Risk Management "Hot Topics"

"Hot Topics" in Risk Management:

- Fraud
- Appraisals
- Concentrations
- Funding Sources

Feel free to ask questions throughout today's presentation!

Fraud - Unfortunately, It's a Growing Industry

- Fraud was Prevalent in Many Recent Bank Failures and Near Failures
  - Check Kiting
  - Mortgage Fraud
  - Merchant Processing Fraud
  - Deposit Fraud
  - Loan Fraud
- While not always the direct cause, wrong doing by insiders was identified in 93% of the failures and 85% of the near failures.
- Some institutions had more than one individual perpetrating fraud, or multiple types of fraud were occurring simultaneously.

Bank Fraud Cases

Assets:

- Cash
- Due From Correspondent Banks
- Securities
- Loans
- Other Assets

Liabilities & Capital:

- Demand Deposits
- MMDA
- Savings Deposits
- Certificates of Deposits
- Other Borrowings
- Capital

Fraud Prevention – Internal Measures

►**Perform a risk assessment** - Determine your bank's most vulnerable areas, by taking a bottom-up approach to looking at its processes and determining where weaknesses or vulnerabilities lie.

►**Then, return to "the basics"**:

- **Institute dual control throughout** – keep in mind that one fraudulent customer can put you completely out of business
- **Don't place too much trust in any one individual** – provide oversight; checks and balances help honest people stay honest
- **Give the "perception of detection"** – give employees the impression their activities are being monitored, e.g. cameras, computer monitoring systems, etc.

Fraud Prevention - Internal Measures (Continued)

- **Don't over rely upon technical security** - we oftentimes assume computer systems interface, but unless someone tests the system, there is no way of knowing whether they're operating the way they should be
- **Comply with the vacation policy, and don't grant exceptions** – people need to be absent from the process for a period of time
- **Establish a Board risk committee**, and have committee members or other insiders not involved in a certain process spot check practices and determine whether policies are being followed
- **Check pre-employment references** – by law, written employment references may contain suspicions of involvement in illegal activity (Section 18(w) of the FDI Act which was enacted pursuant to the USA Patriot Act)
- **Monitor employees' bank accounts; look for unusual activity**. Ask questions if something does not appear appropriate or typical.

Fraud Prevention - Internal Measures (Continued)

The system you internally use to minimize fraud risk need not be complex.

Keep in mind that a strong internal control environment (e.g., dual control and strict implementation of the bank's vacation policy) can also enhance cross-training and management succession planning.

Fraud Prevention – External Measures

- Engage annual external opinion audits
- Tailor audits to banks' high risk areas, as identified in a bank's risk assessment
- When electing to instead perform a directors' exam (unless otherwise required by regulation), consider performing an external audit every second or third year.
- Perform periodic loan reviews which are tailored to your bank circumstances, e.g. focus on loans just under a bank officers lending authority, focus on new loan officers, etc.
- Periodically meet with local enforcement and/or your trade organization to distinguish fraud-related trends and the potential impact on your institution

Fraud – Reference Materials

- **FDIC Risk Management Manual of Examination Policies**

  Sections 4.2 – Internal Routines and Controls

  http://www.fdic.gov/regulations/safety/manual/section4-2_toc.html

  Section 10.1 – Suspicious Activity and Criminal Violations

  http://www.fdic.gov/regulations/safety/manual/section10-1_toc.html

- **FinCEN March 2011 Report on Commercial Real Estate Financing Fraud -** Discusses the tripling of CRE-financing related fraud over the past three years, as well as trends and patterns in suspicious activities, based upon SAR filings.http://www.fincen.gov/news_room/rp/files/Commercial%20Real%20Estate%20Financing%20Fraud%20FINAL%20508.pdf

- **FFIEC July 2009 White Paper on *The Detection and Deterrence of Mortgage Fraud Against Financial Institutions*.** The White Paper discusses various mortgage fraud schemes perpetrated against financial institutions and provides best practices for deterring such schemes. http://www.ffiec.gov/exam/whitepapers.htm

- ***SAR Activity Review* - Trends, Tips & Issues** - http://www.fincen.gov/news_room/rp/sar_tti.html

  Refer to periodic issues for fraud-related trends, and tips and tricks

FDIC Fraud-related Contacts:

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- Your Local Field Supervisor/Supervisory Examiners
- Your Local Certified Fraud Examiners

Appraisals/Evaluations

Bankers often wonder whether an updated appraisal, or an evaluation is <u>required</u> at loan renewal. Well, it depends…

The regulators primary concern: that you have the information you need to make a well-informed decision before renewing/extending a credit.

Collateral is a secondary source of repayment. If the primary repayment source becomes unreliable, then a reliable collateral value becomes all-the-more important.

<u>Note</u>: If the appraisal obtained prior to the original loan origination did not include an income approach, and the property is now income producing, then an updated, conforming appraisal should be obtained.

