Directors and Credit: Understanding the Risk

Western Independent Bankers Webinar

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Agenda

- DFI Overview
- De Novo Bank Activity
- Subprime/NTM Crisis
- Managing CRE Concentrations
- Common RE Lending Criticisms
- Management Priorities

The following presentation contains the views and opinions of the speaker and his interpretation of regulatory guidance.

DFI Department of Financial Institutions

The Department has four office locations:

San Francisco
111 Pine Street, Suite 1100
San Francisco, CA 94111
(415) 263-8500

Sacramento
1810 13th Street
Sacramento, CA 95811
(916) 322-5966

Los Angeles
300 South Spring Street, Suite 15513
Los Angeles, CA 90013
(213) 897-2085

San Diego
7575 Metropolitan Drive, Suite 108
San Diego, CA 92108
(619) 682-7227

• DFI annual budget (F/Y 2007/2008)	$29.0 Million
• Total number of employees	216
• Total number of examiners in all divisions and offices	130
• Number of Bank Examiners	92

Licensee Services

The Department currently grants licenses to conduct financial services business in California under ten different sets of statutes: bank and trust, savings associations, credit union, industrial loan, foreign banks, business and industrial loan, transmitters of money abroad, payment instruments, and travelers checks.

	No. of licensees as of 12/31/07		No. of licensees as of 12/31/07
Banks	214	Premium Finance Companies	116
Industrial Banks (ILCs)	13	Transmitters of Money Abroad	59
Foreign Bank Offices (Incl. Rep)	64	Issuers of Payment Instruments	10
Trust Companies	10	Issuers of Travelers Checks	3
Credit Unions	197	Business and Industrial Development Corp.	1

De Novo Bank Activity

New Banks

2007

1st Capital Bank
American Principle Bank
Bank of Feather River
California Bank of Commerce
California Republic Bank
Commerce Bank of Folsom
Commerce Bank of Temecula Valley
Community Valley Bank
Focus Business Bank
Folsom Lake Bank
Golden Coast Bank
Lighthouse Bank
Pacific Enterprise Bank
Partners Bank of California
Santa Ana Business Bank
Security First Bank
Stellar Business Bank
Sunrise Community Bank

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2006

Community 1st Bank
Western Commercial Bank
Golden Valley Bank
Sutter Community Bank
River Valley Community Bank
1st Enterprise Bank
Atlantic Pacific Bank
Pinnacle Bank
American Riviera Bank
Presidio Bank
Premier Business Bank
San Diego Private Bank
U.S. Metro Bank
Friendly Hills Bank
New Resource Bank
Alta Alliance Bank
Cornerstone Community Bank
Americas United Bank
Promerica Bank
Embarcadero Bank
Pacific Alliance Bank

