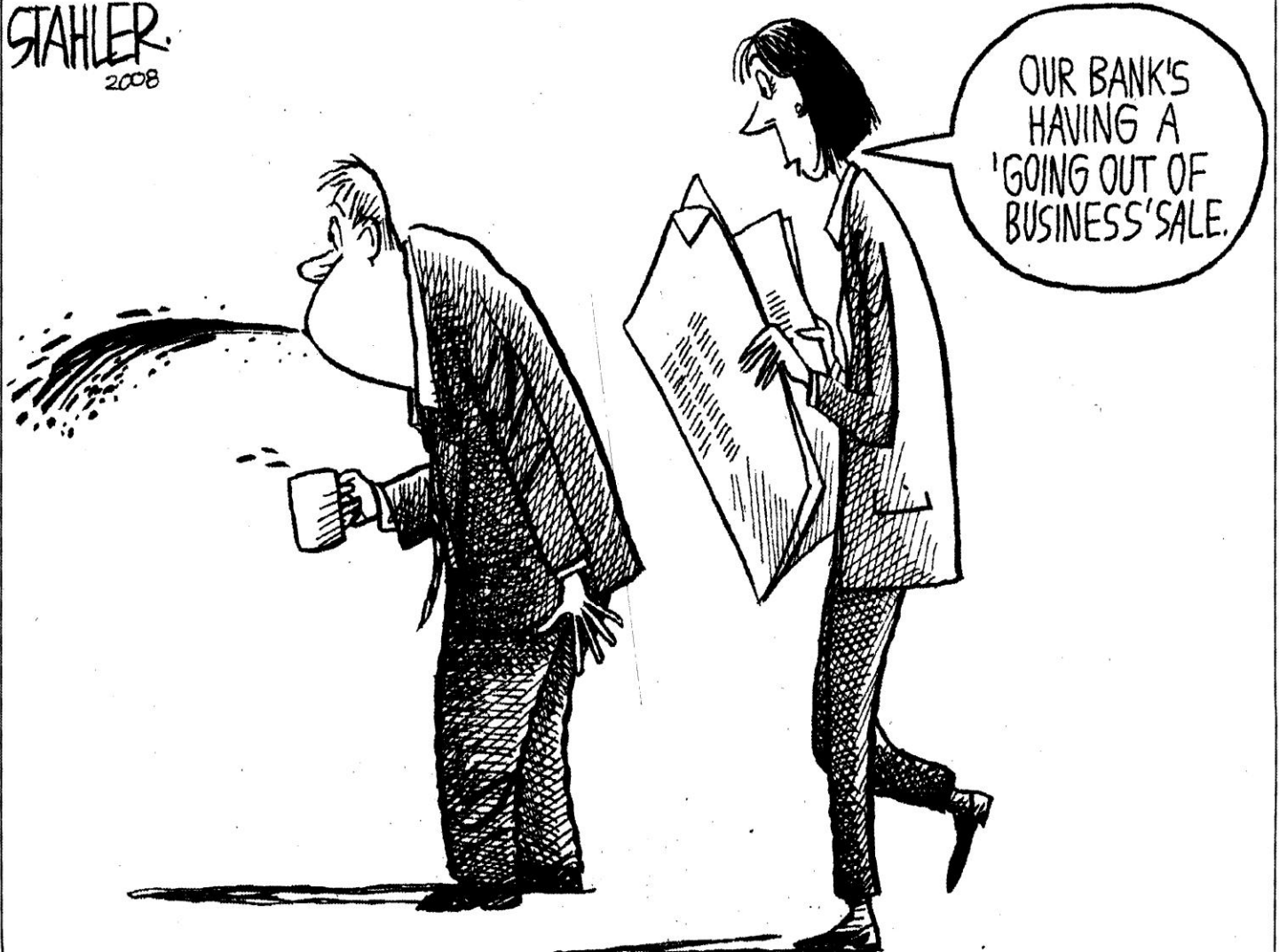


# Asset Quality and Directors

Maine Bankers  
Association  
May 11<sup>th</sup>, 2011

STAHLER.  
2008



# Appreciation Rates

- | <u>State</u>                  | <u>Peak</u> | <u>% Decline</u> | <u>Next 12 MThs</u> |
|-------------------------------|-------------|------------------|---------------------|
| ● Nevada                      | May 06      | -52.0%           | -2.4%               |
| ● Maine                       | May 07      | -17.5%           | -2.7%               |
| ● Foreclosure Rate            |             | 3.89% (7)        |                     |
| ● Negative Equity: Nationally |             | 23.0%            |                     |

# Introduction, Asset Quality

- *Today's Safety & Soundness Examination is not your father's Exam!*
- The credit that was a **Pass** loan for the last several exams, is now a **Substandard** loan
- The **Appraisal process** that was OK is now an area of major concern
- Given that you fell short on the above, We have to downgrade **Earnings, Management, & Capital**

# What Will Drive Growth?

- A. Increase cross-selling for current customers
- **B. Expand presence on the internet**
  - Facebook, Twitter
- **C. Provide customers with mobile banking**
- D. Acquire another bank
  - Are there markets that strategically congruent?
  - Does management have the capability to manage a larger bank?
  - Is there sufficient Capital?

