Asset Quality

“A” Stands for Apple…and Asset Quality – “1” a Day Keeps the Regulator Away

San Francisco Region
Community Bankers Workshop 2024/2025

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

Disclaimer

These presentations express the views and opinions of individual FDIC employees, which may not reflect the official positions of the FDIC and are not binding on the FDIC, its Board of Directors, or any Board member. The information contained in these presentations may become outdated, superseded, or may be revised, modified, revoked, or suspended.

Discussion Points

- Asset Quality Trends
- Concentration Risk Management
- Managing CRE
    - December 2023 Guidance
    - Loan Modifications
    - June 2023 Guidance
- Exam Observations
- Loan Classification Case Study
- Resources

Inflation Ta

Lo

Con

job

Office-loan delinquencies jump to

The bill on past-due commercial property loans surpassed $19.1 billion in April

Quality of Certain Bank Multifamily Loans to Deteriorate

Loans on past-due or non-accruing status are still below long-term averages.

Mort

24

Matu

KBRA

Overdue Bills Are Rising With US Debt Delinquencies, Fed Survey Shows

- In the first quarter, US household debt rose by $184 billion
- Maxed out credit card borrowers are falling behind on payments

Gen

Aut

Sur

US banks' construction loan delinquencies hit highest level in at least 3 years

Asset Quality Trends

Asset Quality Trends – Consumer Headwinds

Increased interest rates	High cumulative inflation
Elevated consumer debt levels	Elevated credit card charge off rates

Consumers have been impacted by increased interest rates and inflation.

Asset Quality Trends – Business Headwinds

Increased interest rates

High cumulative inflation

Noncurrent rate for non-owner occupied CRE increasing

Credit metrics showing weakening trends

Similar to consumers, businesses have been impacted by increased interest rates and inflation.

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

Asset Quality Trends – Business Headwinds

Commercial real estate showing increasingly challenging lending metrics

Headwinds are converging:

Property Values		Property Cash Flows	
Metric	Direction	Metric	Direction
CAP Rates	↑	Rents	↑ ↓
Valuations	↓	Vacancies	↑
Loan-to-value (LTV)	↑	Expenses	↑
		P&I Payments	↑
		DSC Ratios	↓