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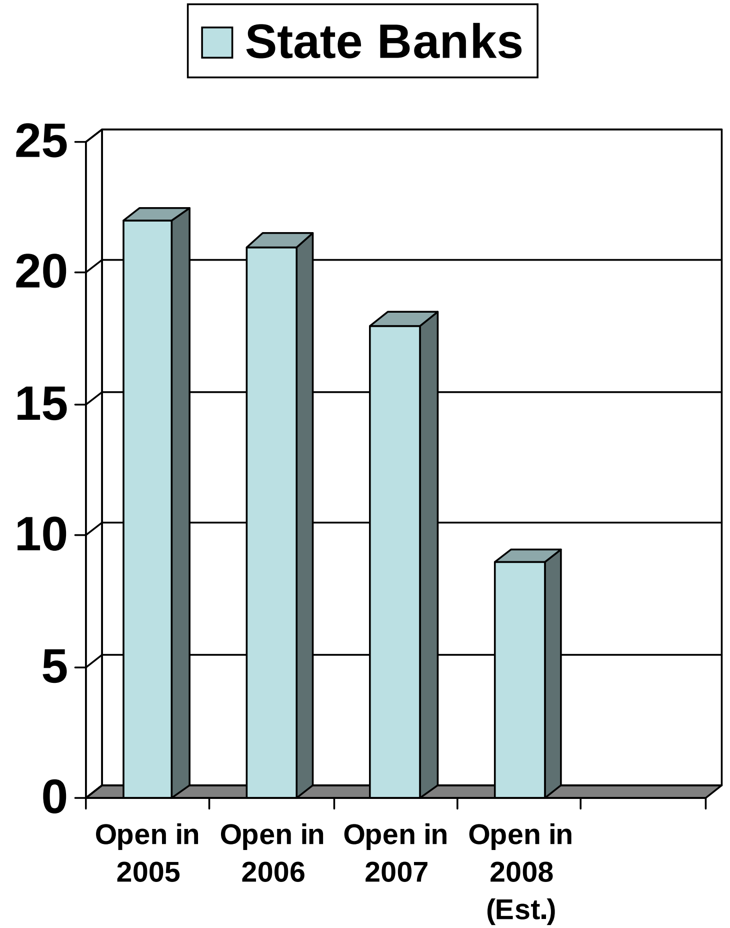
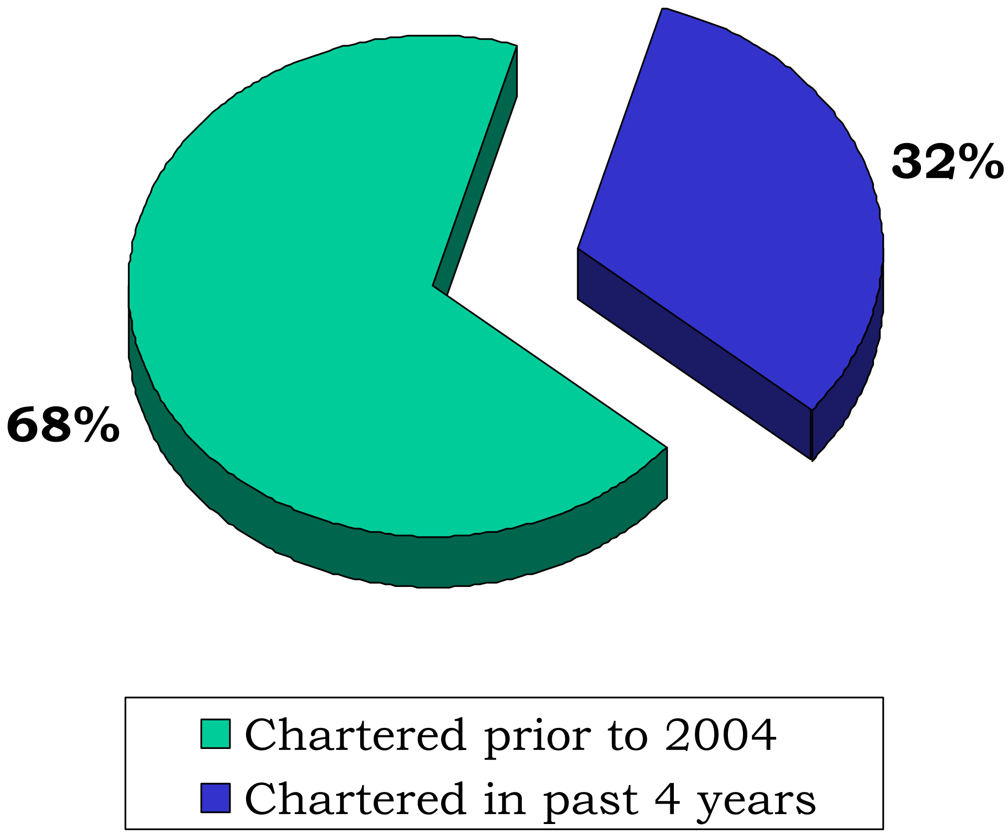
De Novo Banks Opened in Past Three Years

Year	No. of banks opened
2005	22
2006	21
2007	18



Percentage of Banks Chartered in Past Four Years

As of 12/31/07, there were 227 state-chartered banks in California. 72 of them have opened just in the past four years (about 1/3 of our current bank licensees).



