FDIC Federal Deposit Insurance Corporation

Credit Risk Management and Supervision

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Discussion

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- Credit Risk Management
  - Supervisory standards
  - Credit underwriting
  - Loan documentation
  - Loan administration
  - Lending policies
  - Internal loan review
  - Loan problems
  - Selection of risk
- Credit Risk Supervision
  - Off site indicators
  - Core lending analysis
  - Loan review process
  - Loan selection and analysis
  - Adverse classifications
  - Examination results
  - Credit quality indicators
  - Syndicated lending
  - International lending
  - Rating asset quality
  - Supervisory response
  - US lending

Safety and Soundness Standards

- Credit underwriting
  - Establish prudent credit underwriting practices
- Loan documentation
  - Establish loan documentation practices
- Asset quality and growth
  - Establish a system to identify and address problem assets
- Internal controls and information systems
  - Effective risk assessment, safeguard/manage assets, policy/regulatory compliance, etc.

Real Estate Lending Standards

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- Real estate lending policies must establish specific <u>standards</u> per regulation for
  - Loan portfolio diversification
  - Prudent underwriting practices and loan-to-value limits
  - Loan administration procedures
  - Documentation, approval and reporting requirements
  - Monitoring conditions in real estate markets

- Real estate lending policies must also reflect consideration of detailed supervisory <u>guidelines</u> that accompany the standards

Supervisory Review

- Supervisory evaluation of real estate lending policies and practices must take into account
  - Nature and scope of real estate lending activities
  - Size and financial condition of the bank
  - Quality of management and internal controls
  - Expertise and size of lending and loan administration staff
  - Market conditions

Unsafe or Unsound Lending

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- Unsafe or unsound lending practices
  - Contrary to generally accepted standards of prudent operations
  - Due to management actions or lack of management actions

- Unsafe or unsound lending conditions
  - Factored into overall asset quality conditions, affecting capital positions of the bank, and reflecting poorly on management

Credit Underwriting

- Under standards for safety and soundness, prudent credit underwriting practices must take into account
  - Types of loans and nature of the markets
  - Terms and conditions of the loan
  - Overall financial condition and resources of borrower
  - Borrower character and willingness to repay
  - Nature and value of collateral
  - Financial responsibility of guarantors
  - Concentrations of credit risk
  - Size of bank and nature and scope of activities
  - Independent and ongoing credit review

Loan Documentation

- Under standards for safety and soundness, loan documentation practices should support the following objectives
  - Ensure an informed lending decision
  - Permit the assessment of risk on an ongoing basis
  - Identify the purpose of the loan and source of repayment
  - Assess the ability of a borrower to repay in a timely manner
  - Administrate and monitor the loan on a continuing basis
  - Take into account the size and complexity of the loan

Loan Administration

- Lending and collection policies
  - Written, periodically updated and approved by the board
- Internal loan review system
  - From origination through administration and payment in full or collection
- Allowance for loan losses
  - Sufficient to absorb all estimated loan losses and periodically reviewed for adequacy

Lending Policies

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- Some leading considerations
  - Fields of lending, banking trade area, and volume limits
  - Portfolio mix and diversification of risk
  - Lending authorities by officer and committee
  - Interest rates, repayment terms and loan-to-value limits
  - Credit file documentation and real estate appraisals
  - Loan review and grading system
  - Collections procedures
  - Review of allowance for loan losses

Internal Loan Review

- General objectives
  - Identify loans with well defined weaknesses
  - Provide input to assess the allowance for loan losses
  - Identify trends affecting collectability of portfolio loans
  - Determine compliance with policies and procedures
  - Evaluate lending personnel and their activities
  - Provide management with credit quality information
  - Objective assessment of overall portfolio quality

