

Saltmarsh
Saltmarsh, Cleaveland & Gund
CERTIFIED PUBLIC ACCOUNTANTS AND CONSULTANTS



Community Bank Executive Forum

*The Current Lending Environment /
Credit Risk Strategies & Trends*



**Presented by:
David Ruffin**



Key Contact



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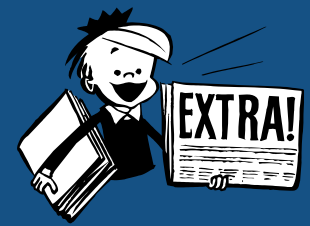
Raleigh, NC

Agenda

- The Current Credit Environment
- Interest Rates
- Credit Concentrations
- The Community Bank Conundrum
- New Approaches to Credit Risk Management—*and Board Oversight*

**The Credit Environment:
*Generally Benign...
But “Long in the Tooth—Still”***

The current credit environment



- Pick the metaphor: *4th quarter; overtime*; the current credit cycle won't last forever
- Some stresses emerging; are markets and political tensions pointing to more stress ahead?
- Loan growth?: communities (+6.6%) outstripping larger banks (+4%)—new C&I activity at expense of CRE
- We're back to the future on CRE concentrations—and perhaps a couple of bubbles (*multi-families & class c strip centers?*)
- Some loosening of underwriting and servicing seen to chase loans
- In search of credit talent / lending niches / credit cultures (too often a *confederation* of lenders)
- The competition extends beyond other commercial banks (PE/ABL)
- Primarily due to efficiency pressures: *Too small to succeed* is a popular presumption—prompting consolidation.

Beware of other **RED FLAGS**:

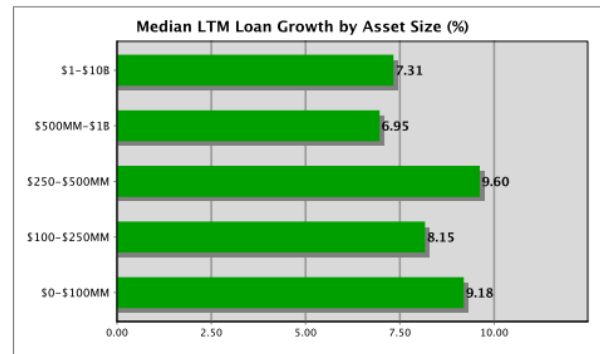
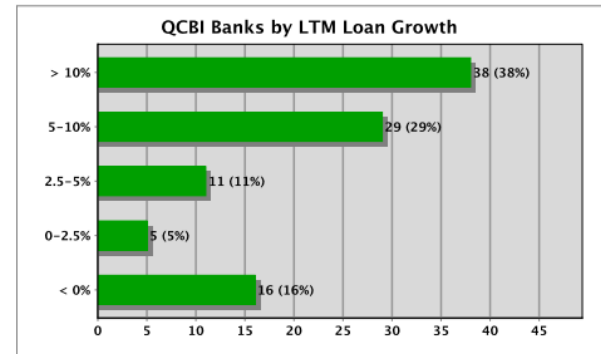
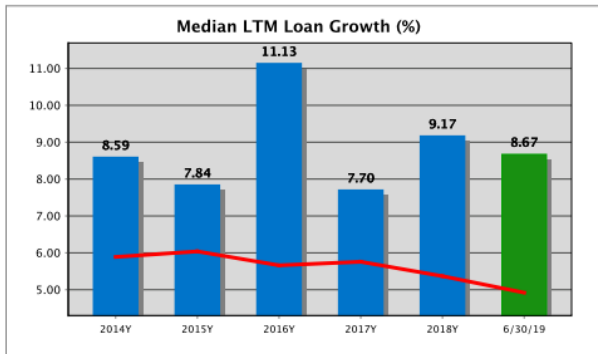
- Regulatory and industry inconsistencies in assessing credit risk—often still *trailing* indicators
- For acquirers, are targets window dressing their balance sheets?
- Recognizing problems late-in-the-game; *all loans good...until they're bad*
- After a decade of subsidized low rates, rates headed up
- Negative / instability aspects of tariffs and trade conflicts (i.e. commodity values & construction costs)
- Cracks in LFT (Leveraged Financial Transactions) / Indirect consumer credit quality
- Beware of loan participation pitfalls
- Vintages are key
- Now not the time to reduce loan review coverages
- Structural problem loan disadvantages at smaller banks



FL Bank Loan Growth Recently > National Peers

QwickAnalytics State Performance Trends Loan Growth Trends

Florida
Banks
June 30, 2019



— National Trend

* LTM = Last 12-months (or "trailing" 12-months)

Loan Growth Nationally

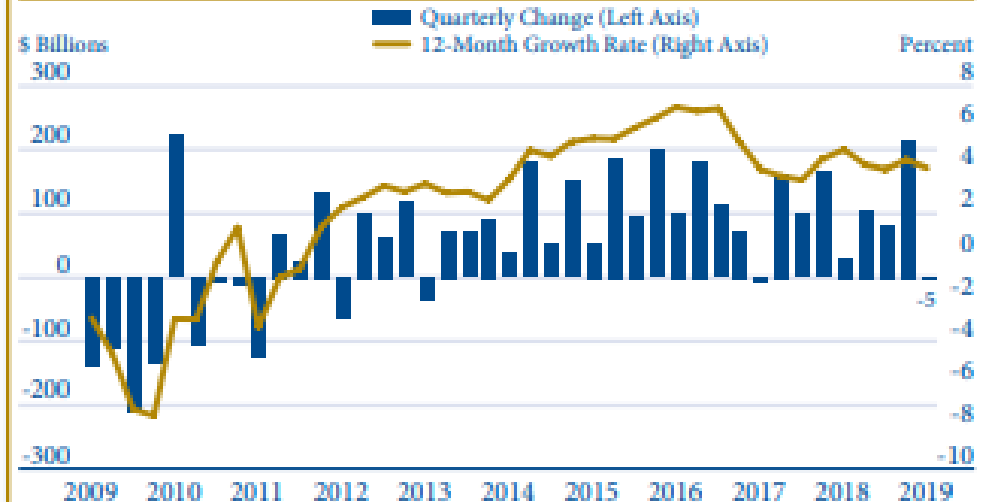
Annualized Compare '17-'18:

- Loans ↑ 4.4% (all banks)
- Loans ↑ 6.5% (community banks)
 - C&I ↑ 8.3%
 - C&D ↑ 9.0%
 - Multi-Family ↑ 8.2%

Big Spurt in 4Q '18

Quarterly Change in Loan Balances

All FDIC-Insured Institutions



Source: FDIC.

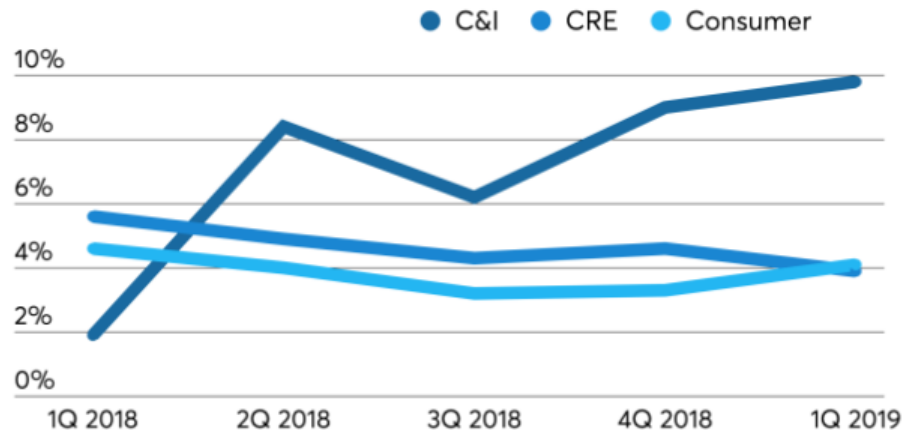
Note: FASB Statements 166 and 167 resulted in the consolidation of large amounts of securitized loan balances back onto banks' balance sheets in the first quarter of 2010. Although the total amount consolidated cannot be precisely quantified, the industry would have reported a decline in loan balances for the quarter absent this change in accounting standards.

2018: *the year for C&I*

C&I a bright spot in 'disappointing' quarter for lending

--American Banker 1/25/2019

Where loan growth is strongest



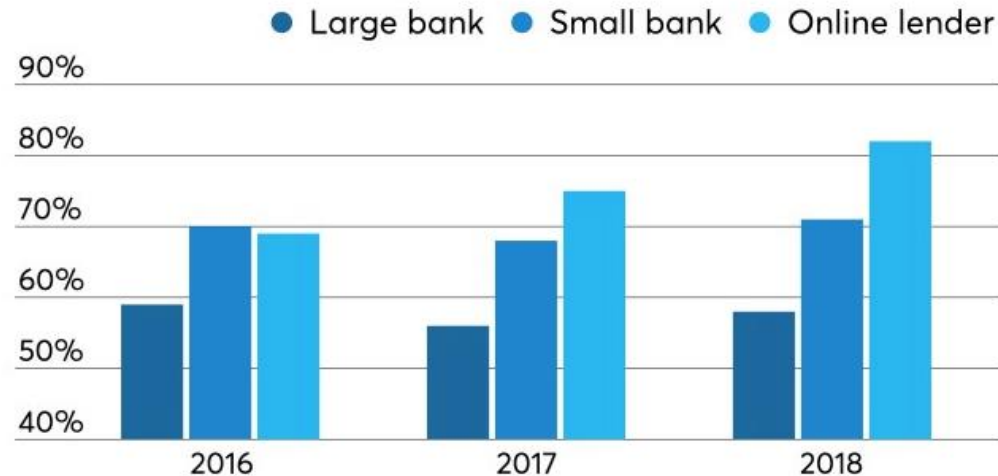
Source: Federal Reserve (Year-over-year growth)

Non-bank lenders showing stress

OnDeck lowers revenue target after charge-offs climb

--American Banker 5/2/2019

Who's lending to small businesses



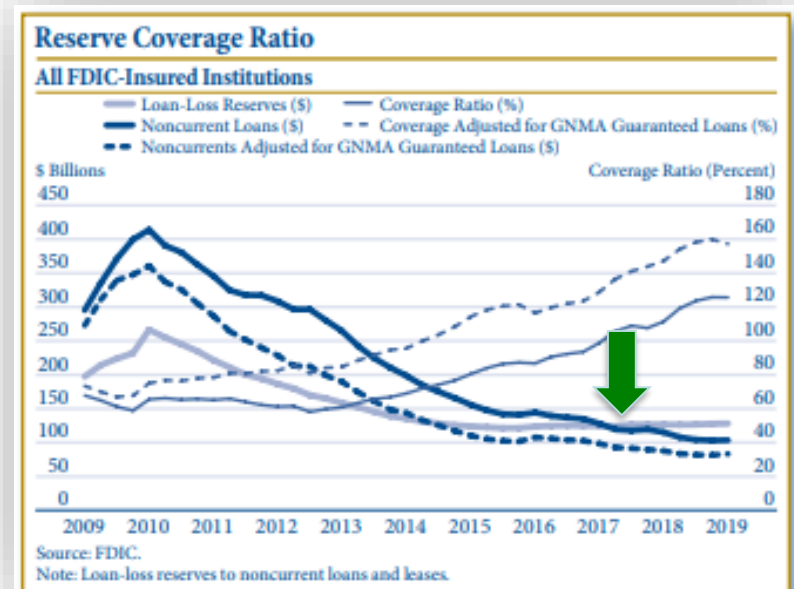
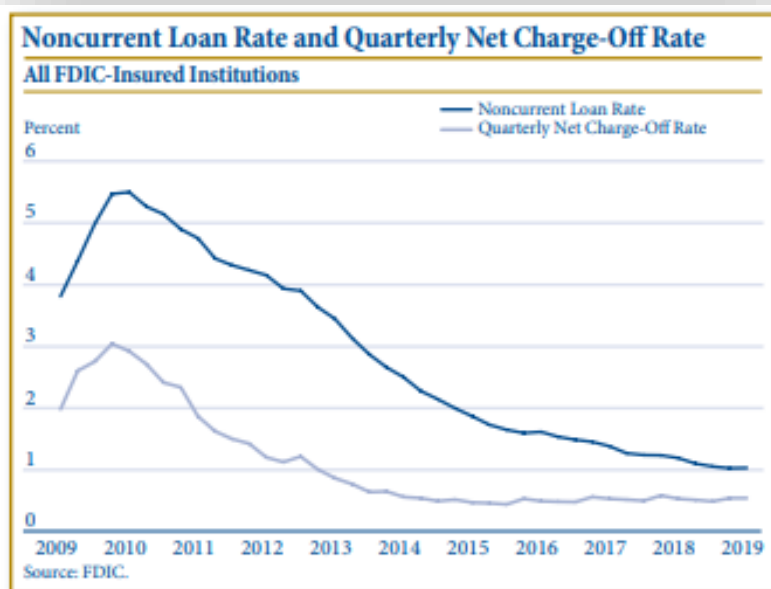
Source: Fed banks' survey of small-business owners
Note: Bars show approval rate by lender type

--American Banker 4/16/2019

Given these trends, *where's the worry?*

'18 Net Charge-Offs Decline 4.6% From '17

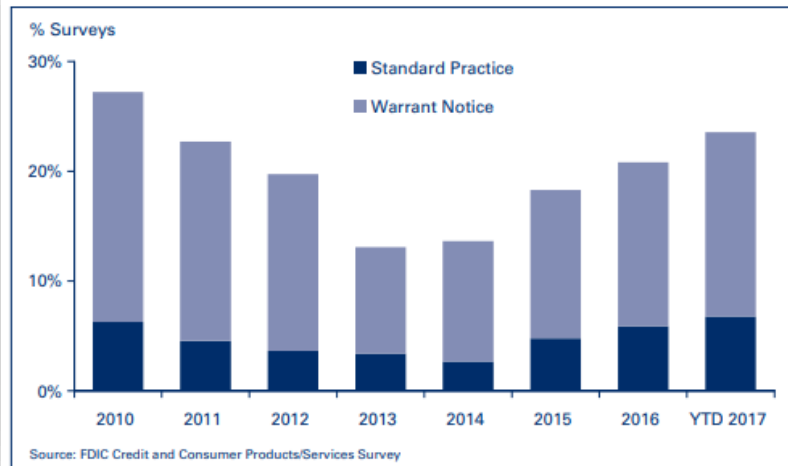
Reserves Now Exceed NCL's—finally!



