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The Board's Role in Overseeing Credit Risk

By: Vince Van Nevel
Managing Director

Agenda
Topics Being Covered

- Current Trends in Credit Risk and Regulatory Focus
- Lessons Learned from the Crisis
- The Board's Role in Credit Risk Oversight
- Take-Aways

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FDIC Federal Deposit Insurance Corporation
Each depositor insured to at least $250,000 per insured bank

Chairman Jelena McWilliams' Opening Statement Second Quarter 2018 Quarterly Banking Profile
August 23, 2018

"Community banks also reported another solid quarter. Their net income benefitted from higher revenue and a lower effective tax rate, and loan growth that was stronger than the overall industry.
It is worth noting that the current **economic expansion is the second longest on record**, and the nation's banks are stronger as a result. The **competition** to attract loan customers will be intense, and it will remain **important for banks to maintain their underwriting discipline and credit standards. Prudent management of credit risk** in this economic environment **will continue to be an FDIC priority."**

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Office of the Comptroller of the Currency
U.S. Department of the Treasury

OCC Semi-Annual Risk Assessment Spring 2018 Quotes

Asset quality, as **measured by traditional** metrics such as delinquencies, nonperforming assets, and losses, is sound. Capital and liquidity are at or near historical highs, and earnings are improving. Recent examination findings indicate incremental improvement in banks' overall risk management practices.

Competitive pressures from banks and nonbanks contribute to **easing in underwriting** and to the risk that sound **pricing structures and practices may be compromised**. Rising interest rates generally benefit net interest margins at small banks **but pose potential risks** that warrant monitoring.

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Office of the Comptroller of the Currency
U.S. Department of the Treasury

OCC Semi-Annual Risk Assessment Spring 2018 Quotes

The **key risks** facing the federal banking system **include**:

- incremental easing in commercial credit underwriting practices;
- bank risk management of cybersecurity threats;
- third-party concentration risk for certain products and services.

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OCC Semi-Annual Risk Assessment
Spring 2018 Quotes

Other risks that warrant awareness among bankers and examiners include:

- **Concentrations** of commercial real estate (CRE) and the need for sound concentration risk management practices.
- Low or declining prices for grain, livestock, and dairy that result in lower cash flow and **increased farm carryover debt** for agricultural borrowers.
- Challenges to the data collection requirements under the implementation, beginning in 2020, of the **current expected credit losses standard**, which may pose operational and strategic risk to some banks when measuring and assessing the collectability of financial assets.

OCC Semi-Annual Risk Assessment
Spring 2018 Quotes

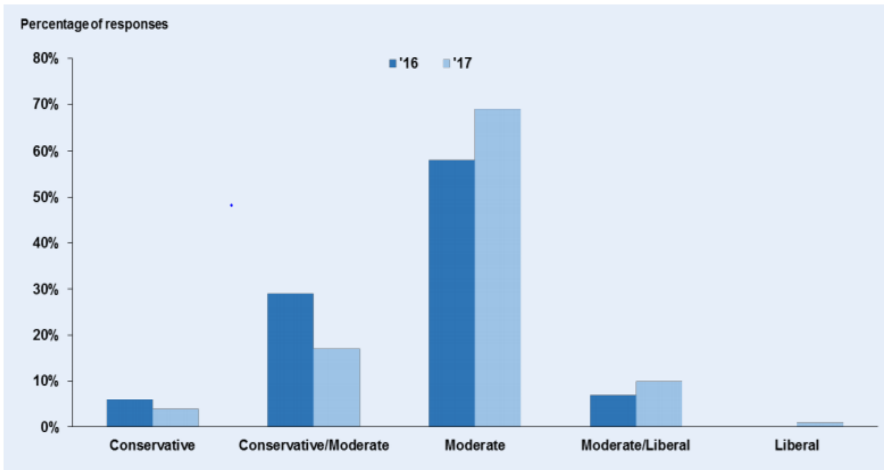
Key Risk Themes

"At this point in a long economic expansion, asset quality metrics are typically good, and changes in risk appetite and external factors become the primary drivers of credit risk and future performance. While this is the case today, **the OCC is monitoring the effects of competition and complacency on the quality of new loans, credit risk management practices, and the reasonableness of concentration limits**."

