CCBN Lending & Regulatory Compliance

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FDIC and OCC
Examiner Update

FDIC and OCC Update

- **Bankers are facing many headwinds in the upcoming year. How are the examiners focusing on the Banks, underwriting standards and credit quality?**
  - Examination Approach Does Not Change - Risk Focused
  - General Risks Facing Banks

FDIC and OCC Update

- **Are the recession fears behind us?**
  - Mixed Viewpoints
    - Positive Aspects
    - Cautionary Economic Drivers

FDIC and OCC Update

- **Should Banks begin to ease credit underwriting standards in response to being past the peak in interest rate hikes?**
  - Inflation is still above Federal Reserve Bank's target
    - Rate Reduction is the Consensus Forecast for 2024
  - Underwriting Standards - Based on Risk Appetite of Each Bank - Approved by Board of Directors
  - Managing CRE Concentrations in Challenging Interest Rate Environment

FDIC and OCC Update

- **Are there areas of troubling exposure from new long-term trends in CRE product types.**
  - Office CRE
    - Maturity/Repricing
    - Rising Vacancies
    - Softening Property Values
  - Multifamily CRE
    - Volume
    - Maturity/Repricing

FDIC and OCC Update (Cont.)

Refinance Risk

Refinance Risk Defined

Refinance risk is the risk that borrowers may not be able to replace existing debt at a future date under reasonable terms.

Centered in portfolios that rely on refinancing to pay off existing debt

Borrowers experiencing multiple stressors such as increased operating costs, increasing interest rates, and margin compression are at higher risk

Exacerbated by concentrations

Can affect a bank's current and future earnings

Why Now??

- Rising interest rates and other economic stressors are increasing the risk that borrowers may need to refinance at higher rates while also experiencing cash flow challenges.
- Roughly 20% of commercial loans reprice/mature in under one year.
- Concentrations in CRE lending, including construction, are increasing.
- Balloon structures in commercial lending typically have a 5-7 terms, and loans originated from 2017 through 2019 are maturing in a very different environment.

Vulnerable Borrowers

- Marginal borrowers at loan origination who received loan funding at historical low interest rates.
- Borrowers in industry sectors where material gross revenues are derived from consumer discretionary spending.
- CRE sectors (Office, Retail, Residential Housing)

Vulnerable Borrowers

- Borrowers with higher leverage ratios than industry standards or norms
- Borrowers who cannot pass through input costs to customer base
- Borrowers heavily dependent on aggressive growth to reduce leverage.
- Borrowers in industries dependent on low wage workers.

Tips/Considerations

- Have you identified a universe of borrowers who may experience increasing refinance risk?
- How are you monitoring this universe of borrowers?
- Do you perform realistic loan-level stress testing that incorporates refinance risk?
- Are you appropriately considering refinance risk in risk ratings?

Tips/Considerations

- Do renewed, extended, or new loans to existing borrowers meet your current underwriting standards? Are you bank underwriting deals below market rates or with terms that the borrower couldn't get from a competing bank?
- Are you extending maturities for borrowers who cannot refinance/resize their debt?

Tips/Considerations

- Does underwriting and annual reviews consider reasonable and supportable projections of debt repayment capacity?
- Have you updated stress testing assumptions as appropriate?
- Do renewals of revolving lines of credit include a new assessment of repayment capacity and are lines “right sized” as needed.

Refinance Example

	2020	2024
Interest Rate	3.25%	6.25%
Gross Rents	$1,000,000	$1,000,000
Less: Expenses:	$925,000	$925,000
Cash Flow Before Debt Service:	$75,000	$75,000
Debt Service:	$68,064	$87,708
Debt Service Coverage Ratio:	1.10	0.86

CRE Stress: Interest Rates & Cap Rates

Average National Cap Rate Spread over 10-year Treasury

Low	0.11%	2006
High	4.07%	2012
Average	**2.53%**	**15 years**

10-Year Treasury			Interest Rate	Cap Rate
9/30/2022	3.80%	+200 bps	5.80%	6.33%
6/30/2022	2.97%	+200 bps	4.97%	5.50%
3/31/2022	2.36%	+200 bps	4.36%	4.89%
12/31/2021	1.51%	+200 bps	3.51%	4.04%
12/31/2020	0.93%	+200 bps	2.93%	3.46%
12/31/2019	1.88%	+200 bps	3.88%	4.41%
12/31/2018	2.72%	+200 bps	4.72%	5.25%

