American Bankers Association®

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Improving Relationships With Your Regulator—a Mutual Examination Guide

About the authors

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About the American Bankers Association

The American Bankers Association (ABA) represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its two million employees. The majority of ABA's members are banks with less than $185 million in assets. ABA's extensive resources enhance the success of the nation's banks and strengthen America's economy and communities.

Introduction

Mutual banks are the quintessential community banks. Community service at every level of the bank is a hallmark of being a mutual. The inability to raise capital except through retained earnings is counter-balanced by the independence and longer-term vision that you are able to take.

During the writing of this paper we asked a number of CEOs if mutuality was a strategy or an ownership choice. The answers were pretty evenly split. Some thought mutuality is embedded in every strategic decision that is made, because raising capital from external sources is not an option.

Others believe mutuality was an ownership decision made 75 or 100 years ago that shaped their roots but not their current operations strategy. Regardless of the difference, all believe that factors fundamental to mutual banks should be reflected in examination conclusions. In order for that to happen, however, it is essential that regulators understand your institution and the unique role it plays in your community.

The purpose of this guide is to encourage mutual bank leaders to make their beliefs, decisions, and actions known to their regulatory team and to suggest practices that will result in your regulators' better understanding of your institution.

Prepare for the Examination Process

Focus on establishing or expanding two-way communication with your regulator. Once you have received your pre-exam information request from your regulatory agency, read through it and call your regulatory contact (EIC, Portfolio Manager, Case Manager, ADC or AD) to discuss. Your goal is to let them know you have received it and that your team is working on it. Respectfully request names of the exam team, ask who will be in charge, whether the EIC has experience with mutuality, the start date and how long the on-site portion of the exam should take. At that time let your contact know that your team will be making a presentation to the exam team at the exam opening meeting. We will go into more information on that on page 8.

End the conversation by letting the contact know who is responsible (if not the CEO) for managing the exam relationship, when you plan to be able to return the completed pre-exam request and that you will be available between this call and the exam start to discuss any issues that arise.

What Drives the Examination Team?

Examiners are driven by more than one objective when visiting your bank. The timing of your exam is determined by statute. Your exam will be on either a 12- or 18-month cycle, based on your size, CAMELS rating and risk appetite. Your Community Reinvestment Act Public Evaluation Exam runs on a separate schedule, also based on size and rating. It is incumbent on you to have an idea of when your next examination is scheduled. Good two-way communication between you and your exam contact will provide a respectful forum for you to ask about upcoming exams.

Your exam team is probably not driven by your charter type as much as you would prefer. Ideally, the team is aware of mutuality and has had prior experience examining mutual institutions. It is in your best interest to determine this before the exam starts. If it seems that your contact is not aware of how important this issue is to you, take the time to mention it.

Since 2008 and earlier in certain regions of the country, examiners have examined more problem banks than they had in the prior ten to fifteen years. Although things have been improving, no examiner wants to miss anything substantive during an exam. Their enhanced focus covers corporate governance issues, including your board of directors. They are not simply interested in your financial results and consumer compliance but also are looking closely at your risk management systems that identify, measure, monitor and control the amount and type of risk that your institution has and will take on. They will spend a considerable amount of time to understand your risk assessment process, strategic and capital planning, and corporate governance. Few of these things are driven by charter type, in their eyes.

If your approach to business/strategic planning is driven or heavily influenced by your mutuality, it is important that you communicate this to the EIC and exam team. Do not approach this issue as an industry issue but as a personalized issue for your institution. Be instructional on how mutuality affected your business planning, including any community service that has been important to the bank but is not necessarily reflected in the financial portions of your business/strategic plan.

The communication of your business plan's success (or lack of same) should be part of the presentation your team makes to the exam team at your opening meeting.

The exam team will also be impressed, one way or the other, by the quality of your Call Report filings, the availability of internal reports and how well your staff is prepared for the exam process. These last few things are completely within your control.

What Should an Institution Get Out of Its Examination Besides a Rating?

You and your staff should have a goal to establish the two-way communication mentioned above. The time and effort put into that communication will pay dividends over the years to come. This will help ensure that if regulatory issues arise at a future exam, any tension between your team and the regulatory team will be held to the particular issue and will not be expanded to the overall relationship between bank staff and regulatory staff.

Additionally, you and your staff should want your exam team to have a good understanding of your strategic process and plan; your approach to risk management, including your ability to identify, measure, monitor and control risks; and your regimen of management, including that of the board of directors. If you can accomplish these things, your exam team will see you as an institution that plans for the future and has an interest in its own destiny.

Suggestions on How to Present Yourself to Your Regulator

Do not let your bank fall into a reactive position with your regulators. Communicate and tell your story.

Let your regulatory contact know from the moment they send you the pre-exam request (or even earlier if the opportunity presents itself) that you and your team are proactive. Take full advantage of meetings that the exam team schedules and actively participate at the highest levels of your organization. Consider having appropriate outside directors/trustees attend these meetings. Perhaps more importantly, take the initiative to schedule meetings with the EIC on a frequent basis during the length of the on-site exam. During the interviews with our focus group of CEOs, many mentioned how important it has become for them to hold status meetings—perhaps weekly—during on-site exams.

