Spring 2010 Newsletter

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Executive Corner - What are they focused on?

(Special thanks to credit and lending executives from Eastern Bank, Cambridge Trust Company, Boston Private Bank, Enterprise Bank, First Republic Bank, and Lowell Five Cents Bank for participating in this brief survey.)

It is hard to believe that 2011 is already nearing its midpoint... The economy and our industry specifically continue to face challenges, recovery woes, and uncertainty of direction. Will we face a double-dip recession; will the recovery be prolonged and painful; is there a significant risk of inflation; and which competitors will be the next acquisition targets? These are some of many issues we worry about as commercial bankers.

In an effort to get a better sense for direction through the rest of the year, we asked Chief Credit and Lending Executives in Massachusetts to share the top 2-3 issues and challenges they are focused on in the near to mid-term. Below is a summary of their responses.

- Not surprisingly, the constant need to balance a highly competitive environment with credit quality of commercial loan portfolios was the challenge mentioned most frequently. Asset quality has been perhaps one of the top concerns on the minds of banking executives. Now add to the mix what appears to be an unfounded or unreasonable return to aggressive pricing, and we may have an unhealthy trend which could result in thinner returns and loosening of credit structures (e.g.: credit structures that lack proper or any loan covenants, sensible amortization schedules, reasonable LTVs or adequate collateral, or recourse). This is a tough situation to deal with when deposits are moving in, but marketable securities produce low returns and you are pressured to book assets "at any cost" to deploy your capital more effectively.
- Despite some signs of improvement or at least stabilizing, commercial real estate (CRE) is still a concern and there is a sense that various areas of New England have so far been spared from the brunt of recession other parts of the country are still living through. Are we out of the woods yet? If your bank's growth or asset levels have been largely supported by CRE, do you have the next sustainable alternative when the

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IN THIS ISSUE:

CRE market overheats? If you wait to find and implement that next growth strategy, you may be left in the dust by your competition.

- Another area of concern cited is attracting and retaining top talent both in lending and credit. As the environment continues to improve, the battle for the best employees is likely to intensify, placing pressure on compensation packages, focusing on employees' satisfaction, growth and retention, and facing increased risk of losing your key staff.
- The next challenge mentioned is integration of new employees as bankers continue to move around more than they used to. This point links back to finding the right balance between business development and credit needs in maintaining strong credit culture and credit quality. New employees are expected to contribute to an organization's success, but, if left unmanaged from the cultural integration point of view, can cause tension or even disruptions within the already established and functioning corporate, credit and risk cultures.
- Efficiency of the credit process is yet another priority area. This includes not only most efficient and effective underwriting and approval but also "building proper processes and automated systems into a business model to enable faster access to critical information to manage risk". Technology is a critical component of an effective credit function but overhauling processes and procedures can be more cost-effective, especially if it can bring lending and credit teams together.
- Compliance, compliance, and compliance, especially in the areas of residential lending. There are likely more regulations in store for banks, leading to additional costs. Those organizations that can quickly capitalize on adapting to the new regulatory environment with the least cost impact and those that can establish new residential broker-originator relationship strategies should be able to cash in on these challenges.
- Last but not least, client service continues to be in focus. "Being nice is just no longer enough." Technology is an important component of client focus. For instance, "strong cash management capability is critical in order to compete for relationships." This implies access to up-to-date technology. This is a given in today's competitive market. Another aspect of this is widespread contradiction between practicing what you preach when it comes to "the excellent client service" and yet choosing to price as a mass marketer. Clients catch onto this disconnect very quickly and will treat you as yet another commodity provider.

"This is a great customer of the bank!" or Reference Checks 101 (abridged)

As an industry, we go through waves of, at times, focusing more and, at other times, less on financial statements in analyzing prospective financing opportunities. Sometimes the emphasis on operating cash flow, liquidity, leverage, and other financial qualities serves us well. However, we again and again turn to the importance of analyzing the character of business owners and capabilities of management teams (and management teams and their governing bodies for public enterprises) in getting a balanced picture of credit risks. After all, financial statement analysis goes only so far, and a portion of risk is driven by non-quantitative, human factors. References are a significant component of evaluating the character of business owners and management teams.

What are the most common misconceptions, excuses, or reasons for not obtaining references?

