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Exams Will Change After Crisis

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Throughout the credit crisis bank supervisors - federal and state - have strayed from their usual remedial practices.

Considering what has transpired, there have been few written agreements and cease-and-desist orders, which are publicly issued. Instead, the nonpublic memorandum of understanding has been the favored remedial tool.

This is about to change. As banks beef up their capital and financial markets begin to stabilize, bank supervisors will feel less constrained, and public remedial actions will become more likely.

As usual, the emphasis will be on the components of Camels ratings: capital, assets, management, earnings, liquidity, and sensitivity to market risk.

Banking organizations have increased their capital ratios, many with government assistance, and some may be phasing in their leverage ratios. However, in light of recent lessons, the Basel Committee on Banking Supervision can be expected to modify the Basel II capital adequacy guidelines. This would be consistent with one of the major rules of bank supervision: More capital is better than less capital.

When it comes to assets, on Nov. 28 the Basel Committee issued for comment its consultative document on supervisory guidance for assessing banks' fair-value practices for financial instruments. Examiners can be expected to begin using this tool to review valuation practices.

The major focus is likely to be on risk management. Bank managers should be familiar with the report the Senior Supervisors Group issued March 6 that sets out examples of best and worst practices in this area.

Earnings are likely to become more of an issue late next year. As the markets come back and the Federal Reserve Board starts to raise interest rates, there may be pressure on earnings from market valuations of portfolios booked in a low-rate environment.

Once the Fed begins to pull back its massive liquidity programs and the financial markets recover from the crisis, examiners can be expected to scrutinize liquidity contingency planning.

Sensitivity to market risk will also be a key issue. Examiners will assess the degree



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to which changes in interest rates, foreign exchange rates, commodity prices, or equity prices can hurt the organization's earnings or economic capital.

Examiners can be expected to be especially rigorous in their application over the near term. One result may be an increase in remedial actions.

The bank supervisory authorities and bank boards should have a common goal - a safe, sound, and profitable banking system. Managers should try to address any critical comments promptly.

If examiners appear to be contemplating remedial action, the bank should seek to preempt such action by implementing a corrective program that can be expected to address the examiner's concerns. If the bank supervisor goes forward with a remedial action, such as a written agreement or a cease-and-desist order, the banking organization should staff itself to prepare for the onslaught. A key concern should be how a settlement would impact business in an affected line over the longer term and how customers, counterparties, and the financial press would react to the settlement.

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