Concentration Risk Management

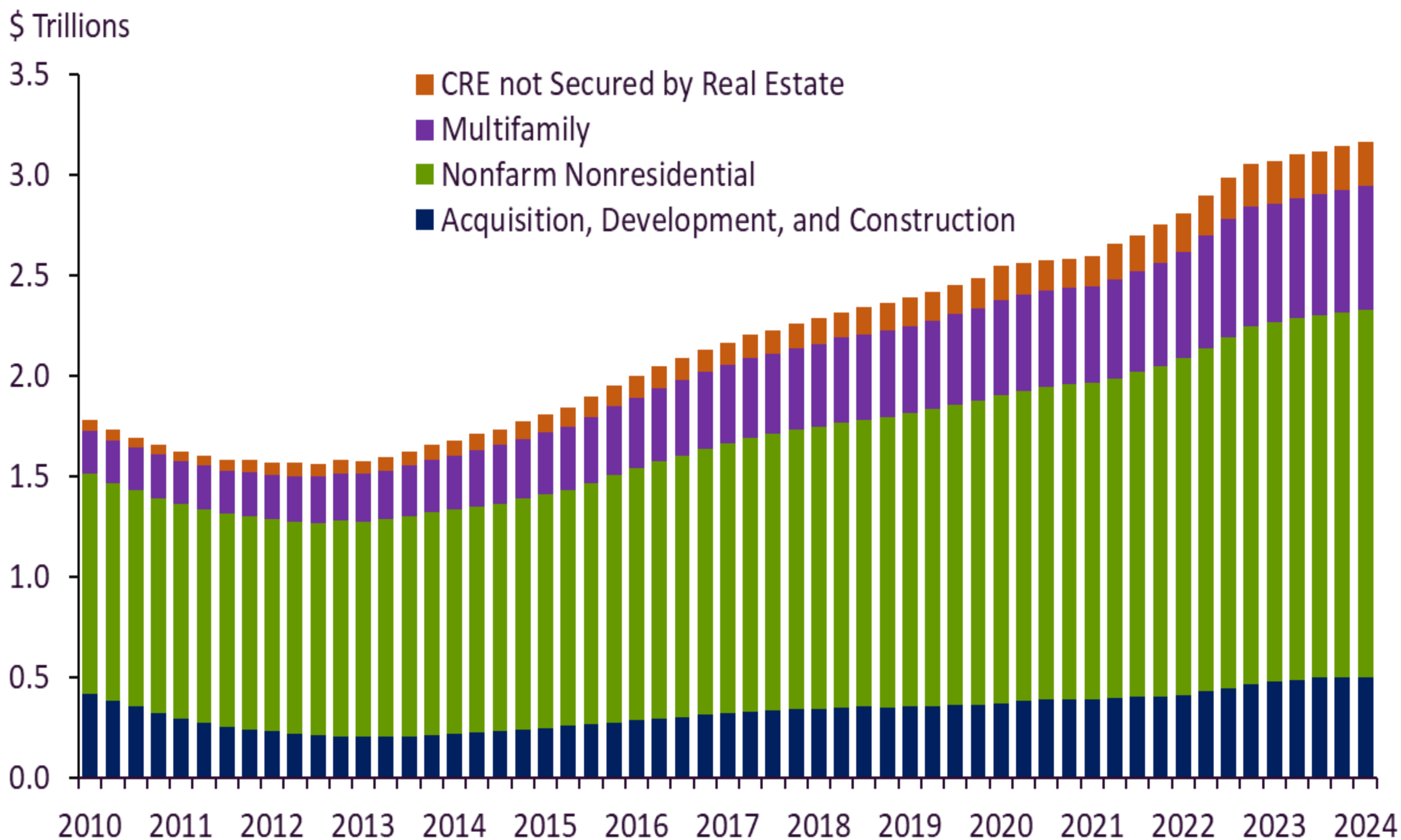
Concentration Risk Management

Concentration Risk Management

Why are regulators talking about concentrations?

- Highly cyclical in most markets –
  - Agriculture crisis of mid-1980s (not CRE, but similar story)
  - Banking and thrift failures of the late 1980s/early 1990s
  - 2008 banking crisis
- CRE lending is a significant business line
- Risk management practices and strategic planning have not always kept pace with growth in CRE lending
- Headwinds in the credit metrics