Be open and completely honest about issues at your institution. Do not hesitate to credit your bank for having success since the last exam. Have a list of accomplishments to discuss. Talk about meeting or exceeding budget, success in extending credit in difficult times, strategies that are being developed or refined and new initiatives that are underway.

Spend a considerable amount of time and effort showing why being a mutual institution is important. More than one focus group CEO explained to us that they keep a list of community activities that each officer and employee is involved in. They share this list at each exam. These CEOs believe that some or all of the activities add real value to their communities even though the fruits of these labors may not make a financial difference to the bank.

That same openness should be extended to anything that has not gone right since the last exam. If your plans have not come to fruition or the bank has tripped over some regulatory issue, you should be upfront with the exam team. They will find the issues anyway. But if you bring them up, you will have the opportunity to indicate how you have already addressed the issue. This approach adds credibility and is something a number of our focus group CEOs are already doing.

If the nature of any financial, consumer compliance or corporate governance issue is at all serious, do not wait for the examiners to discover it at your next exam. Contact your regulatory agency and schedule a meeting to discuss the issue. Come prepared to provide details about what has happened, how serious it is, why it happened and your fix for the issue. If it has not already been corrected, be ready to discuss any corrective actions you have planned, including a realistic timeline for success. Be ready to talk about both strategy and tactics for correcting the problem.

Filing inaccurate Call Reports will hurt your bank in the eyes of regulators. Make sure that the individual or department that completes the reports does so in an efficient and effective manner. Do not allow them to wait until the last minute before a Call Report is to be submitted.

You Are a Community Bank First

The regulators have recently undertaken a series of initiatives to determine the best way to define what a "community bank" is. Traditionally those same regulators and many in the industry tended to define a bank primarily by its asset size. For instance if your assets were $1.0 billion or less you were considered a community bank. But as community bankers know too well, asset size is just one of a bank's defining characteristics. This is true whether the community bank is a stock bank or a mutual. The more critical characteristics of being a community bank are found in your business plan. If your business plan involves traditional lending and deposit gathering and does so in a relatively defined and limited geographic area, you are most likely a community bank.

While a definition does not determine your business plan, it certainly should be a guide as to how you will best serve your customers. The strategies you develop and execute to serve those customers and your community should enhance your bank's success. Your focus on your community and the persons therein will determine the appropriate loan and deposit products for your community. As the FDIC concluded in its Community Banking Study released in December 2012, "Community banks tend to be relationship lenders, characterized by local ownership, local control, and local decision making. By carrying out the traditional banking functions of lending and deposit gathering on a local scale, community banks foster economic growth and help ensure that the financial resources of the local community are put to work."

To be clear, knowing your community drives your business plan. Your regulator will not know your community as well as you do and obviously will not have been in a position to develop the relationships with your community. So it is critical to share with your regulator your standing in your community and how your institution enhances the financial resources of the community for its betterment. Your board members, senior officers, and even employees should be prepared to share their insights on the value the bank brings to the community in terms of your bank's products and participation in your community's affairs.

You Are a Mutual Bank—This Is a Fact of Ownership Structure

As a community bank that operates in mutual form, you have additional responsibilities when dealing with the regulators to differentiate your bank from stock-owned community banks. The need to focus on these differences cannot be understated. In the 2013 and 2014 ABA Mutual Bank Surveys, about 90 percent of the respondents stated that mutuality played a part in their bank differentiation strategy. In addition to their mutuality, the respondents set out additional characteristics of a mutual that set them apart from their competitors. They cited their emphasis on investments in the community, favorable product pricing, focus on customer service and industry experience, and their strong focus on being safe, sound and stable. They also noted that they are member-owned, not investor-owned; that they portfolio their loans; and that they are not for sale.

All mutuals want to be understood. You are the most qualified to provide the information needed to gain that understanding. To do so you must step up at every opportunity and offer examples of what you are and why you are a mutual. This is particularly true when dealing with your regulators and your community. Neither lives mutuality every day like you, and each must be provided the benefit of your experience as a mutual and the advantages and challenges that result from mutuality.

It is important that your regulator understand that the strategies you and your board develop to run the bank are first and foremost to operate the bank in a safe and sound manner. The unique characteristics of the mutual must not be allowed to permit management to be complacent in overseeing the operations of the bank.

Mutuals are unique and present a number of unique risks in their daily operations. However, in the minds of the examiners there are basic requirements that bank management must understand and execute, such as risk management. The board of directors and senior management must set triggers for critical ratios such as capital. The exam team needs to know that both management and the board of directors have set reasonable and measurable standards. This includes management being able to state what options they have available to them when the triggers are hit.

Manage the Exam Process

At the exam opening meeting, bank management--not just the CEO--should seize the opportunity to tell their success story since the last exam. Don't ignore any rough patches during that same period of time, but discuss and demonstrate your fixes to these issues as well as explanations for new products, new markets, new customers and/or new strategies. Discuss the ongoing tactics in delivering your bank's plan in these challenging times. This approach can be a big change for those banks and their management who have believed, up until now, that the sole purpose of an entrance meeting for an examination is for the exam team to introduce themselves and talk about what they intend to look at during the course of the examination.

