2019 LENDERS & CHIEF CREDIT OFFICERS CONFERENCE

Driving Growth, Sustaining Performance

Improving Credit Risk Management: Moving from Doing the Deal to Understanding the Risk-to-Loan Portfolio

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Audio Visual sponsored by Pearl Meyer

What is Credit Risk Management

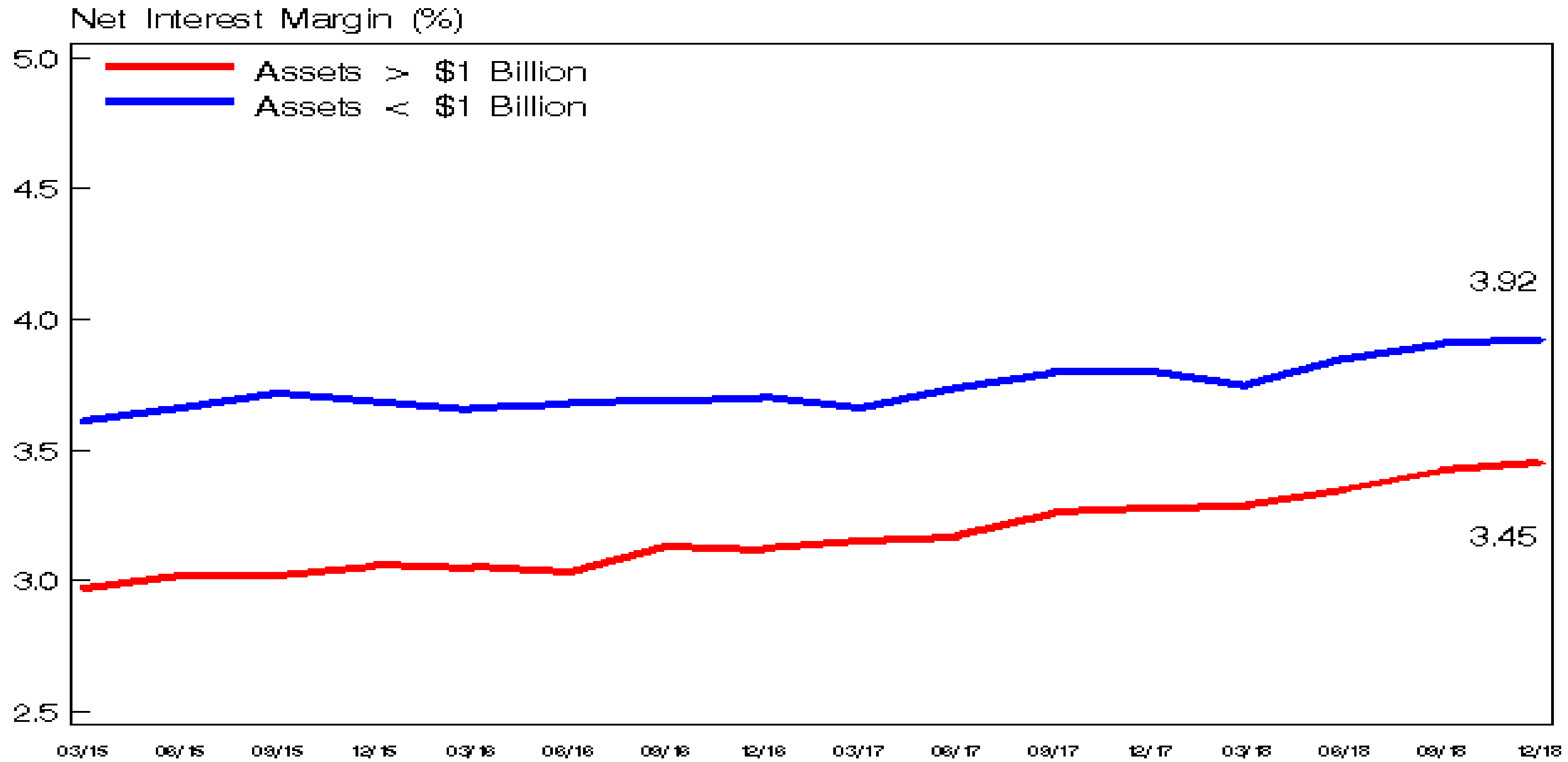
- To insure stability and orderly growth of shareholder value by managing credit risk through:
- Formulation and enforcement of prudent credit policy
- Accurate identification of risk and sound credit approval decisions
- Timely monitoring and reporting of credit risk management performance
- Successful credit risk management relies on a strong credit culture

Agenda

1) Where are we today?
   - U.S. Banking
2) Regulatory Expectations
   - Asset Quality
   - Examination Trends
   - "Hot Buttons"
3) Recent Observations
4) Other Issues
   - Underwriting
   - Portfolio Management

FDIC Quarterly

- Net Income Climbs $2.7 Billion From a Year Earlier on Lower Income Taxes and Higher Net Interest Income
- Loan and Lease Balances Grow 6.5 Percent Year Over Year
- Net Interest Margin Expands to 3.78 Percent From a Year Earlier
- Asset Quality Improves as Noncurrent and Net Charge-Off Rates Decline
- **Loan Balances Rise by $98.5 Billion**
- **The Number of "Problem" Banks Falls to 60**



