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Best Practices for Dealing with Heightened Levels of Asset Quality Issues

With the recent trends experienced in the residential real estate market, which have resulted in an increased level of non-performing assets, the Department has noted that a number of banks have formulated and executed some effective strategies and best practices for monitoring and managing increased exposures in these areas. We thought that we would outline some of these practices in order to assist banks in effectively meeting these challenges.

Board and Committee Involvement with Asset Quality Issues

One of the hallmarks of an effective bank management team is having frequent communication and involvement with the Board of Directors particularly when a bank is experiencing increased asset quality issues. Certainly the status of identified problem assets should be discussed with the Board of Directors at the monthly board meetings. One of our bankers indicated to us recently that he provides his Board Members with copies of the results of the weekly reviews of identified problem assets.

Another measure being taken by a number of Boards of Directors in the current market environment is to reduce loan approval limits, so that credit approvals over a certain dollar amount receive either Loan Committee or Board approval before funding. Having more sets of eyes reviewing large credits can be effective, particularly when Boards of Directors have knowledge of the marketplace, which is often the case. Committee and Board involvement should not just focus on loan approvals but also collection strategies for large non-performing credit relationships.

One of the best practices regarding the Board of Director involvement is having an effective procedure in place to ensure that loan policies established by the Board of Directors are complied with on a consistent basis and that there are significant consequences for non-compliance with policy. This can be done by incorporating policy compliance with the loan operational area (which is ideal since it can prevent non-compliant loans from being funded) or alternatively having a review process to check credits for policy compliance.

Identification of Problem Loans

It has been noted that many experienced bankers are “scrubbing” their loan portfolios to identify problem credits on a proactive basis. This means looking not only at non-performing loans but also at borrowers that have structural or operational issues, even where payments may have been kept current through interest reserves or payments from other sources. By identifying such loans, management can then establish appropriate strategies to strengthen these credits and initiate the collection strategy that is the most effective in minimizing potential loss exposure to the bank.

Management Oversight of Identified Problem Loans

Effective bank management has increased their level of supervision of identified problem assets. In some banks, a management loan committee is reviewing loans on the bank’s watch list on a weekly basis to determine the status of the loan, identify action items that need to be accomplished and establish timelines for these action items. In addition, some of these banks are reviewing all residential construction and development loans on a monthly basis to monitor the condition of the borrower, housing or lot sales, and the condition of collateral. It is important that bank management be aware of the condition of their collateral. If a borrower is not maintaining the physical upkeep and security of the collateral, the bank may need to take possession of the property to safeguard the condition of the collateral.

Another issue is delineating who has management responsibility regarding identified problem credits. Several banks have established a special assets structure for problem loans that transfers collection responsibility away from the originating loan officer once the credit has been moved to a Special Mention or Adversely Classified Status. This permits a more objective, and often times, a more seasoned loan officer to supervise the collection of impaired or non-performing assets.

It is particularly important that senior management assess the adequacy of loan staffing during this period of increased asset quality issues. It is vitally important that staffing be both adequate in number and experience to meet the challenges of properly managing asset quality issues.

Appraisals

One of the key issues that bankers are noting in the current market environment is a decline in appraisal market values on construction loans, and more particularly, on values of developed residential lots in certain markets. Bank management is choosing in many cases to have reappraisals performed in order to better quantify their bank’s potential loss exposure on residential real estate loans. Bank management is also looking more closely at the qualifications of the appraisers performing these updated appraisals, and in some cases, decreasing the number of qualified appraisers being used by the bank in order to maintain quality control. Several banks have also contracted to have third party reviews of appraisals, to ensure that the appraisals meet Interagency Guidelines on Real Estate Appraisals and Evaluations and USPAP requirements and appear appropriate based on the reviewer’s knowledge of the market.

