FDIC

San Francisco Region Bankers' Forum

FEDERAL DEPOSIT INSURANCE CORPORATION 1933

Credit Risk Reminders & Accounting Update

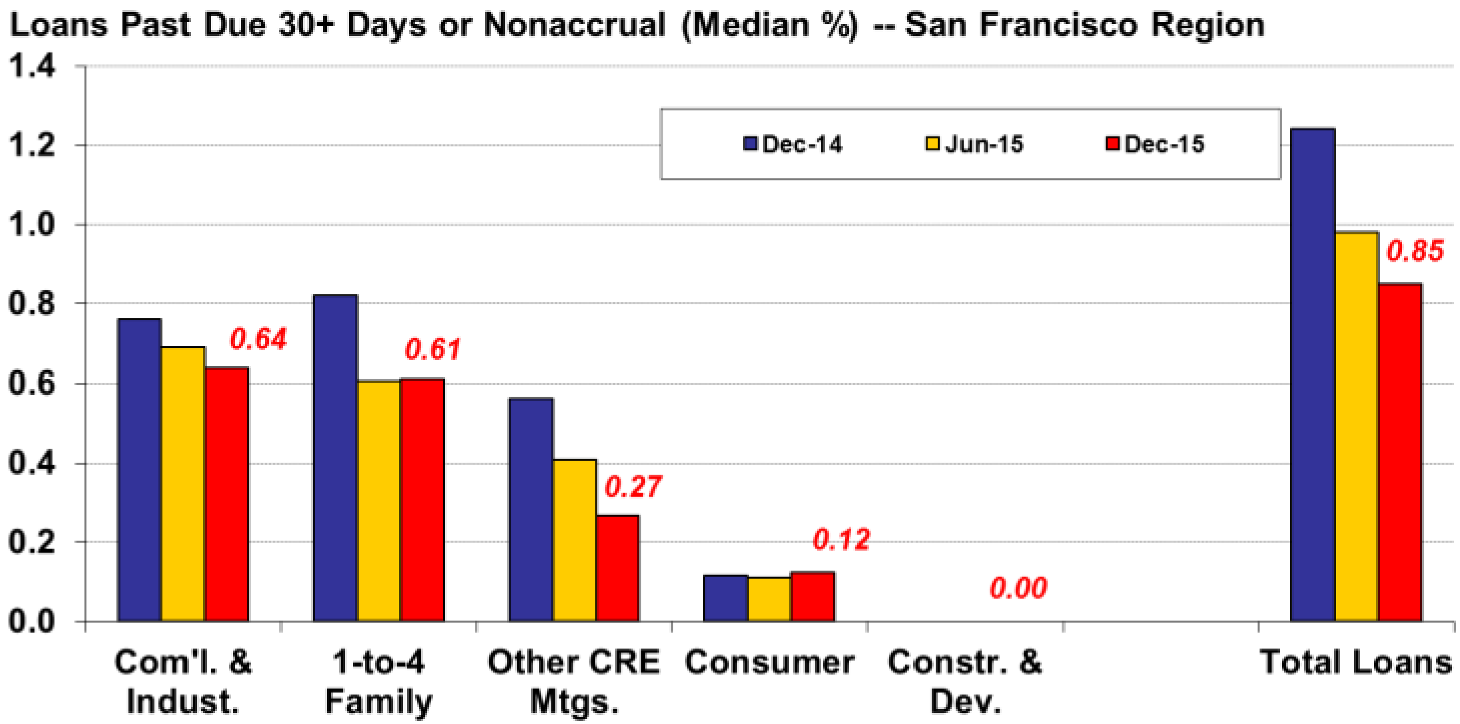
March 31, 2016

Agenda

- Credit Risk Metrics
- Underwriting Survey Results & Credit Reminders
- Proposed Accounting Changes: Accounting for Credit Losses

