

**CREDIT PORTFOLIO
MANAGEMENT
2nd Year Class
2020**

Session 1 - Overview

- Banking Industry Update
- Review Home Study Problem
- Historical Causes of Bank Failures
- Concentrations
- The Capital Need for Commercial Banks
- Risks Assumed by Commercial Banks
- Credit Risk Classifications
- Risk Profile
- Current placement on the “Risk Curve”
- Key Credit Risk Management Controls
- Team Breakouts - Review of Sea Harvest, Inc. and Key Credit Risk Management Controls

Banking Industry Update

Home Study Problem

Historical Causes of Bank Failures

- High Concentrations of CRE
- Inadequate Control Environment for the lending function – especially CRE
- Inadequate Controls over Credit Underwriting
- Aggressive Loan Growth (relative to GDP)
- Inadequate and ineffective Risk Management Processes
- Weak Board oversight
- Management Team ineffectiveness
- Capital Levels relative to loan losses

Concentrations

- Large volume of economically related loans by collateral type, industry, or borrower
- Potentially created by factors such as location, economic environment or the bank's market niche
- Considerations should include growth plans, policies, inspection requirements, and prudent limitations
- Monitoring routines should be increased with more in-depth review - the greater the concentration, the greater the need for monitoring
- Management reporting should address the dollar volume of the exposure, industry status and direction, supply and demand trends for the type of property, and changes in underwriting standards

The Capital Need for Commercial Banks

- *Expected Losses* are covered by Current Earnings
- *Unexpected Losses* are covered by Capital

Risk Assumed by Commercial Banks

- Credit
- Liquidity
- Market and Interest Rate
- Operational
- Legal and Compliance
- Reputation

Credit Risk Classifications

- Transaction Risk
Deal Risk - Risk Rating
- Inherent Risk
Industry - Line of Business
- Concentration Risk
Borrower, Industry, Geographic

What is a Loan with a higher
Risk Profile

?

What is a Loan Portfolio with a
higher Risk Profile

THE “RISK CURVE” & UNDERWRITING STANDARDS

- Where are we today on “Risk Curve”?
- Indicators?
- Consistent trend line?
- What will 2021 – 2024 look like?

Key Credit Risk Management Controls

- Lending Officer
- Lending Management
- Loan Approval Process
 - Credit Underwriting Procedures
 - Loan Authorities and Approvals
 - Credit Policy
- Loan Administration
 - Documentation
 - Monitoring Methods and Processes
 - Collection
- Credit Review
- Internal Audit
- Board Oversight
- External Auditing Firm

Key Questions for Discussion – Sea Harvest, Inc. Case

Focus for Team Breakouts and Discussion:

- Outline three key observations regarding how the assigned Key Credit Risk Management Controls could have prevented or reduced the weaknesses noted for Sea Harvest, Inc.
- Key Observations could include:
 - What questions could have been asked?
 - What actions could have been performed or prompted?
 - What frequency of any suggested actions be performed to limit a noted weakness?

Team Breakout Assignments

- Lending Officer 1, 2, 3
- Lending Management 4, 5, 6
- Loan Approval Process 7, 8, 9
 - Credit Underwriting Procedures
 - Loan Authorities and Approvals
 - Credit Policy
- Loan Administration 10, 11, 12
 - Documentation
 - Monitoring Methods and Processes
 - Collection
- Credit Review 13, 14, 15
- Internal Audit 16, 17
- Board Oversight All Teams
- External Auditing Firm All Teams

Session 2 - Overview

- Review Team Assignments and Deliverable
- Team Breakout Sessions
- Class Discussion and Team Reports -
Review of Sea Harvest, Inc. and Key Credit
Risk Management Controls

Session 3 - Overview

- Continued - Class Discussion and Team Reports - Review of Sea Harvest, Inc. and Key Credit Risk Management Controls
- FED Examination Process
- Commercial Bank Examination Manual
- CBEM Sections of Focus
- Team Break out assignments – Overall Goals for Team Discussions

FED EXAMINATION PROCESS

Essential Objectives

- Provide an objective evaluation of a bank's soundness
- Determine the level of risk involved in the bank's transaction and activities
- Ascertain the extent of compliance with banking law and regulations
- Permit the FED to evaluate adequacy of corporate governance and to appraise the quality of the board or directors and management
- Identify those areas where corrective actions is required to strengthen the bank, improve the quality of its performance, and enable it to comply with applicable laws, regulations, and supervisory policies and guidance
- Examiners should also evaluate and the determine the prudence of the bank's practices