# Preferred Banking Methods

● <b>Age group 18-34</b>	<b><u>2010</u></b>	<b><u>2009</u></b>
● Branches	20%	16%
● Internet	44%	38%
● ATM	17%	15%
● <b>Age group 35-54</b>		
● Branches	24%	21%
● Internet	44%	26%
● ATM	12%	19%

# Preferred Banking Method

● <b>Age group 55+</b>	<u><b>2010</b></u>	<u><b>2009</b></u>
● Branches	32%	26%
● Internet	20%	11%
● ATM	16%	17%
● <b>All Age Groups</b>		
● Branches	25%	
● Internet	36%	
● ATM	15%	

# FCA Handbook: Compensation Committees

- “In recent months the matter of executive compensation has received significant attention from Government Officials, members of Congress, Investors, the Media, and Public.”
  - **“The economy did not get into a mess because people were paid too much. It got into a mess because they were paid to do the wrong things.”**
  - June Gallup poll
    - 59% of Americans support government imposed limits on executive pay!

# Kenneth Feinberg, Special Master for Compensation!

- Bank's share value fell by 50% in 2008
  - Executive pay fell by 1%???
- Bank/Association executive pay must be tied in part to **Risk Management**
  - **Camel Ratings**
  - **Risk Ratings**
  - **Reports of Examination**
  - **Loan Losses**

# Lending Philosophy

- “Bank’s make loans to borrowers with the **demonstrated willingness** and **capacity** to pay”
  - Demonstrated; a record of performance
  - Willingness; Credit history
  - Capacity; \$\$\$\$

# Introduction

- **Loans Portfolio Indicators**
  - Growth rate of portfolio (normal 7%-14%)
  - Past Dues, Non Performing, & Classified as a percentage of Capital (35%)
  - Regulatory Feedback
    - Review Safety & Soundness Exam
    - Asset Quality Rating of 3 – 5
    - Ask Regulators to prioritize concerns

# Introduction

- **Concentrations**

- Real Estate

- Proceeds used to acquire or improve real estate
- Real Estate taken as collateral to support loan
- Monitor Commercial Real Estate as a % Capital

- **Insider transactions**

- Regulation O loans approved by entire board
- Employee Loan Policy

# Lending for Directors

- Bank's provide short term (5 – 7 years) financing for loan customers.
- There are several areas of consideration:
  - A. Deal Desirability
    - Type of Borrower
    - Use of Proceeds
    - Underwriting Standards
  - B. Acceptability of collateral; (valuations)
  - C. Sources of repayment; (primary & secondary)

# What should be in Loan Policy?

- **A. Adequate Credit Policy**
  - 1. Types of loans made & not made
  - 2. Repossession & Collection
  - 3. Summary of each type of loan
    - Terms, maximum length of loan
    - Down payment required, LTV
    - Documentation requirements
    - Excluded collateral (i.e..... Older vehicles)
    - Required Guarantors

# Loan Policy

- **B. Proper Staffing**

- 1. Training; Sales, Lending, Compliance
- 2. Rapid loan growth; Staffing vs. Outstanding \$, #
- 3. Incentive Compensation
  - Volume
  - Yield
  - Risk Ratings
  - Past due's & Charge-offs
  - Documentation exceptions

# Loan Policy

- **C. Established Procedures**
  - 1. Loan audit & review
  - 2. Exceptions
    - Acceptable reasons for the exceptions
    - Required approval
  - 3. Loan committee packages
    - Deal Sheet (Summary of Loan Terms & Conditions)
    - Credit Memo recommending the loan
    - Financial data (PFS, Company Fin., Tax Returns, CBR's)
    - Documentation Checklist

# Loan Committee

- With whom are we doing business ?
  - Due diligence; Is it clear the lender had enough information to make an informed decision ?
    - Application
    - Credit Bureau Report
    - Personal Financial Statement
    - Tax Return
    - Company financial statements

# Loan Committee

- How will Loan proceeds be used ?
  - Does policy allow this type of loan ?
  - Does loan structure match expected source of repayment ?
- How will they repay us ?
  - Asset Conversion
  - Cash Flow
  - Secondary source of repayment

# Loan Committee Questions

- 1. What are the uses of the proceeds
  - Real Estate
    - Building
    - Acquisition & Development (A&D)
  - Equipment
  - Agricultural
  - Seasonal Line of Credit
    - Accounts Receivables
    - Inventory

# Loan Committee??

- 2. Source of Repayment
  - Primary
    - Asset Conversion; Less than 12 months
    - Cash Flows; Longer Term
  - Secondary
    - Collateral; Liquidation Value vs. Market Value
    - Guarantor; Outside Net Worth, Contingent Liabilities
- 3. Cash Flow Analysis
  - Debt Coverage Ratio
  - Cash after Debt Amortization?