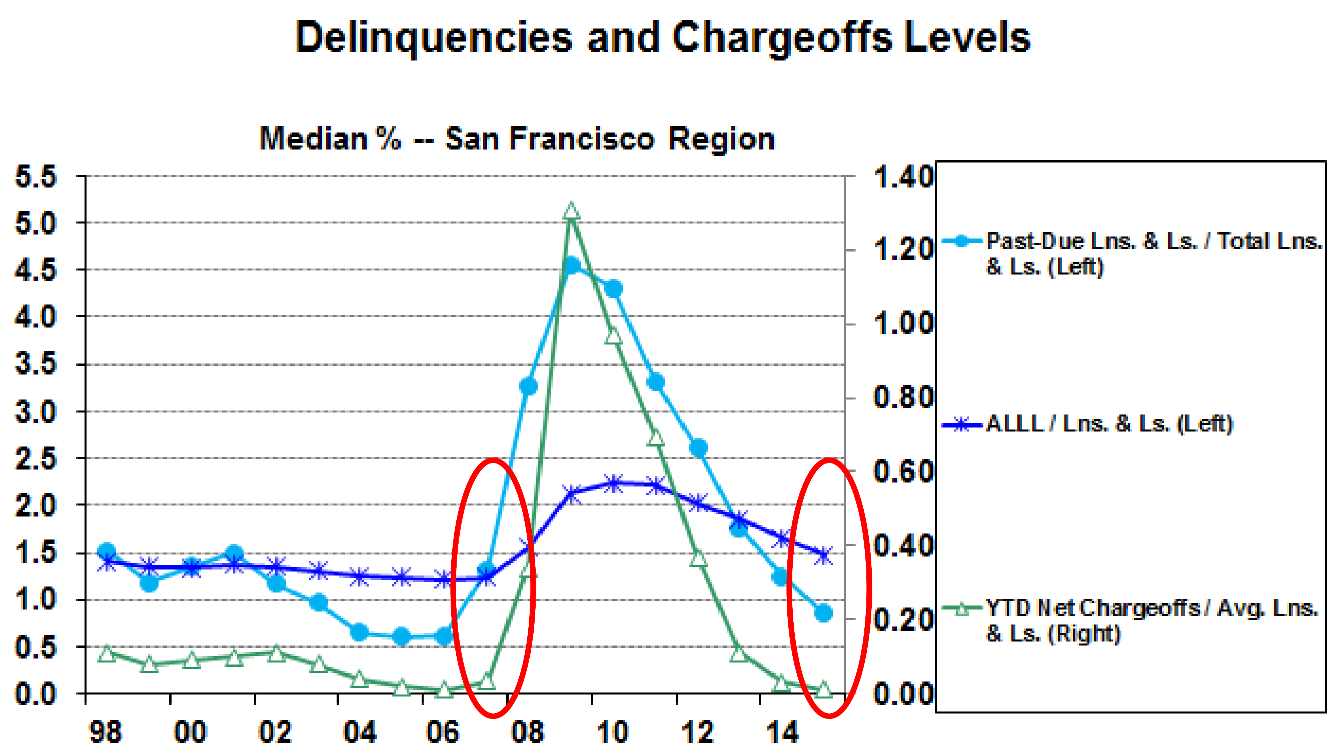
Credit Risk Metrics – Where Are We?

