

Bank Safety & Soundness Advisor

Executive intelligence on bank exams, enforcement and risk management.

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For Examiner-Friendly Workouts, Focus on Classification, Documentation

Regulators are looking harder at distressed assets and putting more pressure on banks holding those assets. What can you do to manage your examiner and your work outs at the same time? Document your decisions and keep up with trends in loan classification, experts say.

You won't get far with your regulator if you don't document your decisions, experts say. "The regulators want banks to work with people, not liquidate them, but if you do work with your borrowers, you need to document the reasons behind any decisions you make," says Bob Viering, a workout specialist and consultant with River Point Group, Inc. in Monticello, Minn.

Regulatory scrutiny of workouts doesn't mean that banks can't take chances or get creative with borrowers. Regulators will allow banks flexibility in workouts, but only if the bank can justify whatever changes it makes.

"My understanding is that the regulators want banks to work with people," he adds. "But [regulators] will want to know why you

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5 Tips for Better Workouts

In last week's issue, we looked at the arguments in favor of hiring a chief workout officer (see "Should You Hire a Chief Workout Officer?" *Bank Safety & Soundness Advisor*, January 31, 2011). Whether your bank opts to hire one, already has, or has instead chosen to assign workout duties to current staff, it needs to manage those distressed assets and examiner expectations. As one source told us last week, the workout function may be the most important function in your bank right now. To that end, we've talked to several veteran workout officers and asked their advice on running a successful workout operation. Here's what they had to say.

1. Be creative

Loans do go bad and banks recognize that, but banks tend to give up on the loan right then and that's often way too early, says Viering. Banks can turn troubled assets into functioning ones with a little creativity.

"A borrower will get into trouble and the bank will say, 'This isn't working out,' but the bank doesn't think: 'What can we do to make this

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Alternate Sources of Insurance a Winning Strategy, Experts Say

When it comes to liability, don't assume that your insurance is the only option. There are alternate sources of insurance recovery available to many banks in plenty of circumstances, though many banks may not know it. Experts advise banks to go out and find it, because it's always in a bank's best interest to recover from those parties first.

When the economy takes a downward turn, litigation goes up and that's exactly what we're seeing in the community banks. "Banks are being sued by government, shareholders, former investors, and former customers" and as a result, the "insurance industry is hardening," says Walter Andrews, an insurance litigation attorney in the McLean, Va. and Miami offices of Hunton & Williams.

Insurance companies are trying to protect themselves by limiting payouts, which is why banks are seeing the return of coverage carve-outs such as the regulatory exclusion (see "10 Proven Ways to Reduce Your Bank's D&O Exposure," *Bank Safety & Soundness Advisor*, August 23, 2011).

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Alternate Sources

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"Insurance companies have their own best interests in mind," says Cliff Rudolph, an insurance broker with Parker, Smith & Feek, Bellevue, Wash. "They do want to provide great service and maintain their reputation, but at the end of the day, they want to make their claims process as inexpensive as possible."

Don't assume that the only coverage you have is the coverage you arranged for and paid for yourself. There are other sources of indemnity out there and, as litigation goes up, it's all the more critical for banks to dig up and tap those other sources wherever they can find them, Andrews says.

How can alternate coverage sources help? They may help you get around exclusions, Williams says. Banks could check to see if they're still covered under an older policy, which may not have the exclusions your newer policy does.

Another reason to dig up alternate sources of recovery? It's always cheaper, in the long run to file a claim under someone else's policy.

It's in a bank's best interest to "recover from other parties first," Rudolph says. "Sometimes banks rush to settle claims. They're trying to do the right thing but they inevitably take responsibility for the claim and file it against their insurance policy, hoping they'll pay. In most cases they will, but at the end of the day, the insured is really the one who ends up paying because premiums will go up."

"Check to see if you have alternate insurance," Andrews says. "You might have it as the result of a merger, acquisition or an investment vehicle. Those policies might

have broader coverage than you're your current policy covers and still might apply."

Where can you look? Here are several sources:

1. Your predecessor's insurance coverage. If you've been involved in a merger, acquisition, spin-off or reorganization, you may still be covered by insurance procured by the other firms involved.