# Loan Committee??

- 4. Credit Bureau Reports
  - Credit Score
  - Derogatory Information
    - Bankruptcy
    - Foreclosure
    - Tax Liens
  - Other Lenders
  - Recent Inquires
- 5. Credit Memo
  - Recommendation from Loan Officer
  - All Financial analysis completed

# Asset Quality and the Director

- Loan Volume
  - Referrals to Loan Officers
  - Joint Calling
  - Incentive Compensation Programs
- Portfolio Yield
  - What is the bank's targeted ROA ?
  - You should ask if the relationship is profitable ?

# Tools to manage credit risk

- 1. A good loan grading process
  - It should shadow the regulatory designations
  - It should have more than one “Pass” grade
  - It should be consistently applied
    - Lender
    - Loan Review
    - Regulators

# Asset Quality

- Risk Rating; 1 thru 8
  - Sample
    - **1-3 Pass**, Meets bank's underwriting standards, Pays as Agreed
    - **4 Watch list**, Frequent visits, Quarterly Financials
    - **5 Special Mention**
    - **6 Substandard**, Payment issues, Inadequate collateral coverage, Cash flow coverage
    - **7 Doubtful**, Non accrual, 50% reserve
    - **8 Loss**

# Risk Rating

% outstand	Loan Balance	Borrower	Risk Rating	Weighted Average
67%	\$2mm	ABC, Inc.	3	$3 \times .67 =$ 2.01
33%	\$1mm	XYZ, corp.	4	$4 \times .33 =$ <u>1.32</u> <b>3.33</b>

# Loan Loss Provision

- Enough reserve to cover all anticipated losses and all unanticipated losses
  - Set a Reserve for classified & watch list credits
  - Set a Reserve for all performing loans
  - Compare to peer group

# Tools to carry out Responsibilities

- Setting Loan Policy
  - Is there a policy for each loan product
  - Distribution of policy
  - Updates to Lenders
  - Annual approval of lending authority
- Participating w/Loan Committee
  - Setting \$ Limit for loans
  - Approval document in loan file
  - Record any questions or concerns in minutes

# Tools

- Loan Review
  - Reports to audit committee of the board
  - Sets compensation for Loan Review
  - Reports Quarterly to Board
  - Should not be performed by external auditors

# Loan Review

- Independent, 2 board meetings per year
  - Scope of review/Higher risk
    - Large \$ loans & Large \$ facilities (\$250K)
    - Classified, Non Accrual, Past Due
    - Insider & Employee Loans
    - Small \$ Sample (4%)
    - Policy Exception Loans
    - Multiple renewal Loans 3X
    - All OREO
    - Trouble Industry Loans
    - Real Estate Appraisals

# Portfolio Health

- Losses and Recoveries
  - Target recoveries 25% - 35% of gross charge-offs
    - Assign each charged off loan to an officer (special assets)
    - Require quarterly status updates
    - “Cover the body memo” no chance for additional \$\$\$
- Portfolio Performance vs. Peer Group
  - Management should report quarterly
    - Growth rate
    - Loan loss reserve
    - Past due loans & classified loans

# Portfolio Health

- Insider Transactions
  - The bank must have a clear policy (insider loans)
  - Employee loans should be reviewed by Loan Review
- Regulatory Feedback
  - Do not ignore regulatory concerns
  - Monitor any change of CAMEL Rating
  - Inquire as to the adequacy of Risk Rating System

# Introduction

- Problem loan management is a critical component of the credit process. The ‘Special Assets’ function is often the responsibility of the individual loan officers. We must minimize the losses on loans that go bad,
  - “Murphy’s Law”

# Classified Loan Management Report

- Manages corrective action process
- Document is used to change Loan Grades
- Watch list or Special Mention; Quarterly
- Substandard or Doubtful; Monthly

# Classified Loan Management Report

- Status reports and Updates, Corrective actions
  - Frequency
    - Watch list, OAEM: Quarterly
    - Substandard, Doubtful: Monthly
  - Recent activity
    - Payments
    - Financial Information
    - Litigation
  - Action plans
    - Change in classification
    - New collateral

# OREO; Other Real Estate Owned

- Quarterly reports to the board
  - Date in inventory
  - Latest appraised value
  - Estimated holding cost
    - Maintenance, Taxes, Opportunity cost
  - Write down dollars
  - Insurance coverage
  - Real estate agents