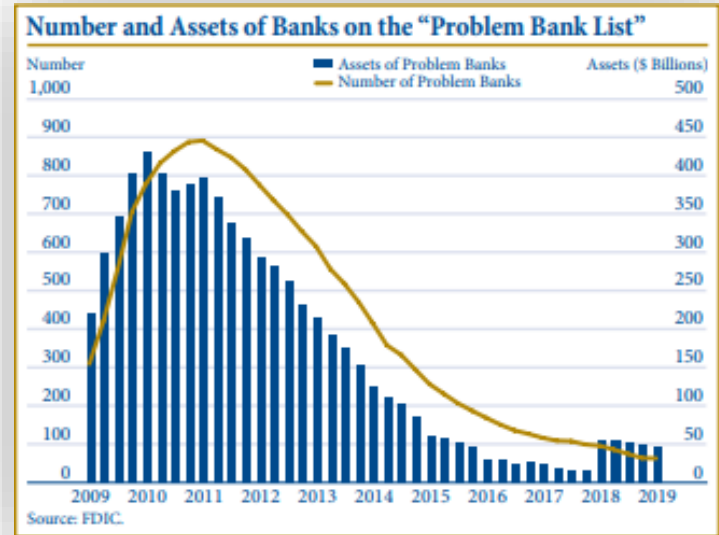
Composite periodic regulatory lending survey findings

- Out-of-area lending (including whole loan purchases, loan participations, and shared national credits);
- Growth in loans, ADC or CRE concentrations, assets, or deposits; and
- Higher risk practices in lending or underwriting, often in response to increased competition.
- Banks set aside \$14 billion in loan-loss provisions during the fourth quarter, the highest level since fourth quarter 2012.

Chart 4: Out-of-Area Lending Continues to Increase



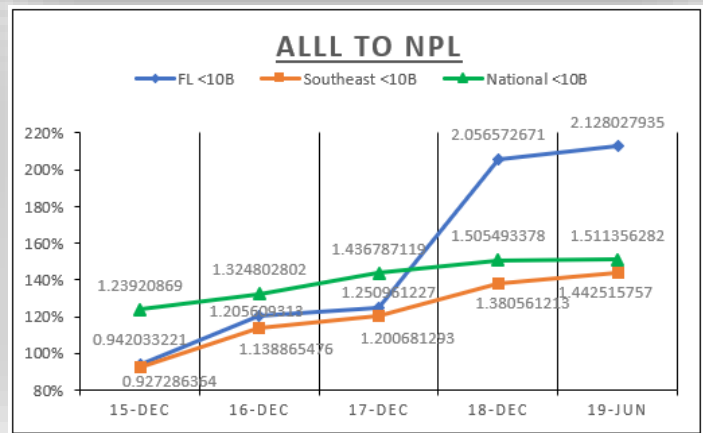
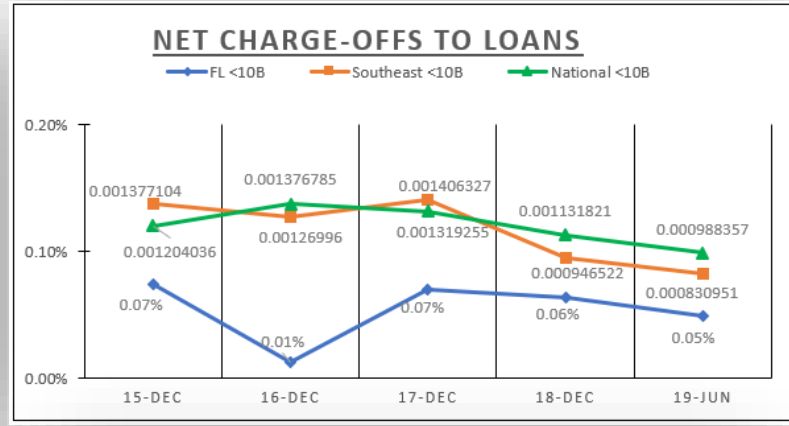
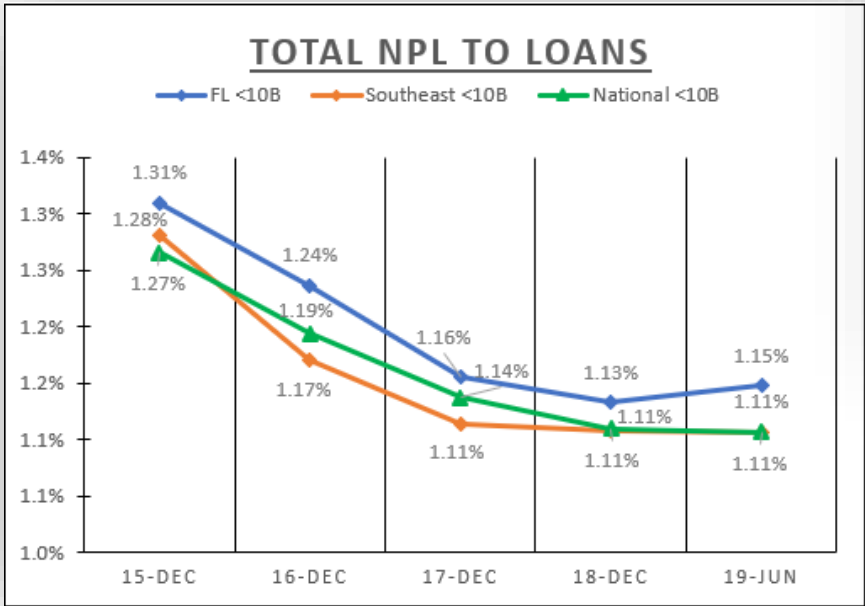
Source—FDIC



Trifecta of Loan Quality: Banks <\$10B

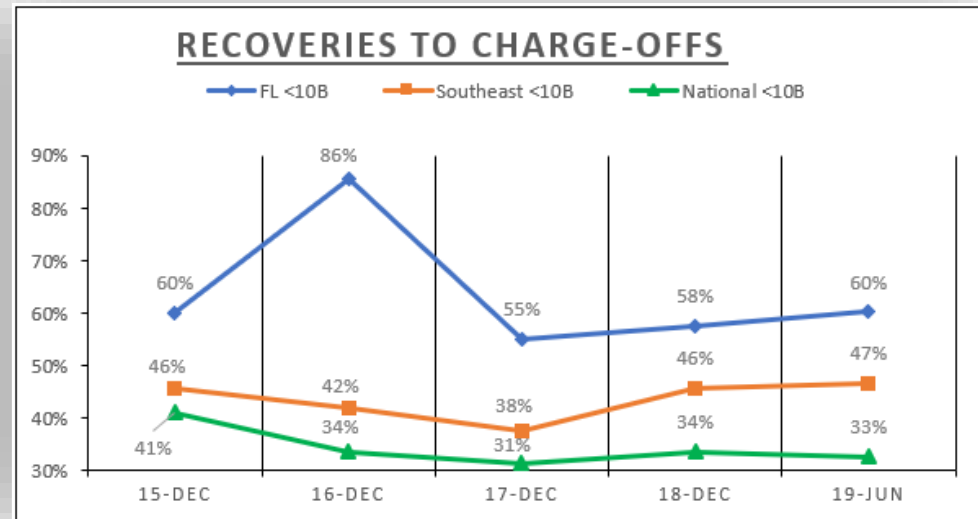
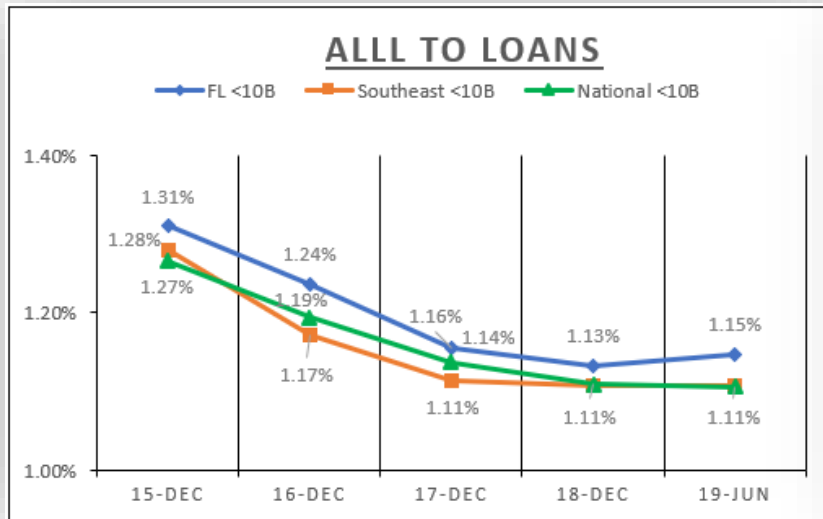


FL <\$10B / SE <\$10B / National <\$10B



ALLL & Recoveries: Banks <\$10B

FL <\$10B / SE <\$10B / National <\$10B



Credit Challenges: *Consumer*

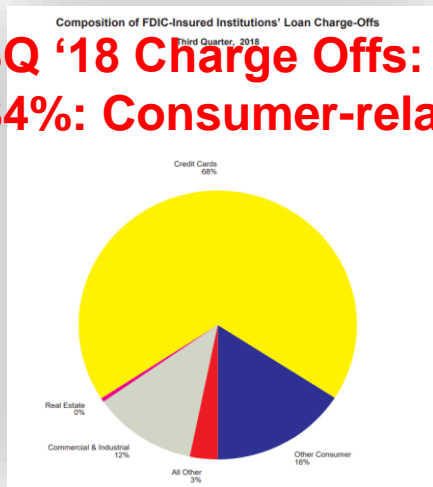
America's debt load is hitting record — and risky — territory

--American Banker 1/10/2018

Consumer debt is at an all-time high. Should banks be worried?

--American Banker 7/31/2018

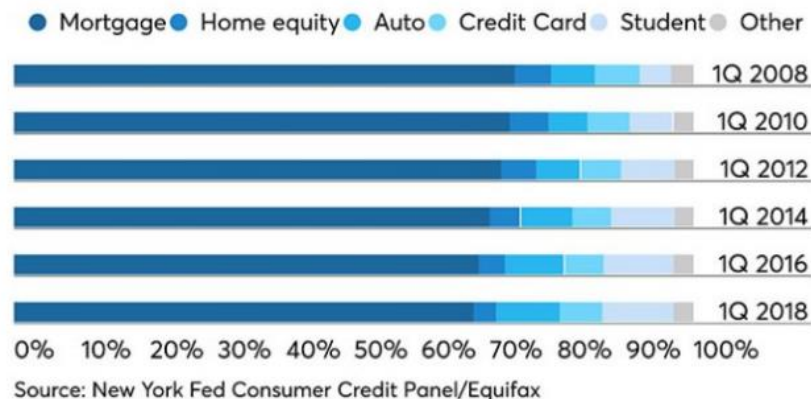
**3Q '18 Charge Offs:
84%: Consumer-related**



Source—FDIC

How consumer debt has evolved

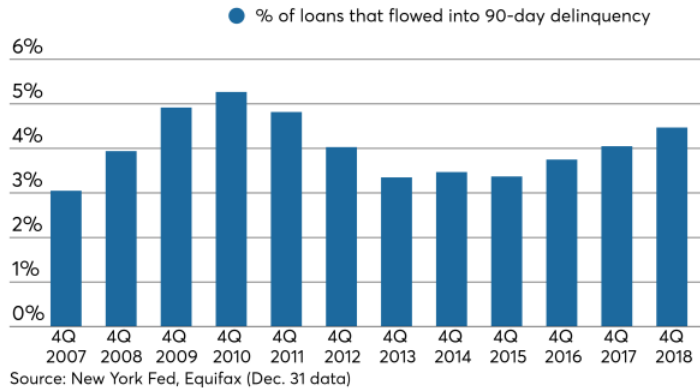
The composition of U.S. debt has changed in the last 10 years:
more owed on auto and student loans, less on mortgages



Credit Challenges: *Consumer*

Seriously delinquent

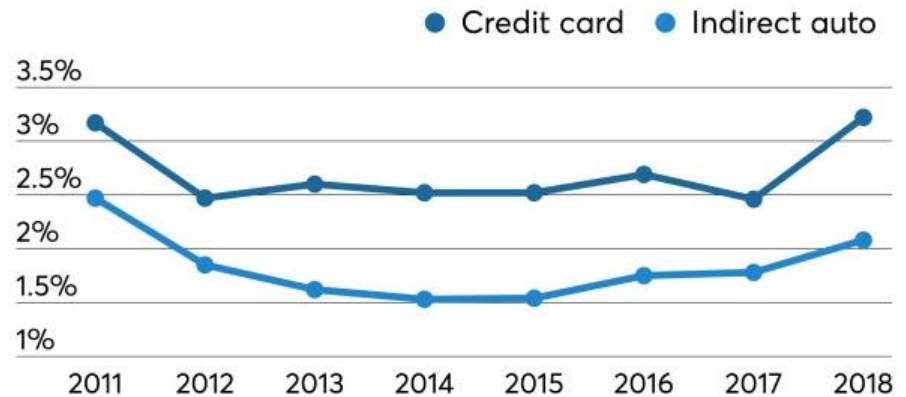
In the fourth quarter, 4.5% of car loans became at least 90 days past due. That was a 7-year high



--*American Banker* (2/12/2019)

Credit card, auto loan delinquencies hit seven-year high

Two consumer delinquency rates on the rise



Source: ABA (Data from 4Q of each year)

--*American Banker* (4/11/2019)

Sign of the times: Some *commercial* stress emerging

Quality of shared credits improves but leveraged-lending risks remain

--American Banker 1/25/2019

--American Banker 2/28/2019

Brace for West Coast CRE bubble inflated by tech boom: Bank chief

RBC's results show signs of weakening credit conditions

--American Banker 2/22/2019

--American Banker 4/1/2019

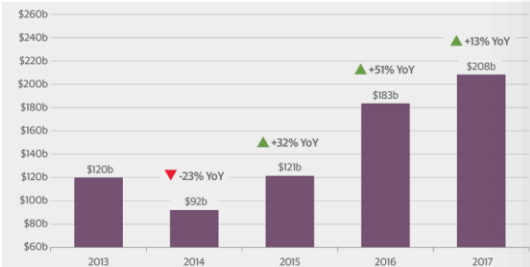
Preferred Bank to take 1Q hit on foreclosed Manhattan condos

Credit Challenges: Commercial

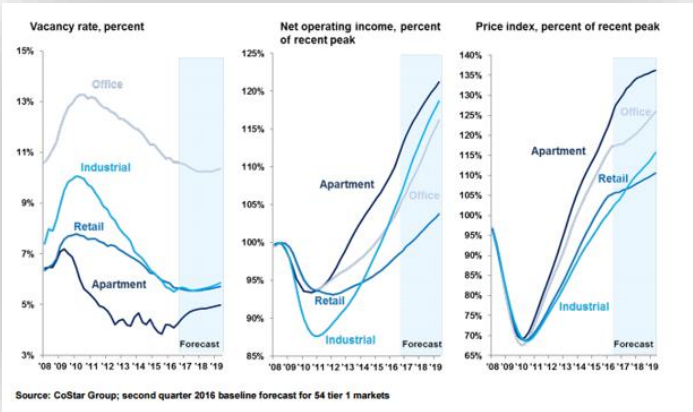
Various

- Energy
- Ag
- LFT's
- SNC-tied to retailers
- Some smaller C&I
- Medallion loans
- Non-profits

CRE

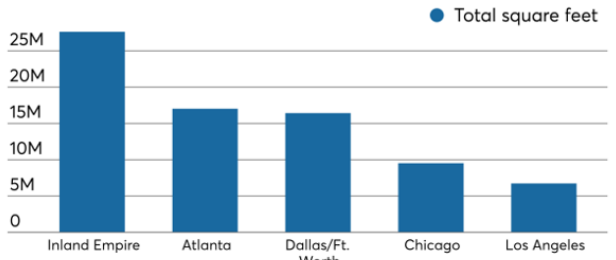


Huge proportion of Class C-type retail strip centers financed at community & regional banks—could be quite vulnerable to rising rates.