Quarterly Net Interest Margins, Annualized
2015 — 2018
Net Interest Margin (%)
5.0
4.5
4.0
3.5
3.0
2.5
Assets > $1 Billion
Assets < $1 Billion
3.92
3.45
03/15
06/15
09/15
12/15
03/16
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12/16
03/17
06/17
09/17
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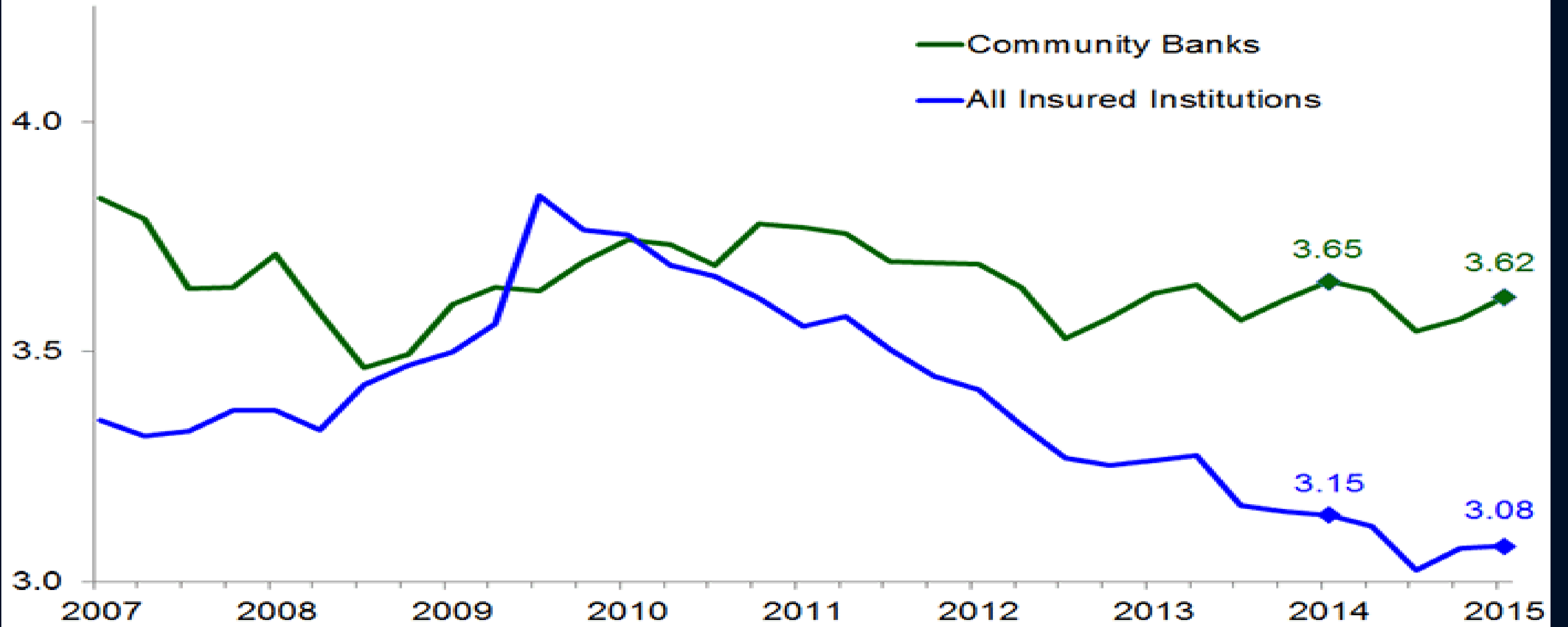
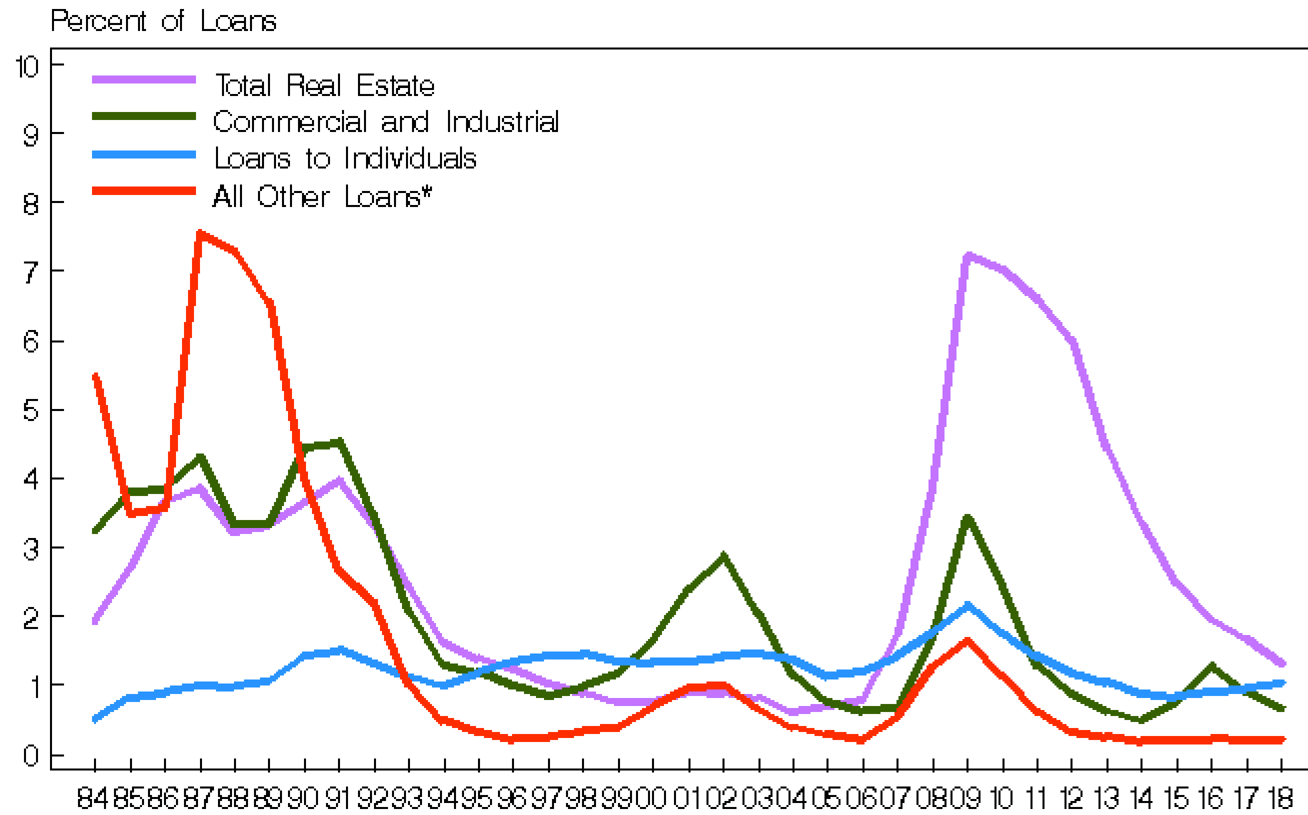
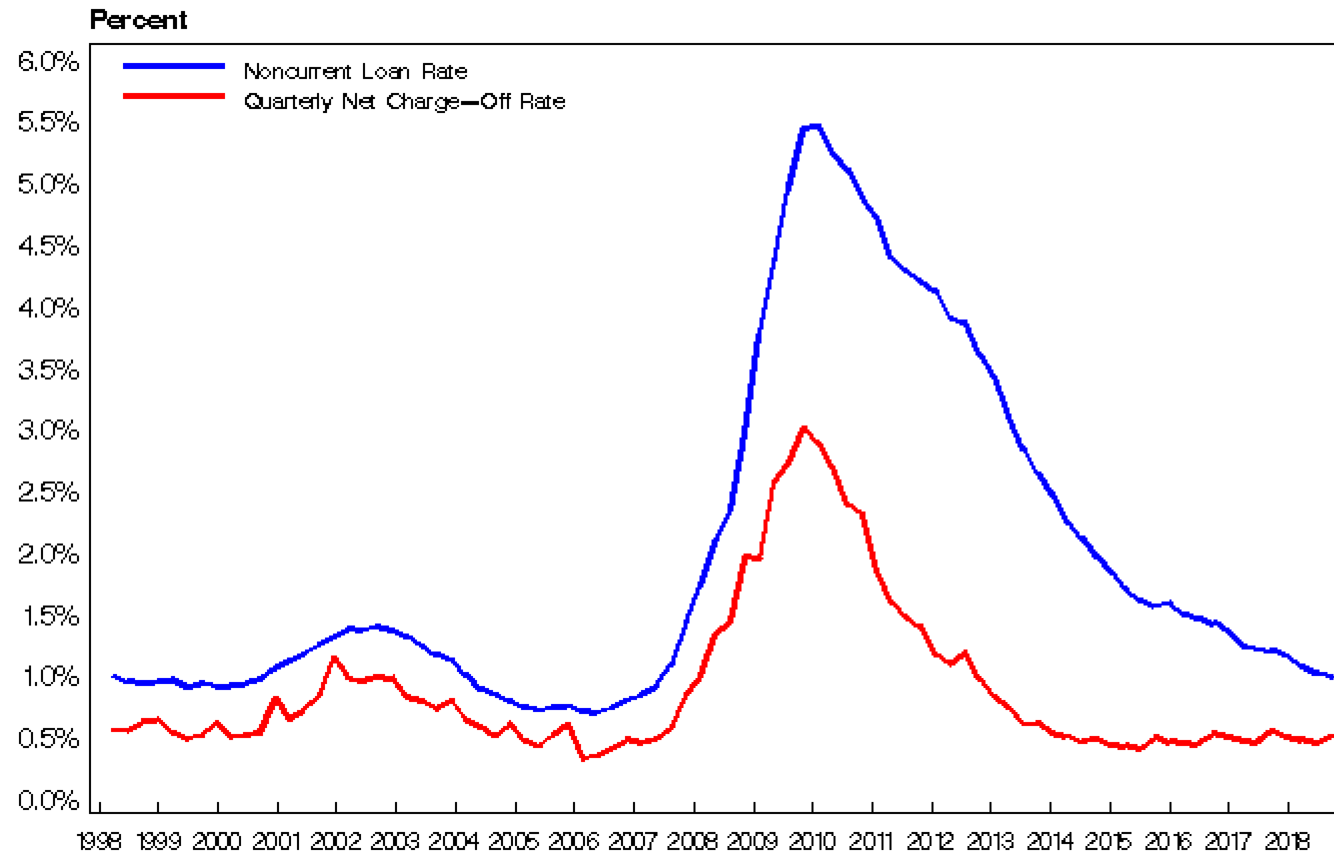

