Quarterly Conversations with the Federal Reserve Bank of St. Louis

Live from Bear State Bank
Little Rock, AR

September 8, 2016
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Today’s Presenters

• Julie Stackhouse
  Executive Vice President
  Federal Reserve Bank of St. Louis

• Cathy Kusmer
  Assistant Vice President
  Federal Reserve Bank of St. Louis

• Allen North
  Assistant Vice President
  Federal Reserve Bank of St. Louis
Agenda

• Examination Hot Topics in the 8th District
  – CRE concentrations
  – Third-party relationships
CRE Concentrations
A Renewed Focus on Commercial Real Estate Concentrations

• 2013 Whitepaper
  – “An Analysis of the Impact of the Commercial Real Estate Concentration Guidance” written by economists from both the OCC and Fed concluded that banks with high CRE concentrations, especially high CLD, had a higher probability of failure during the crisis.

• December 2015, Fed issues SR Letter 15-17
  – “Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending”
  – “The agencies have observed substantial growth in many CRE asset and lending markets, increased competitive pressures, and an easing of CRE underwriting standards.”
Interagency Guidance on Concentrations in CRE

SR Letter 07-01, SR 15-17, and the joint agency guidance issued 2006 are the primary source of guidance that still applies today.

Basics

• Guidance only applies to non-owner occupied CRE
• Enhanced risk management and increased supervisory oversight is triggered by:
  – CLD is equal to or greater than 100% of total risk based capital; or
  – Total NOO CRE represents 300% or more of total risk based capital and the CRE portfolio has grown by 50% or more during the prior 36 months.
  – While not hard limits, when levels approach these thresholds, banks have significant exposure and should take appropriate steps to ensure sound risk management.
  – Bank management should start the process of enhancing risk management once a strategic decision is reached to grow CRE lending and long before levels approach these thresholds.
The Percentage of Fed District SMBs Exceeding CRE Concentration Guidance Is on Par with the Average for All SMBs

<table>
<thead>
<tr>
<th>Fed District (#SMBs)</th>
<th>Percent SMBs exceeding 300% CRE/RBC guidance (non-owner occupied)</th>
<th>Percent SMBs exceeding 100% CLD/RBC concentration guidance</th>
<th>Percent SMBs exceeding both CRE and CLD concentration guidance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Boston (37)</td>
<td>8.1%</td>
<td>2.7%</td>
<td>0.0%</td>
</tr>
<tr>
<td>New York (23)</td>
<td>21.7%</td>
<td>4.3%</td>
<td>4.3%</td>
</tr>
<tr>
<td>Philadelphia (21)</td>
<td>23.8%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Cleveland (35)</td>
<td>2.9%</td>
<td>0.0%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Richmond (73)</td>
<td>12.3%</td>
<td>8.2%</td>
<td>2.7%</td>
</tr>
<tr>
<td>Atlanta (41)</td>
<td>14.6%</td>
<td>19.5%</td>
<td>7.3%</td>
</tr>
<tr>
<td>Chicago (135)</td>
<td>5.2%</td>
<td>1.5%</td>
<td>0.7%</td>
</tr>
<tr>
<td><strong>St. Louis (127)</strong></td>
<td><strong>5.5%</strong></td>
<td><strong>7.1%</strong></td>
<td><strong>2.4%</strong></td>
</tr>
<tr>
<td>Minneapolis (57)</td>
<td>0.0%</td>
<td>1.8%</td>
<td>0.0%</td>
</tr>
<tr>
<td>Kansas City (190)</td>
<td>6.3%</td>
<td>5.3%</td>
<td>3.2%</td>
</tr>
<tr>
<td>Dallas (52)</td>
<td>17.3%</td>
<td><strong>23.1%</strong></td>
<td><strong>9.6%</strong></td>
</tr>
<tr>
<td>San Francisco (38)</td>
<td><strong>31.6%</strong></td>
<td>5.3%</td>
<td>0.0%</td>
</tr>
<tr>
<td><strong>AVERAGE</strong></td>
<td><strong>12.4%</strong></td>
<td><strong>6.6%</strong></td>
<td><strong>2.5%</strong></td>
</tr>
</tbody>
</table>
First, You Have to Know What You Have

