

***FICTIONAL* Material Loss Review – ABC Bank**

Background

Established in the 1960's, ABC was a commercial bank based in Anywhere USA. The institution maintained eight branches in its primary market area. The bank was wholly owned by a one-bank holding company.

The of state of Anywhere experienced a number of bank failures from the beginning of 2008 through 2012. The number of failures was related to declines in real estate values, excessive supply of housing, and the unemployment rate. The deterioration in the Anywhere real estate market had a particularly hard impact on banks with significant exposure to real estate lending. After peaking in April 2007, average home prices in Anywhere had fallen by >25 percent through 2013.

ABC's lending strategy focused primarily on Commercial Real Estate (CRE), particularly residential acquisition, development, and construction (ADC) projects. Specifically, during the mid-2000's the bank had CRE and ADC levels of >400% and >200% percent of total capital, respectively. These CRE and ADC concentrations levels increased significantly during the late 2000's. These concentrations made up the vast majority of ABC's loan portfolio in the years preceding its failure.

At the time of the Bank's closing, ABC had assets of \$600,000, total loans of \$350,000, deposits of \$500,000, ROA of -2.01%, net interest margin of 2.09%, noncurrent loans (% of total loans) of 27.5%, CRE loan as a % of total capital 1,500%.

Causes of Failure

ABC failed primarily because the company did not effectively manage the risks associated with the bank's heavy concentrations in CRE and ADC loans. The Company did not enforce prudent ADC loan concentration limits or maintain capital at adequate levels. Established lending practices also contributed to the asset quality problems that developed when economic conditions in ABC's lending markets deteriorated. Also, the company was slow to recognize the deterioration in the loan portfolio and was unable to successfully

address the depth and breadth of financial problems.

ABC's significant exposure to ADC loans and risk management practices made the institution vulnerable to a sustained downturn in the real estate market. In late 2008, conditions in ABC's primary lending areas began to deteriorate, resulting in a decline in the quality of the bank's loan portfolio. Much of the deterioration in the loan portfolio was centered in ADC loans. ABC's financial condition continued to deteriorate between 2009 and 2012. The associated provisions for loan losses depleted ABC's earnings, eroded its capital, and strained its liquidity.

Concentrations in ADC Loans

ABC maintained a large concentration in CRE & ADC loans throughout its history. The bank increased its ADC lending activities in response to a strong real estate market in the market area. However, the company did not effectively manage the risks associated with the institution's significant loan concentrations.

During the early to mid 2000's, ABC grew its loan portfolio by >70 percent. Contributing to this growth was an increase in CRE loans (including ADC loans) from >\$200 million in the early 2000's to >\$500 million in the mid 2000's. By 2008, ADC loans represented >70 percent of ABC's CRE portfolio. ABC's ADC loans included speculative construction and land development projects in and outside the market area.

Although ABC had implemented certain controls for managing ADC loan concentrations, the concentration risk management practices were not sufficient. The institution's loan policy established limits by category for the acquisition and development loans in relation to total loans. However, ABC did not follow those limits. Additionally, ABC conducted limited stress tests on its ADC loan portfolio and had not adequately monitored the cash flows and global debt service of several large borrowers.

Capital Levels

In early 2000's, the bank's capital ratios were about the same as its peer group average despite having ADC loan concentrations that were

significantly higher than peer. The bank's capital levels declined significantly during the late 2000's.

Lending Practices

Ineffective oversight of the lending function contributed to the asset quality problems that developed when the economy and ABCs local real estate market declined. Certain risk management norms such as reluctance to downgrade risk ratings had the effect of delaying recognition of the deterioration in the bank's loan portfolio. The observations noted below contributed to the failure.

Loan Underwriting

- ABC had numerous loans in its portfolio with credit decisions that exceeded prudent and typical **loan-to-value** positions.
- **Underwriting exceptions** were not centrally tracked and were approved without appropriate justification or documentation in credit approval packages.
- Certain loans were approved/structured with **violations to loan policies** but were not noted as such in credit approval packages.
- ABC did not routinely perform **global cash flow analyses** and did not consistently consider the impact of larger borrowers' **contingent liabilities**.
- **Incentive plans** for customer facing employees were based solely on loan production and growth as asset quality measures were absent from those plans.

Credit Administration and Loan Monitoring

- ABC did not have an effective **Loan Review** and the internal risk rating process failed to recognize problem credits in a timely manner.
- **Collateral and documentation exceptions** were noted on final loan closing documents without appropriate approval.

- **Loan covenant violations** were noted that had not been acknowledged to the customer (reservation of rights) or reviewed by the approving person or committee.
- ABC did not consistently obtain **updated borrower financial information**. Instances were noted where updated financial information had not been spread or reviewed.
- ABC renewed loans after a significant change occurred in the bank's real estate lending markets without obtaining **updated appraisals**.

As borrowers defaulted on their loans, ABC's OREO increased from <\$400,000 in early 2000's to >\$75 million in the late 2000's.

ABC explored available alternatives for raising capital but these efforts were not successful and the institution closed in 2012.