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In part two of this multi-part series on "Regulatory Relationship Management," the authors describe a best practices approach for preparing for and managing banking examinations. By centralizing exam management in a regulatory relationship manager and leveraging a network of key contacts within each area of the financial institution to provide information rapidly, the bank should be in a constant exam-ready mode, which will contribute to a successful outcome.

Regulatory Relationship Management: Planning, Organizing And Managing Examinations

BY JO ANN BAREFOOT AND LORI J. SOMMERFIELD

PART 2. Financial institutions, being highly regulated, are subject to various types of recurring examinations by both federal and state supervisors. Typically, financial institutions are examined every 12-18 months for safety and soundness (depending on their size and how well-capitalized and well-managed they are) and annually for compliance, plus other specialty examinations that occur periodically. For large financial institutions, examinations may run almost continuously as regulatory agencies examine each area of the bank. In addition to these realities, the expanding scope of examinations (such as loss mitigation and foreclosure reviews) and the changing regulatory landscape created by the Dodd-Frank Wall Street Reform & Consumer Protection Act of 2010 have increased the need to effectively and efficiently manage the examination process.

The key to a successful outcome of any bank examination is careful planning, preparation and management of the exam by the bank's regulatory relationship manager. Every financial institution should remain in "exam-ready" mode at all times to respond to safety and soundness, compliance and specialty examinations. To achieve exam-ready mode, banking organizations must develop solid risk management programs that allow quick preparation for exams, agency visitations or investigations. Central to this concept is having a regulatory relationship manager who manages the examination function by leveraging a network of key contacts within each area of the institution to provide requested information quickly and accurately. In addition, a process to effectively manage and present that information to the regulator is needed.

As may be obvious to every regulated financial institution, the bank examination function involves considerable costs to the bank. These costs include expenses associated with the bank's own staff, any outside consultants engaged, and non-staff resources such as computer time, costs for the bank examiners themselves plus their travel expenses in some cases. Moreover, responding to bank examiners' findings may involve changes to policies and procedures that have a direct impact on a bank's profitability. Despite these costs, an unfavorable examination outcome can have even greater costs to the bank, particularly if enforcement actions or other regulatory sanctions are imposed as a result. For all these reasons, a successful outcome to an examination is mission-critical for a bank.

In this article, we use the shorthand "RRM" to refer to the regulatory relationship management function.[1]

[1] RRM is described in greater detail in the first installment in this series, "Regulatory Relationship Management: Building Trust and Credibility with Regulators," by the same authors;

Recommendations for successfully planning, organizing and managing the examination process are set forth below, after a brief explanation of the purpose and types of bank examinations.

The Purpose of Bank Examinations

Simply put, the purpose of examinations of financial institutions is to determine if they are solvent and complying with applicable laws and regulations. Federal and state bank regulators are charged with ensuring that financial institutions are operated safely and soundly in compliance with all laws and regulations (including consumer protection regulations) to protect depositors, ensure that banks remain in business, and promote public confidence in the U.S. banking system.

Types of Examinations

Full-scope, periodic on-site examinations are an essential element of the supervisory process and serve as an integral part of each banking agency's oversight program for financial institutions. Limited scope examinations (also known as "visitations") or investigations, which have a more flexible format, may also be conducted by regulators when deemed appropriate. A visitation may be used to determine changes in an institution's financial condition or risk profile; monitor compliance with a particular corrective action program; review adverse or unusual situations; determine progress in correcting deficiencies noted at a previous examination; or simply serve as a supervisory tool. An investigation is an inquiry into a targeted area or issue facing the financial institution, as identified by the regulatory agency.

Examinations typically consist of three primary components: (1) off-site analysis and review of information; (2) on-site examination of the bank's operations, information and documents; and (3) the written examination report. A very brief refresher on the general types of bank examinations follows.

A. Safety and Soundness Examinations

Regulators evaluate the safety and soundness of a financial institution by assessing the adequacy of capital, the quality of assets, the capability of management, the quality and level of earnings, the adequacy of liquidity, and sensitivity to market risk.

B. Compliance Examinations

The primary purpose of a compliance examination is to determine whether a financial institution is meeting its compliance responsibility under federal consumer protection laws and regulations.

C. Specialty Examinations

Specialty examinations, which are focused on specific topics, are generally conducted concurrently with safety and soundness examinations, except when the size of a financial institution makes it impractical or inefficient to do so. Examples of specialty exams include information technology, trust, registered transfer agent, government securities brokers/dealers, municipal securities broker/dealers, and Community Reinvestment Act compliance.

Preparing for an Examination

As noted in our first article in the RRM series,[2] an effective regulatory relationship manager must be knowledgeable about the laws and regulations applicable to the financial institution's operations, understand the regulatory structure and key personnel (including the Examiner-In-Charge (also known as the "EIC") and his or her supervisor, or the lead safety and soundness or compliance examiner), and know the bank's business in detail. The regulatory relationship manager and his or her team must be highly knowledgeable about all three of these areas as a starting point for exam preparation.