- They do not add value;
- They are not worth time invested; they take too long to obtain; or we have no time for this;
- No references are truly objective and independent, so what's the point?
- We already know the prospect;
- The principals whom we know "well" may be offended if we ask for references.

Are these concerns valid? They are not and here is why.

- They do not add value – How do you quantify adding value? Most naysayers can't explain. The value is in avoiding those few loans every year that, if they were to become workouts, your institution is not likely to recover.

- They are not worth time invested – On the grand scale of various due diligence responsibilities, obtaining references is the task you would want your staff to be spending time on; negative references will often lead to loan requests turndowns.
- They take too long to obtain – One reference takes approximately 10-15 minutes to obtain. Is 30-40 minutes spent on getting 2-3 references that long, especially when you can ask an analyst or another staff member obtain them?
- We have no time for this – Almost anybody in your organization can obtain references if you are too busy. All you need is a list of carefully selected questions, instructions and a bit of practice. In our day-to-day work lives we waste time on much less important details.
- No references are truly objective and independent, so what's the point? – This may be true if you obtain all references from individuals or companies that technically work for the prospective borrower, somehow may have a legitimate conflict of interest, or may be incentivized in the borrower passing your reference checks. More objective reference providers are key suppliers, customers or other business partners. The key is to obtain them from several dissimilar entities and to keep detailed records of obtaining each such reference.
- We already know the prospect – This is by far my favorite and not in a good way. A week has not gone by in my banking career that I have not heard this or similar phrase: "this is a great customer (or prospect) of the bank", especially when prospects are already customers with other groups in your institution. What does this mean? The length of relationship does not automatically mean creditworthiness of a client. How do you quantify or qualify "greatness" or "excellence" as it applies to credit worthiness? Most of my attempts to get this questions answered did not yield anything coherent that had to do with assessing credit risk.
- The principals whom we know "well" may be offended if we ask for references – What nonsense! Do not forget that prospects and existing clients sell to their respective prospects or clients all the time too and have to provide and pass reference checks. They understand why we need them. For those few who do not, it is a commercial lender's responsibility to provide a reasonable rationale for why references are needed and good, experienced lenders have no issues getting them.

I am a firm believer that the majority of commercial lenders have the best intentions in doing whatever needs to be done to vet a prospect and make good loans. However, they may not always have the right incentives or experience to assess correctly the character of a prospective borrower's management team. It is dependent upon your institution to create the culture that understands the importance of evaluating character and capabilities of your prospects' owners and management teams as well as their abilities to deliver results. Can they deliver and behave with integrity in an adverse situation?

In conclusion, below are some best practices that will help your institution develop a robust reference due diligence program. They were sourced from mine and my peers' commercial banking experiences.

- Have reference checks as part of your credit policy. However, the ultimate goal is to make reference checks a part of your credit culture. The policy is a good start though or they will never get done.
- Average recommended number of references is 2-3.
- Document references in writing and save in the file.
- Devise a template of sample questions.
- Verify or at least be cautious of unfamiliar sources of reference.
- Always shy away from assumptions.
- As an obvious but often missed conclusion from the previous bullet point, referral is NOT the same as reference! Trust but verify!

If you would like a full version of this article, please contact the RMA New England Chapter.

By (Dima) Neil Berdiev.

Street Chatter - interview with Jack D'Ambrosia of Chaston Associates

Jack D'Ambrosia, an Executive Vice President at Chaston Associates, joined the RMA New England Chapter's Dima Berdiev to talk about some of the industry trends and outlook as Mr. D'Ambrosia works with a wide range of banking clients.

Mr. D'Ambrosia indicated that he is seeing a decline in the increase in problem loans. There appear to be signs of stabilization within Chaston Associate's 100+ banking clients in New England. Criticized commercial assets are in the 11-12% range on average for the clients D'Amrosia works with. Classified balances are in the 5-6% range (substandard or worse). At this point, it looks like banks are starting to put their construction and investment real estate problems behind them.

There may even be some hope for sales growth looking forward but certainly there was not much activity in 2009-2010. Commercial loan delinquencies are up but appear to be decelerating (~3%). To put things in perspective, Chaston's clients largely fall within $100 million to $5 billion by assets, with loan portfolios ranging from de novo to $2-3 billion (average of $300-$400 million); and portfolio distributions in favor of investment real estate versus other others (e.g. C&I) of 60%x40% or 70%x30%.

