products and overly-complex investment instruments. They remain focused on the long-term success of their communities and banks, and are not influenced by Wall Street's obsession with short-term results. Although prudent and time-tested policies should mitigate the financial damage, community bankers cannot rely on past practices to get them through this recession.

The extent of the current economic crisis requires increased director vigilance.

Banks need to be prepared for a long and deep recession. This is not meant to be a "doom and gloom" economic forecast, but a reminder to directors to shore up business plans, operating policies, and monitoring procedures in light of the severe economic conditions.

Early identification and recognition of emerging problems are critical. As always, the goal should be "no surprises."

Loans and investments already on books should be your first priority. If you've acquired some "toxic" investments, your pricing reports have alerted you. If you haven't amended your investment policy to prevent such acquisitions, do it now.

An assessment of the loan review process is the next place to start. The review process should be independent of the lending function. If that's not entirely possible due to

personnel constraints, ensure lenders do not review their own customers' credits. Oversight by and involvement of outside directors in the review process adds objectivity. Loan grades should be realistic and consistent, and collateral valuations conservative. Also, the frequency and scope of internal reviews should increase during any economic downturn. If the outside loan reviews conducted by consultants or examiners result in more than a handful of downgrades, your program is deficient and needs prompt revision.

Given the role of real estate loans in the current recession, the need to evaluate those policies is obvious. If terms and margins have drifted from conservative standards, policy adjustments are necessary. Don't swing the pendulum too far though. You still want to serve your market and don't want to exclude your creditworthy customers.

With the overall decline in the economy, we've seen the loan problems spread from residential real estate to commercial real estate, small business, and consumer loans. Those policies should receive the same scrutiny as real estate loan policies. Conservative standards need to be ensured and prompt revisions made where needed.

Once problem loans emerge, they require prompt, effective action to minimize losses. That requires reviews of collection, extension and foreclosure policies. Permissive overdraft, loan extension and collection policies have proven to be ineffective. Flexibility on foreclosures and repossessions has gained some respectability in the current economy due to the glut of those assets on the market.

Foreclosure policies are heavily impacted by the local real estate market. Each bank must weigh the benefits and costs of foreclosure for each property. Those banks in communities with extraordinarily high numbers of residential properties on the market, may find it prudent to work with viable borrowers rather than incur the costs and risks associated with holding other real estate owned (OREO). In many markets, the benefits of keeping the properties occupied and maintained outweigh the costs of bank ownership.

Application of more conservative collateral values during loan reviews obviously impacts reserve adequacy, which will require increased provisions for loan losses. In addition, your reserve calculation should include a component for the distressed economy, given the high level of uncertainty. As in the past, the best time to increase reserves is before large losses occur.

Closer oversight of the loan portfolio may require additional staffing in that area. Your most economical source is to use existing staff from other areas of the bank. Now is the time to begin cross-training and preparing those personnel to ensure they have the necessary skills. Then, if or when the need arises, employees can be shifted smoothly to their new responsibilities.

If the size of your staff is not sufficient to deal effectively with emerging problems, you'll need to quickly add skilled personnel. If unavailable, you may need to call upon outside consulting or accounting firms to train your staff or perform certain functions on a

temporary basis. This is an expensive solution, so it is critical that you thoroughly evaluate the qualifications and references of the firms you are considering.

For those banks that are faced with any significant level of problem assets, the board needs to formulate and implement a plan to resolve those problems and ensure the bank's condition remains sound. The plan should identify each of the problem areas, and specify how each will be addressed and who is responsible for taking action. It should set clear goals and include procedures for monitoring the bank's progress. Outside directors should be given responsibility for plan oversight.

Directors should also ensure that oversight of other regulatory areas such as consumer compliance and information technology does not deteriorate. Strong programs in these areas can help to contain remediation efforts to one area instead of having multiple "fires to fight." Although this discussion has focused primarily on loan problems, these basic steps can be applied to most problems encountered by community banks.

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