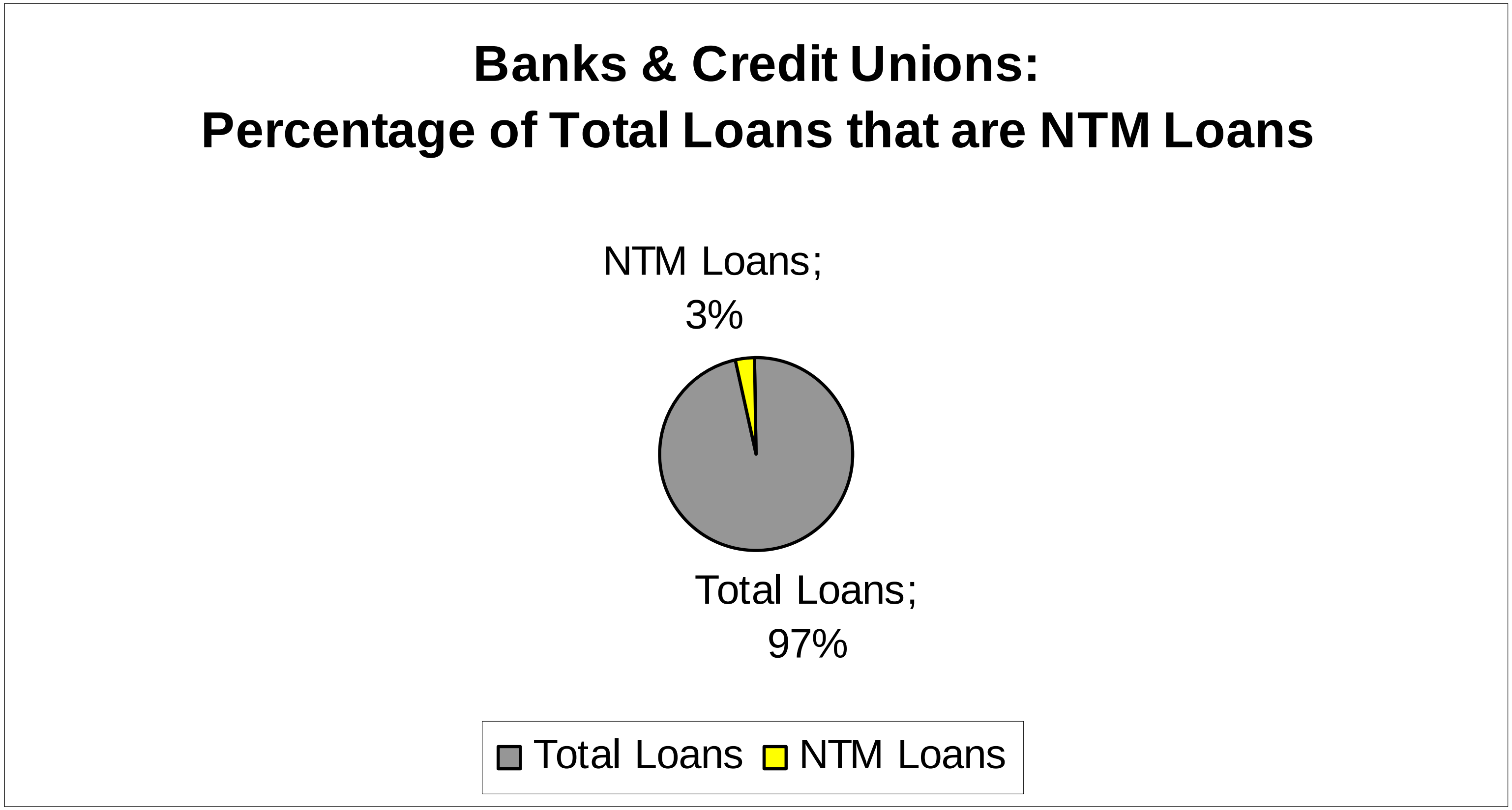
De Novo Bank Activity

- As of 2/29/08, four (4) new commercial banks were in the process of organizing (raising capital), and six (6) new bank applications were pending.

- It appears that the peak activity in de novo bank formation is behind us. However, we are still getting inquiries. We are still having pre-filing meetings, and receiving applications, but not at the level that it reached in the past three years.

Subprime/NTM Crisis

Subprime/NTM Crisis



Subprime/NTM Crisis

- Only about 18% of CA State-chartered banks (40 banks) hold NTM loan products
- NTM loan products (14,012 loans totaling $4.1 billion) account for 2.5% of total loan portfolio
- Approx. 15% of the outstanding loan balances were delinquent 90 or more days or in the process of foreclosure
- Only one institution services a large portfolio of 1-4 mortgages

Source: DFI survey of banks and credit unions as of 8/31/2007

Subprime/NTM Crisis

California Regulatory Actions

- Effective 1/1/2008, FC Section 215.5 requires the DFI to apply the objectives of the Interagency Guidance on NTM Product Risks (9/06) and the Statement on Subprime Mortgage Lending (6/07)
- Effective 1/1/2008, SB 223 makes it a crime for licensed appraisers to engage in any appraisal activity if their compensation is impacted by the final price generated by the appraisal
- AB 69 (pending) would require monthly financial reporting (volume, delinquent status, etc.) on subprime and NTM loans from mortgage servicers
- DFI Monthly Bulletin (1/08) encourages licensees to modify mortgage loans to avoid foreclosure whenever possible. Place REO property on the market within one month of taking possession. Maintain all landscaping, and accept and/or counter any and all written offers within 72 hours of receipt.

