FALL
2018

BANKEXAMMONITOR

INSIGHTS ON RECENT EXAMINATIONS FROM FinPro
Building value together

This analysis is based on data gathered anonymously from banks across America by the Coalition of Bankers Associations

Regulatory examinations continue to be tilted toward liquidity risk with stress testing, interest rate risk with a flattening yield curve, asset quality concerns in a highly competitive environment, and corporate governance. The examiners persist in their apprehension with the length of this economic expansion and the possibility of a downturn over the next 12 to 24 months. Strategic planning remains the roadmap to planned performance, and the examiners expect to see quarterly assessments of actual to budget results documented in Board of Director minutes.

> **"The banking industry experienced continued improvement in net interest income, noninterest income and loan performance this quarter. However, the interest-rate environment coupled with competitive lending conditions have led to heightened exposure to interest-rate, liquidity, and credit risks. The industry must continue to position itself to be resilient through economic cycles."**
> ***-- FDIC Chairman Jelena McWilliams***

Liquidity Risk and Stress Testing

Let's start with the easy part . . . examiners want to see every bank stress test its liquidity position under a "less than well capitalized" scenario. This analysis must be completed in a "stagnant" environment. The adverse impact to such a stress test is obvious: banks cannot offer "high rate" deposits and banks cannot (without FDIC approval) use brokered deposits. Remember, these are two separate issues. As an example, even if the FDIC grants a brokered deposit approval, such deposits cannot be "high rate."

RECOMMENDATION #1: Due to this expected stress test, banks should determine if they operate in a "High Rate" area. The analysis is prescriptive and not overly complex, so banks would be well served to perform this assessment and maintain documentation for examiner review.

RECOMMENDATION #2: Banks would also be well served to calculate their local rate cap. Again, this analysis is not overly complex but is quite helpful in working with examiners through both the liquidity risk analysis and stress testing mitigation strategy.

Now to the more complicated part of Liquidity Risk. Examiners expect banks to distinguish their funding base into the relevant Core, Non-Core, and Wholesale categories. There are a number of important nuances to consider when executing on this segregation. First, and as previously mentioned, management should be prepared to share with the examiners their analysis of deposits that exceed the local rate cap and those deposits that exceed the national rate cap. These distinctions could result in the placement of some small deposits, normally captured in the Core bucket, into the Non-core bucket. Second, management should have a developed strategy on how the bank uses technology to attract deposits, which will contribute to the determination of whether such funds are core or non-core.

More importantly though, banks need to have a mechanism to distinguish which funding sources (e.g. Core, Non-Core, or Wholesale) are Stable versus Volatile. There are multiple factors that must be considered in this distinction of Stable funding, depending on whether such funds are Wholesale, Non-core or Core. The resultant calculation ultimately allows the bank to accurate assess its reliance on volatile funds to support longer term assets, an area that receives significant scrutiny in recent examinations.

RECOMMENDATION #3: Using supportable and documented data, banks should break down their funding base (Core, Non-core, Wholesale) into Stable and Volatile categories.

RECOMMENDATION #4: Banks should stablish appropriate policy thresholds for wholesale funding, high cost deposits, municipal deposit, brokered deposits, volatile funding, etc.

While the regulators have not established specific mandates, the RFI feedback shows that banks with on balance sheet liquidity in excess of 10% avoid regulatory criticism. Since this analysis removes pledged (even if unencumbered) securities from the calculation, banks should carefully assess the best strategic alternatives when collateral is required.

THERE ARE MORE THAN 500 BANKS OPERATING WITH ON-BALANCE SHEET LIQUIDITY BELOW 10% AND MORE THAN 100 BANKS OPERATING WITH ON-BALANCE SHEET LIQUIDITY BELOW 5%.

As of June 30, 2018

RECOMMENDATION #5: Whenever possible, banks should use the FHLB LOC product to secure municipal deposits.

RECOMMENDATION #6: Since liquidity is under such intense examination scrutiny, banks should pledge the maximum amount (as determined by its risk appetite statement) of their loan portfolio to the FHLB regardless of their perceived borrowing needs. The availability of the borrowing capacity is heavily scrutinized by the examiners as part of their liquidity risk analysis.

Interest Rate Risk with a Flattening Yield Curve

Examination data suggests that regulators are focused on a number of risks within this category. First, and most obvious, is whether Boards have appropriately established acceptable risk parameters for positive and negative interest rate shocks to both 12 and 24-month Net Interest Income (NII) as well as the Economic Value of Equity (EVE). Next, and equally obvious, is whether banks are operating within the risk thresholds established by the Board. Remember that this analysis should initially be performed in a "static" environment, but well managed banks also must assess risks and strategic options in a "dynamic" environment.

Examination scrutiny in the Sensitivity analysis tends to be focused on the key assumptions: Beta, Decay, and Prepayment Speeds. These assumptions need to be well documented and clearly captured in ALCO committee reports and Board meetings.

RECOMMENDATION #7: Banks must regularly "back test" their financial performance and establish acceptable variance metrics to assess the reasonableness of their key assumptions. These key assumptions should also undergo a stress test at least annually.

RECOMMENDATION #8: The bank's interest rate risk policy should clearly identify the bank's risk appetite (e.g. policy limits) in balancing product duration for yield in the current flattening curve environment.

Asset Quality Concerns

THERE ARE MORE THAN 550 BANKS ACROSS THE UNITED STATES THAT HAVE A LOAN TO DEPOSIT RATIO IN EXCESS OF 100%

As of June 30, 2018

Examiners seem to be questioning how long this economic expansion will continue and the potential impact to the quality of the loan portfolio when a downturn occurs. There is no evidence in RFI Survey results that examiners are predicting a recession, instead only raising the concern and investigating whether banks have strategically considered “what if” scenarios.

There is regulatory concern regarding the competitive environment for quality loans. A focus on loan policy exceptions, covenant exceptions, and pricing exceptions is evident throughout survey results. Examiners are also spending a significant amount of time reviewing loan terms, often questioning the reasonableness of non-recourse loans and interest only loans. Cash-out refinancing remains a “hot button” with examiners. Speculative construction lending is under intense review. Loan stress testing is critical both at underwriting and for an ongoing assessment of overall portfolio credit risk. Complete analysis of loan portfolio concentrations is critical and should be analyzed at both the industry and product level. Documentation is critical.

There are more than 500 banks that have a construction portfolio exceeding 75% of Risk Based Capital. There are more than 470 Banks that have a Total CRE Portfolio exceeding 250% of Risk Based Capital.

As of June 30, 2018

RECOMMENDATION #9: Banks should review their loan policy to ensure it covers all lending segments and establishes appropriate risk parameters. For example, if a bank is underwriting speculative residential construction then the loan policy should identify meaningful parameters, risk thresholds such as concentration limits to one builder, etc.

RECOMMENDATION #10: Banks must document all loan policy exceptions and covenant/pricing exceptions and report to the Board at least quarterly. Board minutes should comprehensively document such discussions.

RECOMMENDATION #11: Banks should identify and document “leading indicators” of asset quality concern. As previously mentioned, such indicators could include policy or covenant exceptions.

RECOMMENDATION #12: Examiners want to see identified and tested “exit strategies” for loan concentration buckets. In other words, how will banks predict when the music stops and how effective can the banks execute on the strategic shift.

Scott Polakoff, Executive Vice President
FinPro, Inc.
908-234-9398