• Ongoing risk assessments to identify CRE concentrations
  – Stratifying the portfolio into segments with common risk characteristics; for example: multi-family, residential development, hotel, restaurants, office space.
  – Also consider stratifying by geography for banks that operate in different markets.
  – Stratification should make sense for your bank and be supportable.
  – The CRE portfolio should not be divided into multiple segments simply to avoid the appearance of concentration risk.
Next, Limits Have to be Established

- Establish CRE concentration limits
- Report levels to the board of directors regularly and the board should set limits.
- Any exceptions to these limits should also be reviewed and approved by the board.
- These limits need to be meaningful.
- Establish a contingency plan to ensure levels don’t exceed established limits.
  - Off-load risk by selling or participating loans
  - Establish triggers for raising new capital
Risk Management Expectations

- Board and management oversight
- Portfolio management
- MIS
- Market analysis
- Credit underwriting standards
- Portfolio stress testing and sensitivity analysis
- Credit risk review function
Concentration Key Take-Aways

• Not all concentrations are created equal – understanding the risks is vital
  – Depending on the extent and nature of the exposure, applying the CRE guidance to other concentrations could be necessary (Ag, Oil & Gas)
  – Funding of these exposures is also key to determining overall risk

• No substitute for good underwriting

• Should have risk management in place before levels exceed thresholds

• Limits must be treated as limits, not suggestions
  – Develop sub-limits that make sense for your risk exposure

• SR Letter 07-01 outlines the expectations
  – Develop a reasonable contingency plan
  – Regularly perform some market analysis and discuss it at the board meeting
  – Stress testing should be part of the capital planning process and does not necessarily have to be sophisticated
Third-Party Relationships
Just Like Any Other New Venture, the Following Should Be Considered When Developing an “Opportunity”

• **Board should be involved and kept up-to-date.**
  – Is the new opportunity going to involve a third-party partner? Vendor management is key.
  – Do we have the necessary expertise in-house?

• **Do the risk management upfront.**
  – Compliance (incredibly important! – must monitor complaints that involve third parties and take steps to ensure consumers are treated fairly)
  – Operational risks
  – IT risks
Just Like Any Other New Venture, the Following Should Be Considered When Developing an “Opportunity” (continued)

• Get started in a small way.

• Expand if successful, but establish some limits (concentration risk limits).
  – Limits are key to ensure the business does not get outsized to traditional bank
  – Capital levels may not be enough in the event of a large lawsuit or regulatory action

• Keep in mind legal lending limit and whether the transactions quality as “true” sales under GAAP.
Vendor Management

• **Who are my vendors?**
  – Service providers
  – Business partners – defined broadly

• **How do I manage my vendors?**
  – Centralize this function
  – Start with looking at accounts payable to identify vendors
  – Perform a risk assessment for each
  – Prioritize them in terms of risk (think about business resumption, financial risk, information security, and consumer compliance)
Third Party Loan Purchases

• Who does this include/impact?
• What compliance risks are inherent in purchasing loans?
  – Disclosures (initial and/or ongoing)
  – CRA
Indirect Automobile Loans

• What is the compliance risk?
• What should financial institutions do to mitigate risks?
• Previous/current struggles seen by financial institutions
• Tracking of the core features of the dealer’s loans
Third Party Servicing Relationships

- Third party servicing has evolved
  - Mortgages
  - Add-on Products
- Vendor management requirements
- What should financial institutions do to mitigate the risk of having these relationships?
- Recent case of deceptive practices
  - First National Bank of Omaha fined $32.25 Million
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Questions?

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