Validity of Appraisals/Evaluations

A new appraisal or evaluation is necessary if the originally reported market value has changed due to factors such as:

- Passage of time
- Volatility of the local market
- Natural disasters
- Limited or over supply of competing properties
- Improvements to the subject property or competing properties
- Deterioration in property condition
- Changes in underlying economic and market assumptions
- Environmental contamination

Evaluations, in Lieu of Appraisals, Are Required When:

- The real-estate related loan is ≤ $250M, <u>or</u>
- The commercial loan is ≤ $1MM, and the credit is not dependent upon the sale of real estate collateral, or rental income is not the primary source of repayment, <u>or</u>
- The loan is a renewal of an existing credit in which:

  a) no new monies have been extended, <u>or</u>

  b) there has not been an obvious and material change in the collateral's value affecting the bank's ability to collect the debt

Evaluations

An evaluation should contain sufficient information to detail the analysis, assumptions, and conclusions in support of the credit decision, including the following items:

- The location of the property
- A description of the property and its current and projected use
- An estimate of the property's market value in its actual physical condition, use and zoning designation as of the effective date of the evaluation (that is, the date that the analysis was completed), with any limiting conditions
- The method(s) the institution used to confirm the property's actual physical condition and the extent to which an inspection was performed
- The analysis that was performed and the supporting information that was used in valuing the property

Evaluations (Cont.)

- Any supplemental information that was considered, such as an analytical method or technological tool

- All source(s) of information used to value the property, such as:
  - External data sources (such as market sales databases and public tax and land records)
  - Property-specific data (such as previous sales data for the subject property, tax assessment data, and comparable sales information)
  - Evidence of a property inspection
  - Description of the neighborhood
  - Local market conditions

- Information on the preparer (name, contact information, and signature)

Loan Portfolio Risk Mitigation Strategies

If there's a problem or anticipated problem with the primary repayment source, bank management should consider obtaining an updated appraisal or evaluation.

Additional loan portfolio characteristics may also warrant updated appraisals or evaluations. These might include higher risk real estate-related financial transactions, such as the following:

- Loans which have loan-to-value ratios in excess of the supervisory loan-to-value limits
- Atypical properties
- Properties outside the institution's traditional lending market
- Transactions involving existing extensions of credit with significant risk to the institution
- Borrowers with high risk characteristics

What If Collateral is Deficient?

If you've done an evaluation and determined that the value of your collateral has declined, then a new appraisal may be necessary (refer to Part 323 of FDIC R&R)

Once the amount of any collateral deficiency has been determined, there are two additional considerations:

> ALLL – a specific allocation may by necessary

> Book Value of Loan - your accountant should be consulted if the net present value of the future cash flows is less than the book value. An adjustment to the BV of the loan may need to be made.

If interested in hearing more ~ attend the regulatory accounting presentation being held later today!

Appraisal/Evaluation Resources

- Financial Institution Letter - Interagency Appraisal and Evaluation Guidelines (FIL-82-2010)
- Part 323 of the FDIC Rules & Regulations

  http://www.fdic.gov/regulations/laws/rules/2000-4300.html
- FDIC Case Manager Contacts:

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- Your Local Field Examiner/Subject Matter Experts

Recurring Characteristics from Failed Institutions

- Aggressive growth strategy
- Insufficient capital
- Insufficient liquidity
- Excessive asset concentrations, most commonly commercial real estate (CRE) concentrations
- Heavy reliance on non-core funding

Today, we're going to focus on asset and liability concentrations and discuss risk mitigation strategies.

CRE Trends Within the Dallas Region

- While reduced, CRE concentrations continue to pose significant risk
- Remaining acquisition and development loans pose the greatest risk, due to an excess supply and the weak economic climate
- Land development and lot loans have proven the most toxic; they have contained the most loss and have been the hardest to dispose of
- Non-owner occupied, commercial office building lending continues to face problems, due to the poor economic climate and increasing vacancies in certain sub-markets

CRE Trends Within the Dallas Region

- The most severe problems are concentrated in particular geographic areas which had previously experienced the most rapid growth
- Reduced CRE lending has been partly a result of the migration to ORE, loan charge-offs, as well as payoffs
- Banks still face major challenges selling ORE, although some sales have been evident.
- Certain markets still have large inventories of homes for sale, which means workout will be more protracted than desired.

Concentration/Funding Trends State of Tennessee

	December 31, 2011	December 31, 2010	December 31, 2009
# of Institutions	188	191	194
C& I Loans to Total Risk-based Capital	61.26%	63.29%	68.01%
CRE Loans to Total Risk-based Capital	249.73%	267.40%	275.68%
Non-residential RE to Total Risk-based Capital	177.17%	186.12%	172.07%
Residential RE to Total Risk-based Capital	210.77%	221.88%	225.40%
Noncore Funding to Assets (median)	26.97%	27.85%	30.02%
Brokered Deposits to Assets (median)	3.66%	4.30%	6.70%

Concentration Risk Mitigation Strategies

- Establish reasonable concentration limits as a percent of Total Risk-based Capital
- Monitor and report concentration levels
- Maintain strong capital levels, commensurate with concentration risks, e.g. higher than Prompt Corrective Action minimums
- Establish a capital plan which considers concentration risks

Concentration Risk Mitigation Strategies (Cont.)