Deliquencies Are Improving in Major Loan Portfolios



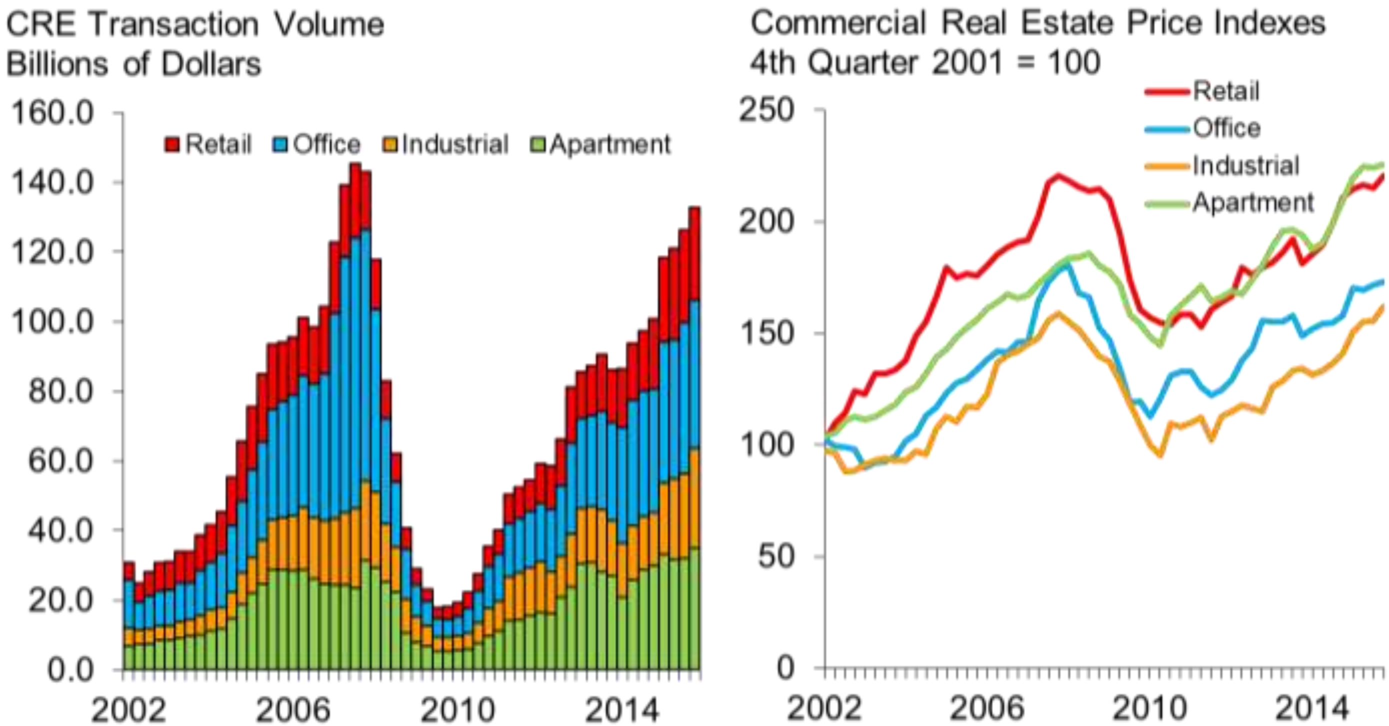
Source: Bank and Thrift Call Reports.
Note: Includes institutions based in the San Francisco Supervisory Region only. Other Commercial Real Estate (CRE) mortgages includes nonfarm-nonresidential and multifamily mortgages.

Past Due and Charge Off Rates Returned to Low Levels



Source: FDIC (December of each year).
Note: Includes institutions based in the San Francisco Geographic Region. Past-due = 30+ days delinquent plus nonaccrual; ALLL = allowance for loan and lease losses; Noncurrent = 90+ days plus nonaccrual.

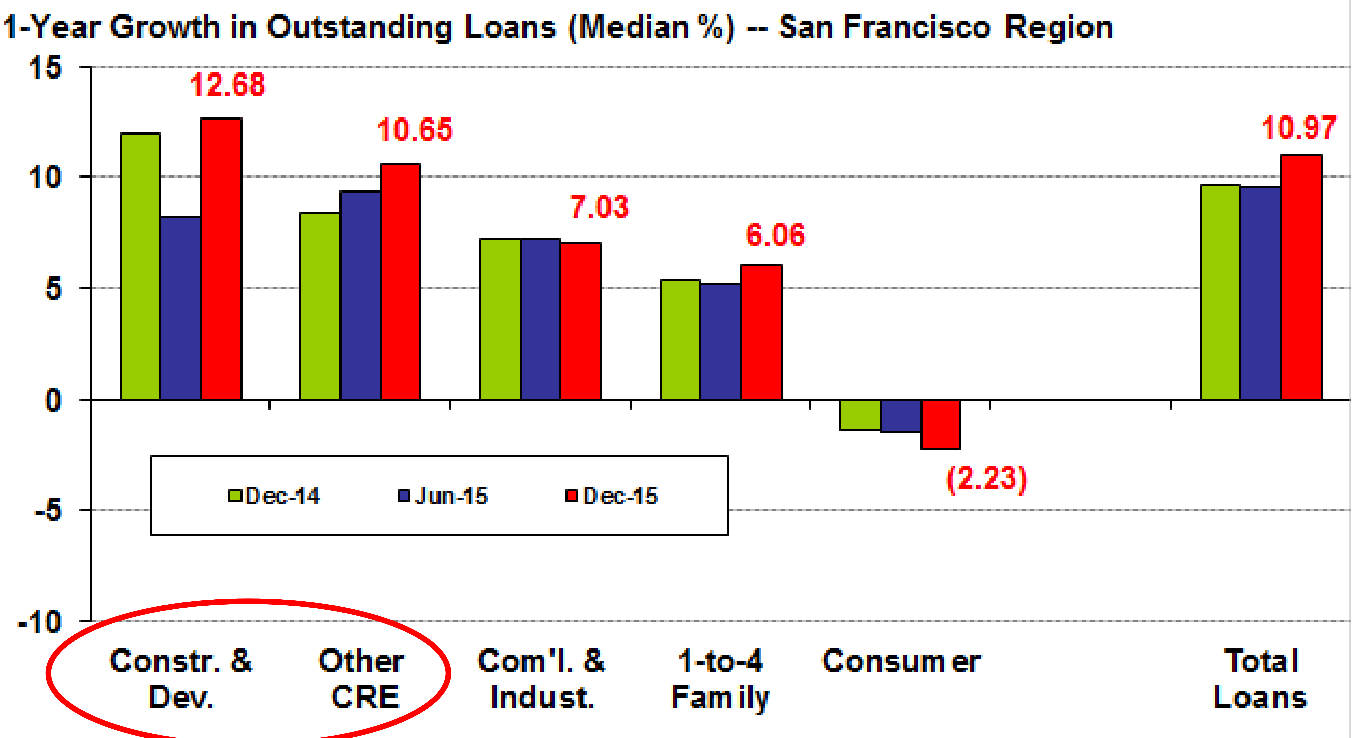
Trends in CRE Transaction Volumes and Pricing