Ideally, a financial institution should be prepared at all times to quickly mobilize and prepare for regulatory examinations. This requires the development and implementation of robust risk management programs at every level of the organization, as well as contacts throughout the bank who can provide relevant documentation to the regulatory relationship manager and/or knowledgeably provide oral information during meetings or interviews with examiners. Such contacts should include representatives from business, legal and compliance, as well as support functions (e.g., finance, credit risk, etc.).

During the third or fourth quarter of each year, the regulatory relationship manager should request and obtain a copy of the supervisory agency's proposed exam schedule for the forthcoming year. With this preliminary information in hand, the regulatory relationship manager can begin proactively preparing for the sequence of examinations that will likely be scheduled the next year. Regulatory agencies typically transmit a final version of the examination calendar to the financial institution by December for the following year. Upon receipt of the final examination schedule, the regulatory relationship manager should confirm the slate of exams, paying close attention to the scope and/or complexity of each. He or she should then assign or allocate internal resources accordingly to ensure that underlying risk management programs are brought up to date and business contacts are aligned to support each exam well before each one begins.

Organizing the Examination

Each regulatory agency notifies the financial institution and its regulatory relationship manager concerning the upcoming examination by letter which includes a list of requested documents. Each agency calls this pre-examination package by a different name — for example, the Office of the Comptroller of the Currency refers to it as a "30-day letter" (the correspondence is typically received 30 days in advance of the commencement of the exam), and the Office of Thrift Supervision calls it a "PERK package" (which means Pre-Examination Review Kit).

Upon receipt of the exam notification letter, the regulatory relationship manager should assign responsibil-

see *BNA's Banking Report*, Vol. 96, No. 18, May 3, 2011 (96 BBR 837, 5/3/11).

[2] See "Regulatory Relationship Management: Building Trust and Credibility with Regulators," *BNA's Banking Report*, Vol. 96, No. 18, May 3, 2011, by the same authors.

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ity for each item requested to an appropriate party within the institution and set a deadline to receive the documentation or information. It is advisable to follow up or hold meetings with the assigned working group throughout the pre-examination period to ensure that the information is collected and delivered in a timely manner.

It is also advisable to take a risk-based approach to gathering these responses. For example, the institution may have well-recognized problem areas that it has either identified for itself or that were raised in prior examinations. These key issue areas need active management, with material submitted well in advance of the agency deadline to provide time for review by the people who will interface with the examiners on these topics. Sufficient lead time should be allotted to permit the team to gather additional material or to present information differently, if necessary, to address high-risk topics thoroughly and clearly.

Even with routine information, the regulatory relationship manager should thoroughly review the materials before submitting them to the agency. We once experienced a situation where examiners received a bank's internal monitoring report quoting a manager's statement that he was not focusing on compliance because his boss said it would conflict with making a profit.

Supervisory agencies expect that financial institutions will provide all requested information contained in the pre-examination package prior to the commencement of the exam or make the information available immediately upon the examiners' arrival on-site. Even if the information requested is onerous or burdensome to produce, the regulatory relationship manager should attempt to provide all of the information that is requested by the deadline set by the agency. If only part of the requested information can realistically be gathered and provided by the deadline, the regulatory relationship manager should consult with the agency to determine the permissibility of providing the remaining information on-site when the examiners arrive. If the agency consents to this approach, the regulatory relationship manager should ensure that all remaining information is available on-site on Day 1 of the exam — without exception.

As a matter of courtesy, the regulatory relationship manager should also inquire about the preferred format for the information or documentation — hard copy or electronic. If electronic, a further inquiry might be whether the examiners want the information burned onto disks or access provided directly through a bank-owned computer. Advance preparation of this nature helps avoid examiner confusion or difficulty in accessing the information. Once the pre-examination information request deadline has been met and/or a plan achieved to provide any remaining documents on-site, the regulatory relationship manager should begin planning and coordinating appropriate presentations and key contact people who will be made available to the examiners during the exam.

Here, high-risk areas deserve special attention. This may include intensive briefings of senior people who may need to discuss sensitive topics with the examiners. That process should sometimes include board members. In our experience, examination outcomes have been undermined because examiners interviewed the chairman of the board or a board committee member who could not answer basic questions or discuss issues that board meeting minutes indicated had been the subject of board deliberation and action.

Managing Examinations

The regulatory relationship manager should serve as the central point of contact within the financial institution to manage and coordinate all regulatory exams. Similarly, the regulatory relationship manager also serves as the key contact for the EIC and the examination team. Most bank examinations consist of an on-site and an off-site element, although the greater effort in coordinating and participating in RRM will occur in connection with on-site activities.

Whether the supervisory agency requests it or not, the bank should create a user-friendly information package for on-site examiners. The package should provide contact information on the regulatory relationship manager and others with whom the examiners will meet. It should also offer basic material such as a summary of the bank's strategy and business, relevant organization charts, and biographies of key individuals. While rare, examiners sometimes fail to grasp the basic nature or business model of an institution, especially in a specialized examination. We have seen cases where severe penalties were recommended based on concerns that were completely irrelevant to the individual bank involved. If the bank has a new lead examiner, the regulatory relationship manager should offer him or her a special overview briefing. Even a veteran examination team will appreciate a periodic recap or update of the bank's strategic and business plan.