"**Competition for quality loans is strong**, however, and examiners note evidence of **eased underwriting**, **increased CRE concentration limits**, and a **higher level of MRA concerns** related to **policy exceptions**. The accommodating credit environment warrants a continued focus on underwriting practices to monitor and assess **credit risk and lender complacency**."

Office of the Comptroller of the Currency
U.S. Department of the Treasury

Figure 9: Trends of Credit Underwriting Practices of Overall Credit Portfolios



Source: OCC

Examples of Underwriting Concerns

- Longer amortization terms
- Longer periods for fixed rate pricing
- No or relaxed pre-leasing requirements
- Approving LTV and DSCR exceptions to policy
- Allowing nonrecourse or limited guarantees by principals
- Weak project supported only by global cash flow

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Examples of Structural Weaknesses

- Indefinite or speculative purposes
- Indefinite or liberal repayment terms
- Nonexistent, weak or waived covenants
- Inadequate or *projected* debt service coverage
- Weak borrower financial strength

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Examples of Structural Weaknesses

- Inadequate collateral support
- Inadequate collateral documentation and valuation
- Inadequate guarantor support
- Inadequate financial analysis

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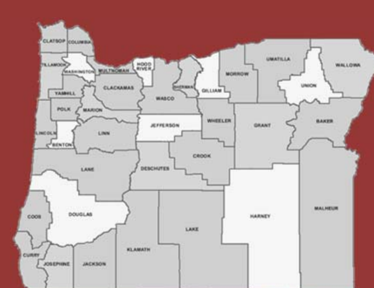
FDIC Focused on Standard of Care

2017 Oregon Code

ORS Code 65.357 – General Standards for Directors

Sec. 1. A director shall discharge the duties as a director, including the director's duties as a member of a committee:

a. in good faith;
b. with the care an ordinarily prudent person in a like position would exercise under similar circumstances; and
c. in a manner the director reasonably believes to be in the best interests of the corporation.



Source: https://www.oregonlaws.org/ors/65.357

2017 Oregon Code

ORS Code 65.357 – General Standards for Directors

Sec. 2. In discharging such duties a director is entitled to rely on information, opinions, reports, or statements, including financial statements and other financial data, if prepared or presented by:

a. one or more officers or employees of the corporation;
b. legal counsel, public accountants, or other persons; or
c. a committee of the board of directors of which the director is not a member….

…when the director reasonably believes these parties to be reliable and competent in the matters presented.

2017 Oregon Code

ORS Code 65.357 – General Standards for Directors

Sec. 3. A director is not acting in good faith if the director has knowledge concerning the matter in question that makes reliance otherwise permitted by subsection (2) unwarranted.

2017 Oregon Code

ORS Code 65.357 – General Standards for Directors

Sec. 4. A director is not liable to the corporation, any member or any other person for any action taken or not taken as a director, if the director acted in compliance with this section. The liability of a director for monetary damages to the corporation and its members may be eliminated or limited in the corporation's articles to the extent provided in ORS 65.047 (Articles of Incorporation) (2)(c)

2017 Washington Code

Code 23B.08.300 – General Standards for Directors

The requirements for Washington are identical for those of Oregon above.

Source: http://app.leg.wa.gov/rcw/#23B.08.300

The Georgia Supreme Court wrote:

"… statutory reference to ordinary 'diligence, care and skill' is most reasonably understood to refer to the care required with respect to the process by which a decision is made, most notably the diligence due to ascertain the relevant facts."

- *FDIC v. Loudermilk,* 761 S.E. 2nd at 341-42

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The Bottom Line

The business judgment rule appears to protect directors and officers when the alleged negligence concerns only the wisdom of their judgment, but…

…may not protect when those decisions are shown to have been made without proper deliberation and reasonable investigation of the facts needed to make the decision.