Source: Real Capital Analytics (data through fourth quarter 2015).
Note: Prices indexed to four-quarter moving-average prices for each property type.

Three Years of Consistent Loan Growth

Lending is Accelerating in the Region – Driven by CRE and C&I



Source: Bank and Thrift Call Reports .
Note: Includes institutions based in the San Francisco Supervisory Region only.

Underwriting Trends – C&I and CRE Portfolios

Remain Mindful of Risk Selection

- **Areas of Easing Underwriting Standards**
  - Pricing
  - Maximum Size of Credit Lines
  - Loan Covenants
  - Maximum Maturity/Amortization

Lending Policy Reminders

- **The Loan Policy Should:**
  - Establish guidelines for interest rates/pricing
  - Determine maximum exposure limits for borrower relationships, product types, and in aggregate.
  - Define standards to evaluate the financial condition and repayment capacity of borrowers and guarantors.
  - Guidelines for appropriate amortization terms and requirements for loan covenants and financial reporting.
  - Guidelines addressing loan review, credit grading, and Allowance for Loan and Lease Losses (ALLL)
  - Determine acceptable collateral, loan-to-value limits, and valuation programs.

Policy Exceptions

- Loan policies should identify procedures for considering loans that are exceptions.
- Exceptions should be documented with compensating factors that mitigate or limit the risk of a loan's exception to policy.
- Management should track and report portfolio level exceptions over time.
- Based on volume and trend of exceptions, periodically re-assess exception levels and trends, and assess any overall shifts in credit risk appetite to ensure ongoing prudent risk management.

Prudent CRE Lending (FIL 62-2015)

- Encourages banks to review policies related to CRE lending commensurate with concentration risk.

- Highlights successful practices, including:
  - Global cash flow analyses on reasonable (not speculative) rents, sales, and expenses.
  - Market and scenario analyses of portfolio
  - Re-assess strategies and policies in light of changing market conditions

- Reinforce existing supervisory expectations

ADC & Out of Area Lending

- Survey Results: Higher-risk activities in Acquisition, Development, and Construction (ADC) lending were noted in 22 percent of satisfactorily-rated banks.
  - Speculative Lending
  - Repayment Source Weaknesses

- Survey Results: Out of area lending warranted notice as common or frequent practice in 19 percent of institutions.
  - Purchased Loan Participations

Credit Risks Summary

- **Board & Management should:**
  - Ensure appropriate strategies, credit risk management and underwriting practices, contingency plans, and liquidity and capital support
  - Understand vulnerabilities to stress
    - Actively Monitor Competitive and Economic Conditions
    - Reassess exception trends and credit risk appetite
  - Ensure clear guidance regarding acceptable risk exposures
  - Ensure policies, procedures, and practices translate the Board's goals, objectives, and risk limits into prudent operating standards

Existing Incurred Loss Model

- **Current U.S. GAAP**
- **Weaknesses in accounting for impairment under current U.S. GAAP**

Proposed CECL Model

- **FASB's Proposed Accounting Standards Update (ASU)**
  - No "probable" recognition threshold
  - Allowance balances updated at each reporting date
  - Consider past events, current conditions, and reasonable and supportable forecasts that affect expected collectability

Proposed CECL Model Application

- **Tentative FASB Board Decisions During Redeliberations**
  - Applies to held-for-investment loans and commitments
  - Applies to held-to-maturity securities
  - Evaluate financial assets on a collective basis when similar risk characteristics exist

Proposed CECL Model Measurement

- **Measurement of Expected Credit Losses**
  - Consider both quantitative and qualitative factors
  - Consider both internal and external information
  - Consider all contractual cash flows during the financial asset's life
  - Consider expected prepayments
  - Always consider risk of loss, even if remote

Expected future cash flows	+	Expected credit loss	=	Total contractual cash flows

Proposed CECL Model Measurement (cont.)