Net Interest Margin
Percent
Community Banks
All Insured Institutions
4.0
3.5
3.0
3.65
3.62
3.15
3.08
2007
2008
2009
2010
2011
2012
2013
2014
2015
Source: FDIC.


Noncurrent Loan Rates at Year—End
1984—2018
Percent of Loans
Total Real Estate
Commercial and Industrial
Loans to Individuals
All Other Loans*
10
9
8
7
6
5
4
3
2
1
0
84 85 86 87 88 89 90 91 92 93 94 95 96 97 98 99 00 01 02 03 04 05 06 07 08 09 10 11 12 13 14 15 16 17 18
Note: Noncurrent loan rates represent the percentage of loans that are past due 90 days or more or in nonaccrual status.
* Includes loans to foreign governments, depository institutions and lease receivables.


Noncurrent Loan and Quarterly Net Charge—Off Rates
1998—2018
Percent
Noncurrent Loan Rate
Quarterly Net Charge—Off Rate
6.0%
5.5%
5.0%
4.5%
4.0%
3.5%
3.0%
2.5%
2.0%
1.5%
1.0%
0.5%
0.0%
1998 1999 2000 2001 2002 2003 2004 2005 2006 2007 2008 2009 2010 2011 2012 2013 2014 2015 2016 2017 2018

Regulator Concerns – TODAY
Emerging threats and vulnerabilities

- Systemic Risks that exist in your bank
- Cybersecurity
- Compliance Risk
- Increased risk taking in a low-rate environment
- Easing of lending standards –

In response to competitive pressures and abundant market liquidity.

