Embedding Lessons Learned

San Francisco Bankers’ Forum March 25, 2015

Teleconference Objective

After participating on today's call you will:

- Become reacquainted with the lessons learned from the recent financial crisis
- Learn that strong risk management practices and a strong capital base are fundamental to the long-term viability of banks and supports the communities they serve
- Understand changes in the supervisory framework and examiner focal areas

FDIC OIG Report to Congress

- The markets drove imprudent behaviors
- Banks expanded lending to keep pace with rapid growth in construction and real estate development, rising mortgage demand, and competition
- Management teams that maintained sound underwriting standards, as well as effective oversight and controls performed better
- Material Loss Reviews showed that supervisors could have provided earlier attention to troubled institutions

Comprehensive Study on the Impact of the Failure of Insured Depository Institutions (January 2013), EVAL-13-002

FDIC OIG Study Covering ADC

- **FDIC Office of Inspector General's (IG's) October 2012 Acquisition, Development and Construction (ADC) Loan Concentration Study found many banks with a concentration in real estate loans successfully managed the risk in their portfolio by:**
  - Implementing more conservative growth strategies.
  - Relying on core deposits and limited net non-core funding dependence.
  - Implementing prudent risk management practices and limiting speculative lending, loan participations, and out-of-area lending.
  - Maintaining stable capital levels and had access to additional capital if needed.
  - Being responsive to supervisory recommendations, actions, and guidance.

Office of Audits and Evaluations, Report No. EVAL-13-001

FDIC OIG Study Covering ADC

- **Many institutions that failed:**
  - Experienced rapid loan growth.
  - Did not recognize the growing risk exposure from their concentration in real estate loans.
  - Did not develop risk assessments that sufficiently considered economic conditions and likely performance under stress conditions.
  - Did not develop contingency planning that sufficiently reduced or mitigated concentration risk in the downturn.

GAO Report: Causes and Consequences

- **Small and medium-size banks with concentrations that weathered the crisis exhibited sound risk management practices:**
  - Well-informed and active Board
  - Strong management
  - Sound credit administration and underwriting practices
  - Non-reliance on high rate deposits
  - Maintained higher capital levels

Causes and Consequences of Recent Bank Failures (January 2013), GAO-13-71

GAO Report Causes and Consequences

- **Small and medium-sized banks that failed were largely associated with high concentrations of CRE loans, particularly ADC loans, and inadequate management of risks**
  - Institutions pursued aggressive growth strategies using riskier funding sources and weak underwriting and credit administration practices.
  - Excessive concentrations increased the bank’s exposure to the real estate market downturn.
  - Banks engaged in out-of-territory lending where they did not have experience.
  - Young banks departed sharply from their approved business plan by aggressively pursuing growth in higher risk ADC loans.

Community Bank Study

- Diversified community banks were generally the strongest and steadiest performers

- Community banks that followed a traditional, conservative business plan of prudent growth, careful underwriting and stable funding were able to weather the crisis

FDIC Community Banking Study, 2012

- **Three primary factors contributed to bank failures:**
  - Rapid loan growth,
  - Excessive concentrations in commercial real estate loans (especially acquisition and development loans),
  - Funding through reliance on highly volatile funding sources.
- Many banks shifted to ADC and other CRE loans in search of growth, and while the strategy initially provided a small performance advantage, it proved highly problematic in the crisis

Enhancements to Supervisory Framework

- **Strengthening Pre-Examination Process**
- **Improving Communication**
  - Clarify Applicability
  - Providing Outreach and Technical Assistance
  - Enhancing Dialogue on Risks

Supervisory Focal Areas

- Corporate Governance
- Standards for Safety and Soundness
- Concentrations Risk Management
- Interest Rate Risk Management
- Cyber Threats
- Basel III Capital

Corporate Governance

Ensure effective corporate governance practices

- Sound oversight and risk management
- Effective strategic planning
- Clearly articulated risk tolerance and limits
- Strong policies and procedures
- Effective monitoring and audits

Corporate Governance

Conform with the Standards for Safety and Soundness

(Appendix A to Part 364)

- Internal Control and Information Systems
- Internal Audit System
- Loan Documentation and Credit Underwriting
- Interest Rate Exposure
- Asset Growth and Asset Quality
- Earnings
- Compensation, Fees, and Benefits

Concentrations Risk Management

Effectively manage concentrations

- Identify specific asset and funding concentrations
- Assess economic vulnerabilities
- Ensure effective risk management practices
- Establish contingency plans when concentrations are large

Interest Rate Risk (IRR) Management

Refine and strengthen policies and systems for managing IRR

- Effective Governance
- Reasonable Assumptions
- Independent Testing

Cyber Threats

Assess the bank's current state of preparedness and identify opportunities to strengthen resiliency to operational risks

- Strongly encouraged to utilize available resources to identify and help mitigate potential cyber-related risks
- Operational Risks occur through internal and external events, and threats to information technology and related operations are increasing and evolving

Basel III Capital

Implement the Basel III capital requirements

- Common Equity Tier 1 Capital
- Capital Conservation Buffer
- Revised Prompt Corrective Action (PCA) thresholds and adds the new common equity Tier 1 capital ratio
- Changes risk weights for certain assets and off-balance sheet exposures

Resources

- Comprehensive Study on the Impact of the Failure of Insured Depository Institutions (January 2013), EVAL-13-002

http://www.fdicoig.gov/reports13/13-002EV.pdf

- Office of Audits and Evaluations, Report No. EVAL-13-001

http://www.fdicoig.gov/reports13/13-001EV.pdf

- Causes and Consequences of Recent Bank Failures (January 2013), GAO-13-71

http://www.gao.gov/products/GAO-13-71

Resources

- Material Loss Reviews provide insight into corporate governance weaknesses at failed institutions

http://www.fdicoig.gov/mlr.shtml

- Community Banking Study, 2012

https://www.fdic.gov/regulations/resources/cbi/study.html

- Resources for Bank Officers & Directors

https://www.fdic.gov/regulations/resources/

Resources

- Supervisory Insights – Winter 2014 *covering Managing Interest Rate Risk*

https://www.fdic.gov/regulations/examinations/supervisory/insights/

- Cybersecurity Resources

http://www.ffiec.gov/cybersecurity.htm

- Basel III Resources

https://www.fdic.gov/regulations/capital/

Next Bankers' Forum

- **Division of Depositor and Consumer Protection Bankers' Forum**
  - May 21, 2015: 1:30pm Pacific
  - Emerging Consumer Protection and Community Reinvestment Act (CRA) Topics

Questions