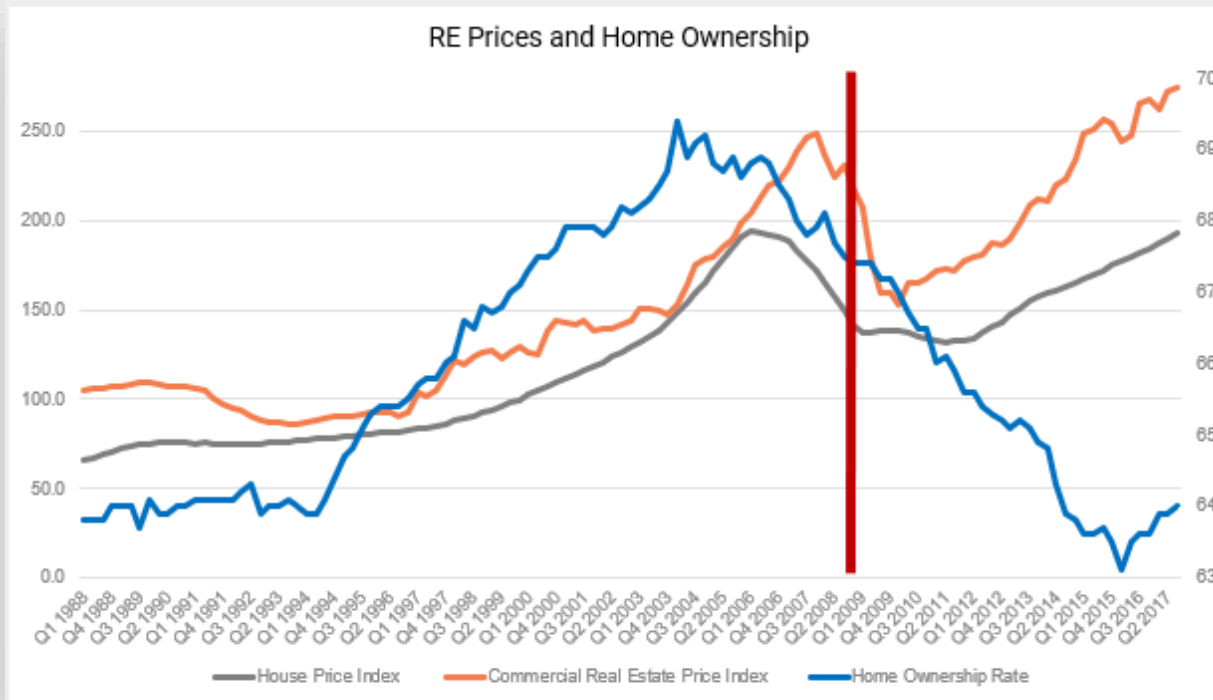
Hot spots

Nearly 80 million square feet of new warehouse and distribution space is under construction in these five metropolitan markets



Source: CBRE

Are CRE Values A “Back to the Future” Warning?



Source: FRB

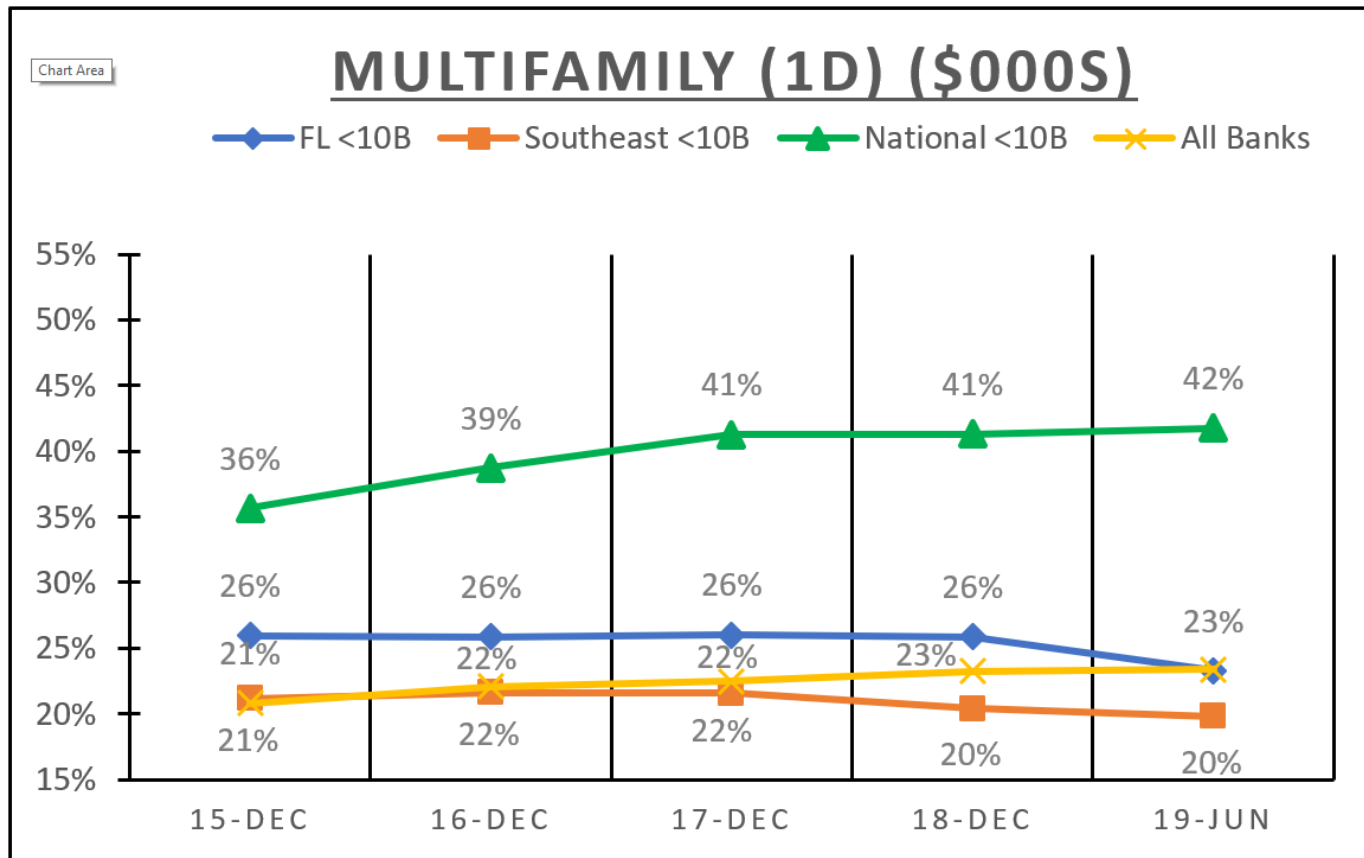
NATIONAL REAL ESTATE
Investor.

CRE Lenders Ended 2018 on a Strong Note

--February 13, 2019

Is Multifamily a Bubble?

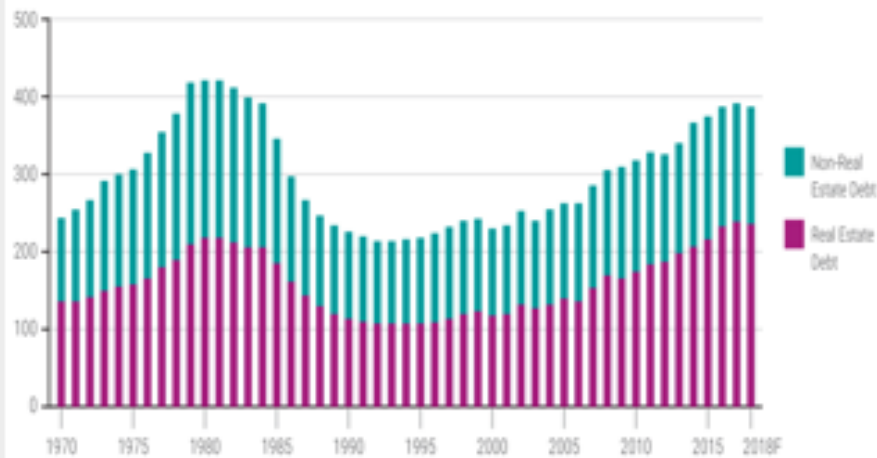
FL <\$10B / SE <\$10B / National <\$10B / All Banks



Farm Debt ↑ / Farm Income ↓

Interest rates & tariffs add to headwinds

Farm Debt – BIL (Inflation Adjusted)



Net Cash Farm Income - BIL(Inflation Adjusted)



Source: Washington Post / USDA

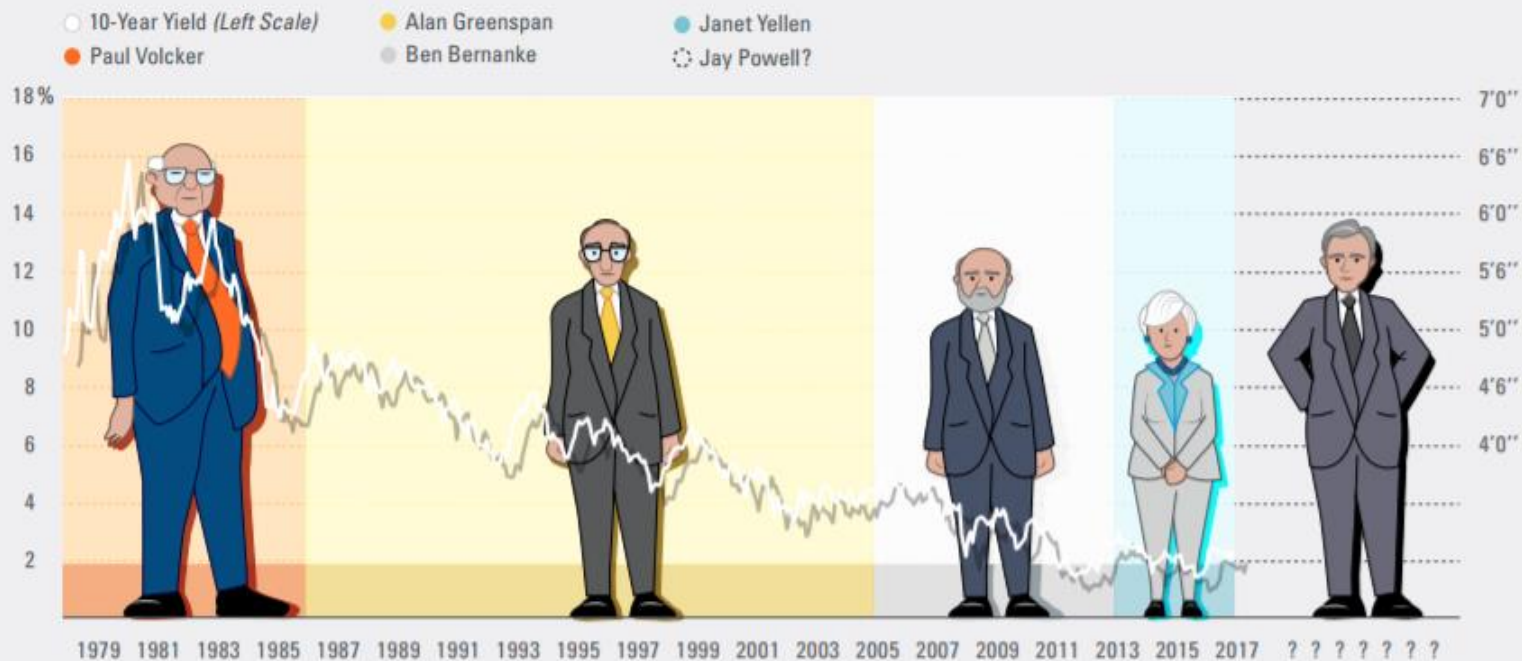
Interest Rates:

Dusting off old play books for both sides of the balance sheet

JAY POWELL HAS RE-SET THE HEIGHT TRAJECTORY

2

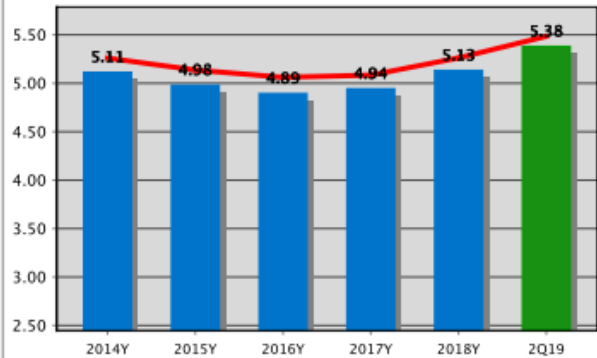
BOTH THE HEIGHT OF THE FED CHAIR AND RATES HAVE FALLEN OVER TIME, COULD A TALLER FED CHAIR MEAN RATES RISE?