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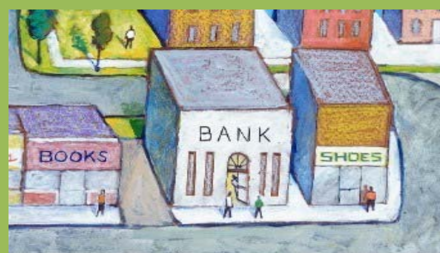
ProBank Austin has seen a wide variety of loan approval and administration processes that work well in the context of community banks.



Community banks have an added advantage of knowing their customers and markets well.

FDIC Improvement Act 1991

- 12 CFR 32 -RE Lending and Appraisal Standards (OCC)
- 12 CFR 365-RE Lending Standards; 12 CFR 323-Appraisal Standards (FDIC)
- 12 CFR 208.50 and 225.61- RE Lending and Appraisal Standards (FRB)

12 CFR 208.51 - RE Lending and Appraisal Standards (FRB)

B.1. Real estate lending policies adopted pursuant to this section shall be:

- Consistent with safe and sound banking practices;
- Appropriate to the size of the institution and the nature and scope of its operations; and
- Reviewed and approved by the bank's board of directors at least annually.

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12 CFR 208.51 - RE Lending and Appraisal Standards (FRB)

B.2. The lending policies shall establish:

- Loan portfolio diversification standards;
- Prudent underwriting standards, including LTV limits, that are clear and measurable;
- Loan administration procedures for the real estate portfolio; and
- Documentation, approval, and reporting requirements to monitor compliance with the bank's real estate lending policies.

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12 CFR 208.51 - RE Lending and Appraisal Standards (FRB)

C. *Monitoring conditions.* Each member bank shall monitor conditions in the real estate market in its lending area to ensure that its real estate lending policies continue to be appropriate for current market conditions.

D. *Interagency guidelines.* The real estate lending policies adopted pursuant to this section should reflect consideration of the Interagency Guidelines for Real Estate Lending Policies (contained in Appendix C of this part) established by the Federal bank and thrift supervisory agencies.

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Common Allegations in FDIC-R Complaints

Lack of adequate underwriting practices in approving loans:

- Failure to follow policies and/or properly approve exceptions
- No or outdated financial information on hand at approval or renewal
- Inadequate or outdated DTI or DSCR ratios and weakness not mitigated
- Lack of adequate collateral valuations
- High LTVs
- No or lacking construction inspection process

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Common Allegations in FDIC-R Complaints

Lack of proper internal controls in the lending function:

- No separation of duties between credit analysis and approval
- If credit officer existed, reported to Chief Lender
- No independence/separation of duties in appraisal order and review process
- Most complaints alleged some form of lack of independence

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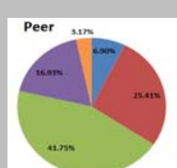
Common Allegations in FDIC-R Complaints

Significant concentrations of credit in ADC and CRE categories:



- Well above peer and regulatory guidelines
- Weak monitoring of concentrations
- Cited continued CRE lending in the face of national downturn

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Common Allegations in FDIC-R Complaints

Excessive growth strategies:

- CRE was profitable line of business
- High demand in certain markets
- Directors failed to follow economic conditions sufficiently
- Lack of backroom infrastructure/expertise
- Claimed Board should have known of downturn as early as 2006!

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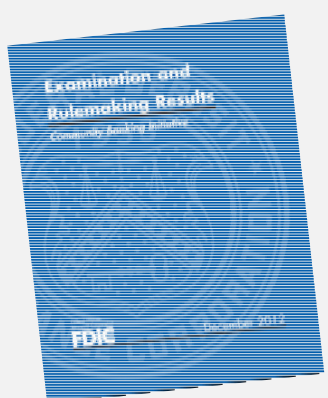
Examination Report



- Examiners very well trained (FDIC/State joint training)
- Don't be lulled into a sense of complacency by regulatory examination results
- FDIC as receiver and their law firms use the exams against you
- Ditto on audits and loan review reports of findings

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The Board's ROLE in Lending

The FDIC expects Boards to provide a clear governance framework that incorporates sound:

Objectives	Policies	Risk Limits

Equally important, the Board should monitor the extent to which officers and employees comply with this framework.