This is where you and your team can demonstrate the initiative discussed in an earlier section. By taking the opportunity to tell your story, you send a positive message to the exam team that you are as serious about the exam as they are. If you have not taken this approach in prior exams, you may want to let your pre-exam contact at your regulator know that the entrance meeting may go longer than prior entrance meetings and that a number of your staff will be reporting on the accomplishments of the bank since the last exam. An agenda for the meeting, provided to the exam EIC and team in advance of the meeting, is always a good idea.

Prior to the start of the exam, possibly even prior to receiving the pre-examination request, contact your regulator and strongly but respectfully request exam team continuity.
Most of the federal regulatory agencies will allow an EIC to serve for two or three consecutive examinations. When a new EIC is installed for your bank, perhaps that EIC has had the opportunity to be an assisting examiner of prior exams of your institution. If this is not the case, there could be a steep learning curve during your examination. You or the proper regulatory contact at your bank should discuss this long before your exam.

Furthermore, based on your size and the complexity of your operations, it may make sense to ensure that a number of the upcoming exam team members have experience with your institution. If it does happen that you are being assigned a new EIC that does not have experience with your bank or with mutuality, you must request strong assisting examiner support by examiners that do have substantial experience with your bank and with mutuality.

In addition to managing the beginning of the exam process, you must manage the end of the process. The examiners will schedule an exit conference before they depart your bank. Make sure you bring the proper people to that meeting. Certain board members, particularly the chairman of the audit committee, should be considered, along with the CFO, chief lending officer and those managing the bank's risk management or enterprise risk management should also attend. Engage in a discussion of the issues presented by the exam team. Try to get them to commit to ratings or at least language that translates to ratings. Make sure you know if they consider your bank a problem bank. Most importantly, do all of this in a professional and respectful manner.

Corporate Governance and Succession Planning

Mutuals, like all community banks, must be familiar with and responsive to the full range of issues that fall under the general rubric of corporate governance. Corporate governance refers to the process by which banks are directed and controlled. The governance structure specifies the rights and responsibilities among the different interested parties in the bank, in particular the board of directors and senior management. It specifies the process by which a bank makes decisions affecting its operation and conduct. Corporate governance also includes the role of the board in succession planning both for directors/trustees and senior management.

Regulators who have reviewed any of the material loss reviews (MLRs) done on failed institutions they regulated can't help but be struck by the fact that the MLRs consistently cite weak management as a leading cause of failure. Regulators have properly adjusted their review of all financial institutions and increased their focus on management and corporate governance–both for senior officers and the board.

In discussions with our CEO focus group, we asked the CEOs to talk about the role of their board in the management of the institution. Where was the line drawn between senior management and matters that were delegated to them, and matters that required board input if not actual approval? Not surprisingly the answers varied.

A possible reason for the differences was the impact of past relationships. If you had been doing something a certain way for years, why change? Others wondered why you wouldn't involve your directors.

Discussions at a number of industry events, including meetings of the OCC's Mutual Savings Association Advisory Committee (MSAAC) and the ABA's Mutual Institutions Council, have increasingly begun to focus on the role(s) of the board of directors/trustees and senior management. For community banks like mutuals that have no shareholders, corporate governance and the role of the board take on an additional degree of importance. Participants at these industry meetings, perhaps representing the increasing awareness of the issue, are openly looking for guidance. The FDIC and OCC have online a number of helpful publications and other sources that provide insight and guidance to banks, their boards and senior management. To find these go to http://www.fdic.gov/regulations/resources/mutual/index.html and www.occ.treas.gov/publications. In addition, the American Bankers Association has a very extensive and informative archive, including Corporate Governance for Mutuals, at www.aba.com/mutuality.

You must have a succession plan in place for all of your critical leadership roles—not just for the board and the CEO. This is critical for a number of reasons, including the fact that banks with a majority of senior leadership (including board members and senior managers) under the age of 50 are outliers in the marketplace. Second, as the challenges faced by the financial services industry (including your institution) over the past six years have begun to resolve, fatigue will have set in to those employees and board members you have come to rely on so heavily. Although they may not all want to retire, there are many opportunities available to talented and hardworking individuals who may move on to other institutions looking for battle-tested leaders. It is important that you not overlook in-house candidates who have demonstrated the necessary qualifications and performance results.

Your institution most likely existed before you became a critical part of its operations. You have an obligation to its employees, depositors and the community it serves to ensure that it will continue after you have moved on. Assuming your bank is not in a troubled condition and more direct involvement by your regulator is not required, your regulators expect your bank will continue to exist and be operated in a safe and sound manner.

Succession planning is as critical for mutuals, if not more so, as it is for shareholder-owned institutions. All the characteristics that distinguish a mutual may also present challenges to your ability to recruit candidates from outside of your shop. Appropriate indexes of qualifications for a successor must always be observed, including your bank's economic and financial factors at the time of the senior leadership position opening (including board positions), its product offerings, margins, asset quality, capital situations and earning capacity. It is critical that your selection is made with full awareness of all the challenges your bank faces in the future.

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