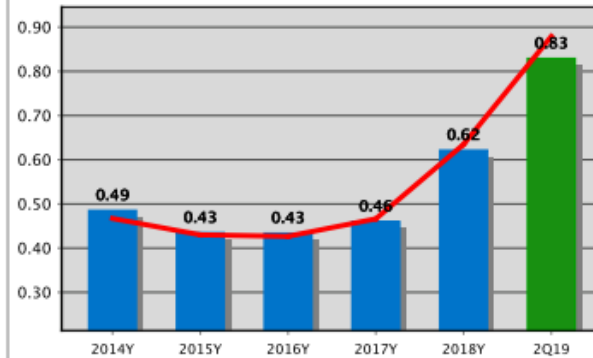
Source: LPL Research, Bloomberg 10/22/17

FL Banks Loan Yields / COF / NIM's: *Mixed With National Peers*

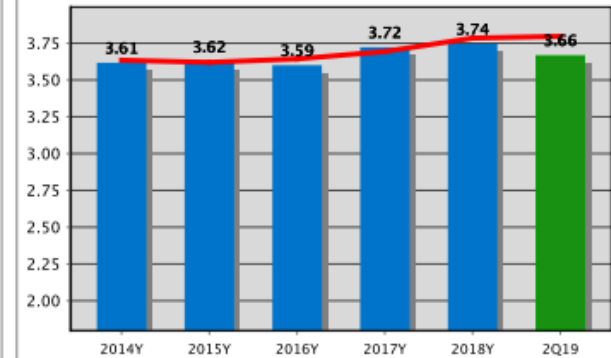
Yield On Loans (%)



Cost of Funds (%)

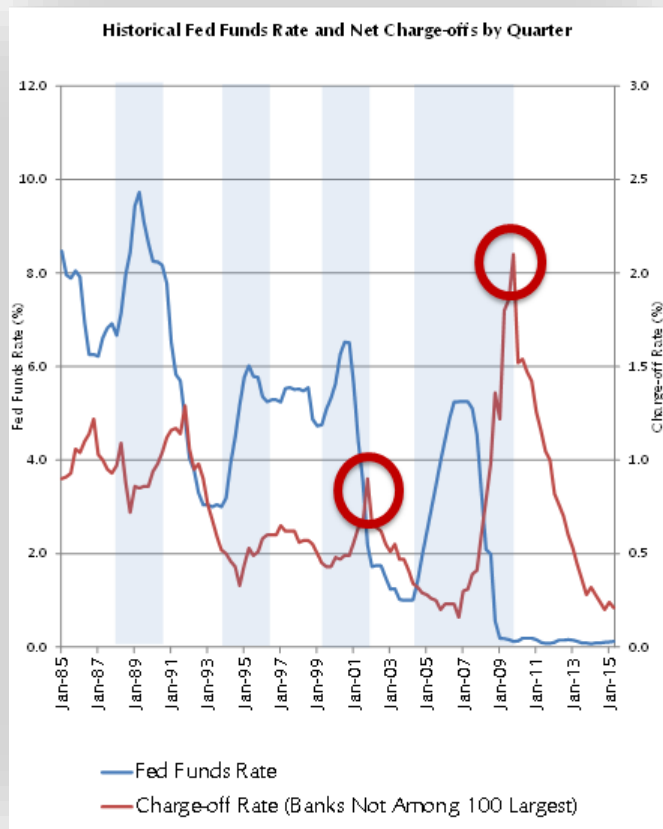


Net Interest Margin (%)



— National Trend

Impact of ↑ / ↓ interest rates



Source—FDIC; Federal Reserve

BUT...

**Regulators Predict
Hundreds of Bank
Failures with Zero-
Negative Interest Rates!**

-- Regulator Panel at Wisconsin Bankers
Management Forum 9/11/2019

**Higher Rates : Higher
Credit Stress**

Flattening of the Yield Curve: *What does it portend?*

U.S. Treasury Yield Curves

June 30, 2018 - June 30, 2019

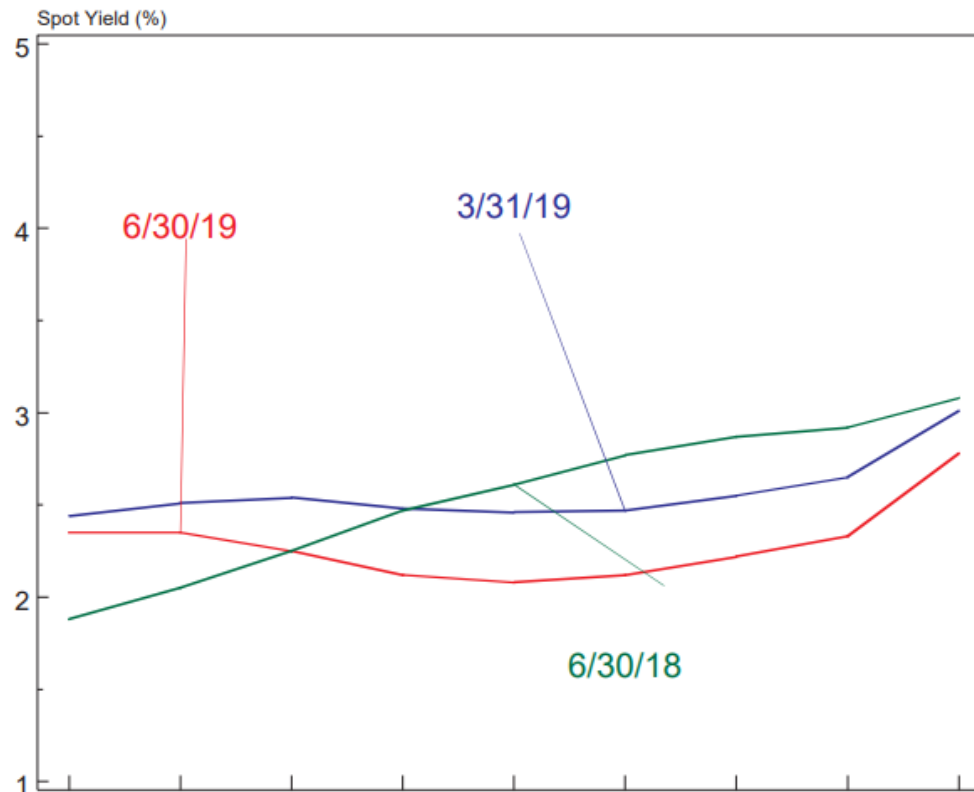
End-to-End Basis Point Differential

6/30/19: 0.43

12/31/18: 0.91

9/2018: 0.99

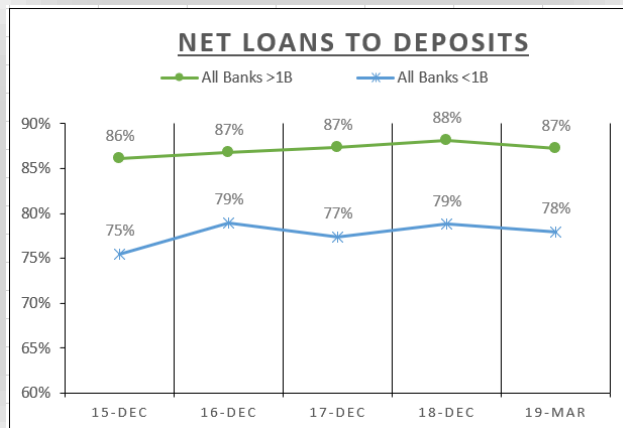
6/2017: 2.00



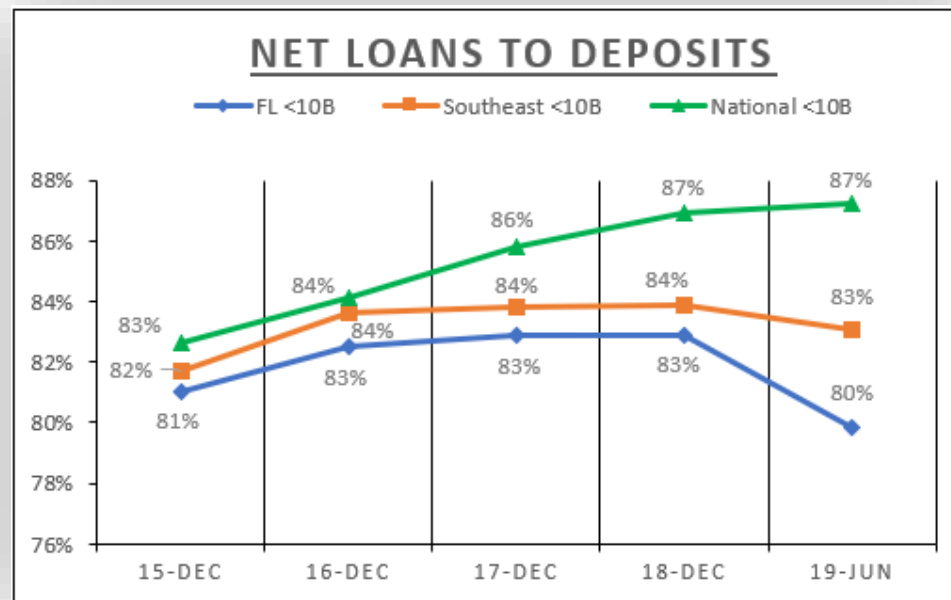
Source—FDIC

Impact of interest rates

All Banks >\$1B / <\$1B



FL <\$10B / SE <\$10B / National <\$10B



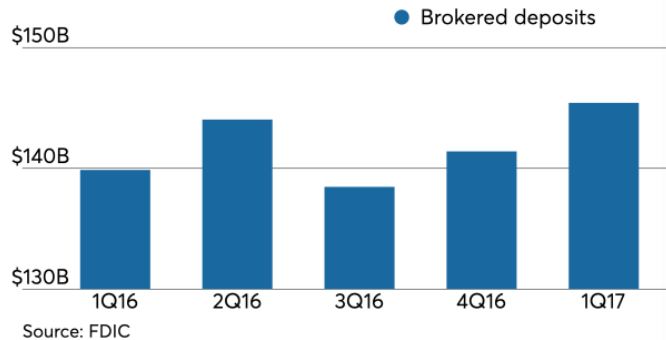
Loan funding: back in focus

Wholesale funding is back in regulators' sights

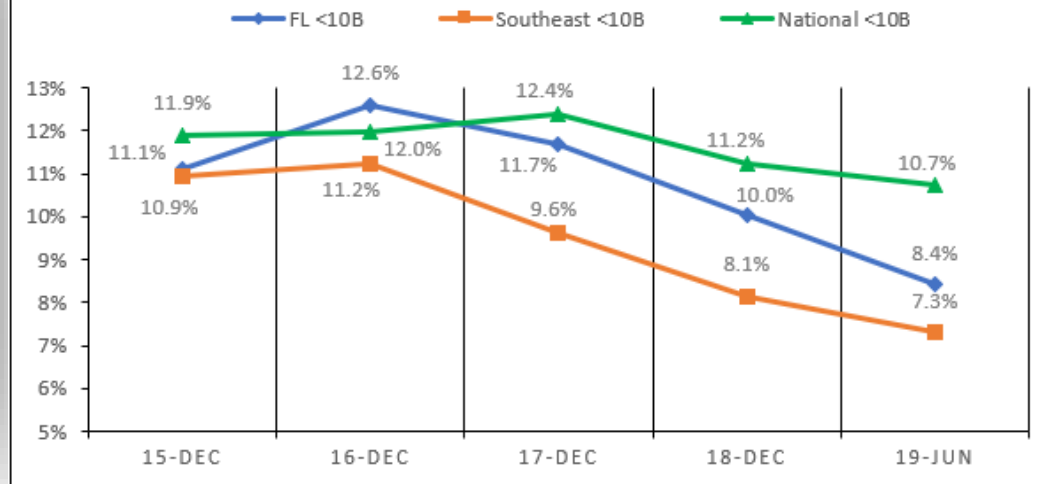
FL <\$10B / SE <\$10B / National <\$10B

Funding challenge

Banks with less than \$10 billion in assets are relying more on brokered deposits to support loan growth



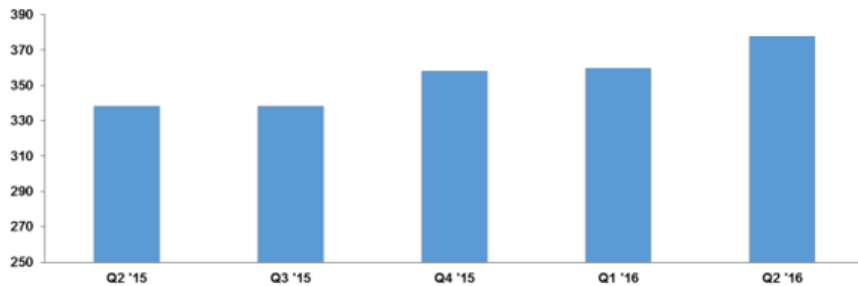
WHOLESALE FUNDING/DEPOSITS



Credit Concentrations: *Easy to Build—Hard to Avoid Cyclical De-valuations*

CRE Concentration Risk is Back—and Beware of *Correlation*!

Figure 9: Number of Banks With 25 Percent of Capital in CRE and Three-Year Growth Rate of 50 Percent or More



Source: Integrated Banking Information System (OCC)

Note: Data are quarterly from the second quarter of 2015 through the second quarter of 2016.

Source—OCC

Correlation—like speed—can kill.

- The biggest single factor in bank failures in the last financial crisis
- OK, but requires significant investment in *talent*, *infrastructure* and *redundancy*.

Concentration Analysis—more than it used to be

Credit concentrations (whether by loan product, collateral type, geography, or borrower) represent the single largest risk to Community Banks, and this risk spans the CAMELS spectrum. We can help automate your concentration analysis while preserving interactive granularity to constituent borrowers / accounts. Critically, we can also help you build a mature concentration analysis that looks beyond concentrations to capital; if you also incorporate growth and asset quality inputs for each pool, your concentration analysis can become a living-and-breathing and vital component to your ERM and ALLL activities.