Note: This is not an exhaustive list.

Managing CRE Concentrations

Why are Regulators Concerned about CRE Concentrations?

- CRE lending is a significant business line for many small to medium-sized institutions
- CRE has historically been highly cyclical which led to large losses in the banking industry during the early 1990s
- CRE concentration ratios are at record levels
- Economic conditions have adversely affected debt service coverage ratios and property values
- Risk management practices and capital planning have <u>not</u> always kept pace with growth in CRE lending

Managing CRE Concentrations

- Greater regulatory concern for banks with concentrations in CRE loans, particularly C&D loans
- Regulatory expectations:
  - Maintain appropriate levels of capital & ALLL
  - Maintain updated financial/analytical information
  - Close monitoring of CRE and C&D loan portfolios
  - Bolster loan workout infrastructure, as needed
- Regulatory framework for assessing CRE concentrations in *Joint Guidance on Concentrations in CRE Lending, Sound Risk Management Practices* issued 12/2006 (CRE Guidance)

Source: FIL-22-2008 dated 3/17/08, "Managing CRE Concentrations in a Challenging Environment"

A Brief Tour of the CRE Guidance

- Directed to institutions with significant CRE lending
- Applies to banks but principles are broadly applicable to bank holding companies and their non-bank subsidiaries
- Guidance is NOT intended to limit banks' CRE lending
- Outlines key risk management expectations
- Reinforces and builds upon existing regulations and supervisory guidelines

Key Elements of a CRE Concentration Risk Management Framework

- Board and management oversight
- Portfolio management
- Management information systems
- Market analysis
- Credit underwriting standards
- Portfolio stress testing and sensitivity analysis
- Credit risk review function

Source: Joint Guidance on Concentrations in CRE Lending, Sound Risk Management Practices (12/2006)

Interagency Guidelines for RE Lending Policies*

When real estate lending is undertaken in a prudent manner, "it will not be subject to examiner criticism." The RE Guidelines identifies prudent practices an institution should include in its policies.

Common Deficiencies Noted by Regulators

- Failure to consider or establish limits of exposure by type (e.g., condo conversion, multifamily) or geographic market
- Reports of activity for management and board of directors are not sufficient to make informed decisions
- Inadequate or nonexistent interest rate stress testing
- Failure to prepare timely or consistent concentration reports
- Failure or incomplete tracking of aggregate loans in excess of loan-to-value limits in the RE Guidelines
- Real estate lending policies are not reviewed and approved by the board of directors annually

* Interagency Guidelines for Real Estate Lending Policies – 12 CFR 365, Appendix A (FDIC) and 12 CFR 208, Appendix C (FRB)

Points of Emphasis

- Supervisory CRE ratios are not limits, rather they are used as supervisory monitoring tools
- Banks should perform internal risk assessments
- Board and management oversight is critical
- Regulatory expectations for risk management practices are commensurate with risk profile of institution
- Capital adequacy will be evaluated on a case-by-case basis
- CRE guidance does <u>not</u> supercede the Agencies' real estate lending guidelines* and appraisal regulations

* Interagency Guidelines for Real Estate Lending Policies – 12 CFR 365, Appendix A (FDIC) and 12 CFR 208, Appendix C (FRB)

Management Priorities

Management Priorities

- Prompt Identification of Developing Problems
- Appropriate Risk Diversification
- Sound Underwriting - LTV's, Appraisals, DTI Ratios, Cash Flows, etc.
- Appropriate Stress Testing and Sensitivity Analysis
  - CRE Concentrations
  - IRR
  - Liquidity Requirements
  - Operating Budget
  - Other
- Sound Liquidity Risk Management Practices
- Strong Compliance Programs - BSA/AML
- Strong Information Security Practices

Questions?

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