

Bank Reform Begins with Board of Directors



Candor. Insight. Results.



Brad Erbes

brad.erbes@bakertilly.com
612 876 4759

As seen on MinnesotaBusiness.com

From January through August of 2009, the FDIC reported 95 bank failures in the U.S. and included hundreds more on its troubled banks watch list. Some experts predict that the total number of possible bank failures this year could eclipse 300.

Most economists agree that the recovery of the U.S. economy will be more gradual than aggressive, and possibly take many months to return to pre-downturn form. While much attention has been paid to the financial measures used to mend the nation's largest banking institutions, many small and mid-sized banks still face an uncertain future as the nation's economy begins its long road to recovery.

Of particular concern for many small and mid-sized banks are the loans on their books that may be negatively impacted by a slow and drawn out economic turnaround. Many smaller banks have significant portions of their loan portfolios in commercial real estate. Commercial asset values have dropped dramatically with the downturn and will likely remain undervalued well into the recovery. Accurately valuating these assets, especially at smaller banks, is ultimately dependent on the institution having a well defined and conservative credit policy that is well executed.

Along with asset value exists a strong possibility that a slow economic recovery will continue to put pressure on borrower cash flows, increasing the likelihood of default and ultimately threatening a bank's capital structure. While access to federal

capital has helped many institutions weather the storm thus far (aided by the Federal Reserve's decision to keep interest rates at historically low rates), it is by no means certain that the government will continue to prop up troubled banks.

In the wake of the bank crisis, there has been little meaningful regulatory change or additional oversight to bank's lending practices. Thus, the responsibility of monitoring and guiding bank's risk management practices continues to be, as it has always been, on the shoulders of the institution's Board of Directors.

In an open memo sent to bank CEOs in July, the U.S. Treasury Department's Office of Thrift Supervision re-emphasized the importance of risk management practices, as well as the need for bank boards to impart and enforce guidance on credit risk practices. Over the last few months, the most frequent topic discussed by Baker Tilly mid-sized banking clients is Board oversight of credit practices – particularly when the institution faces regulatory actions. These practices should include standards for risk reporting, robust data collection, and on-going portfolio monitoring. Portfolio monitoring includes regular stress testing and sensitivity analysis, enforcement of strong underwriting standards, and a defined process for asset risk review.

The responsibility of Board Members for small and mid-sized banks to demonstrate conservative and sensible credit risk principles has never been greater. Economists and critics can argue whether or not the nation's largest banks are "too big to fail," but small and mid-sized banks do not have that luxury. Small and mid-sized banks must take appropriate action to strengthen their risk practices and processes to ensure not only their long term success, but also their commitment to customers.

Small and mid-sized banks must take appropriate action to strengthen their risk practices and processes to ensure not only their long term success, but also their commitment to customers.

We understand the unique needs of financial institutions.

Our experienced team provides tailored services that include:

- > Audit and Accounting
- > Technology Solutions
- > Distressed Assets Advisory
- > Financial Examination Assistance
- > Regulatory Compliance
- > Internal Audit Co-Sourcing

bakertilly.com

An independent member of Baker Tilly International

Pursuant to the rules of professional conduct set forth in Circular 230, as promulgated by the United States Department of Treasury, nothing contained in this communication was intended or written to be used by any taxpayer for the purpose of avoiding penalties that may be imposed on the taxpayer by the Internal Revenue Service, and it cannot be used by any taxpayer for such purpose. No one, without our express prior written permission, may use or refer to any tax advice in this communication in promoting, marketing, or recommending a partnership or other entity, investment plan or arrangement to any other party.

Baker Tilly refers to Baker Tilly Virchow Krause, LLP, an independently owned and managed member of Baker Tilly International. The information provided here is of a general nature and is not intended to address the specific circumstances of any individual or entity. In specific circumstances, the services of a professional should be sought.
© 2009 Baker Tilly Virchow Krause, LLP