Scenario						
Base	Principal	5,000,000	Rental Income	500,000	Collateral	8,659,080
	Interest Rate	**3.51%**	Expense	(150,000)	Cap Rate	**4.04%**
	Amortization	360	NOI	350,000	LTV	57.7%
	Payment	$269,829	DSCR	1.30		
+230 bps	Principal	5,000,000	Rental Income	500,000	Collateral	5,525,734
	Interest Rate	**5.80%**	Expense	(150,000)	Cap Rate	**6.33%**
	Amortization	360	NOI	350,000	LTV	90.5%
	Payment	$352,205	DSCR	0.99		
	Payment	**$82,376**	**DSCR**	**(0.30)**	**Collateral**	**(3,133,346)**
+100 bps	Principal	5,000,000	Rental Income	500,000	Collateral	4,772,293
	Interest Rate	**6.80%**	Expense	(150,000)	Cap Rate	**7.33%**
	Amortization	360	NOI	350,000	LTV	104.8%
	Payment	$391,315	DSCR	0.89		
	Payment	**$121,486**	**DSCR**	**(0.40)**	**Collateral**	**(3,886,786)**

TDRs and Loan
Modification Trends

TDR or Loan Modified to Borrower Experiencing Financial Difficulty (LMBEFD)?

- What are the elements needed to determine if a "reportable modification" has taken place.
- How do you determine if a loan modification is a "major or minor" modification?
- The 10% cash flow test and recording requirements.
- With the adoption of CECL and the subsequent elimination of the TDR what is the new definition of a modified credit.

Reportable Elements

A reduction in the loan's interest rate because of the interest rate market's movement is not considered a loan modification that needs reporting.

- If you have a loan that was a five year or ten year reset on a balloon, and you renew the loan within your current underwriting guidelines at a rate, that is now market, it should not be a reportable loan modification.

No Concessions?

The need to evaluate if a “concession” was made has gone away. The new term is loan modified to borrower experiencing financial difficulty **(LMBEFD)** Determined if:

- Term extension under ASC310-10-50-39
- Interest rate reduction
- Principal forgiveness

No Concessions? (cont.)

- Other than insignificant payment delay. Consider:
  - The amount of the modified payments subject to the delay is insignificant relative
    to the unpaid principal or collateral value of the debt and will result in an insignificant
    shortfall in the contractual amount due.
  - The delay in timing of the modified payments period is insignificant relative to any
    one of the following:
  - The frequency of payments due under the debt
  - The debt's original contractual maturity
  - The debt's original expected duration
- Disclosures are only required for (LMBEFD)

Is It a New Loan? Is there a rebuttable presumption of a modification?

The 10% guideline is used to determine if a modification is considered a new loan or modified loan. Guideline – When the Discounted Cash Flow is reduced by more than 10% -

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- To be a new loan, must meet **both** criteria:
  - Modified loan's effective yield is at least equal to the yield for similar new loans **and** Modification is more than minor (i.e., DCF under modified loan terms is at least 10% different than DCF under original loan terms)
- It should be very rare that a **LMBEFD** to meet this criteria. If the conditions are not met, the modified loan is a continuation of the existing loan.

Payment Delay

Delay in payment – a delay in payment that is considered "insignificant" is not required to be disclosed. However, if a receivable has been previously restructured than all restructurings within the last 12 months should be considered to determine the "insignificance of the delay"

"Do you know why you've never see an elephant hiding up in a tree?" "No, why?" "Because they're really good at it.""

Asset Classification Review Annual Review Form

- Example #1
- Example #2
- Example #3

Annual Review Form Questions

1) What is your suggested Credit Grade?
   - Pass
   - Watch List – until follow -up item is obtained and evaluated
   - Special Mention
   - Substandard
   - Remain on accrual (Yes) /(No)
2) Is there a Defined Weakness in the credit?

Annual Review Form Questions

3) Are there mitigants to the defined weakness
    - LTV
    - Payment History
    - Global Cash Flow
    - Reserves
    - Borrower current credit position
    - Borrower net worth
    - Property in Transition

Annual Review Form Questions

4) Do all the suggested mitigants actually mitigate?
5) Is there a projected Defined Weakness and how does that factor into your Credit Grade?
6) Is there a Plan to correct the defined weakness?
7) Other Comments?

Special Assets – Is your Bank Prepared?

If the next year brings a recession or "soft landing" that is considered
overall mild, there will still be an uptick in classified assets and REO's.

What are some of the best practices from the past, and are they still relevant?

Some best practice suggestions for handling Special Assets

The Awesome Loan example

Click here to view

The Awesome Loan Discussion Topics

What suggestions do you have for Honest Bank to implement procedures in:

1. Identifying “red flags” of a problem loan at its inception and on an ongoing basis
2. Staffing personnel for troubled assets (develop or hire people with the skill set)
3. Having in place policies and procedures for timely involvement of a “work out officer” or SAD
4. Focusing line officers' attention on non-monetary defaults and their enforcement
5. Timely reviews of borrowers/guarantors structural and operational issues and financials

Questions??