Loan Problems

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- Common causes of developing loan problems
  - Poor selection of risks
  - Lending beyond the capacity to repay (over-lending)
  - Failure to establish or enforce repayment agreements
  - Failure to obtain or evaluate credit information
  - Over-emphasis on loan income in lieu of creditworthiness
  - Extension of unsound credit to insiders/interests (self-dealing)
  - Technical incompetence on the part of management
  - Inexperience or lack of expertise with specialized lending
  - Lack of effective management oversight of individual loans
  - Failure to oversee/ensure policy implementation/compliance
  - Lack of attention to changing economic conditions
  - Competition leading to compromised principles of credit

Poor Selection of Risk

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- Common examples of poor selection of risks
  - New and untried businesses with insufficient capital
  - Dependent on completing business transaction
  - Speculative purchase of goods or securities
  - Collateral-based loans with insufficient margin
  - Approved for other benefits in lieu of creditworthiness
  - Inadequate equity in real estate collateral
  - Questionable liquidation value of collateral
  - Borrower of poor character or reputation
  - Financial capacity limited or not assessed
  - Lending to out-of-territory borrowers

Off Site Indicators

- Bank structure
  - Loan portfolio mix
  - Off balance sheet activity

- Select ratios (totals and by type of lending)
  - Net loan loss to total loans
  - Delinquent and non-accruing loans to total loans
  - Rate of growth in net loans

- Early warning screens
  - Growth, high-risk lending, real estate stress test, fraud

On Site Review

- Loan portfolio management and review
  - Core analysis of key decision factors for lending

- Loan reference modules (examples)
  - Construction and land development
  - Commercial and industrial loans
  - Commercial real estate concentrations
  - Agricultural lending
  - Consumer lending; credit card activities; home equity
  - Real estate appraisal programs

Core Analysis

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Examples: Areas reviewed for loan portfolio management during on-site exams

- Managerial effectiveness
  - Loan approval process; financial analysis of borrowers; underwriting and documentation; response to changing conditions; regulatory compliance
- Policies and controls
  - Adequacy of lending policies; policy exceptions; charge-offs; renewals, extensions and capitalized interest; concentrations; off balance sheet
- Credit administration
  - Lending authorities and staffing; real estate appraisal review; collections and work-outs; prior exam classifications
- Credit risk and allowance for loan losses
  - Internal loan review and watch list; methodology for determining allowance
- Independent audit or review
  - Coverage versus bank size, lending activities and risk profile; adequacy of allowance for loan losses

Loan Review Process

1. Loan selection and sampling
   – Validating the internal loan review system
2. Loan file and records review
   – Reading credit/collateral files and documenting reviews
3. Loan analysis
   – Six Ps framework for analyzing individual loans
4. Loan discussion
   – Discussion with loan officers and determination of prospects
5. Loan classification
   – Pass, special mention and adverse classification
6. Loan write-ups
   – Supporting adverse classifications and examination report

Loan Selection and Sampling

- Common selections/sampling
  - Large loans above a pre-determined threshold
  - Internal bank watch list classifications
  - Previously classified and special mentioned loans
  - Material delinquencies and non-accruing loans
  - Loans to insiders and related interests
  - Higher-risk loans, rapid-growth loans, new loans/customers
  - Loan concentrations by type or related borrowers
  - Loans to out-of-territory borrowers

- Sufficient number, volume and variety to form reasonable conclusions about portfolio conditions and effectiveness of credit administration policies and practices

Loan Analysis Framework

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1. People
   – Borrower, business profile, and internal/external risks
2. Purpose
   – Purpose, loan structure and repayment schedule
3. Protection
   – Collateral values and guarantees in the event of default
4. Payment
   – Financial capacity of the borrower to repay the loan
5. Problems
   – Significant or potential weaknesses jeopardizing repayment
6. Prospects
   – Determination of steps to address loan weaknesses

Special Mention

- Loans with potential weaknesses deserving management's close attention. Left uncorrected, potential weaknesses may result in deterioration of repayment prospects or the bank's credit position at some future date

- Examples of potential weaknesses
  - Improper loan structure (underwriting)
  - Material defects in loan documentation
  - Lack of control over collateral positions

Adverse Classifications

- Substandard
  - Inadequately protected by the current sound worth and paying capacity of the obligor or by any collateral pledged. Well defined weakness or weaknesses that jeopardize liquidation of the debt. Characterized by the distinct possibility that the bank will sustain some loss if deficiencies are not corrected

- Doubtful
  - All the weaknesses of substandard, with the added characteristic that weaknesses make collection or liquidation in full, on the basis of current facts, conditions and values, highly questionable and improbable

- Loss
  - Considered uncollectible and of such little value that continuation as bankable assets is not warranted

Retail Credit Classifications

- Adverse classification scheme for consumer credit
  - Open-end (credit cards, revolving lines, etc.)
  - Closed-end (installment loans, mortgages, etc.)