Most easing occurring in commercial real estate (CRE) construction, other CRE, leveraged loans, indirect consumer, and credit cards.

Are We at The Peak?

- The RMA Annual Risk Management Conference thinks so…

➢ "The Ups & Downs of the Business Cycle"

➢ "Prepping for the Downturn, Again"

➢ "Is Your Balance Sheet Ready for the End of the Credit Cycle?"

- Are Tomorrow's Problem Loans being made today.….

REGULATORY - "CURRENT MOOD"

- Asset Quality Good, HOWEVER…

- Banks reaching for deals creating higher risk profiles
- Fewer loan covenants being required – AKA covenant light!
- Thin pricing
- Several national markets are becoming overbuilt

- Examiners also noted increasing exceptions to banks’ loan policies, primarily in commercial products and to a lesser degree in retail products. The combination of increasing policy exceptions and easing of underwriting standards can increase portfolio risk to excessive levels and result in less resilient portfolios during times of stress.
- The primary reasons supporting the projected increases in credit risk included continued loan growth along with easing underwriting standards, strong competition, expected changes in interest rates, and the impact of other economic factors.
- Credit risk is showing up in two of its classic forms: relaxed credit underwriting and increased loan concentrations.

- Mergers & Acquisitions – As part of Due Diligence, understand the target bank's risk management.
- Agricultural Challenges – Trade war with China is causing pressure on commodity prices. There is some carry over debt that is being rolled into the farm real estate loans. What happens if/when the farm values decline as they have done in the Midwest?
- Appraisal Reviews – How well are the Cap Rates being used supported in the Appraisal? The range on the west coast on Cap Rates is much lower than the rest of the country. The Midwest and Southwest as an example is 6-9%. What's your base mark and is the rate being used outside the base mark?

POLICIES, PROCEDURES, PROCESSES

- ALLOWANCE for LOAN & LEASE LOSSES
- CONCENTRATIONS MANAGEMENT– PORTFOLIO RISK
- APPRAISALS
- RISK TOLERANCE

Optimum Credit Culture

- Top management sets asset quality as a corporate priority and says so regularly
- Line management consistently supports asset quality objectives
- Policies written in collaboration with line, approved, monitored, and enforced by independent CRM across various LOB portfolios
- Policy exceptions infrequent and mitigated
- Credit standards, credit policy, business plans, and incentive plans are in sync
- Credit discipline tools are in place . . .

Critical Asset Quality Indicators

- Concept - Reflects quantity of existing and potential credit risk associated with assets and off-balance sheet items
- Evaluation Factors

➢ Adequacy of underwriting standards

➢ Credit Administration Practices

➢ Level, severity and trends of problem assets

- Appropriateness of the level of the ALLL
- Off-balance sheet credit risk
- Loan Portfolio Mix
- Asset concentrations
- Asset Growth Rate
- Adequacy of policies
- Ability of management to administer problem assets

- Adversely Classified Items/Tier 1 Capital and ALLL
- Non-current Loans/Leases to Gross Loans and Leases
- Net Losses to Average Total Loans and Leases
- ALLL to Total Loans

Underwriting – Current Trends

- Loan Approval Structure – How does your committee function?
- Structure, Controls, Policy Compliance, Risk Selection & Collateral
- Risk Rating Integrity
- Pricing for risk
- Stress Testing
- Leveraged Lending (Debt/Worth > 4x & or 50% of the total debt should amortize in seven years)
- Participation Management

Underwriting

- Margins are thinner, protective covenants are weaker or non-existent and loan maturities are longer.
- Banks are increasing their participation in riskier products, such as leveraged lending.
- The pattern I'm describing is common during the later stages of the economic cycle, which happens to be where we are today. – *OCC*
- Challenges in the energy sector speak more generally to the risk associated with loan concentrations.
- At present, these concentrations flash yellow lights rather than red ones

Credit Memos

- Presentation Styles
- Quality Control
- Liquidity Verification
- Pricing

Underwriting - Examiner Focus

- New underwriting – Doing the “right” deals
- Portfolio Management – Staying on top of your portfolio quality
- Interest Rate Risk – Low rates and lack of investment alternatives without assuming significant extension or credit risk
- Strategic/Business Planning – Uncertainty highlights the need for sound planning

- Global cash flow is often deficient
- Difficulty in getting timely financial information
- Waiting on tax returns and other information before performing updated analysis
- DSC is often overstated – Banks are not taking into consideration reasonable living expenses, and other outside debt
- Understand use of proceeds and loans obtained elsewhere – Potential problem

Risk Tolerance vs. Risk Appetite

- Risk Appetite - Amount and type of risk a bank is willing to accept in pursuit of its business objectives
- Risk Tolerance - Specific maximum risk bank is able to take, absorb, accommodate
- Risk Appetite vs Risk Tolerance - Wants (appetite) vs. needs (tolerance)

Risk Tolerance

- A bank's CEO/President, CRO and CFO, together with other senior mangers should work with the Board Risk Committee (BRC) to establish a targeted risk tolerance for the Bank.

- A bank's targeted risk tolerance is usually set at Moderate Risk, i.e., defined as a bank's willingness to accept certain business risks provided it can achieve a prudent risk/return objective. Though higher returns may be acceptable given the risks assumed, risks have to be appropriately managed, governed to meet the Bank's business objectives.