Industry risks and weaknesses in commercial real estate continue to exist in hospitality and lodging. Mid-tier hotels are still at risk because they are dependent on discretionary consumer spending. Hotels that are more aggressive on pricing and internet sales are doing better than competition. Similarly, restaurant and specialty retail space is also challenged by discretionary consumer spending.

Construction and related industries may still be trending downward. Mr. D'Ambrosia explained this by the fact that while many bank borrowers survived the latest cycle, many have exhausted capital and thus diminished their staying power. On the business development front, where there were no sales, there may be a pickup in activities, but it should not be mistaken for a rebound in sales just yet. As anecdotal knowledge and as a summary, the residential market still has a large contributor of problems in the construction sector. Banks continue to face challenges in repositioning industrial CRE. Retail is also worrisome.

What does Mr. D'Ambrosia see as the outlook for the rest of the year?

As the environment and banks' portfolios are stabilizing, they are beginning to position themselves for growth. This means looking for more lending staff. We should not forget support and credit staff as these should remain areas for concern. It is tough to grow without the right people. Banks will be deciding whether to outsource certain functions or to bring them in-house. Some banks have hired staff to work through loan problems, and there may be decisions made to absorb them into other roles, as business stabilizes and problems are addressed.

One area of concern is fairly young and inexperienced credit staff. The question becomes whether to hire the right skills from outside or develop them in-house. Some of these problems can be resolved through bank acquisitions and through moving people around as part of their career progression. Mr. D'Ambrosia did note that there is and will continue to be pressure to increase compensation for credit roles. While smaller banks have tried to develop their own talent internally, successes have varied significantly. Ideally, success stories have been achieved through mentoring and providing adequate resources to support the internal development efforts. One way to achieve this goal is by bringing in an experienced person to oversee the implementation.

In conclusion, our readers often ask about what regulators look for. A number one priority is transparency in accounting for non-accruals, impaired assets, and timely charge-offs. You will also need to demonstrate and justify how you value OREO portfolios. Regulators focus on how accurately banks account for problem loans in general. Mr. D'Ambrosia recommends addressing criticized and other adversely impacted loans as part of portfolio management. It is also important to be able to analyze your loan portfolios from a variety of angles, including but not limited to industry concentrations and risk ratings.

Last word of advice from Jack D'Ambrosia - be conservative and consistent!

Contact the RMA New England Chapter with ideas for future discussions.

What is RMA New England?

For those who do not know us well and are interested in learning more, RMA New England Chapter is a chapter of the RMA or Risk Management Association. We have over 750 individual members, largely in Massachusetts, but we also have a few members in the neighboring states.

The Risk Management Association was founded in 1914. It is a not-for-profit, non-lobbying, member-driven professional association, headquartered in Philadelphia, Pennsylvania. RMA has approximately 3,000 institutional members that include banks of all sizes as well as non-bank financial institutions. They are represented in the association by 18,000 risk management professionals who are chapter members in financial centers throughout North America, Europe, and Asia/Pacific. RMA New England Chapter is one of dozens of chapters within RMA. Our objective is to further the ability of our members to identify, assess, and manage the impacts of credit risk, operational risk, and market risk on their businesses and their customers.

So, who are we? We are banking and other financial services professionals. We work with the RMA National Headquarters to bring to you learning and development, educational events, roundtables, networking events and a variety of other resources and tool to make your organizations and employees successful in the field of risk management.

If you would like to learn more about RMA New England, please visit www.RMANewEngland.org.

Recap of our Recent Events

The 2011 RMA New England Chapter Loan Officer Resident Seminar (LORS) was recently held and proved to be one of the best classes in our long 35 year history. This was the first year that the event was held at the Exeter Inn in Exeter, NH, with wonderful reviews received on the quality of the Inn's hospitality.

The 2011 LORS program boasted its largest class in recent memory, with 28 registered participants, representing over 15 different financial institutions from throughout New England.

The LORS Committee would like to extend our congratulations and appreciation to each and every one of the participants for their efforts, dedication, and contributions. Through their efforts, and with the guidance of our volunteer Instructors and Facilitators, the 2011 LORS has set a very high benchmark for future classes.