- Substandard
  - Closed-end and open-end retail credit delinquent 90 days

- Loss
  - Closed-end retail credit delinquent 120 days (5 payments)
  - Open-end retail credit delinquent 180 days (7 payments)
  - Bankruptcy accounts within 60 days of notice

Examination Results

- Adverse loan classifications
- Technical exceptions
- Concentrations of credit
- Allowance for loan losses
- Other loan review programs

Analysis of Loan Classifications

		Substandard	Doubtful	Loss	Totals
1.	**Book value last exam** (000s)	$17,348	$171	$ 407	$17,926
2.	**Less reductions**				
	– Payments	1,007			1,007
	– Not now classified				
	– Now classified substandard				
	– Now classified doubtful	47			47
	– Now classified loss	301			301
	– To foreclosure or repossession	965			965
	– Charged off the books	1,465	171	407	2,043
3.	**Plus additions**				
	– Not classified previously	4,788		2,047	6,835
	– Further advances on loans not classified previously	4,138			4,138
	– Further advances on loans classified previously	4,347			4,347
	– Credits newly extended				
	– Previously classified substandard		47	301	348
	– Previously classified doubtful				
	– Previously classified loss				
4.	**Book value this exam** (000s)	$26,836	$ 47	$2,348	$29,231

Technical Exceptions

- Deficiencies in loan documentation identified while reviewing loan and collateral files
  - Deficient, missing or out-of-date appraisals, inspections, lien searches, borrowing authorizations, insurance, financial statements, etc.

- Excessive volumes are scheduled in examination reports and presented as a percent of loans reviewed
  - Reflection on the credit administration process and management overall

Concentrations of Credit

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- Concentrations of credit may be scheduled for lack of proper diversification or for purposes of information only

- Types
  - By individual borrowers and groups of related borrowers scheduled at 25 percent of tier 1 capital

  - By industry, product line, type of collateral, and short-term obligations of individual financial institutions scheduled at 100 percent of tier 1 capital

Allowance for Loan Losses

- Requirements
  - Sufficient to absorb all <u>estimated credit losses</u>
  - Periodically reviewed for adequacy (at least quarterly)
  - Supported by an effective internal loan review system

- Components of portfolio analysis
  - Significant credits reviewed on an individual basis
  - Loans with elevated risk characteristics
  - Homogeneous loans evaluated as a group
  - All other loans

Loan Write Ups

- Purposes
  - Communicate decisions and loan portfolio issues for significant loan classifications to management, board of directors, and other supervisors
  - Lend substance and support to analysis and presentation in examination reports, especially for problem banks with credit administration and loan portfolio issues
- Written presentation based on the six Ps framework for the analysis of loans

Credit Quality Indicators

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- Examination ratios
  - Adversely classified loans to total loans (% portfolio classified)
  - Adversely classified items to tier 1 plus reserves (% capital classified)
  - Loans with technical exceptions to total loans reviewed (administration)
- Other portfolio ratios
  - Delinquent loans 30-89 days to total loans (developing problems)
  - Delinquent loans over 90 days and non-accrual loans to total loans (non-performing loans)
  - Delinquency and non-accrual ratios by type of lending (consumer, commercial/industrial, construction/development, etc.)
- Other exam information
  - Analysis of adverse loan classifications
  - Core analysis of loan portfolio management and review