Portfolio
Management

Annual Reviews

- Threshold
- An annual review should be sufficient to accomplish the following minimum objectives:
  - Determine current debt service coverage;
  - Discuss material changes in the credit since last review;
  - Address any perceived changes in the value of the collateral securing the loan;
  - Ensure the borrower is in compliance with loan agreement covenants.
  - Re-affirm the risk rating assigned to the credit;

Loan Review

- How the Regulators Assess Effectiveness of Loan Review Function:

    Test Independence

    Review the Scope

        Risk-Based?

        Dynamic?

    Accuracy of Ratings

        Timing and Accuracy

    Loan Review Well Respected?

        Credit Culture

        Management Support

CONCERNS

- Cost Cutting a non-revenue generator
- Frequency of the review is being increased

PORTFOLIO DYNAMICS

- Portfolio Passing Rate
- WARR (Weighted Average Risk Rating)

Establish a Scorecard vs. High Performing Banks Industry Benchmarks

- Past Dues - <1%
- Criticized/Capital - <20% of capital
- Classified/Capital - <10% of capital
- Non Performing/Loans - .62
- Non Current Loans/Total Loans
- Total Loans/Annual Loan Loss
- ALLL/Net Loan Losses

- ALLL/Net Charge Offs
- ALLL/Total Loans Outstanding – 1.51%
- Texas Ratio – 9.82%
- Loan/Deposit – 80%-85%
- Net Interest Margin (NIM) – 4.32%
- Net Charge Offs/Loans Outstanding - .19
- Average Loan Growth - +8%

Exception Management

- By Type of Exception being approved
- By Account Officer of Exception being approved
- By Dollar Volume of Exception being approved

Concentration Management

- ***Concentration Management*** – OCC revision of its *Concentrations of Credit Handbook.*
- Recent revisions update the regulators definition of a credit concentration and make explicit connections between concentration management and stress testing.
- Definitions have not changed but the management expectations have increased.

Timely capture of data is critical. A bank can have great policies and procedures but if it doesn’t have good data, your concentrations can be over or understated.

Size of the concentration does not necessarily correlate with the magnitude of risk.

When regulators dig deep into a loan portfolio, they often start by reviewing concentrations (aggregate exposure exceeding 25% of bank capital) and correlations (pools of loans that may perform similarly).

This gives the examiner on site a good idea of potential risk, underwriting quality and risk management processes. This makes sense, particularly when you consider that the loan portfolio is usually the largest percentage of assets, with the greatest amount of potential risk to the bank's capital.

