A Director's Role in the Community Bank Credit Function

MAINE ASSOCIATION OF COMMUNITY BANKS
COMMUNITY BANK DIRECTORS COLLEGE
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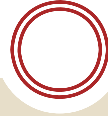
Why Talk About the Credit Function Now? What Do the Next 24 Months Look Like?



- Challenging real estate cycle.
- Increasing delinquencies.
- Increase in non-performing assets.
- Loss of income on problem loans.
- More foreclosures and loan-related expenses.
- Increase in loan losses and loan loss reserves.
- Increasing bankruptcies.
- Significant increase in regulatory orders.
- Commercial real estate becoming more of a problem (the next "shoe to drop").

Why is Director Involvement Important?

- Most of the risk in the bank is in the loan portfolio.
  - Board members and management need to focus their time and efforts on understanding and managing that risk.

- The Board's role is at the 40,000 foot level, <u>not</u> at the detailed level.
  - Setting policy and approving strategy is where directors can make the maximum impact for their bank.

Four Areas of Director Involvement

- Policy.
- Resources to support the lending function.
- Credit approval process.
- Oversight/monitoring.

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Business Plan Shapes the Loan Policy

- The bank's business plan defines lending's role and risk profile.
- Loans to assets (in Maine at 06/30/09: 62% to 89%).
- Composition of the loan portfolio:
  - Residential (25% to 84%).
  - Home equity (4% to 21%).
  - Commercial (1% to 30%).
  - Commercial real estate (1% to 47%).
  - Consumer/indirect (1% to 15%).

Lending Policy: Define the Bank's Credit Culture

- Define lending markets.
  - In-market lending → knowledge of local market is important.
  - Out-of-market lending → the farther away from the bank's core market, the higher the potential risk.
- Define loan products.
  - Retail focus (residential and consumer loans).
    - Lower risk weight.
    - More standardized.
  - Business focus (commercial and commercial real estate loans).
    - Higher risk weight.
    - More complex.
- Loan portfolio composition.
- Size of credits (spread the risk).
- Concentrations (one borrower/industry).
- Borrower risk profile (risk averse/high risk).
- Debt service coverage.
- Lending authorities.
- Appraisers/appraisals.
- Loan grading/loan review.
- Loan reporting.

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Directors Ensure Appropriate Lending Expertise

- Management lending expertise:
  - Residential → plain vanilla.
  - Commercial → more complex.
  - Construction/land development.

- Lending infrastructure:
  - Processing.
  - Credit/underwriting.
  - Servicing.
  - Secondary market management.
  - Collection.

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Credit Approval

- When do Directors get involved in specific credit approvals?
  - Size of loan.
  - Complexity of loan.
  - Out-of-market loan.
  - Outside of policy limits.

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- **Oversight/monitoring.**

Oversight

- Compliance.
  - Regulatory compliance.
  - Policy compliance.

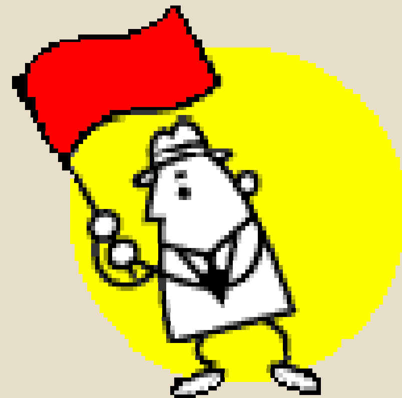
- Risk management.

- Loan loss reserves.
  - Reviewed quarterly.
  - Appropriate for the size and complexity of the loan portfolio.
  - Comply with accounting (FAS 5 and 114) and regulatory requirements.

- Loan reporting:
  - Composition (trend).
  - Concentrations (individuals/industries).
  - Delinquencies (compared to peers).
  - Real estate owned (trend).
  - Watch list.
  - Problem loan report (work-out plans).

Warning Signs of Potential Problems

- What are the "Red Flags" a Director should look for?



Warning Signs or "Red Flags": New Loans and Concentrations of Credit

- New Loans:
  - New loans that vary significantly from the bank's business plan.
  - Rapid entry into new types of lending without adequate planning.
- Concentrations of Credit:
  - Increasing exposure to one borrower.
  - Increasing concentration of loans:
    - To one industry (for example, restaurants/hotels/motels).
    - Of one risky loan type (for example, land loans, golf courses or high loan-to-value loans).

Warning Signs or "Red Flags": Delinquencies

- Increasing levels of delinquencies, especially longer-term delinquencies of 60 days or more.
- Unexplained or excessive extensions of due dates or maturity ("delay and pray").
- Delinquent loans and leases originated within the past year.
- Modifying, extending, re-aging or restructuring a loan, or advancing funds to pay interest, merely to avoid reporting a delinquency, without strengthening the bank's position.
- Lending additional funds to delinquent or struggling borrowers or their affiliates without acquiring additional safeguards.

Warning Signs or "Red Flags": Asset Classification/Criticism and ALLL

- Asset Classification/Criticism:
  - Large increases in classified asset amounts.
  - Significant differences between classifications established by management and those established by regulators or independent auditors.
  - Significant increases in classified assets without corresponding increases in ALLL.
  - Growth in the ALLL that is significantly less than the percentage growth in total loans over a given period.
- ALLL:
  - Ratios that indicate decreased coverage of probable losses.
  - A trend of increasing losses.

Warning Signs or "Red Flags": Real Estate Owned ("REO")

- A rapidly increasing level of REO.
- REO resulting from a loan that was not classified.
- REO sold at a price significantly below its carrying value

Wrap-Up

- Questions?
- Comments?

Thank you!