Concentration Risk Management

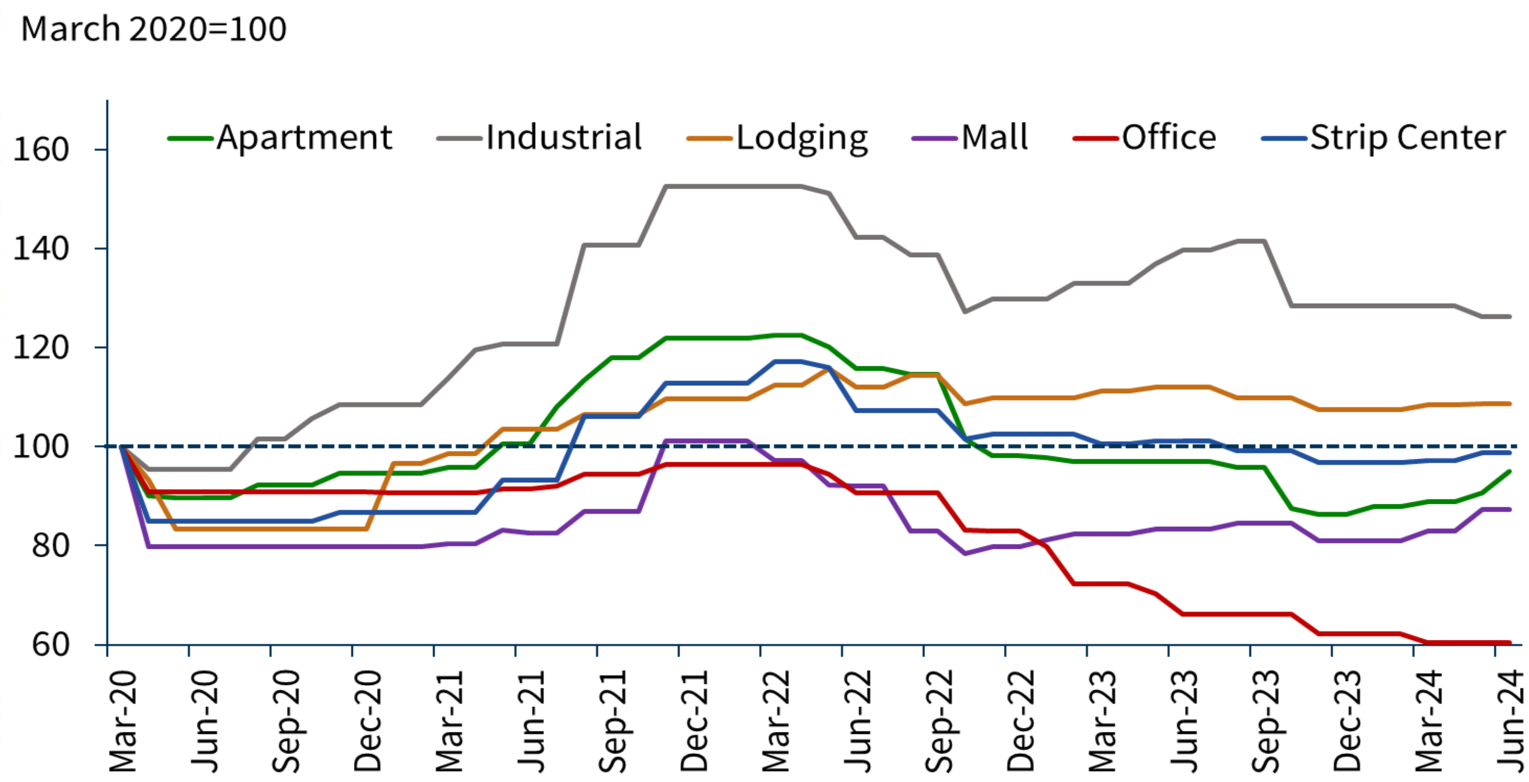


Source: FDIC.

Note: Quarterly data, first quarter 2010 through first quarter 2024.

Concentration Risk Management

Commercial Property Price Index



Source: Greenstreet.
Note: Data are monthly through June 2024.

Concentration Risk Management

2006 Concentrations in CRE Lending, Sound Risk Management Practices

Construction – Not Limits	General CRE – Not Limits
• Construction, land development, and other land loans represent 100% or more of total capital, **or**	• Total non-owner occupied CRE loans represent 300% or more of total capital, and the CRE loan portfolio has increased 50% or more during the prior 36 months

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

Concentration Risk Management

FDIC Rules and Regulations Part 364
Appendix A.II.G – Asset Quality

Asset quality. An insured depository institution should establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets. The institution should:

1…4

5. Consider the size and potential risks of material asset concentrations; and

6…

Concentration Risk Management

Board & Management Oversight

Portfolio Management

Management Information Systems

Market Analysis

Credit Underwriting Standards

Stress Testing and Sensitivity Analysis

Credit Review

Managing Commercial Real Estate

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

Managing CRE – December 2023 Guidance

“Managing CRE Concentrations in a Challenging Economic Environment”

- Maintain strong capital levels
- Ensure appropriate ACL
- Closely manage construction & CRE portfolios
- Maintain updated financial information
- Bolster loan workout infrastructure
- Maintain adequate liquidity

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

Managing CRE – Loan Modifications

Loan
Modification

Managing CRE – Loan Modifications

Estimated under the same CECL methodology as all other loans

Evaluated on a collective basis unless…

Evaluate for changes in risk characteristics:

- Credit risk changes
- Borrower circumstances
- Recognition of charge-offs
- Cash collections that have been fully applied to principal

Managing CRE – Loan Modifications

Discounted Cash Flow Method:

- Use the post-restructuring effective interest rate as the discount rate

Fair Value of Collateral Method:

- Required in allowance for credit losses measurements for modifications where the loan is collateral dependent
- Measure the fair value of collateral (less cost to sell, as appropriate)

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

Managing CRE – June 2023 Guidance

Banks that implement prudent CRE loan accommodation and workouts after performing a comprehensive review of a borrower's financial condition will not be subject to criticism.