DEFAULT PROBABILITIES

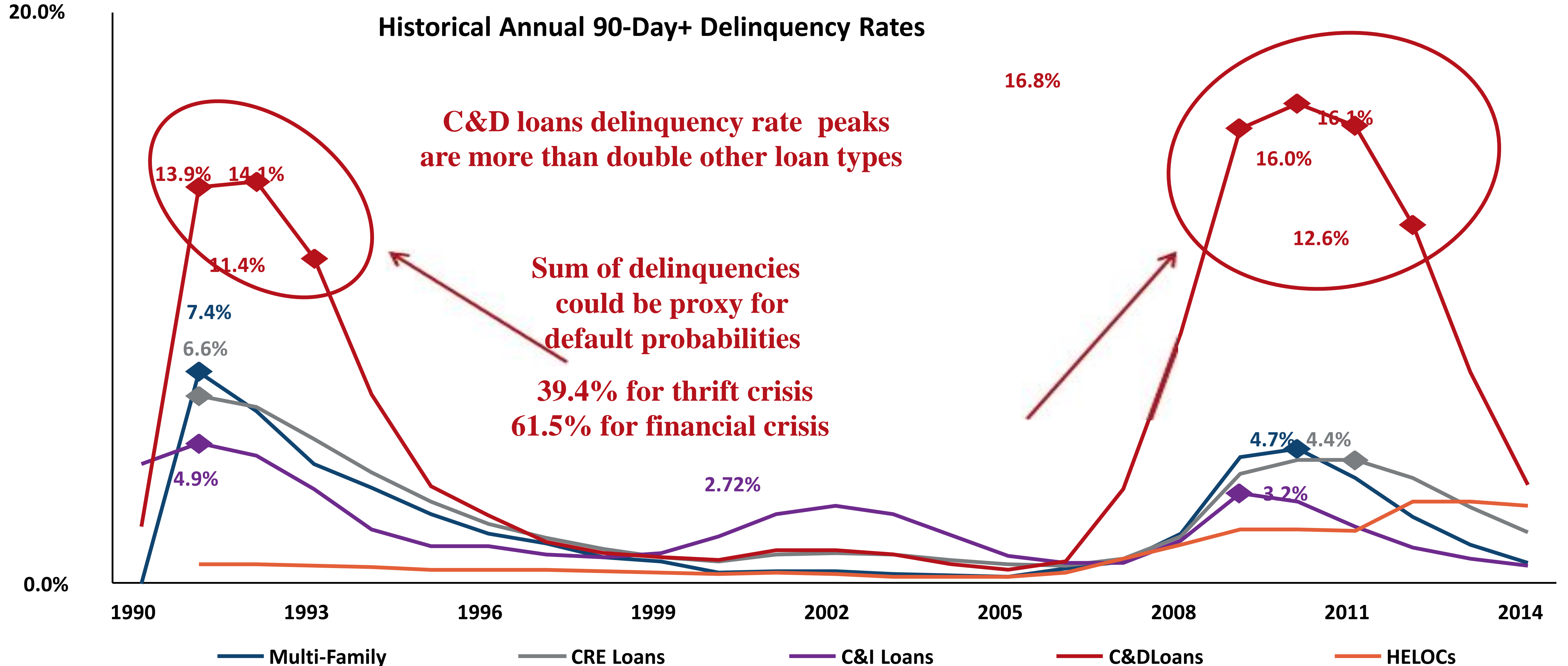
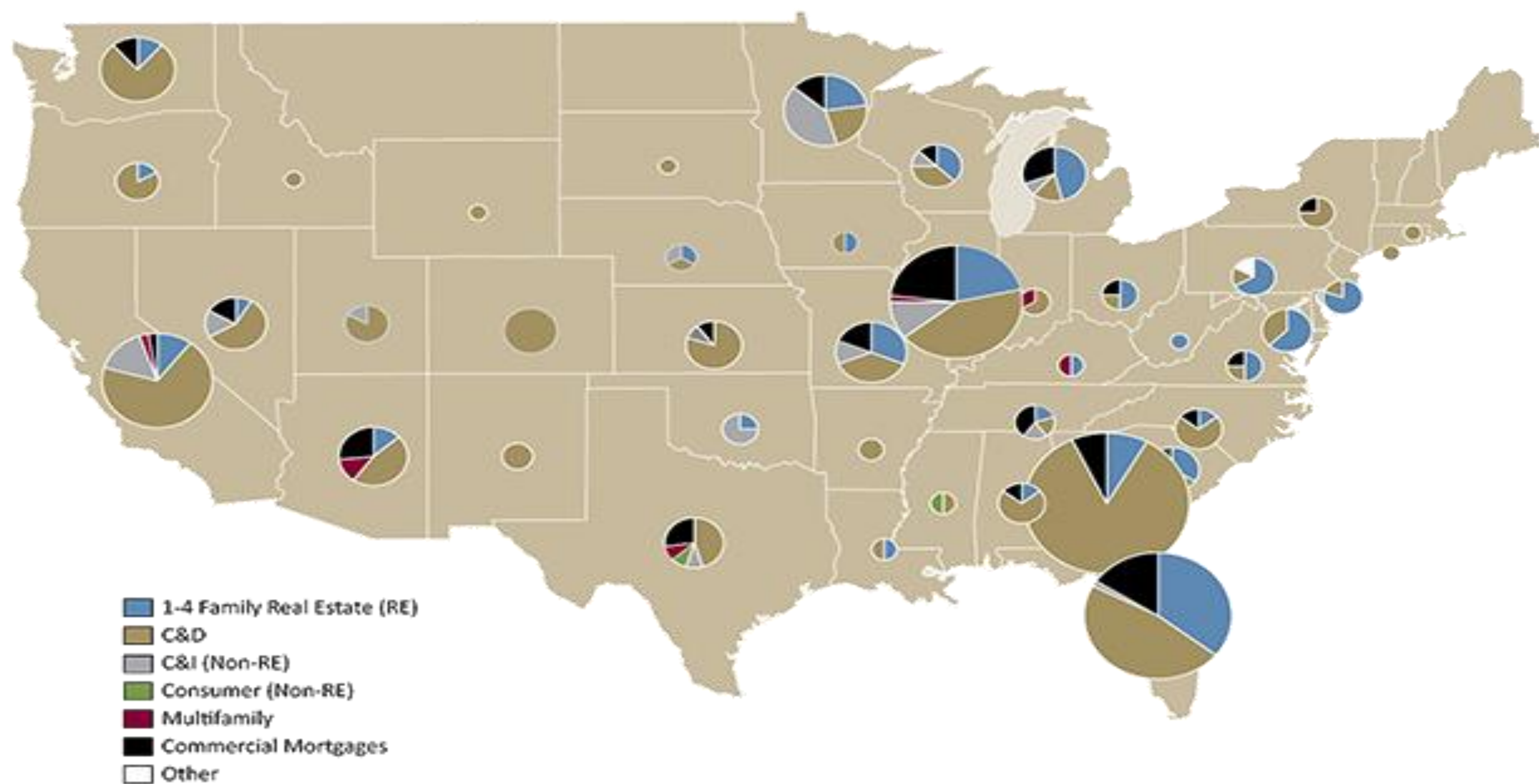
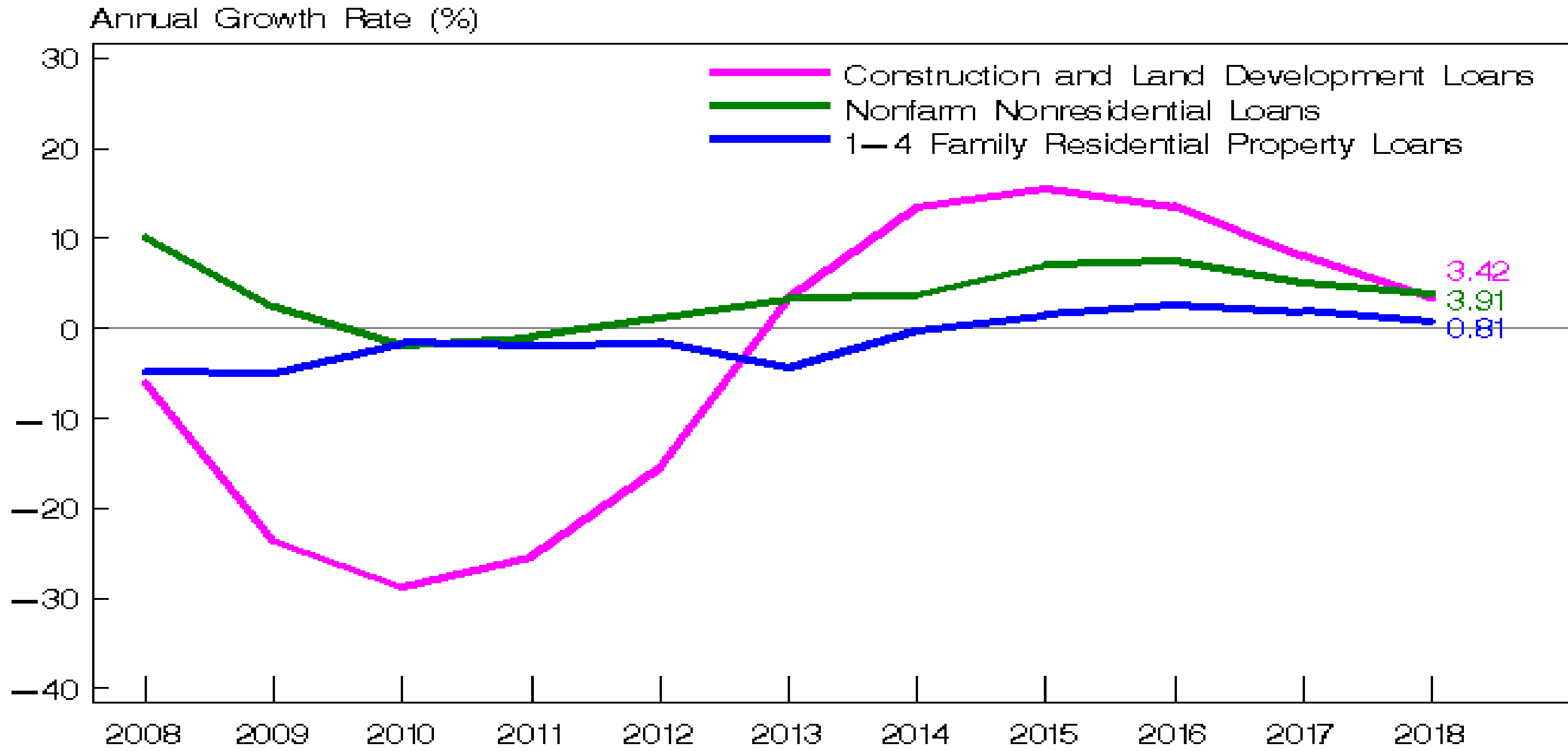