The briefing package should also contain well-organized sections covering the categories of activity the examiners want to review, labeled and indexed for easy search and study. The more easily the examiners can find the material they want, the less likely they are to explore areas that could potentially raise new questions or widen the examination scope.

For the on-site portion of an examination, most regulatory agencies will schedule both an entrance meeting and an exit meeting. From a RRM perspective, it is advisable to coordinate these meetings with the regulator and work collaboratively to determine mutually agreeable dates and times for each meeting.

Examiners may request additional meetings and/or information during both the on-site and off-site portions of the examination. If so, the regulatory relationship manager should always coordinate the needed action, and must ensure that the financial institution responds to such inquiries promptly and makes them a business priority. Responsiveness is vital, even for requests made on short notice. If no other option is available, the bank may consider offering an interim response, reserve the right to revise its response, or even ask for more time to respond. The key to responsiveness is to avoid delay and provide a realistic timeframe for a full response.

The entrance meeting presents an opportunity for the financial institution to present its own facts and key players, which helps set the tone and guides the framework for the exam. The regulatory relationship manager is responsible for facilitating the entrance meeting with the examination team. He or she should prepare an overview of the area or topic being examined and invite appropriate bank representatives to make presentations and/or answer examiners' questions. For example, a regulatory relationship manager may present a Power Point overview of the process by which credit risk is managed and introduce one or two senior managers from Credit Risk Management to answer questions, be interviewed by examiners, or serve as contacts for additional information. The entrance meeting sometimes includes a courtesy greeting by the CEO or another senior business executive to help set a positive tone and demonstrate that the bank's executives take the examination function seriously.

It is both helpful and critical to keep the exam team "on task" by directing them only to appropriate and necessary information and contact people within the organization, or examination "scope creep" may occur. Within the bank, the regulatory relationship manager should help other bank personnel, particularly those with purely operational business functions, be aware of "scope creep" and help them prepare responses that get the examination back on track. At the same time, the regulatory relationship manager should remember that on-site examiners are free to explore areas beyond the bounds of the original scope of the examination, and often do so.

An effective regulatory relationship manager can also help facilitate a clear understanding of each document or put information in context for examiners by helping them understand the business or the industry in general. The risk of presenting documents or information to an examiner that cannot be readily understood or fully explained diminishes an institution's credibility and may lead to a prolonged examination or visitation. The manager should also exercise a quality control function to ensure that no extraneous or non-responsive information, or privileged information, is provided inadvertently.

The regulatory relationship manager should maintain an ongoing dialogue with the examination team during both the on-site and off-site portions of an examination. A collaborative dialogue with the EIC and his or her exam team is more likely to result in a less adversarial examination experience and minimize surprise at the outcome. A key objective is to assure that any concerns arising during the examination are addressed immediately, before the examiners become entrenched in a negative viewpoint. Once examiners start to shift from asking questions about an issue to articulating concern over it, the bank can face great difficulty in defusing a problem.

At the conclusion of the on-site portion of the examination, the agency will schedule an exit meeting. Its purpose is to share the preliminarily findings with the regulatory relationship manager and other key bank personnel. If the results are favorable, the meeting will likely be uneventful. Otherwise, the meeting could turn contentious. In that case, the regulatory relationship manager must set the tone for the bank's staff by asking appropriate or clarifying questions and behaving professionally, rather than permitting emotions to govern. Although it may be tempting to confront the examiners defensively if the preliminary findings are deemed erroneous or unjustified, it is better to remain calm and reserve judgment until the final exam report is received. In general, the bank's representatives should strike a balance, forthrightly defending the bank's actions where appropriate, but doing so without rancor. If the bank is actually in the wrong, it is usually wise to acknowledge the error and commit to aggressive corrective action.

If the examiners do not provide a written summary at the exit meeting, the bank can request a written recap of what was specifically discussed, as well as next steps contemplated by the agency. Barring this, the bank can identify someone on its own staff to take detailed notes of what transpires at the exit interview.

Before the exit interview concludes, the bank should ask when the agency expects to issue its final written report so that the bank can be prepared to quickly provide management's response. Indeed, the outline of management's response can begin to be drafted between the time of the exit interview and the receipt of the final report.

Following the exit meeting, the regulatory relationship manager should ensure that appropriate members of the executive and senior management team and legal counsel are fully apprised of the preliminary results of the examination (and subsequently receive a final copy of the exam report so that they can help craft a response).

Effective regulatory relationship management is focused on the long-term goal of building trust and credibility with examiners and working collaboratively with regulators to achieve the bank's business goals. One of the essential parts of the RRM function is careful planning, organization and management of examinations. Maintenance of a centralized process for examinations, the ability to be in constant "exam-ready" mode, the support of key business, legal and compliance contacts and a step-by-step process for responding to examination findings make successful examination outcomes more likely.

The next article in this series will discuss responding to examination reports.

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