- **Measurement of Expected Credit Losses (cont.)**
  - ✓ When determining life, consider expected prepayments, but do not consider expected extensions, renewals, and modifications unless the entity reasonably expects to execute a TDR with the borrower
  - ✓ Entity would not be required to recognize a loss on a financial asset for which risk of nonpayment is greater than zero, yet the amount of loss would be zero
  - ✓ Entity should revert to unadjusted historical credit loss experience for future periods beyond the reasonable and supportable forecast period
  - ✓ Reversion allowed over financial asset's estimated life on a straight-line basis or over a period and in a pattern that reflects entity's assumptions about expected credit losses

Proposed CECL Model Measurement (cont.)

- **Measurement of Expected Credit Losses (cont.)**
  - ✓ Collateral-dependent financial assets
  - ✓ Troubled debt restructurings (TDRs)
  - ✓ Loan commitments
  - ✓ Available-for-sale (AFS) debt securities
  - ✓ Purchased credit-deteriorated financial assets

Proposed CECL Model Measurement (cont.)

- **Measurement of Expected Credit Losses (cont.)**
  - ✓ No nonaccrual guidance in CECL
  - ✓ Write-off guidance
  - ✓ New financial statement disclosures will be required
  - ✓ Transition
    - ➢ Prospective application to debt securities with previous OTTI
    - ➢ PCI assets become PCD assets at adoption, gross-up of allowance
    - ➢ All other assets within CECL's scope must recognize a cumulative-effect adjustment to retained earnings

Proposed CECL Model Effective Dates

CECL Effective Dates		
	U.S. GAAP Effective Date	Call Report Effective Date (for institutions with calendar year fiscal years)
Public Business Entities (PBEs) that are SEC Filers	Fiscal years beginning after 12/15/2018, including interim periods within 2019	3/31/2019
Other PBEs (Non-SEC Filers)	Fiscal years beginning after 12/15/2019, including interim periods within 2020	3/31/2020
Non-PBEs	Fiscal years beginning after 12/15/2019, including interim periods beginning after 12/15/2020	12/31/2020
Early Application	<u>Other PBEs and non-PBEs</u>: Early application permitted for fiscal years beginning after 12/15/2018, including interim periods within those fiscal years	

Implementation of CECL Model

- **Current status**
  - ✓ Transition Resource Group (TRG) for Credit Losses
  - ✓ The FASB is now saying publicly that it expects to issue the CECL standard in "mid-2016"

- **The new standard will allow various methods to estimate expected credit losses under the model**
  - ✓ Differing degrees of sophistication are expected
  - ✓ There will be a range of acceptable outcomes

- **CECL model is intended to be scalable to institutions of all sizes**

Implementation of CECL Model

- **In preparation for implementing the CECL model when it takes effect, institutions should:**
  - Start preparing now; don’t wait
  - Become familiar with the standard – communicate with internal and external auditors/accountants, credit staff/departments, other institutions and regulators
  - Leverage existing ALLL and credit risk processes as applicable
  - Identify data requirements needed to comply and begin to collect the information
- **There is no benchmark level of increase in the allowance upon adoption of the CECL model**
  - Each institution is unique, so the level of the allowance would also be unique

Implementation of CECL Model

- **What will the CECL model's capital impact be upon adoption when it takes effect (2019 or 2020).**
  - Depends on ALLL level, portfolio composition, and credit quality at adoption
  - Depends on current and forecasted economic conditions at time of adoption
  - For planning purposes, consider the impact on capital of increases in the current allowance for loan and lease losses of 25%, 50%, and 100% upon adoption of the CECL model
    - ✓ Outcomes would enable institution to consider actions it could take over the transition period, if necessary, to ensure it will have sufficient capital upon adoption of the CECL model to absorb impact of increase in allowance levels when the new standard takes effect

Questions
?