Figure 4: Bank Failures by State and by Highest Delinquency at Time of Failure: 2008–2013

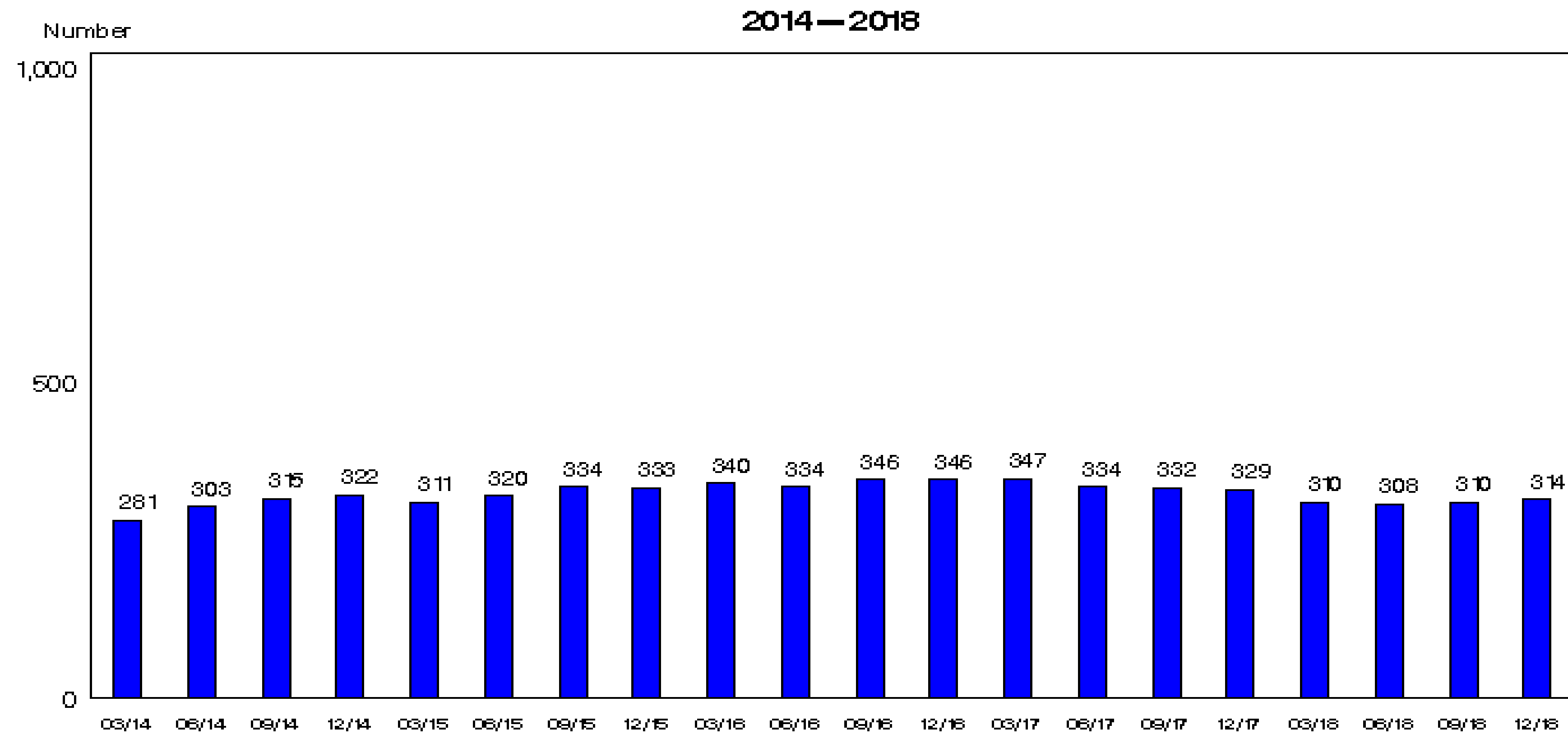


Puerto Rico

Note: The size of each circle represents the relative count of bank failures.
Source: Bank Call Reports