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Policy Development

- Reviewed and approved on at least an annual basis.
- FDIC's Manual of Examination Policies, "…the board of directors at every bank has the ***legal responsibility*** to formulate lending policies ***and*** to supervise their implementation…"

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Monitoring Compliance with Policy

- Effective credit MIS key to strong risk management
- FDIC complaints included failure to follow own policies

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Typical MIS "Performance" Metrics Positions & Trends

- Delinquency
- Nonaccrual
- Restructured Loans
- Charge offs
- Adversely classified assets

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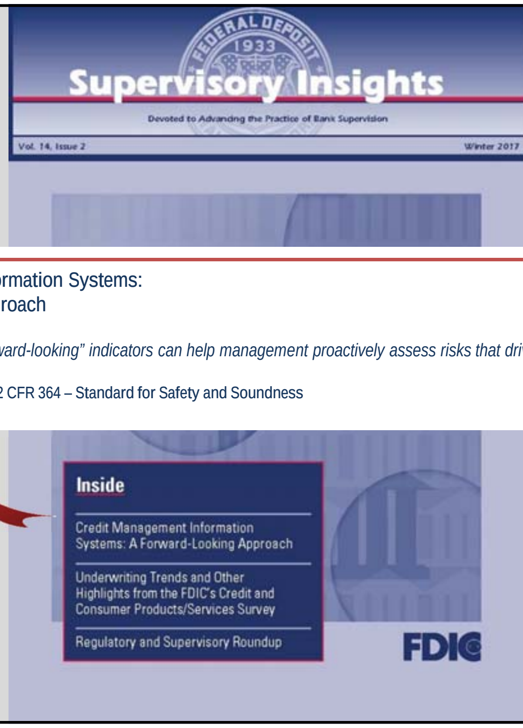


Credit Management Information Systems:
A Forward-Looking Approach

Regular review of more "forward-looking" indicators can help management proactively assess risks that drive these performance ratios.

