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The BANKING DEPARTMENT NEWSLETTER

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Note from the Commissioner

Welcome to the Spring edition of the Banking Department newsletter. And, it is finally beginning to feel like Spring!

This time of year is a busy time for the Department. The Legislature is in full swing. Legislative issues take up a lot of the time of the leadership of the Department. A total of five bills were introduced at our request. These run the gamut from technical corrections to complete re-writes of many of the consumer credit statutes. We have been working with representatives of the various licensees and registrants on these bills. Of course, there are also bills that we didn't request but were introduced anyway! In all, the Department is monitoring or actively working on seventy-two bills. And, besides all of that, we also need to get approval for our portion of the state budget.

In addition to my normal duties, it is Annual Meeting time for many credit unions and I have been getting a lot of invitations to attend and speak to the members. For example, I recently attended Timken Super Precision Credit Union's meeting. Congratulations to them on their 50th Anniversary.

The response to the newsletter has been overwhelmingly positive. We continue to get more people signing up for the electronic version. If you haven't already done so, please send us an email at nhbd@banking.state.nh.us

Confidentiality of the Report of Examination

State law (RSA 383:10-B) PROHIBITS the disclosure or sharing of any information contained in the report of examination with anyone unless expressly approved by the Commissioner. This includes any composite or component rating. Examinations are conducted to ensure that institutions are operating in accordance with applicable state and federal rules and regulations. With the recent attention on corporate governance, more and more information on institutions is being sought by outside parties. So remember when you are asked for the reports or information in them to "just say no".

BANKING DIVISION NEWS

Banking Information for Year End 2002

At year-end 2002 the department regulated 66 institutions. This was comprised of 22 banks, 25 credit unions, 15 non-depositories, and 4 trust departments. At year-end 2002 total assets of all 66 entities was $15.5 billion, with regulatory capital at $1.8 billion, an increase of 8.96% in assets and 2.35% in regulatory capital respectively over year-end 2001. Non-depositories reported $123 billion in fiduciary assets, an 11.90% decrease from year-end 2001.

Policies

Policies are the conduit through which the Board of Directors 'direct' the activities of the institution. Policies are the direct responsibility of the board and considering the general concerns with corporate governance, policy making procedures should be reviewed regularly.

Both state and federal rules and regulations require policy guidance on most, if not all aspects of an institution's activities. As part of the examination process, policies are reviewed for two major purposes: first to ensure that operating management is working within the boundaries of the board approved policies, and second to ensure that the policies satisfactorily outline activities as required by rule or regulation. All exceptions to policy guidance need to be brought before the board for approval. On these occasions both operating management and the board need to ensure that documentation exists concerning the justification for the policy exception and that the justification is noted in the board minutes.

Polices should be reviewed and approved at least annually by the board. In the Banking Department's experience, a staggered policy approval matrix has benefited both operating management and the board in ensuring that the institution's activities reflect the guidance found within the Board's policies.

Allowance for Loan and Lease Losses (ALLL)

Recently, we have had an increase in questions relating to how examiners review the adequacy of an institution's Loan and Lease Loss Allowance, specifically as it relates to Financial Accounting Standards Board Statement Numbers 5 and 114. Both these pronouncements have been around for several years; FAS 5 was issued in 1975 and FAS 114 in 1993. Even though they are not new, management and examiners alike have been unfamiliar with their requirements, and it seems as though little has been done to comply with these pronouncements until recently. It is clear that management should no longer use the formula method of 15% of Substandard, 50% of Doubtful, 100% of Loss, and 1% on all other loans as the basis to establish the ALLL. An institution should establish a definitive methodology to identify potential losses associated with the institution's loans and leases.

The first component of determining the ALLL is that of Statement 114. Under Statement 114, the institution should review their portfolio to identify any impaired loans. Impaired loans are loans for which you do not expect to receive your contractual interest and/or principal by the due date. You should look at this "set" of loans and determine the projected amount of loss you anticipate. When determining this anticipated loss, keep in mind the following: 1) the fair value of the collateral after holding and selling costs, 2) the value you could receive if the loan were sold, and 3) the present value of the discounted <u>expected</u> cash flow you will receive for the remaining life of the loan. The exposure you have between these values and the outstanding amount of the loans should be covered by your allowance. This is what we commonly refer to as a line-by-line analysis of credits within your institution.

