Letter from the Director

Even as the U.S. banking industry continues to perform strongly, the responsibilities and skills of examiners remain as important today as they were during the last banking crisis. For it is during this time that examiners and supervisors continue to work to ensure that the industry is prepared to handle future problems effectively. Input from our field examiners offers key insights into any potentially troublesome trends that emerge from on-site examinations. This ongoing communication, as well as outreach with bankers, helps us develop and implement appropriate supervisory strategies.

At mid-year 2004, there were 102 problem banks (banks examiners rate "4" or "5" on a five-point scale, with "5" being the worst rating), or about 1 percent of all insured institutions. A more inclusive group of banks about which supervisors have heightened concern includes, in addition to problem banks, banks rated "3." Even this more inclusive group of troubled banks comprises only 6.6 percent of insured institutions.[1] This favorable distribution of examination ratings is being reinforced by current trends, as examination upgrades of FDIC-supervised institutions are outpacing downgrades.

In good times such as these, bankers sometimes ask supervisors what we are seeing in banks that concerns us. Recently we conducted an informal review of our reports of examination to address that question. We asked if there are common factors driving those few downgrades to a 3, 4, or 5 rating that are occurring, as well as what weaknesses examiners most frequently cited in banks rated 1 or 2.

Among banks downgraded to a composite rating of 3, 4, or 5 during their most recent examination cycle, lax underwriting and credit administration as well as the fallout from weak management and board oversight were the two most frequently cited reasons for the downgrade. Weaknesses in these areas, if not corrected, have traditionally been a leading indicator of more serious problems.

Deficiencies in credit administration also rank among the most frequently identified weaknesses for well-rated banks. Weakness in the credit administration function was reported in roughly one-third of a sample of examination reports completed during the past three years. This should not be taken to suggest that one-third of all banks are in danger of becoming troubled. Virtually every institution has some weakness, and the examiner's job is to detect and report those weaknesses and alert bank management to areas that should receive attention as a means of heading off potentially more adverse consequences in the future. This communication and the ongoing attention of bank management to identified weaknesses are, in the overwhelming majority of instances, sufficient to ensure the bank remains in a sound condition.

However, if deficiencies are not addressed, further deterioration could occur. For example, examiners may identify specific factors that are contributing to weakening in a bank's asset quality. Although not currently a significant problem, should economic conditions turn down or other operational stresses occur within the institution, the effect of these same factors could become more serious.

When significant deterioration in asset quality does occur, it is generally because of weaknesses in loan underwriting,

[1]Federal Deposit Insurance Corporation, Division of Insurance and Research, *Quarterly Banking Profile*, second quarter 2004 (https://www.fdic.gov/analysis/quarterly-banking-profile/qbp/2004jun/qbp.pdf). Supervisory Risk Subgroups, published in the *Quarterly Banking Profile*, are based primarily on CAMELS (capital, asset quality, management, earnings, liquidity, and sensitivity to market risk) ratings, with some additional adjustments. However, no exact match exists between CAMELS ratings and the Supervisory Risk Subgroups.

credit administration, and risk selection. Overall, factors contributing to weak underwriting and credit administration practices include intense competition that contributes to aggressive risk taking and growth strategies as well as management-related issues, such as weak oversight of the credit administration function. Our examiners report that specific deficiencies cited most frequently are lack of cash flow analysis, excessive loan renewals with capitalized interest, poorly documented appraisals or lack of proper officer review of appraisals, and failure to maintain appropriate credit memos.

In response, supervisors continue to emphasize the critical importance of a strong loan review function and an effective grading system. Both safeguards allow for prompt identification and correction of credit administration weaknesses, and they improve the accuracy of the assessment of the allowance for loan and lease losses. Moreover, the development and implementation of a comprehensive loan policy promote the monitoring of shifts in portfolio concentrations and the early identification of any signs of weakening in asset quality. "The Importance of a Loan Policy 'Tune-Up'" in this issue of ***Supervisory Insights*** discusses the importance of an effective and up-to-date loan policy and outlines steps management should take to ensure the loan policy continues to evolve with the institution.

In several examinations, supervisors have identified poor management practices, high-risk business plans that are not supported by appropriate expertise, and boards of directors who rely too heavily on the judgment and assurances of a bank's chief executive officer. These deficiencies, for the most part, seem to occur in institutions characterized by rapid deposit and loan growth that is not accompanied by adequate internal controls. Additionally, examiners point to a failure to implement appropriate risk management policies and practices and address prior exam recommendations as a cause for deterioration in some of these institutions. Weak internal controls also have resulted in large losses for some institutions and represent key areas of concern for our examiners.

Strengthening an insured institution's management presents significant challenges for examiners, as bank officers may be reluctant to implement appropriate controls or allocate additional financial resources. However, examiners continue to emphasize the value of both a well-informed and involved board of directors and an effective audit program. A strong, responsible, and independent board will insist that they receive pertinent information, engage in sound strategic planning, and fairly weigh the pros and cons of key issues. An effective audit function helps ensure that all necessary internal controls are in place, exam recommendations are promptly addressed, and any deficiencies are reported directly to the board.

Our supervisory staff also is concerned that a rising interest rate environment could be particularly challenging for certain groups of institutions, such as banks and thrifts that have ramped up portfolio concentrations in commercial real estate loans. Increasing competition in various real estate markets across the country has contributed to aggressive risk selection that may compromise an institution's ability to price appropriately for the level of risk assumed. On the consumer side, many residential lenders have reported strong growth in adjustable rate mortgages, increasing affordability for many first-time homebuyers during a period of historically low interest rates. However, should rates spike upward, these consumers could be squeezed, particularly if they have taken on high levels of consumer debt in other areas, contributing to deterioration in consumer credit quality.

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This issue of ***Supervisory Insights*** focuses on other critical issues that are challenging examiners and supervisors as well as bank management. "Economic Capital and the Assessment of Capital Adequacy" describes how an increasing number of banking organizations are using economic capital modeling techniques to quantify and manage risk and allocate capital commensurate with their business risk profile. The article emphasizes how bank regulatory agencies are now incorporating these industry efforts into the supervisory evaluation of capital adequacy. "Linking International Remittance Flows to Financial Services: Tapping the Latino Immigrant Market" explores how recent demographic shifts will continue to influence banks' strategies for tapping new markets. The article discusses the implications of the rapid growth and significant size of the Latino market for the U.S. banking industry. Large and small banks are capitalizing on remittance flows as a means of bringing "unbanked" immigrants into the banking system.

This issue's "From the Examiner's Desk" focuses on the key role of the bank examiner in the real estate appraiser referral process, details what situations typically result in referrals, and describes how the referral process works. The "Accounting News" feature describes accounting procedures for the various products offered under the Mortgage Partnership Finance programs by several Federal Home Loan Banks and highlights the participation of insured institutions in these programs.

We thank those of you who submitted positive, instructive feedback on the inaugural issue of ***Supervisory Insights.*** We encourage our readers to continue to comment on articles and suggest topics for future issues by sending an e-mail to SupervisoryJournal@fdic.gov.

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