- Maintain a strong ALLL level, commensurate with any lending concentration risk.
- Diversify the loan portfolio – a concentration of loans to any one borrower can expose the bank's capital to undue risk
- Minimize reliance upon volatile funding sources - deposit funding concentrations can be particularly problematic when a bank encounters asset quality problems
- Attempt to match asset and deposit funding maturities, whenever possible

CRE Concentration Risk Mitigation Strategies

- Follow regulatory guidance when a CRE concentration exists and exceeds certain thresholds
- Establish sub-limits for various categories of CRE loans (e.g. speculative 1-4 family residential loans, multi-family, office buildings, retail buildings, hotels, industrial buildings, etc.)
- Establish an effective loan policy with well defined lending guidelines, e.g. LTV’s, appraisals, draw procedures, inspections, limits per builder (number of specs/pre-solds), etc.
- Ensure robust monitoring of underwriting guidelines through a strong loan review program
- Require Board reporting of policy exceptions

CRE Concentration Risk Mitigation Strategies (Cont.)

- Ensure loan officers are experienced, and provide training, as necessary
- Perform comprehensive cash-flow analysis of all loans; with global cash-flow analysis of the most complex and largest credits a must. Analysis of the borrower debt load at other institutions is critical to understanding credit risk.
- Review appraisals closely before acceptance; make sure the appraisal matches the proposed project.
- Require an in-depth market analysis for any RE development project; compare building permits to current absorption rates. Make sure conclusions are reasonable.

Reference Sources

Financial Institution Letters:

- Policy Statement on Prudent CRE Loan Workouts (FIL-60-2009)
- Managing CRE Concentrations in a Challenging Environment (FIL-22-2008)
- CRE Lending: Joint Guidance (FIL-104-2006)

Your Local Field Examiner/Subject Matter Experts

Funding Sources

- Recently, community banks have had difficulty acquiring traditional core funding sources.
- Consequently, more and more community banks have sought alternative funding sources, e.g. brokered CDs, internet deposits, and FHLB borrowings.
- The recent crisis has highlighted the need to have a strong contingency funding policy and plan, particularly since Part 325 of the FDIC R&R restricts banks from alternative funding and other activities when a bank's capital falls below Well Capitalized, for PCA purposes.
- Note that the existence of an outstanding regulatory action precludes a bank from being considered Well Capitalized

Funding Sources (Continued)

- Note that it’s not just internet and formally brokered deposits which can be considered volatile and prohibited
- Deposits acquired from the local market which exceed the national deposit rate by more than 75 basis points can be considered brokered deposits

Statement of Policy on Funding and Liquidity Risk Management

- FIL issued in May, 2010
- Supplements FIL-84-2008.
- Incorporates principles for sound liquidity risk management and supervision
- An interagency statement, it unifies the regulatory expectations for liquidity risk management practices

Sound practices of Liquidity Risk Management

- Ensure the Board and senior management understand the expectations
  - Ultimate responsibility rests with the Board
- Establish and communicate liquidity management strategy through policies, procedures, and risk limits
  - Including risk mitigation strategies
- Measure, monitor, and report on liquidity risks
  - Comprehensive and robust practices
- Stress test the plan

Sound Practices of Liquidity Risk Management (Cont.)

- Routinely calculate collateral position
  - The value of pledged assets to required collateral
- Establish strong management reporting
  - There should be sufficient detail to make informed management decisions
- Ensure enterprise-wide liquidity management
  - Across currencies, legal entities, and business lines
- Manage liquidity, intraday, if appropriate
  - Specifically for those banks actively involved in clearing activities

Sound Practices of Liquidity Risk Management (Cont.)

- Use diversified funding sources
  - Both sources and time horizons
- Maintain a cushion of liquid assets
  - Insurance against a range of liquidity stress scenarios
- Establish a contingency funding plan
  - Needed in some form at all institutions
- Internally test your plan and assumptions
- Maintain sound internal controls
  - To ensure appropriate implementation

Liquidity Funding Reference Sources

- Interagency Policy Statement on Funding and Liquidity Risk Management: http://www.fdic.gov/regulations/laws/rules/5000-5230.html
- FDIC Manual of Examination Policies –

  Chapter 2.1 on Capital http://www.fdic.gov/regulations/safety/manual/section2-1.html#capital

  Chapter 6.1 on Liquidity and Funds Management http://www.fdic.gov/regulations/safety/manual/section6-1_toc.html

Regional Contacts:

- Local Field Examiners/Subject Matter Experts

- For more complex issues/questions, contact a Senior Capital Markets Specialist:

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Questions?

Thank you for your time and attention today!