"In mergers, insurance rights typically move to the successor or surviving corporation," Andrews says.

It's important for banks to understand precisely how and how much of that coverage did transfer, argues Rudolph. "Financial institutions need to understand how insurance policies of the merged entity relate to a claim," he says. "With many policies, there's a right-of-control clause that triggers the policy to be cancelled. You can extend that coverage."

Another consideration: Check to see if there are open claims against a merger partner. "There may be insurance claims open, but not yet reported, that occurred prior to a transaction," Rudolph warns.

2. Additional insured. If your bank wouldn't typically be included in another company's coverage, but you are, because that company wants the protection or is required to provide it, then you're additional insured.

If you are additional insured, you have a right to tender a claim directly to that insurance policy, says Rudolph. For example, he says, if someone is hurt by equipment left lying around by a contractor working on one of your branches and a claim arises, you should be able to tender the claim directly to

that contractor's insurance. "It's important for banks to do this, but it's surprising how many times this doesn't occur," he says.

3. Implied additional insured. Your bank may qualify for additional insured status on another firm's policy even if you're bank isn't specifically listed on that policy. "In some cases of negligence, the other firm is responsible," Rudolph says. "This isn't something you should use as a proactive risk management tool, but you can hire a law firm and argue for implied negligence."

When it comes to finding alternate sources of coverage, make sure that you're submitting your claim to the right policy, which

isn't the easiest thing to manage, Rudolph says.

"There are always multiple ways to look at a claim," Rudolph says. "You can look at a claim from multiple angles to try to find a resolution. Don't be discouraged if one policy denies coverage."

No Alternate Sources for D&O

Scratching up any old, hidden insurance coverage could greatly benefit your bank, but it won't work with D&O claims. Why? Because it's a 'claims made' policy, i.e., it only responds during its effective period and that period typically ends the minute a financial institution is merged into – or its assets are sold to – another bank, says Scott Uhl, SVP of

specialty casualty for EWI Risk Services in Dallas, Texas.

Banks can extend the coverage for those merged bank directors and officers with tail coverage – which is usually designed to catch unknown liabilities for up to six years, which is long enough to include fraud and negligence statutes of limitations in both state and federal court.

Make sure the tail coverage issue is included in merger negotiations, cautions Uhl. It's a detail that can get lost in a complicated merger process, but if your bank neglects to include it, there may not be coverage for wrongful acts committed by directors and officers prior to the merger or asset sale. ■

Tips

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loan better?" he says. "A good workout officer has to be open minded and creative. I've been in too many situations where the real problem was poorly structured debt and the banker [didn't] see that."

Here's one creative idea: ignore the current loan structure. Look at the debt as just a single sum and analyze the situation to see if it's possible to re-structure the loan to fit within the borrower's current situation, Viering suggests.

"With some loans, I'll restructure. I'll see if they can't be done a different way. I'll change the collateral around and all of a sudden, they work. Bankers often don't consider these alternatives since the terms needed may not be within policy guidelines."

A workout officer needs to be a problem solver, Viering says. He needs to be able to imagine

new options for loans that clearly don't work as currently structured. There are some constants, including cash flow and collateral, but other elements of the loan can be changed.

"If a borrower is honest with us – and that's the number one factor – then I'll see if we can make a loan work," he says. "If there isn't a reasonable solution then get after the liquidation right away."

2. Unlearn what you know

The financial industry has changed radically in the last few years. Banks can't rely on old assumptions and habits and that goes double for workout officers, who have to adjust quickly and completely if they're going to help their bank, says Pat Dalrymple, a bank workout consultant with Western Colo.-based BancReps and a former CEO.

What's changed?

- Loans. "What was a good

loan 5 years ago is not a good loan today," Dalrymple says. Loans that may look good to the bank, may not to the regulator, for a number of reasons. Regulators may not like a loan simply because it's a CRE loan, he adds. "It's tough. You grow up learning things a certain way and then, all of a sudden, it's not that way anymore."