Modified loans to borrowers who have the ability to repay their debts according to reasonable terms will not be subject to adverse classification solely because the LTV exceeds 100%.

Banks should employ prudent risk management practices and appropriate internal controls.

Managing CRE – June 2023 Guidance

Short-term Accommodations	Long-term Accommodations
• Occur before a loan reaches workout scenario • Can mitigate long-term adverse effect on borrower	• Extending loan terms • Granting additional credit • Restructuring loan with or without concession

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

Managing CRE – June 2023 Guidance

Examiners will evaluate the effectiveness of a bank's practices:

- Policy and procedures
- Loan workout infrastructure
- Credit worthiness documentation
- Management information systems
- Loan collection procedures
- Ongoing credit risk review

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

Managing CRE – June 2023 Guidance

Examiners will not criticize a bank for workout arrangements as long as:

- Workout is prudent: full credit analysis, updated financials, updated collateral value, appropriate loan structure
- Global cash flow is analyzed, including guarantor
- Borrower performance is monitored
- Risk rating and ACL are appropriate

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

Managing CRE – June 2023 Guidance (Nonaccrual)

A loan that has been restructured so as to be reasonably assured of repayment and performance according to prudent modified terms need not be placed in nonaccrual status.

The restructuring and any charge-off taken on the loan must be supported by a current credit assessment of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the loan must be placed in nonaccrual status.

Return to accrual status: sustained repayment for a reasonable timeframe (at least six months).

Examination Observations

Exam Observations – CECL

Overall, significant effort observed. Recommendations noted in these areas:

- Policies and procedures
- Documentation of reasonable and supportable forecasts
- Qualitative factors – sources, need for adjustments, calculations
- ACL for HTM securities under CECL

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

Exam Observations - CECL

Overall, significant effort observed. Recommendations noted in these areas:

- ACL for AFS securities under new methodology
- Reconciling assumptions with other risk measurement methods
- Independent review and internal control reviews

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

Exam Observations – General

Supervisory recommendations focused on the following weaknesses:

- Board and management oversight
- Portfolio management
- Stress testing
- Sensitivity analysis

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

Asset Quality

Case Study

Loan Classification– Case Study

What would you grade the credit relationship? And, why?

Loan Classification – Case Study

Special Mention Loan Definition

A Special Mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the institution's credit position at some future date. Special Mention assets are not adversely classified and do not expose an institution to sufficient risk to warrant adverse classification.

FDIC
FEDERAL DEPOSIT INSURANCE CORPORATION

Loan Classification – Case Study

Substandard Loan Definition

Substandard loans are inadequately protected by the current sound worth and paying capacity of the obligor **or** of the collateral pledged, if any. Loans so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Loan Classification – Case Study

Loss Loan Definition

Loans classified Loss are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the loan has absolutely no recovery or salvage value but rather it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be effected in the future.

Loan Classification– Case Study

What would you grade the credit relationship? And, why?

Resources

Resources

[Appendix A to Part 365 - Real Estate Lending Standards]

[Appendix A to Part 364 – Interagency Guidelines Establishing Standards for Safety and Soundness]

[Managing CRE Concentrations in a Challenging Economic Environment – December 2023]

[Policy Statement on Prudent CRE Loan Workouts - June 2023]

[Guidance on Concentrations in Commercial Real Estate Lending – December 2006]

[Statement on Prudent Risk Management for CRE Lending – December 2015]

[Supervisory Insights Journal - Summer 2022]