CBEM Sections for Class Focus

- 2040 Loan Portfolio Management
- 2050 Concentrations of Credit
- 2060 Classification of Credits
- 2090 Real Estate Loans
- 2100 Real Estate Construction Loans
- 2103 Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices
- 4140 Real Estate Appraisals and Evaluations

http://www.federalreserve.gov/boarddocs/supmanual/supervision_cbem.htm

Reference Documents for Information

Inter-agency Document (OCC, FED, FDIC)

- Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (12/12/06)

Inter-agency Document (OCC, FED)

- An Analysis of the Impact of the Commercial Real Estate Concentration Guidance (4/13)

Team Focus – Material Loss Case Study

Material Loss Report & Commercial Bank Examination Manual
Topics:

- Teams focus on applicable sections of the Commercial Bank Examination Manual to determine key factors that could have help avoid the events outlined in the fictional Material Loss Report for ABC Bank
- **Each Team will identify 4 key questions from the assigned area of the Manual that, if inspected/tested by the Bank, could have help to avoid the failure**
- Teams should consider the following factors for the key questions
 - Responsible Individual, Group or Function to inspect/test
 - Required Frequency to inspect/test, if applicable
- Team Should note if any of the following factor are potential considerations: Quality of the Control, Level of Independence, Incentive Structure, Tolerance for Loss

Team Assignments – Material Loss Case Study

TEAMS 1, 2, 3, 4, 5, 6

Loan Portfolio Management – Internal Control Questionnaire (2040.4)

Lending Policies and Procedures*

Mortgage Banking Activities

TEAMS 7, 8, 9, 10, 11, 12

Concentrations of Credit – Internal Control Questionnaire (2050.4)*

Classification of Credit (2060.1)

Real Estate Loans – Internal Control Questionnaire (2090.4)

Real Estate Policies, Documents & Administration

Home Equity Lending ALL

Real Estate Construction Loans – Internal Control Questionnaire (2100.4)

TEAMS 13, 14, 15, 15, 17

Concentrations in CRE Lending – Internal Control Questionnaire (2103.4)*

Real Estate Appraisals and Evaluations – Internal Control Questionnaire (4104.4)

*Primary Focus Section

Session 4

- Review Team Assignments and Deliverable
- Team Breakout Sessions
- Class Discussion and Team Reports –
Material Loss Report

Session 5

- Class Discussion and Team Reports –
Material Loss Report
- Warning Signs & Weaknesses
- Asset Quality – Key Duties
- Asset Quality Ratios
- Conclusion & Next Steps
- Home Study Problem

Warning Signs & Weaknesses

- Loan documentation is poor as updated financial information is not being received, is weakly analysis and is a “routine” not a decision point
- Internal credit review is based solely on delinquency
- The “watch list” is inadequate, ineffective and not a “management tool”
- Process is reactive not proactive relative to financial health of the portfolio

Asset Quality – Key Duties

- Bank Management/Executives Should:
- Adopt effective policies prior to loan decisions
 - Send a clear message
 - Tailor policy to past events & experiences
- Inspect & Enforce policies as loans are decisioned
 - Documentation
 - Review Function - Targeting Process
- Enable adequate monitor activities after loan decisions
 - Management Reporting
 - Loan Review Systems
- Maintain adequate allowance for losses
 - Changes in lending policies, staff, nature and volume of loans, trends in past due and adversely classified credits, change in local and national economic conditions

Asset Quality Ratios

- Asset Growth Rate - change in total assets over the time period
- Non-current Loans and Leases to Gross Loans and Leases - reflects the % that past due or are no longer accruing interest
- Net Losses to Average Total Loans and Leases - level of net losses, on an annualized basis, as a % of the total portfolio (recoveries on prior period losses considered)
- Loan and Lease Allowance to Total Loans - measures the allowance available to absorb loan losses relative to total loans outstanding

Conclusion

- Next Steps for Class Topics -
Approaches to Share Knowledge and Awareness
- Review Home Study
- Feedback on class content, structure and approach

Credit Portfolio Management

Home Study Problem

- In seven page or less:
- Part 1 - Outline the Causes and Consequences of Recent Community Bank Failures for the period 1/08 – 12/11. Utilize available reference materials such as the United State Government Accountability Office report GAO-13-704T or other relevant information.
- Part 2 – Highlight three Credit Risk Management Controls at your company. Examine how these Controls operate and the ways in which they help your company protect the quality of the loan portfolio.
- Part 3 – Using the observations from Part 1 of this exercise note any potential future areas of concern for the banking industry during the years 2021-2024.

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