(\$ in 000's)

FFIEC	Category	Exposure	Growth			Asset Quality					Risk-Based Capital				
			Growth % (Y-to-Y)	2015 Mgmt Target	Yearly Growth Var. (%)	% Delinquent	Criticized / Classified %	Exception Rate	Formula Reserve	Stressed Loss Rate	% of RBC	Board Limit (%)	Board Var. (\$)	Regulatory Limit (%)	Variance to Reg (\$)
1A1	1-4 Family Residential Construction	31,013	-4%	10%	14%	0.9%	4.2%	12%	0.15%	0.79%	28%	35%	7,824		
1A2	Commercial Construction	43,247	32%	10%	-22%	0.2%	1.3%	18%	0.24%	1.38%	39%				
1A2	Commercial Lots / Subdivision	8,421	-17%	10%	27%	0.4%	2.2%	6%	0.24%	1.10%	8%				
1A2	Residential Lots / Subdivision	16,214	5%	10%	5%	1.3%	9.4%	9%	0.24%	3.21%	15%				
1A2	Undeveloped Land	27,597	38%	10%	-28%	1.7%	6.9%	22%	0.24%	4.63%	25%				
1A2	Other C&D	95,479	23%	10%	-13%	0.8%	5.4%	14%	0.24%	2.61%	86%	80%	(6,709)		
1A	C&D	126,492	16%	10%	-6%	0.9%	5.7%	13%	0.22%	2.16%	114%	125%	12,211	100%	(15,530)

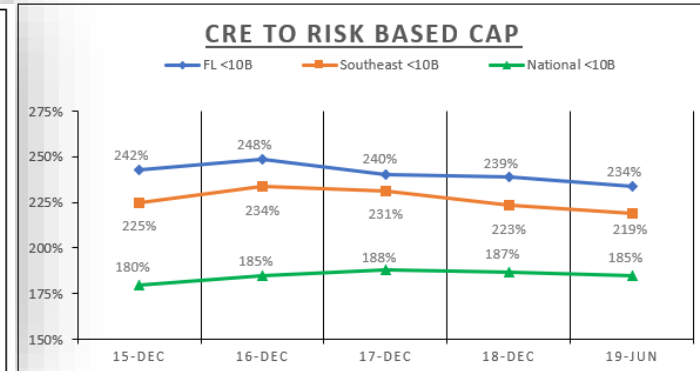
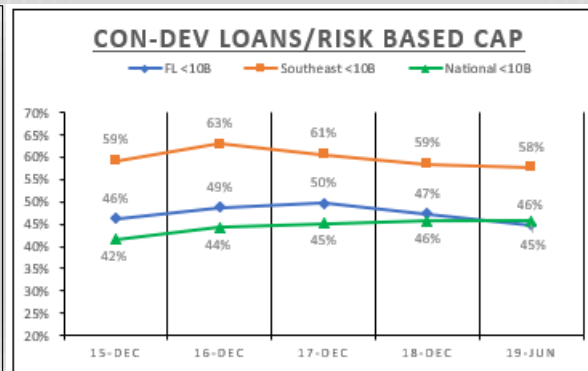
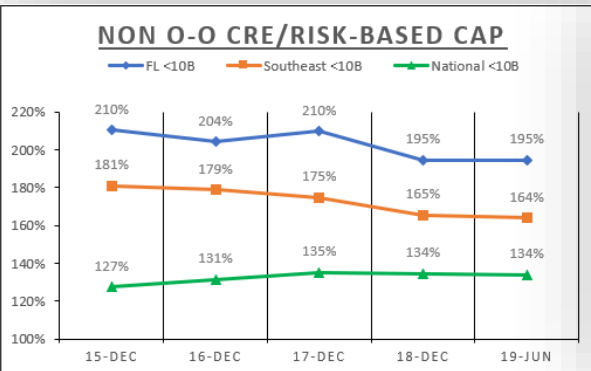
Acceptable:	< 10.0%	< 0.8%	< 3.0%	< 10%	< 2.0%	11,096	< 90.0%	< 90.0%
Watch:	-	-	-	-	-		-	-
Caution:	> 15.0%	1.0%	5.0%	15%	3%		100.0%	100.0%

CRE Concentrations: Banks <\$10B

FL <\$10B / SE <\$10B / National <\$10B

Regulatory Guidance:
≤ 100% RBC

Regulatory Guidance:
≤ 300% RBC



↑ 100%:

FL: 6 SE: 32 National: 283

↑ 300%:

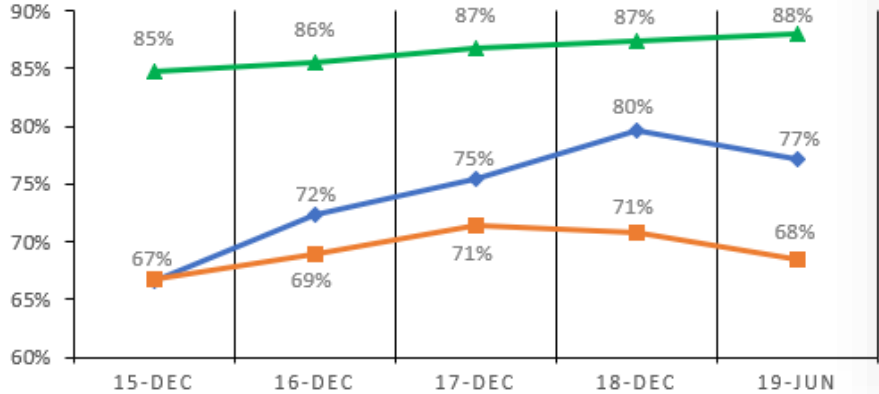
FL: 21 SE: 32 National: 375

Other Concentrations:

FL <\$10B / SE <\$10B / National <\$10B

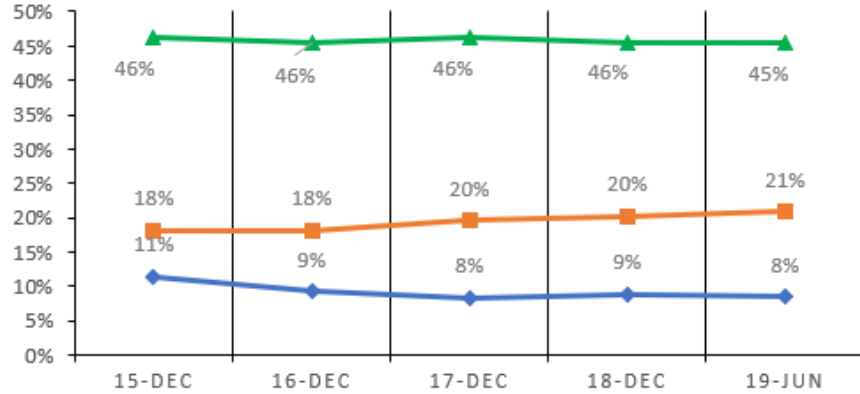
C&I TO RISK BASED CAP

FL <10B Southeast <10B National <10B



AG+FARM LOANS TO TRBC

FL <10B Southeast <10B National <10B



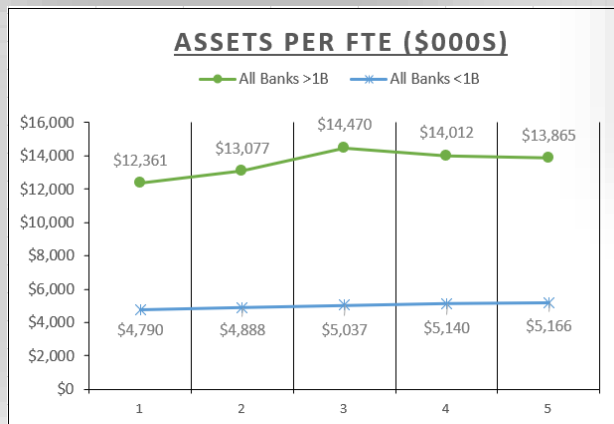
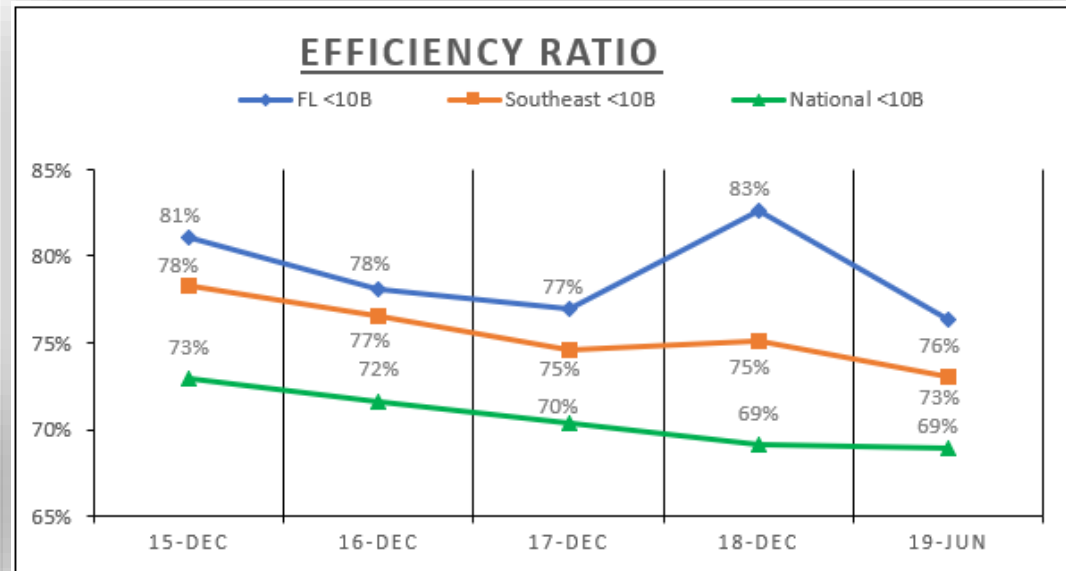
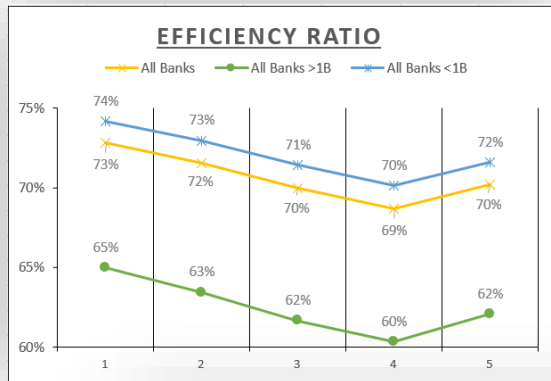
The Community Bank Conundrum:

*The Problem Loan Burden—
When, Not If, Credit is Stressed Again*

Biggest driver of M&A: Efficiency—or *lack thereof*

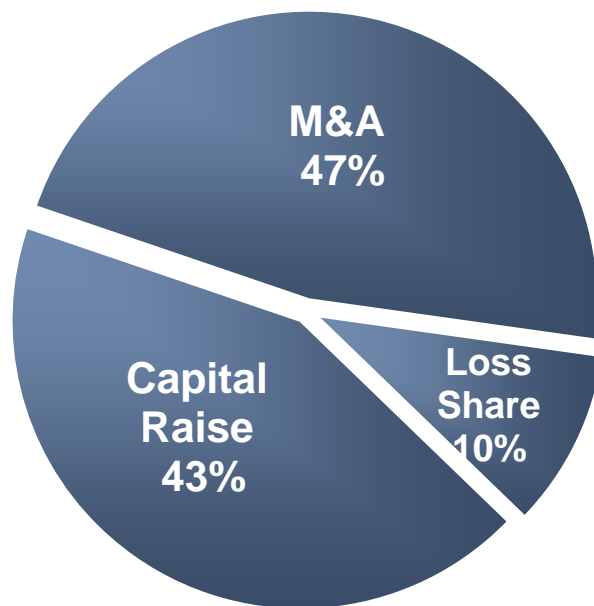
All Banks / >\$1B / <\$1B

FL <\$10B / SE <\$10B / National <\$10B



Loan Portfolio Due Diligence (*Loss Estimates*)

~260 Due Diligence Transactions
since '08



Data current as of Q2 2017



DHG + credit risk management

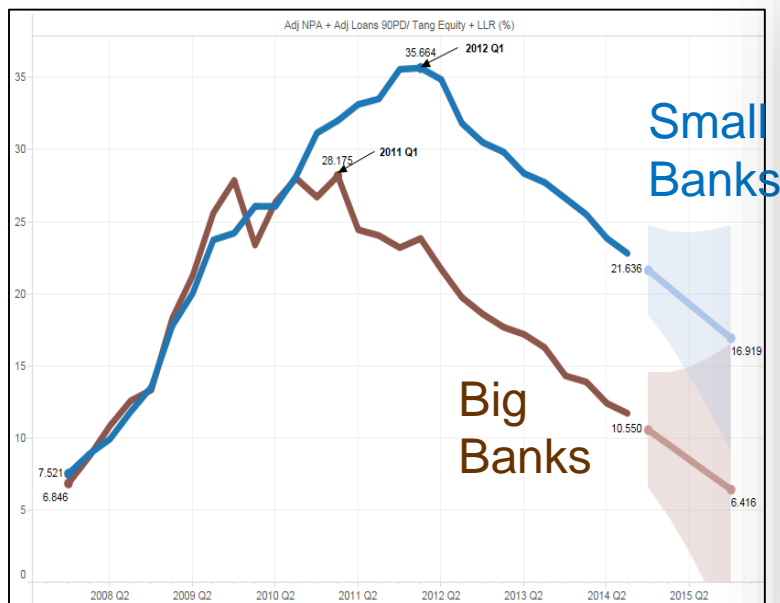
- Accurate and back-tested results
- Expertise in both sides: Credit Mark & Loan Review
- Efficient process – 2-Phases to support Go / No-Go Decision

Time Frame	Range of Credit Marks*
2008-2010	19-6%
2011-2013	7-4%
2014-2016	6-2%
Recent for CRMa / DHG-CRM	19-1.5%

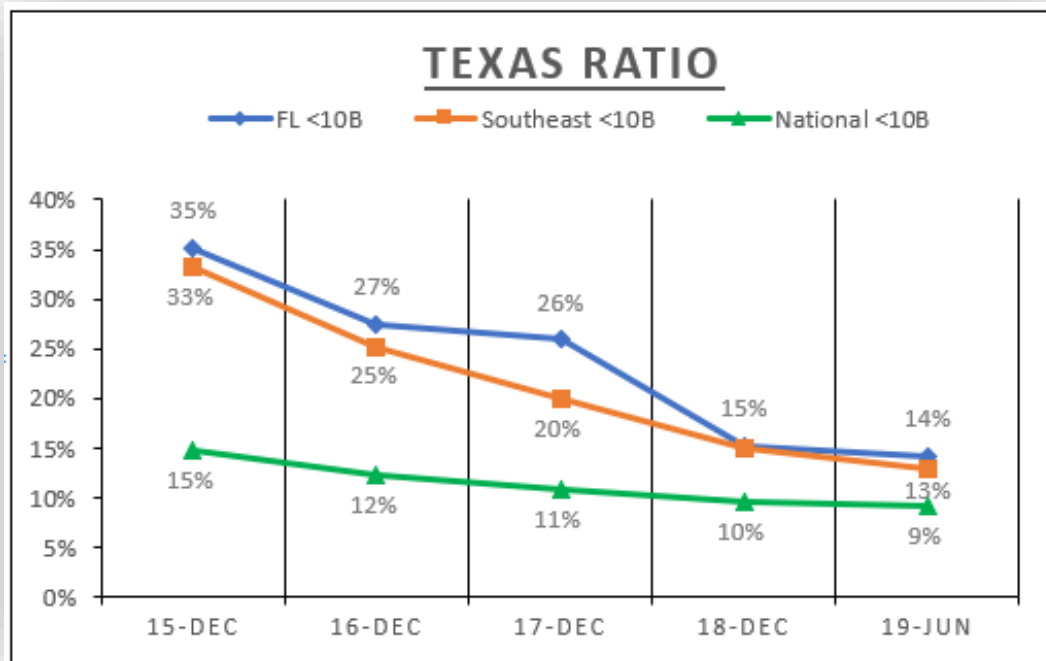
*Ranges only general estimates from CRM work and not necessarily representative of a national averages

NPA's structural challenge at smaller banks— when credit is stressed

NPA'S+90 PD / Tang Equity+ALLL (%)
AKA: "The Texas Ratio"