The next component of establishing an adequate allowance is FAS 5. Under Statement 5, the ALLL is established for all losses (other than those you just established under FAS 114) that are probable and that can be estimated. The institution should segment their loan portfolio by groups that have similar risks. Segmenting by loan types is one method of doing this. Remember to include in these segments any loans that were reviewed under FAS 114 but for which no provision was made. Once you have the loans segmented you should look at internal and external risks for each segment, and a dollar amount should be established in the reserve for each segment. Historical data can be utilized but should not be relied on too heavily, as the focus should be on the current conditions and the potential risk you see at hand or in the future. Methodologies for determining historical losses can range from a simple average of an institution's net charge-off experience to a sophisticated analysis that also weighs differences in underwriting standards, geographic locations, seasoning of loans, etc. Factors to consider when looking at current conditions include levels of, and trends in, delinquencies and non-accruals; trends in volume and terms of loans; effects of any changes in lending policies; experience, ability, and depth of management and lending staff; national and local economic trends and conditions; concentrations of credit; and any legal and regulatory requirements. The FAS 5 component of the allowance should be the sum of the allowances for the different segments you review. The totals of the FAS 5 and the FAS 114 amounts will comprise your total balance in the ALLL.

The institution's ALLL policy and methodology should be reviewed and approved by the institution's board annually. On a quarterly basis, the ALLL should be reviewed for adequacy. Also, if risk factors have changed from one quarter to the next, the methodology should be changed to reflect the change.

Examiners will look to see if the institution has established a policy on reviewing the ALLL. The policy should provide guidance as to which loans will be considered under FAS 114 for individual impairment, and if considered under FAS 114, how to value that set of loans. The policy should also delineate the segments the remaining portfolio will be segregated into, when determining adequacy under FAS 5. It should also provide guidance as to how the risk will be identified for each segment under FAS 5. Examiners will want to see that the institution follows the guidance established in the policy when reviewing the ALLL for adequacy. They will look to see that conclusions for provisions are documented and whether the ALLL balance is adequate to support the risks in the loan portfolio. Examiners will also review the institution's charge-off policy. The policy should require loans to be charged off in a timely manner.

This is a current issue for both management and the examiners. There will be a learning curve for both of us. Management will be responsible to explain the rationale and logic of their ALLL methodology. Examiners will be equally responsible for taking the time to understand and evaluate the institution's methodology. We have asked examiners to work with management on this to "get it right", something that may take some time for both of us.

If you have questions, I would be happy to try and field those inquiries. Call Chief Bank Examiner Charles M. O'Connor at 603-271-3561 or e-mail me at coconnor@banking.state.nh.us

<u>CONSUMER CREDIT DIVISION NEWS</u>

Did You Receive Our Letter?

If your company is licensed as a sales finance company, small loan lender or as a mortgage broker or banker, you may have recently received a letter from the Banking Department notifying you of a pending examination of your business.

The Consumer Credit Division sends letters notifying licensees of upcoming examinations, usually at least 30 days prior to the start of the examination. The Banking Department is mandated by RSA 383:9 to examine the affairs and business practices of licensees at least once every eighteen months.

The examination can take several paths depending upon where the licensed office(s) are located. The statutes require that if the licensee does not have a licensed location within the state of New Hampshire, the examination must be performed at the office of the registered agent named by the licensee in its application for license or renewal.

For licensees without a New Hampshire business location, the examination process starts with the Department's letter requesting information, including a list, about loans made to New Hampshire consumers or mortgages on New Hampshire property. The information sent by the licensee in response to this letter is reviewed by the Department and specific loan files may be requested by the Department for review along with other documents to be examined (financial statements and supporting documents, corporate records, tax filing information, etc.). The licensee is required to submit the documents requested by the Department to the New Hampshire registered agent for examination within 21 days from the date of the licensee's receipt of the request.

Licensees that maintain a location within the state will have the examination performed at the New Hampshire location. A letter requesting certain information and documents will be sent to the licensee, and the documents requested for review must be submitted to that New Hampshire location on or before the date of the examination as set forth in the letter.

In either case, the examination will consist of a review of loan files (complete loan files with documentation are required), financial statements, policies and procedures, transaction histories, advertising, and other documents as required. The examination will be for compliance with state and federal laws and regulations.

The licensee is required by statute to pay the expense of the examination. A report of examination, along with an invoice for expenses, will be sent to the licensee. By law, all reports are strictly confidential and neither the report nor the results, comments, observations or recommendations in the report may be shared with anyone outside of the company.

Please feel free to call the Department with any questions about the examination process. And, so, if you haven't received our letter yet, you probably will receive one soon.