Recap of our Recent Events (continued)

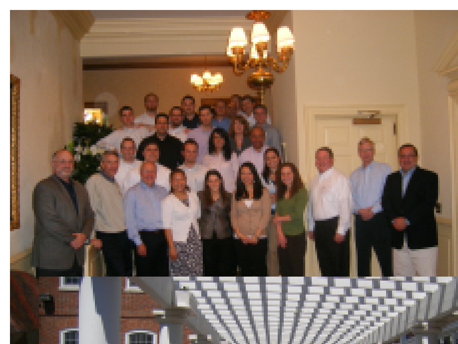
The RMA New England Chapter would like to extend its gratitude to its 2011 LORS Instructors:

Donald Bedard, The Lowell Five Cent Savings Bank
Thomas A. Hollis, Hollis Meddings Group
Grey Bowden, GB Advisory Group
Bruce Lemieux, Sovereign Bank
Edward J. Callahan III, CPA, Feeley & Driscoll, P.C.
Joseph Meddings, Hollis Meddings Group
Joseph Finn, Jr., CPA, Finn, Warnke & Gayton
Neal O'Hurley, Boston Private Bank & Trust
Marc A. Guerin, JD, CHMM, CESIR, Citizens Financial Group
J. Timothy Reiter, MAI, Citizens Financial Group
Christopher Hines, Feeley & Driscoll, P.C.
Gerald Sherman, NorthStar Management Partners, LLC
Dennis Stratton, Bank of America
Andrew Strehle, Esq., Brown Rudnick Berlack Israels LLP
Daniel Sullivan, Eastern Bank
Paul Wielgus, Coastway Community Bank

We would also like to thank the following institution participants:



Boston Private Bank
Central Bank
Century Bank
Claremont Savings Bank
East Boston Savings Bank
Eastern Bank
Enterprise Bank
Farm Credit East, ACA
Greenfield Savings Bank
Milford National Bank & Trust
North Shore Bank
Rockland Trust
Rockport National Bank
Salem Five Cents Savings Bank
TD Bank
Westfield Bank




Recap of our Recent Events (continued)

The RMA New England Young Professionals Group (an affinity group of the Chapter) recently held an evening networking event at Clarke's at Faneuil Hall. The is no age restriction to participate and the group's goal is to bring together financial services professionals as well as "connected" industries such as accountants, attorneys, and many others. The group's plan is to organize another networking event at the end of summer.

The event had over 30 attendees from a wide range of organizations, including MassDevelopment, BDC Capital, Silicon Valley Bank, Boston Private Bank, Enterprise Bank, Century Bank, AR Funding, Sovereign Bank, Bay Colony, Winchester Savings Bank, Central Bank, Bristol Country Savings Bank, and Cambridge Savings Bank.

Stay tuned for future events and join us on LinkedIn!

One more announcement...

Welcome to our new members!

Haverhill Bank
Quinnipiac Bank & Trust Company
Salem Five Cents Savings Bank
Savings Bank

New England Educational Events

New England Area Upcoming Events

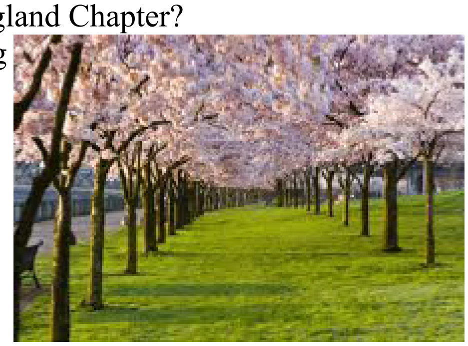
Understanding and Interpreting Real Estate Appraisals
Hartford, CT
Friday, July 15, 2011
8:30 AM to 5:00 PM

Operational Risk for Regional and Community Bankers
Boston, MA
Wednesday, June 29, 2011
8:30 AM to 5:00 PM

RMA Young Professionals 7th Annual CEO Series Event
Boston, MA
This Fall - stay tuned!

If your institution is interested in events other than the ones listed here, do not hesitate to contact us and we will be glad to work with you to bring them to your area.

Do you have training needs, event interest or ideas, suggestions or would you like to get involved in the RMA New England Chapter?
Visit us at www.RMANewEngland.org



RMA New England Chapter
10 Back River Rd.
Amesbury, MA 01913
Julie Conroy, Administrator
Tel.: 978-263-9003
Julie@RMANewEngland.org