Invokes reference to dreaded 12 CFR 364 – Standard for Safety and Soundness

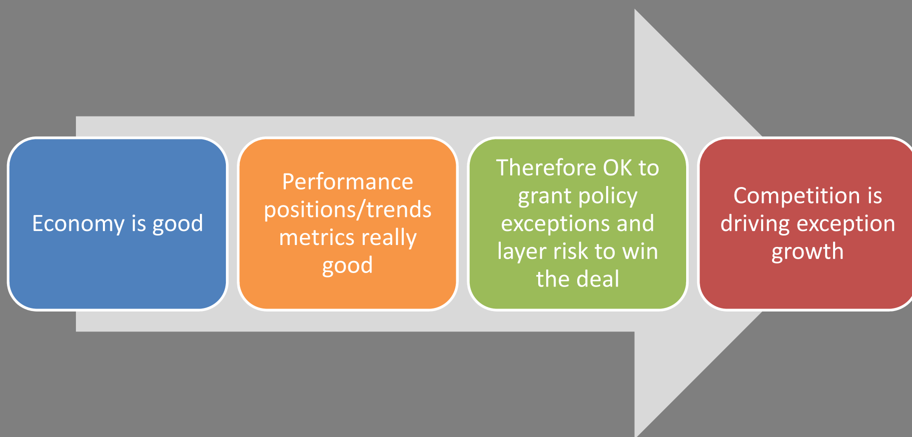
- Winter 2017

Monitoring Compliance with Policy

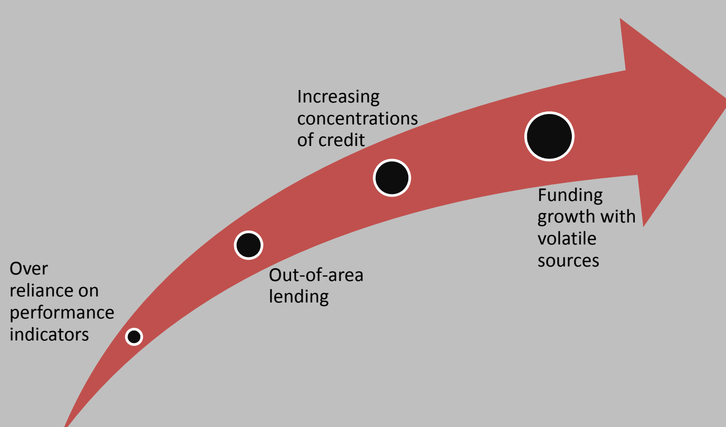
Useful "forward-looking" reporting may include portfolio stratification by:

- LTV for loans secured by RE
- DSCR policy exceptions
- Loan grade migrations
- Loan volume with "risk layering"

Current Underwriting Tendencies



Possible Factors Increasing Risk



Caution Warranted

- In past 33 years, only 12 quarters with lower PDNA ratios
- All those were in years leading to crisis – 2004 to 2007
- Out of territory loans also rising to pre-crisis levels
- Concentrations of CRE increasing again

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Portfolio Composition

- The Board should have a broader perspective on the composition or components of the portfolio as a whole.
- The Board should be aware of any regulatory guidance and/or periodic warnings on the risk in concentrations in certain loan types.
- Consider monitoring reports with "forward-looking" risk indicators.
- Downturns in a particular industry or sector will also impact ancillary businesses serving that industry.

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SUMMARY

Vital Role in Lending

Steps in fulfilling duties in credit area:

- Policies
- Committee
  - ✓ Attend
  - ✓ Participate
- Ask questions and seek explanations
- Monitor compliance with policy, quality and regulatory requirements
- Exercise independent judgment
  - ✓ Each director contributes an important perspective to the Board
  - ✓ Exercise of objective judgment is critical the Board's effectiveness

Be loyal to the bank's interests!

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Regulators' Version of Lesson Learned

One important ***lesson we learned*** from the financial crisis is that poor planning can harm institutions, their communities, and the financial system as a whole.

Many failures were traced to management engaging in a new or expanded business line ***without adequate planning, controls and understanding of the risks*** related to the new activity.

- FDIC Supervisory Insights Summer 2015.

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Who are the regulators holding accountable?

"The quality of management is probably the single most important element in the successful operation of a bank."

"Management includes ***both*** the board of directors and executive management."

- DSC Risk Management Manual of Examination Policies

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Board Independence

"All those opposed, signify by saying, 'I quit.'"

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Takeaways From Lessons Learned

Review Existing Loan Policies

To determine:

- They comply with regulatory guidance
- They sufficiently set forth and reflect the Board's risk appetite
- They are detailed enough to hold management accountable
- They have provisions on a process to identify and approve exceptions

Review Loan Administration/ Operations for Control Points

- Who is responsible for enforcing loan policy compliance?
- What control points exist to identify, capture and report on exceptions?
- Exceptions are reported ***to the Board***, by officer, loan type, branch, etc.
- Aggregate levels of exceptions in the portfolio are reported and reviewed.

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Monthly MIS Reports Should Include:

- **Concentrations of credit**
- **Periodic evaluation of market and national economic trends**
- **Portfolio level trends and metrics (forward-looking)**
- **Stress testing results**
- **The committee should question adverse trends or levels**

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Proactively Support the Existence of ***Your*** Process

- Loan presentations are comprehensive and support the approval of the transaction.
- Loan approval presentations reflect the existence of current information.
- Presentations discuss factors mitigating risk of approving loans with critical exceptions.

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Proactively Support the Existence of ***Your*** Process

- Board and Committee level minutes reflect reasonable deliberative discussion.
- Loan files should be complete and neatly organized.
- Files should lead examiners to your conclusions; a void lets them make their own.

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Review All Audit, Loan Review and Examination Reports

Respond in writing to all criticisms and recommendations.

Document your consideration of recommendations and reason not adopted.

Verify corrective actions have been taken on all criticisms/recommendations.

Avoid repeat recommendations and violations.

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Questions & Answers

THANK YOU

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