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Pressing issues: Four big hot buttons in regulatory credit risk management

The banking industry is in the midst of another good run. Most financial institutions have once again turned profitable, as evidenced by the most recent **FDIC quarterly summary**: It indicates that in the third quarter of 2016, community banks—which represent 92 percent of insured institutions—reported net income of $5.6 billion. That's up $592.6 million (or 11.8 percent) from one year earlier.

But as most bankers know, behind growth and profits lurks a by-product that continues to dog us during such times: credit risk management.

While robust credit risk management always occupies an important place, the need intensifies during periods of expansion. Credit quality has improved—but that does not mean banking regulators have given up their day jobs. While the instances of risk rating changes from safety and soundness exams are few, we've seen an increased "under the hood" focus by the regulators on the quality of credit risk management.

Taking from recent conversations with numerous regulatory agencies, and our experience reviewing loan portfolios of financial institutions nationwide, we offer these “big four” regulatory credit risk management hot buttons.

1. **Loan policy.** Your bank should continually review policies to provide a roadmap current credit underwriting and portfolio management guidelines. The loan policy should reflect your bank’s risk tolerance level, which may change over time. Critical areas within the Loan Policy that currently demand heightened attention include:
    - **Product offerings.** As banks enter new markets and expand product offerings, loan policies should be updated to include specific underwriting guidance for each new loan product.
    - **Appraisals.** We’ve seen evidence that roughly three in four safety and soundness examinations result in an appraisal issue. The bank’s appraisal policy should be frequently reviewed to ensure that appropriate information from both the ***2010 Interagency Guidance*** and current ***Uniform Standards of Professional Appraisal Practice*** are incorporated.
    - **Loan Concentrations.** A bank’s loan policy should speak to the overall level of concentrations considered acceptable to the Board and institution’s strategic plan—both by loan type and as a percentage of capital. The policy should also address the various monitoring reports to be put in place in order to manage the process.
    - **Allowance for loan and lease losses (ALLL).** Substantial changes loom on the horizon for the banking industry on the “methodology side.” But until such changes take place, we must be sure we do not provide sufficient detail

regarding our current methodology. This includes detailed calculations and justification of adjustments to the ALLL, in compliance with appropriate regulatory circulars. There is also a renewed emphasis on the need to validate the ALLL on at least an annual basis.

- **Loan participations/syndications.** As a way to diversify loan portfolios, many banks are reaching out into the secondary market to purchase loan participations. The regulatory expectation is that these loans will be underwritten and scrutinized as though the bank originated the loan. We've seen heightened regulatory concern that community banks are participating in high-leverage transactions. These include:
    1. Transactions where the borrower's Total Debt divided by EBITDA (earnings before interest, taxes, depreciation, and amortization) exceed 4.0X EBITDA
    2. Senior Debt divided by EBITDA exceeds 3.0X EBITDA, or
    3. Other defined levels appropriate to the industry or sector

    As a reminder, regulatory agencies have published an **Interagency Guidance on Leveraged Lending**. Files must be documented to allow a reviewer/regulator the opportunity to fully understand that appropriate underwriting was completed. Banks must also demonstrate ongoing portfolio management after the credit is booked.

2. **Interim Construction Management.** While a bank's loan policy may be general in nature with regard to construction lending, it's critical that by written procedures for monitoring the interim construction process support the loan policy. In addition, a bank must demonstrate that it consistently follows such procedures. Procedural guidelines for this type of product should include underwriting both the borrower and the contractor, when they are separate entities. Draw requests should be covered, as well as expectations for the inspection process employed by the bank, and the independence of this function. Minimum release prices should be established, and limits on numbers of extensions should the property not sell according to original expectations should be set.
   Finally, regulators have made it clear that if banks participate in this type of lending, they must document the current status of the real estate markets where they operate. To achieve this, quarterly reporting is recommended and should discuss current sales, market trends and other significant developments in areas where financing takes place.

3. **Concentration Management.** With recent portfolio growth, we have seen many banks push up against the regulatory concentration thresholds on real estate. If your bank has elected to take this approach, your loan policy should address this issue—as expectations for managing concentrations have increased. Recent revisions update the regulators' definition of a credit concentration and make explicit connections between concentration

management and portfolio stress testing. Timely capture of data is critical. A bank can have great policies and procedures but if it lacks good data, concentration exposure can be misrepresented.

4. **Portfolio management metrics.** Good portfolio management reporting remains critical to effectively monitor loan portfolio trends—not only at an internal level, but at the board of directors' level as well. In addition to the typical reports on criticized/ classified loans and past dues, consider other valuable types of reporting.
    - This should include a listing of policy exceptions by type, officer and dollar amount. It should also include the "portfolio passing rates" and "WARR (Weighted Average Risk Rating)" over selected periods of time.
    - Good information can be gleaned from reports that detail the number of risk rating grade changes identified by independent parties such as loan review, audit and regulatory agencies on an annual basis.

While many areas demand diligent focus on in both credit underwriting and portfolio management, we believe these "big four" hot buttons will help prepare you for your next regulatory examination. To proactively manage those hot buttons now is to avoid a potential red alert later.

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