FL <\$10B / SE <\$10B / National <\$10B



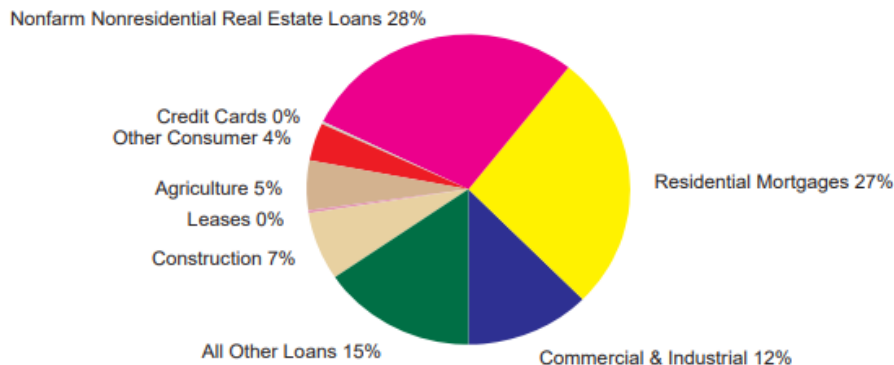
**Smaller Banks couldn't flush—
and made bet to keep more
capital—and more NPA's**

Loan Portfolio Composition by Asset Size

June 30, 2019

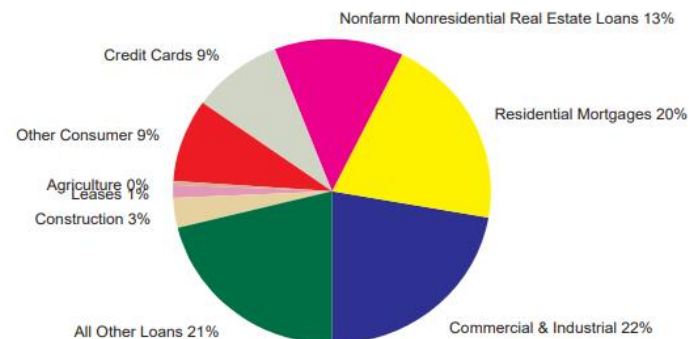
Small Institutions

Assets < \$1 Billion



Larger Institutions

Assets > \$1 Billion

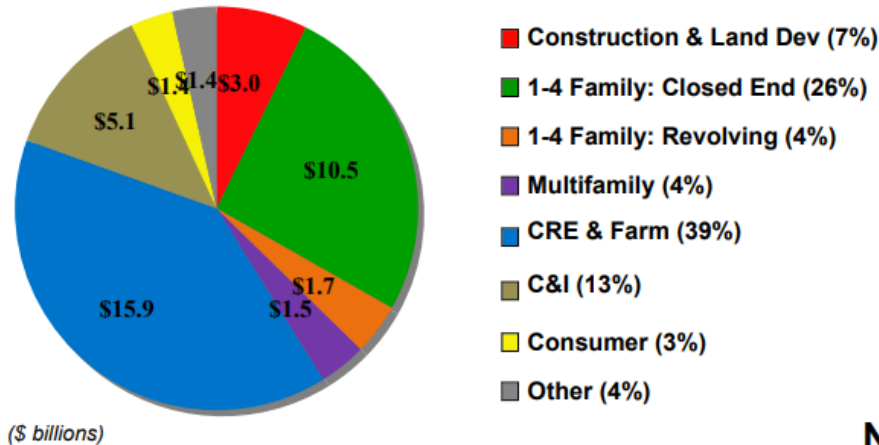


62% Loans Tied To Real Estate
(Exclusive of Agriculture) **36%**

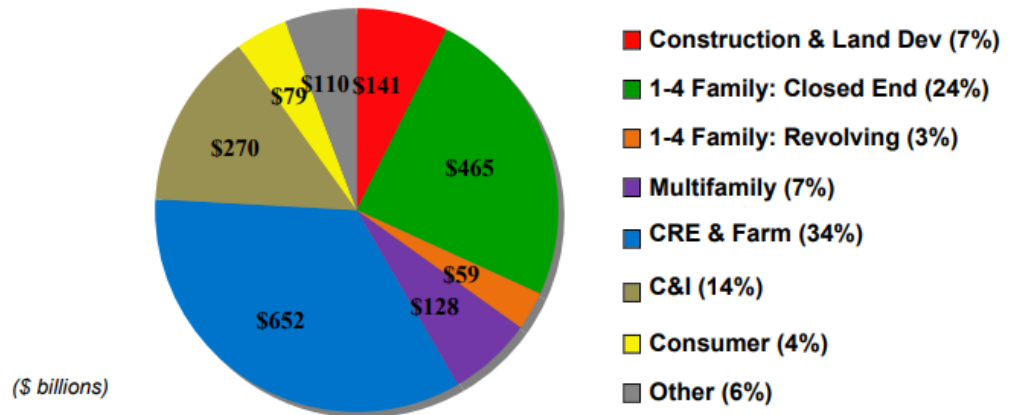
Source—FDIC

FL: > National Peers in RE Exposure YE'18

FL State Aggregate Loan Mix

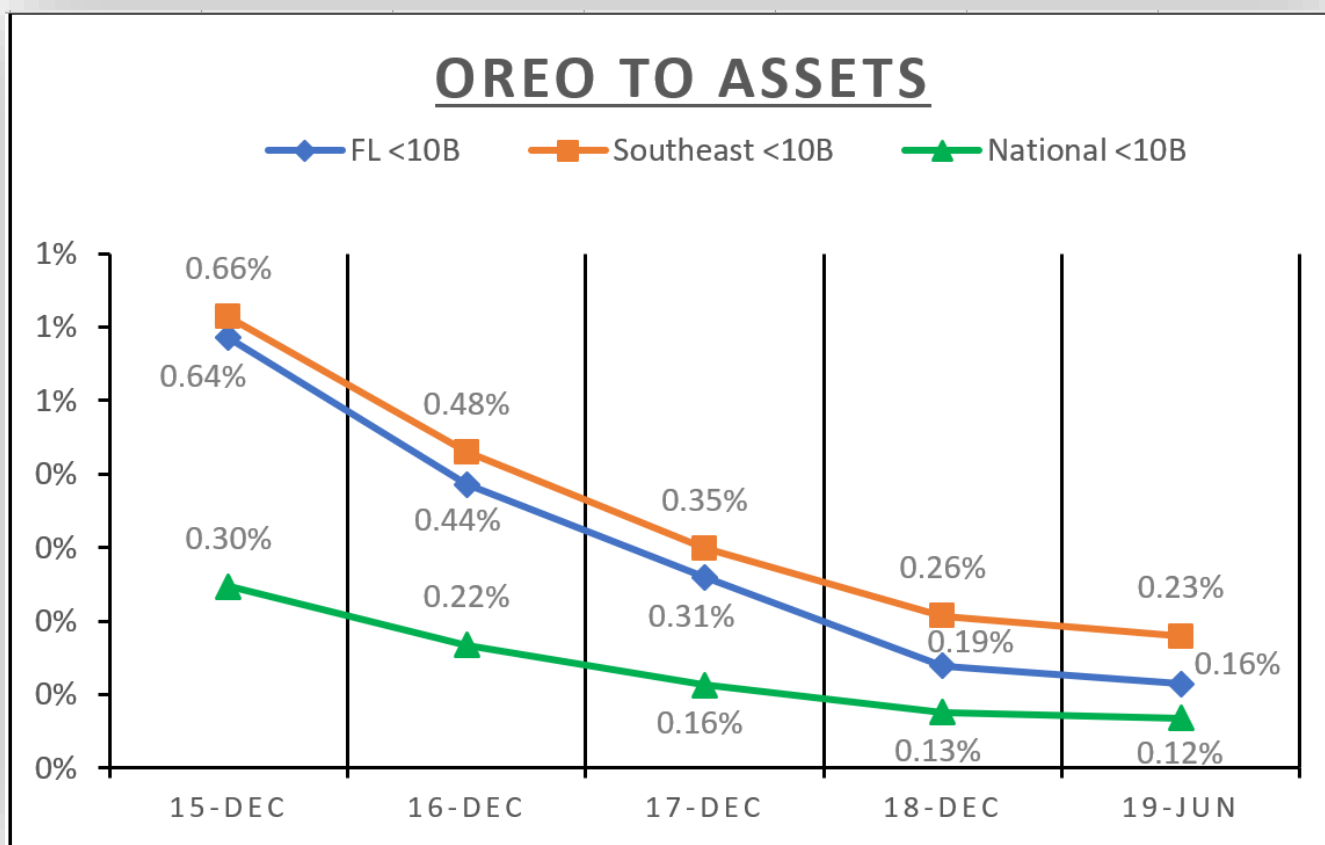


National Aggregate Loan Mix



The illiquid nature of real estate

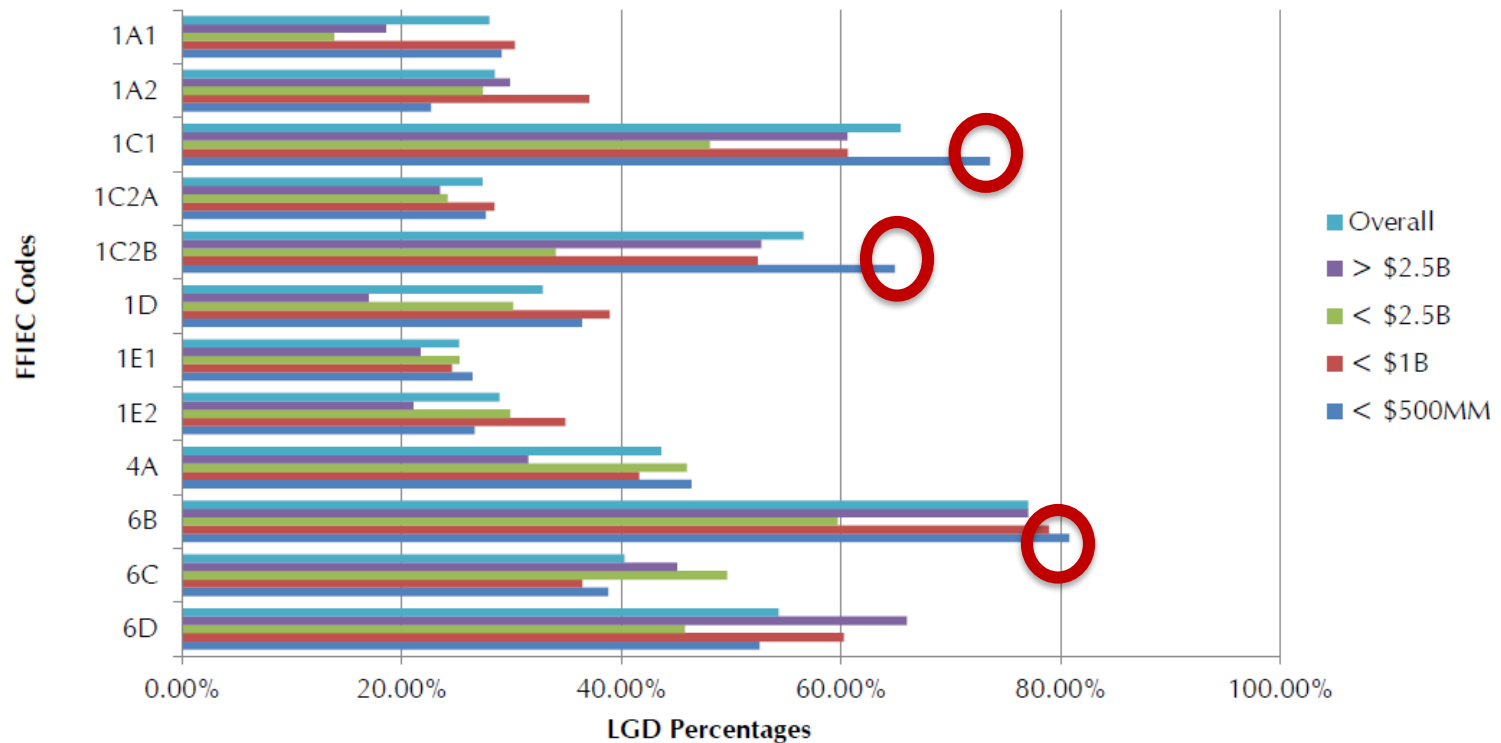
FL <\$10B / SE <\$10B / National <\$10B



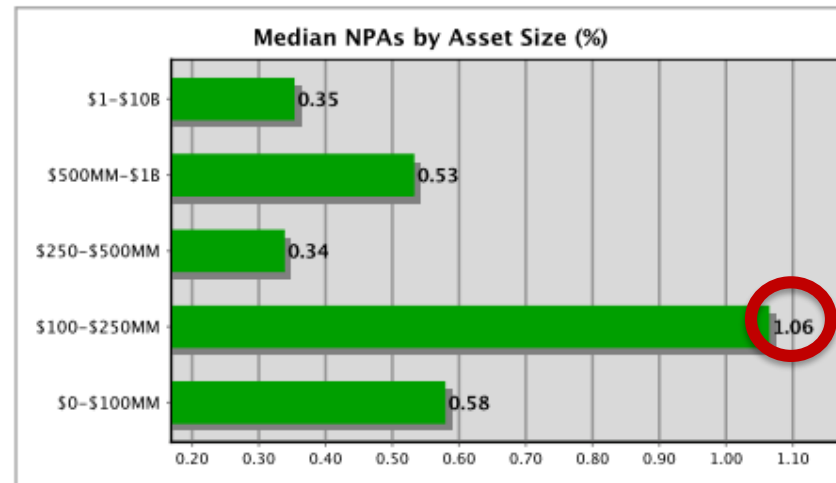
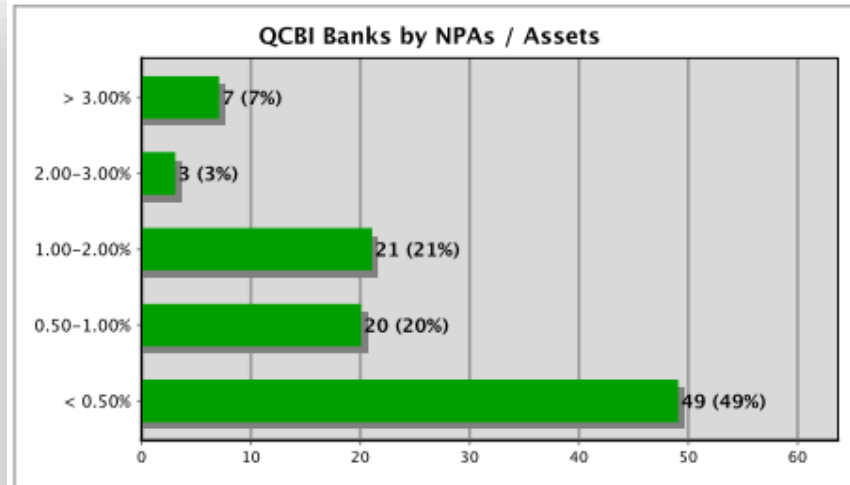
Smaller the bank: greater the *Loss Given Default*

From Blind Pool Data

CRMA[®] Index 4Q15 Average LGD by Portfolio Size



FL Banks (\leq \$10B) 'Q2 '19 NPA's:



Effective Credit Risk Management— *and Board Oversight*

A Radical Directional Change in Risk Management

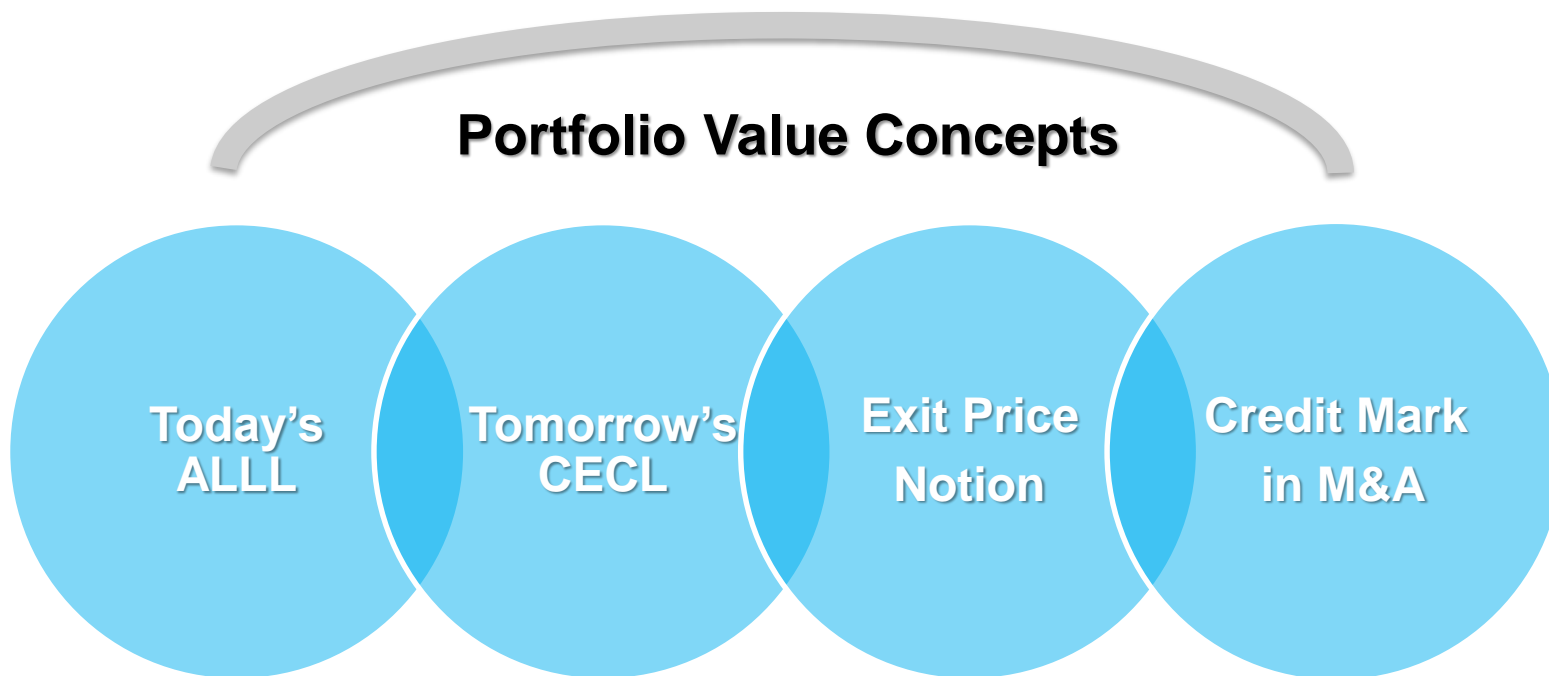
Post financial crisis risk management at financial institutions must be **future focused and probative**—not a mere chronicling of the past.



Using your bank's data, you can compute:

- *PD's*
- *LGD's*
- *EL's*
- *Risk Grade Migrations*

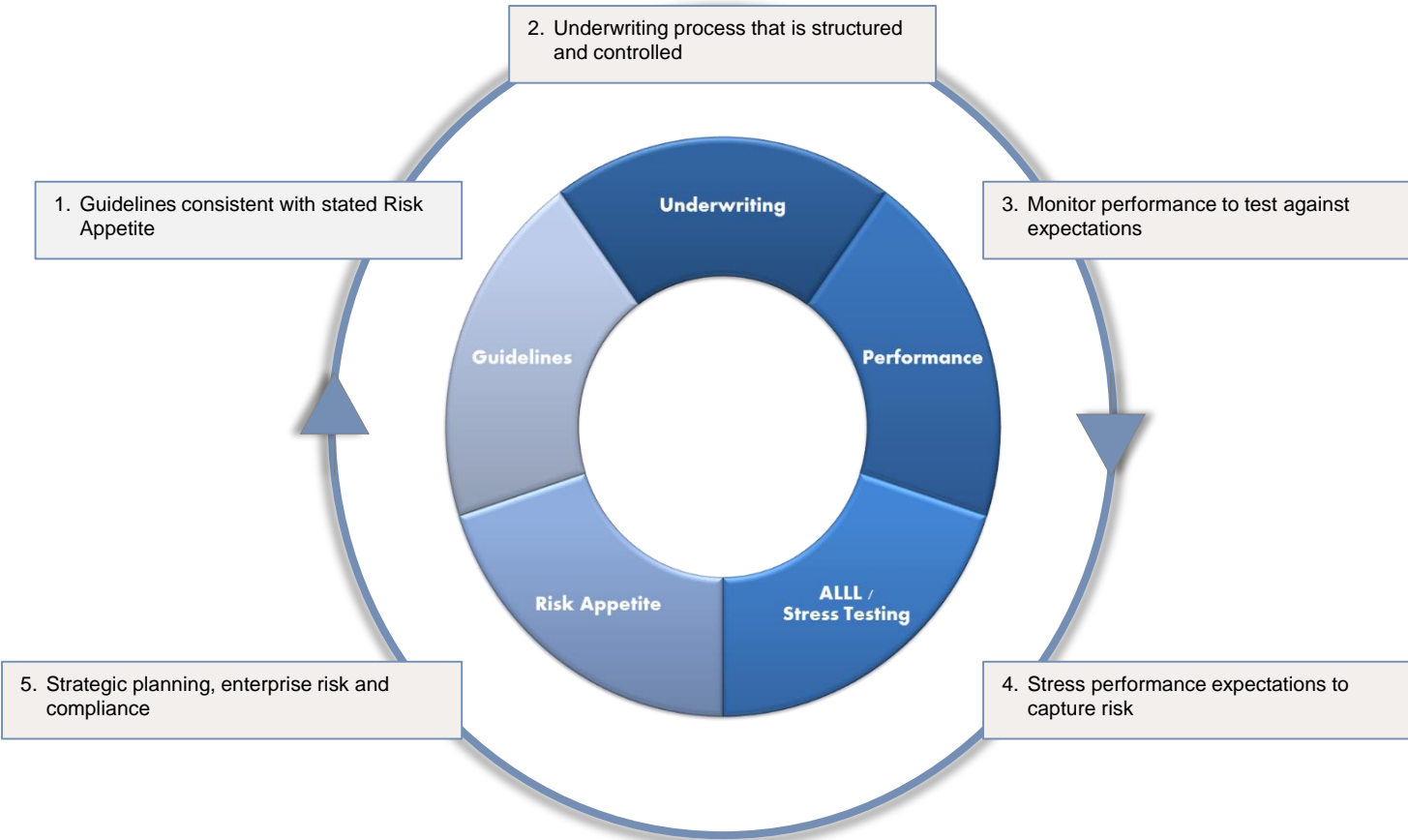
Blending Quantitative Measures to Reflect Credit Quality



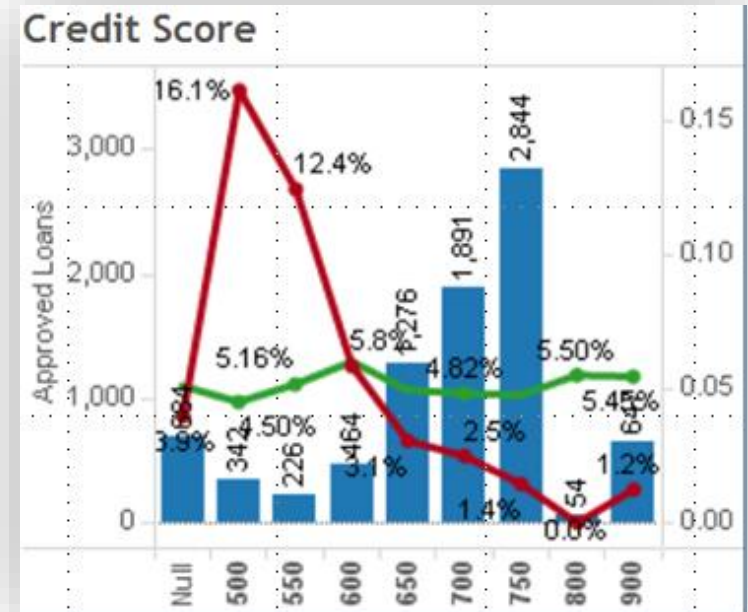
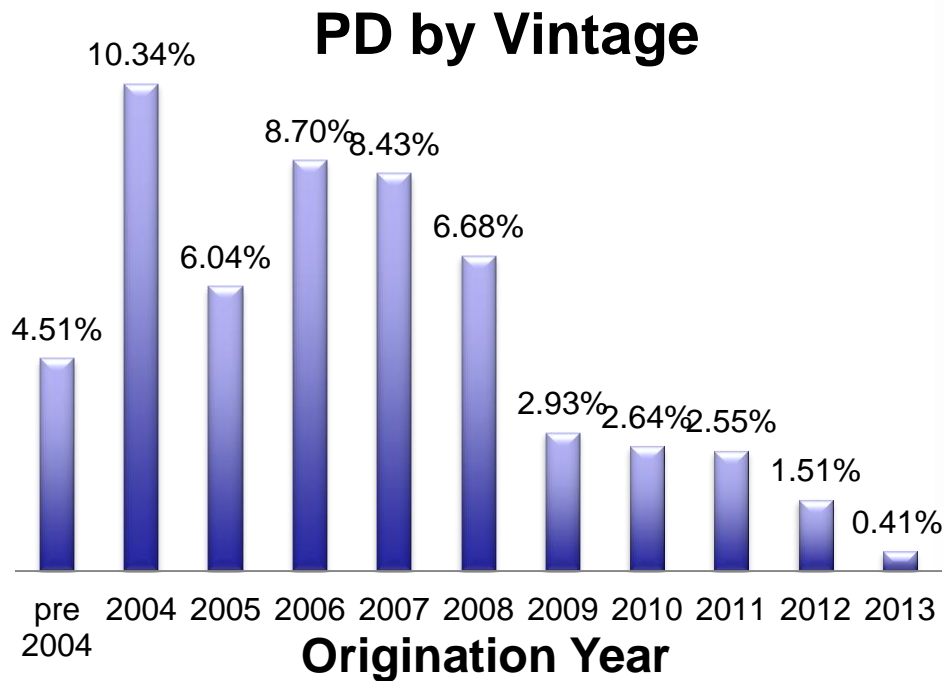
Graphic: **DHG**
DIXON HUGHES GOODMAN LLP

The Credit Lifecycle—5 Key Activities (Transactional ↔ Macro Risks)

The Credit Lifecycle—5 Key Activities

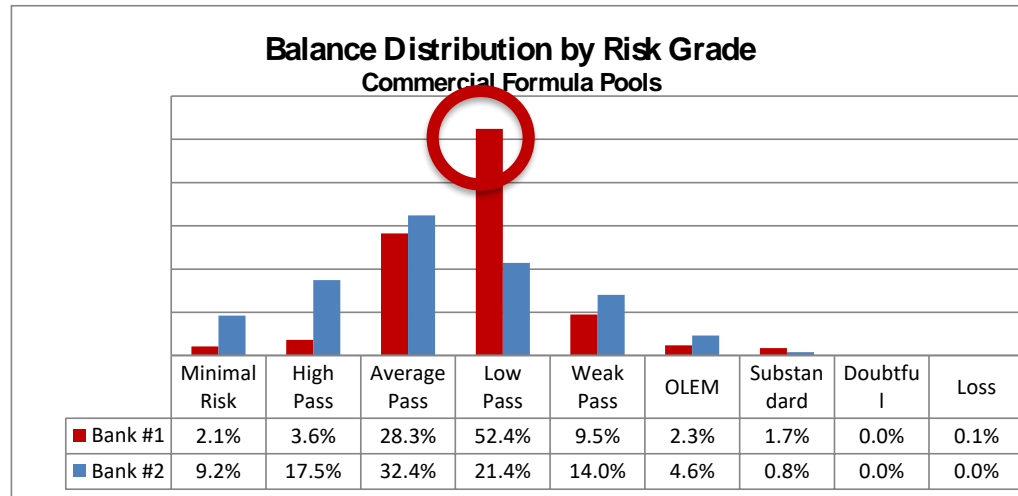


Understanding what macro data can tell us



Tying downgrades / exceptions to defaults

Risk Grade Distribution: *a key to effective credit management*



- Both Banks evidenced limited unimpaired, criticized / classified levels
- Both Banks showed the bulk of their loans in the Average and Low Pass grades
- Bank #2 exhibited higher balances of impaired loans
- Bank #2's grade distribution was a more normal distribution while the majority of Bank #1's loans were graded in the Low Pass Grade

What's the *Credit Cost* of loans you book?

A great way to enhance/inform pricing models

	1	2	3	4	5	6	7	8	9
FFIEC Code	Minimal	Modest	Average	Acceptable	Weak Pass	Special Mention	Substandard	Doubtful	Loss
1A1	0.02%	0.03%	0.09%	0.34%	1.47%	5.98%	10.22%	37.25%	39.69%
1A2	0.03%	0.03%	0.11%	0.39%	1.72%	7.03%	12.01%	43.77%	46.64%
1B	0.02%	0.02%	0.08%	0.29%	1.28%	5.24%	8.95%	32.60%	34.73%
1C1	0.03%	0.04%	0.12%	0.42%	1.84%	7.48%	12.78%	46.57%	49.62%
1C2A	0.02%	0.02%	0.07%	0.25%	1.10%	4.49%	7.67%	27.94%	29.77%
1C2B	0.05%	0.05%	0.17%	0.63%	2.75%	11.22%	19.17%	69.85%	74.42%
1D	0.02%	0.03%	0.09%	0.34%	1.47%	5.98%	10.22%	37.25%	39.69%
1E1	0.02%	0.02%	0.06%	0.21%	0.92%	3.74%	6.39%	23.28%	24.81%
1E2	0.02%	0.02%	0.08%	0.29%	1.28%	5.24%	8.95%	32.60%	34.73%
4A	0.04%	0.05%	0.15%	0.55%	2.39%	9.72%	16.61%	60.53%	64.50%
6B	0.05%	0.06%	0.18%	0.67%	2.94%	11.97%	20.45%	74.50%	79.38%
6D	0.03%	0.04%	0.12%	0.42%	1.84%	7.48%	12.78%	46.57%	49.62%
9A	0.02%	0.02%	0.06%	0.21%	0.92%	3.74%	6.39%	23.28%	24.81%
9B	0.03%	0.03%	0.10%	0.38%	1.65%	6.73%	11.50%	41.91%	44.65%

The Board's Role in Overseeing Credit Risk



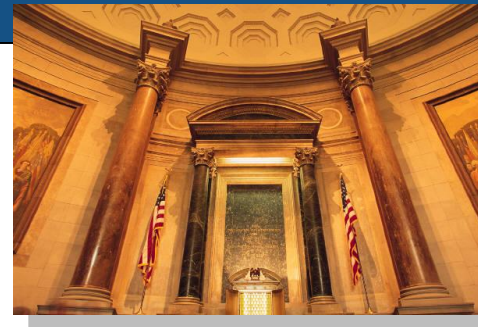
Key Concepts

- Directors approving loans
- Mileposts for macro portfolio risk management
- Managing concentrations In-house limits, purchased loan growth
- Niche lending
- How do you describe your credit culture?
- Signs of problems in managing the credit portfolio

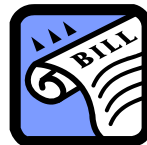
Source—BankDirector.com, May 2017

The Board's Primary Credit Focus: *Policies & Risk Appetite*

*Policies are like the
Constitution*



*Procedures/Guidelines are
like the General Statutes*



Directors must know the difference!