Real Estate Loan Growth Rates
2008—2018
Annual Growth Rate (%)
30
20
10
0
—10
—20
—30
—40
Construction and Land Development Loans
Nonfarm Nonresidential Loans
1—4 Family Residential Property Loans
3.42
3.91
0.81
2008
2009
2010
2011
2012
2013
2014
2015
2016
2017
2018


Number of Institutions with Construction Loan Concentrations
(Construction Loans Exceed Total Capital)
2014—2018
Number
1,000
500
0
281
303
315
322
311
320
334
333
340
334
346
346
347
334
332
329
310
308
310
314
03/14
06/14
09/14
12/14
03/15
06/15
09/15
12/15
03/16
06/16
09/16
12/16
03/17
06/17
09/17
12/17
03/18
06/18
09/18
12/18

Concentration Problems

- Lend too much to one borrower
- Lend too much to one place
- Lend too much to one industry
- Lend too much in one bank line of business
- Not knowing the overall impact to the portfolio
- Not increasing your management efforts with higher levels of concentrations in your portfolio.

Concentration Management – Hotel Loans

- Location
- Flagged
- DSC
- LTV
- Occupancy
- Rev Par Per Room

Concentration Management – Hotel Portfolio

- WARR
- Average LTV
- Average DSC

CECL – Are You Prepared Test (True or False)

- As a banker I don't need to worry about this as Bank Management will take care of it.
- This is a FASB written for large publicly traded institutions and will not effect our community bank.
- It could have a major impact on how the bank addresses ALLL going forward.
- It could have a major impact on how the ALLL is calculated going forward.

- This is another scheme by the regulators to get us to add a lot of cash to our ALLL.
- I need to check with Bank Management to understand where we are in this process.
- Can I still use the percentage allocation method? It worked right for years.
- I need to retire before this whole methodology changes and my Banks ALLL goes up and my dividends go down.

Update on CECL

- Banks are lobbying members of Congress to press their case arguing that the consequences will have dire effects during the next downturn by reducing the ability to lend during future recessions.
- They expect to soon formally propose changes to FASB such as modifying the rule's impact on earnings. FASB indicates that they will consider.
- But even as bank's try to change the rules, they should continue to gear up to adopt it.

Wall Street Journal – 10/18/18

- Regulators have approved a measure, that will allow banks to take three years to phase in the impact of the new accounting rule on their regulatory capital.

- 7-17-19

In a significant move, the Financial Accounting Standards Board today voted to propose a delay for the implementation of the current expected credit loss standard until January 2023 for certain companies. The delay would apply to small reporting companies (as defined by the SEC), non-SEC public companies and private companies.

- “FASB’s vote to delay CECL for certain smaller banks offers further proof that the required efforts to implement this costly standard are far greater than the board has previously led bankers to believe,” said American Bankers Association President and CEO Rob Nichols after the vote. He noted with concern, however, that the delay would not apply to all banks; for larger public companies, the standard would still take effect in January 2020.
- Congress will have to approve

CECL - Timetable

- First Exercise should be the following

1. Consider who is involved in ALLL today and additional resources that may be needed.
2. Determine meeting frequency
3. How will communication with those charged with oversight/governance be achieved?
4. Barriers to implementation.

- Timetable

1. Project plan development – 5/1/2018
2. Pending segmentation and credit risk analysis – 5/1/18 – 12/31/18
3. Data inventory and analysis – 7/1/18 – 2/28/19
4. Model selection & development – 4/1/19 – 12/31/19
5. Update internal controls – 12/31/19 – 4/30/20
6. Model finalization – 1/1/20 – 12/31/20

Stress Testing

Bank management is responsible for determining how best to accomplish this, and effective stress testing, suitable to the particular institution, is one tool.

For community banks, it may be sufficient to shock loss rates projected to be experienced at the portfolio and/or segment levels to simulate base-case and severe stress scenarios, and evaluate the impact on the ALLL and capital. Banks should prioritize the work based on the largest exposures or portfolio concentrations by collateral type, higher-risk segments, or watch-list credits.

Sophisticated systems and models are not necessary or expected, but the concept of stress-testing should be a component of the bank's normal management processes. FDIC officials state that, for most community banks, annual stress testing will be considered sufficient.

Credit Portfolio Red Flags

- Significant shifts in the bank's risk rating profile or increase in the number or dollar amount of problem or watch loans as a percent of loans, in aggregate, or for loan types.
- Large or increasing volume of loans granted or renewed with policy exceptions.
- Large or increasing volume of credit collateral exceptions.
- Rapid growth in total loan volume or particular types of lending.
- Loans remaining on the problem loan list for extended periods of time without resolution.

- Loan review personnel reporting to a person(s) other than the board, a board committee, or a unit independent of the lending function.
- Delinquent internal loan reviews or late identification of problem loans.
- Change in scope and frequency of internal loan reviews.
- Large concentrations of credit.
- Loans to directors, significant shareholders, management, other
- insiders, and third parties performing services for the bank, external accountants, auditors, and marketing firms.
- Loans to affiliates.
- Excessive out-of-territory lending.
- Excessive reliance on third-party loan brokers or service providers.
- Borrowers on the overdraft or uncollected funds reports.

Growth in the ALLL that is significantly greater or less than the percentage growth in total loans over a given period.

Nonperforming or problem loans as a percentage of total loans increasing at a rate greater than the ALLL.

Loan officer compensation tied solely to growth or volume targets (i.e. without credit quality attributes).

Insufficient controls when purchasing loans.

Credit Portfolio Red Flags – Directors Toolkit – OCC

INCENTIVE COMPENSATION!!!!!

Sources…

- FDIC – Various
- FDIC – Future of Community Banking
- American Banker – Daily Briefing – Various
- RMA
- Bank Safety & Soundness Advisor
- Wall Street Journal
- Calculated Risk