- Appreciation. If you're looking for investors for CRE, you used to be able to sell them on appreciation. Not anymore, Dalrymple says. "Even though you know [a property] will appreciate eventually, you don't know when and it could get worse before it gets better."

- Regulatory Standards. Examiners are getting tougher on loan classification and distressed assets and their standards are constantly changing, Dalrymple says. You can't assume that today's regulatory standard will hold tomorrow.

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Examiner-Friendly Workouts

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3. Communicate

In some cases, problem loans persist as problem loans not because the bank and borrower have exhausted all options, but rather because communication between the two parties has broken down. Bringing in a new workout officer can help untangle a work out, says Viering.

"The most successful workouts I have been involved with have occurred because the workout officer and the borrower were able to effectively communicate," he says. "Often having a new person come into the relationship allows better communication as the communication with the bank, as the situation deteriorates, often also deteriorates."

When it comes to non-performing loans, both bankers and borrowers tend to go through the same emotionally fraught process, Viering adds. A fresh, skillful communicator can bring a loan around.

"If you're both in the angry phase, communication will suffer or cease altogether," he says. "If you understand what the borrower is going through it can make communication more effective. You need to be empathetic but, you also need to steer the borrower toward the understanding that we can't change what has happened, all we can do is take where we are at today and see if there is away to make things work in today's reality."

4. Don't neglect income

Banks that focus too intently on workouts are neglecting a pivotal aspect of their business: income. Make sure you devote workout staff to workouts and save some staff for bringing in new business, Viering argues.

"Even if 25% of your portfolio is on your watch list, the flip side is 75% of your portfolio isn't," he says. "You need to make sure someone at the bank is watching your best customers. You can't afford to lose that income. Trust me. Some of your competitors are doing OK. They're calling on your best customers."

Viering recommends segregating troubled borrowers and the workout bankers to go along with them. "Have your other bankers calling on your good customers," he says. "Think about your deposit strategies. Many banks have a high reliance on brokered deposits and FHLB advances. There's plenty of liquidity right now so go find alternatives."

5. When you think workout officer, think long-term hire

A lot of banks tend to think of loan workout officers as temporary employees. After all, banks may only need to focus on workouts for one to three years, and at that point, many of them will give those workout officers a handshake and show them the door. Don't be so hasty, says Viering. Good workout officers often arrive with broad skill-sets, need to be quick studies and have nimble minds. And once on the job, those offi-

cers' abilities only improve. The qualities you find in a workout officer – including a thorough understanding of your loans, your borrowers, the psychology of lending and a keen understanding of how your bank operates – can be very useful to a bank long after the economy turns.

Working out loans gives officers a highly concentrated course of study in the banking business, Viering says. He remembers being a young banking professional drafted into workout work in the 80's. "I learned more doing that for two years than I learned in my previous 8 years of banking."

Don't just think of your workout officers as temporary hires, he says.

"The need for high volumes of workouts comes and goes in the banking industry and often times a person doing workouts doesn't want to work out loans for their entire career," he adds, suggesting that banks can find quality, permanent staff among their workout crews. "[Workout work] is a great way to groom management for a bank." ■

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Tips

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made the decisions you did. Does the current cash flow support this [restructuring]? Does the prospect for future cash flow support this? You need to document the answers for your regulator.”

Not only should workout officers stay on top of documentation, they should also track the regulators’ shifting view of loan classification, argues Pat Dalrymple, a bank workout consultant with Western Colo.-based BancReps and a former CEO.

Regulators are getting more and more stringent when it comes to loan classification, and this has a direct impact on your file of problem loans. That’s why workout officers need to know the classification process backwards and forwards, says Dalrymple,.

For example, a borrower may be paying on a loan, but a bank can no longer expect that regulators will consider it acceptable, he says. The regulators have been emphasizing global cash flow, he adds. Your examiner may look at the still-paying loan, look into the global cash flow trends and say: ‘In nine months, there’ll be problems with this deal.’

“Workout officers should understand the hot-button issues the regulators have at any given time,” Dalrymple says. “The regulatory viewpoint changes more and more dramatically that people in the industry think it does.”

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