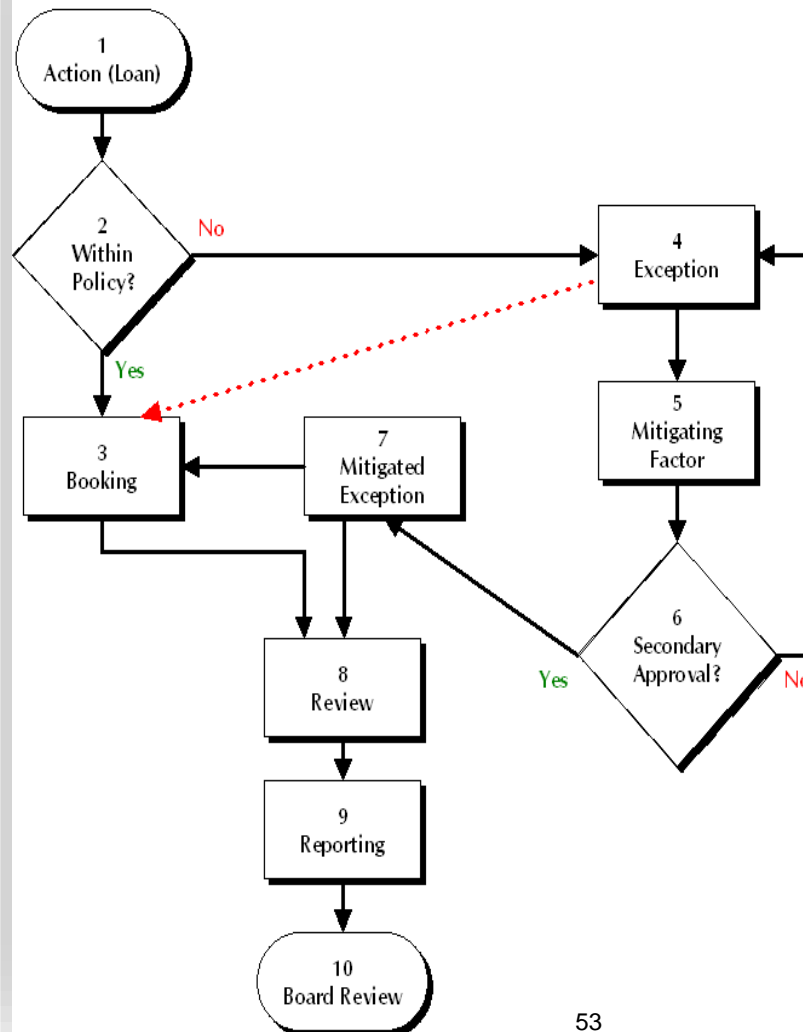
Six Keys to a Good Credit Culture

- 1. Credit Quality is a strong corporate value.**
- 2. Our Bank remains committed to serve the legitimate borrowing needs of our customers and community.**
- 3. A strong credit infrastructure exists.**
- 4. The lenders and lenders' support roles are well defined.**
- 5. Credit behavior is incented.**
- 6. All components of the credit culture are inter-related and complementary, one to another.**

Managing Exceptions

Policy & guideline exceptions *always* need documented mitigations

Policy / Exception / Mitigation / Review Flowchart



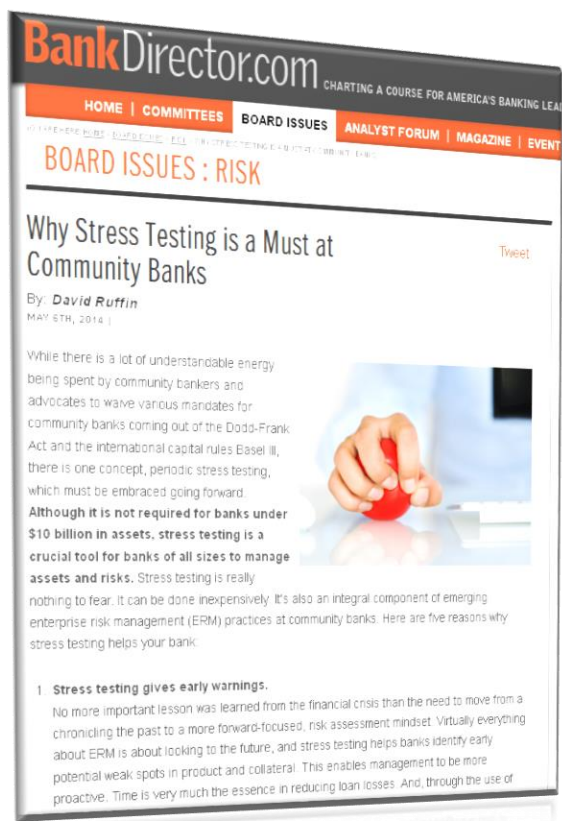
Key Risk Indicators (KRI's) / Early Warning Indicators (EWI's) / Key Performance Indicators (KPI's)

- Level of impaired loans and resulting impairment
- Level of TDRs
- Level of past due loans
- Level of Nonaccrual
- Level of Charge offs
- Credit risk grades (historical migration and credit review level of downgrades)
- Migration into and out of Low Pass Risk Grades
- Level of classified assets and watch list levels
- Level of foreclosed/repossessed assets
- Loan review findings
- ALLL required levels
- Stress test findings
- Credit culture / talent / training
- Policies & Procedures
- Risk weighted assets
- Level of portfolio exceptions (LTV, DTI, etc.)
- Concentration in high risk lending (Construction A&D, NOO CRE, etc.)
- Degree of Correlation in the loan portfolio
- Analysis of credit risk within various vintages
- Macro analysis of portfolio levels of PD's (probabilities of default), LGD's (loss given defaults), Risk Grade Migrations, and probabilistic statistical modeling of the portfolio
- Counterparty risk ratings (Vendors, Insurers, Derivatives, etc.)
- Vendor management issues
- Regulatory findings (Safety & Soundness / Compliance)
- **How many credit surprises?**

External / Economic Drivers of Risk

- Economy impacts credit risk through both default rates and often collateral and commodity liquidation values. Specific measurements can include geographic dispersion of unemployment. Home price indexes and housing inventory can also be used to measure real estate collateral weaknesses. Vacancy rates for CRE impact.
- Interest Rates impact credit risk through increasing default rates and reduction of collateral liquidation values. Monitoring through yield curve.
- Commodity prices affect certain borrowers on revenue side (mining, timber, energy, agricultural credits). Tracking would depend on concentrations specific to the Financial Institution.
- Commodity prices affect certain borrowers on expense side (energy, fuel, material, etc.) Tracking would depend on concentrations specific to the Financial Institution.
- Weather can affect certain borrowers (construction, agricultural) Tracking would depend on concentrations specific to the Financial Institution.
- Tax policy changes can impact all borrower's cashflow.
- Government and political impact (trade policies, tariffs, etc.)
- All the above as tied to and proportionate to the Bank's loan portfolio concentrations and correlations.

Why Stress Testing is a Must at Community Banks



Stress testing:

1. Gives early warnings.
2. Ties traditional *transactional* credit risk to modern *macro* portfolio management.
3. Provides in-depth concentration management.
4. Documents defense of strategic/capital initiatives.
5. Engenders confidence in management.

Source—BankDirector.com, May 4, 2014

Now Not the Time to Save \$'s on Loan Review

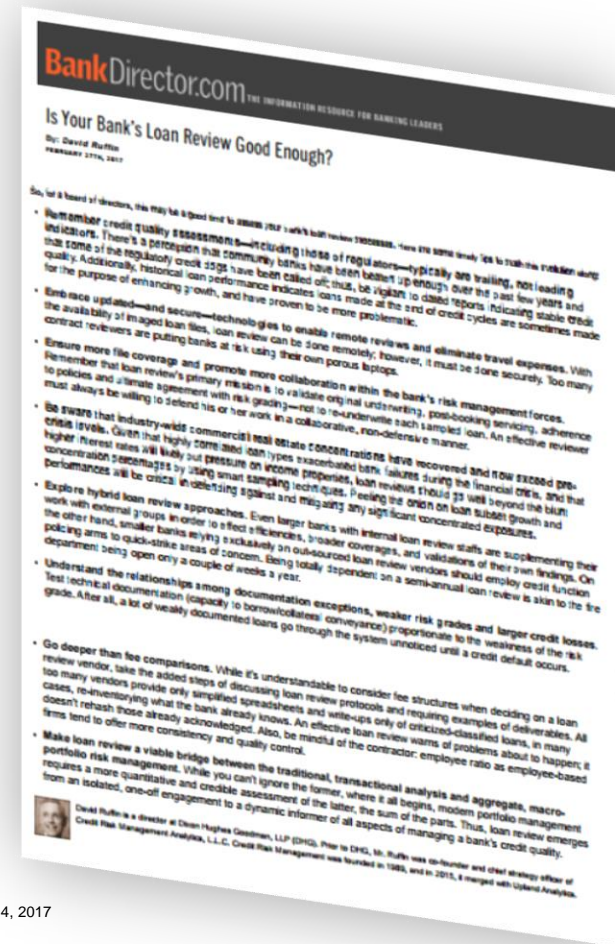
Recent headline from the *American Banker*:

Loosening Terms Make Loan Reviews Vital Again for Banks

Is Your Bank's Loan Review Good Enough?

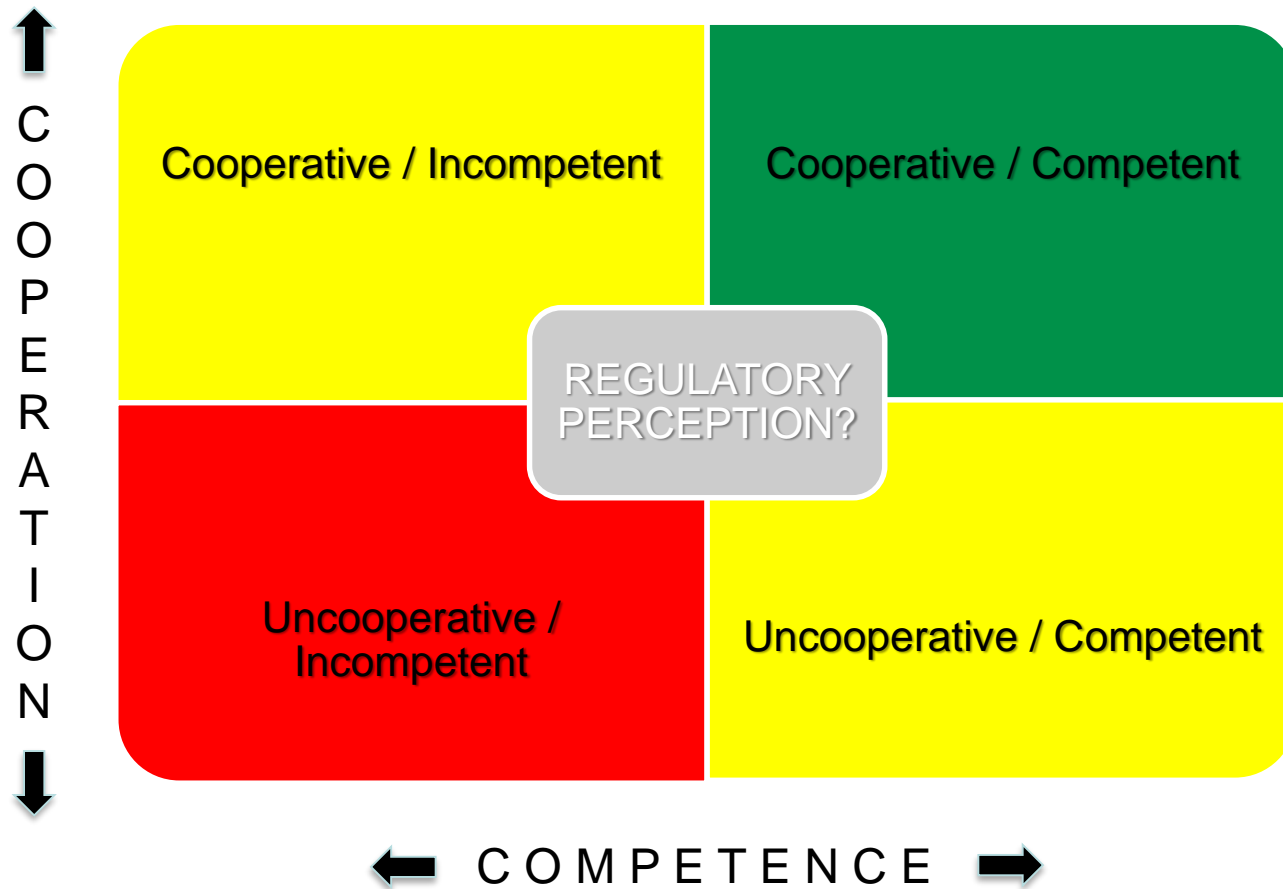
Key Concepts:

- Credit quality assessments
- Secure technology
- Purpose & collaboration
- Concentrations / lines of business
- Hybrid approaches



BankDirector.com | May 4, 2017

Regulatory Expectations



Takeaways:

- **Credit, while currently benign, *WILL* become stressed again.**
- **The smaller the bank, the greater the problem loan management burden.**
- **All aspects of the Credit Lifecycle should be embraced.**
- **A consistent credit culture is key.**
- ***Concentration management, risk grade integrity, and efficacy of loan review* are critical to today's (and tomorrow's) success.**
- **The challenge: *How to convert—and manage—embedded risk into acknowledged risk!***

Q & A

Key Contact



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