Syndicated Lending

- Shared national credits (SNC)
  - Interagency program (FDIC, FRB and OCC) to review and classify syndicated lending arrangements
  - All credit facilities over $20 million shared by three or more lenders (US banks, FBOs and non-banks)
  - Classifications and write-ups used at all subsequent exams

- 2011 SNC review
  - Reviewed $910 billion or 36 percent of $2.5 trillion in SNC
  - Special mention $106 billion or 4 percent of SNC
  - Classified assets $215 billion or 9 percent of SNC
    - Substandard $191 billion, Doubtful and Loss $24 billion

International Lending

- Interagency country exposure review committee (ICERC)
  - Interagency committee (FDIC, FRB and OCC) to review country risks and assign transfer risk ratings
- Countries evaluated per
  - US bank cross-border lending exposures ($3.5 trillion)
  - Factors affecting capacity to service foreign debt
- Transfer risk ratings and write-ups used at all subsequent examinations
  - Substandard, value impaired and loss designations

Rating Asset Quality

- Asset quality is driven by credit risk and exposure to potential loss in the loan portfolio at most banks

- Leading considerations

  – Ability of management to identify, measure, monitor and control credit risk

  – Volume and trend of special mention and adversely classified loans

  – Adequacy of allowance for loan losses

Evaluation Factors

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Credit risk and the evaluation factors for asset quality

- Adequacy of underwriting standards, soundness of credit administration, and appropriateness of risk identification
- Level, distribution, severity and trend of classified, nonaccrual, restructured, delinquent, nonperforming and problem assets
- Adequacy of the allowance for loan losses, credit risks from off-balance-sheet accounts, and existence of asset concentrations
- Diversification and quality of loan portfolio, adequacy of loan policies, practices and procedures, and technical exceptions in loan documentation
- Ability to properly administer assets and collect problem accounts, and adequacy of internal controls and management information systems

Asset Quality Ratings

1 – Strong asset quality and credit administration practices.

2 – Satisfactory asset quality and credit administration practices.

3 – Asset quality or credit administration practices are less than satisfactory. There is generally a need to improve credit administration practices and risk management practices.

4 – Deficient asset quality or credit administration practices. The level of risk and problem assets if left unchecked may threaten the institution's viability.

5 – Critically deficient asset quality or credit administration practices that present an imminent threat to the institution's viability.

Common Lending Issues

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- Managerial
  - Poor underwriting or credit administration practices
  - Inadequate supervision of lending staff by senior management
  - Ineffective internal loan review or credit grading systems
  - Inadequate lending and collection policies, implementation or compliance

- Financial
  - Inadequate allowance for loan losses
  - Excessive volume of problem loans or loan losses
  - Excessive level of adversely classified loans
  - Failure to recognize loan losses
  - Undue concentrations of loans
  - Excessive growth in loan portfolio

Supervisory Response

- Lending requirements and restrictions imposed via formal or informal enforcement actions, usually including
  - Specific plans and timelines to reduce problem loans
- Suspension, removal or prohibition of participation in bank affairs of directors, officers, employees and contractors
  - Including real estate appraisers, lawyers and consultants
- Assessment of civil money penalties of up to $1.25 million per day for either individuals or institutions
  - Bank, bank personnel and any outside contractors

US Lending

FDIC insured banks 7,436; assets $13.8 trillion; deposits $10.0 trillion

Gross loans	$7.3 trillion		
Residential mortgages		$1.9	
Personal loans and credit cards		$1.3	
Commercial and industrial		$1.3	
Commercial real estate		$1.1	
Other loans		$0.7	
Home equity lines of credit		$0.6	($608 billion)
Construction and development		$0.3	($255 billion)
Agricultural loans		$0.1	($60 billion)

Unused loan commitments	$5.7 trillion
Foreclosed real estate loans	$50 billion

Percent of loans	
Loans delinquent 30-89 days	1.37 percent or $100 billion
Non-performing loans	4.22 percent or $310 billion
Net loan losses	1.61 percent or $88 billion
Allowance for loan losses	2.69 percent or $197 billion

Data as of September 30, 2011

Future Inquiries

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