External Loan Review

It cannot be stressed strongly enough that strong independent external loan review is one of the most necessary and cost-effective strategies that bank management can utilize to identify asset quality issues in a timely and effective manner. The Board of Directors of a bank should make certain that the firm

hired to perform this function is experienced and that they are independent in their judgment. Many banks have chosen to increase the frequency of these reviews; where they might have once had an annual review, they may now be having reviews performed semi-annually.

Loan Operational Issues

Experience has shown that when large loan losses are examined in detail, their common characteristics often include:

- 1) Loan documentation problems, including the lack of perfected collateral or other structural issues,
- 2) A misunderstanding or misanalysis of the bank's collateral position,
- 3) Funding of the loan prior to the receipt of complete collateral and/or credit documentation,
- 4) Weak or poorly analyzed financial information, and/or
- 5) An undocumented or poorly understood plan of repayment.

In order to address these issues, bank management in many banks has recognized that they need proper loan operational staffing, policies and procedures in place to ensure that these issues are addressed properly on the front-end. In other cases, bank management has recognized that these issues may not have been properly addressed in the past, and they have subsequently addressed these concerns with increased staffing. In such cases, it may be necessary to perform operational reviews on the existing loan portfolio to identify and correct documentary and operational deficiencies, where possible.

The Allowance for Loan and Lease Losses (ALLL)

Obviously, during a period where greater impairment of assets is being experienced, it is important that bank management increase their focus on maintaining a proper and adequate ALLL. It is an expectation that bank management will establish a proper and adequate methodology that establishes an ALLL that is sufficient to meet the level of impaired assets on the bank portfolio. Bank management should work effectively with their CPA's in the preparation of their FAS 114 and FAS 5 assessments. The best practice in this area is to establish a sound and well documented methodology that is reflective of the condition of the bank and which is affirmed as satisfactory during the examination process and independent audit. Effective banks are primarily focused on the adequacy of the ALLL, and recent experience reflects that it is difficult to be over-reserved in the current market environment.

Strategies for the Disposition of Problem Assets

The Department and the federal regulators expect banks to properly reflect the valuation of assets on their books and records. This means establishment of a properly funded and documented ALLL as discussed above. It also means reflecting Other Real Estate (ORE) at a proper valuation when loans are taken into bank ORE.

Having recognized the need for proper and accurate financial reporting, the actual strategies for disposition of problem assets need to be made at the bank management level. These strategies need to consider the individual circumstances of each bank, and may vary depending on the status and condition of the borrower, the location of the property, and bank management's assessment of the real estate market.

Best Practices in this area include having a structured work-out strategy and timeline for each impaired credit in the bank. These strategies need to make sense based on the structure of the bank and the

total volume of impaired assets in the bank. In assessment of the work-out strategies for problem assets, Department examiners will consider the following:

- 1) Are the strategies outlined realistic and do they appear to maximize the collectibility of the loan or other real estate?
- 2) Are they realistic when taken as a whole with the condition of the bank, including the level of the ALLL, and Capital in the Bank?
- 3) Is there a proper assignment of management responsibility for the work-out strategies and proper oversight?
- 4) Is there an established time-line for these strategies and are these time-lines being met?
- 5) Are the strategies regarding the disposition of collateral (ownership by the borrower or taking possession of the collateral by the bank) appropriate based on the circumstances, conditions and valuation of the collateral?

Operational Issues

Many banks are facing significant earnings pressures as a result of a combination of tightened net interest margins, increased provisions for loan losses and increased collections expenses. While it is important during a period such as this to carefully monitor expenses and perhaps even reduce expenditures, banks are also determining that it is imperative that competent and seasoned loan officers and loan personnel with experience in collections are a prudent and necessary area of expenditure. As a result, a number of banks have actually increased staffing in the lending area during this challenging period in order to help them manage, and hopefully reduce, the level of problem assets and loan losses.

Another area of operational focus is liquidity and funding management. It is axiomatic that banks that are experiencing higher levels of non-performing assets must focus on their funding structure, and if dependent on more volatile sources of funding, they must seek to increase core deposit funding. This involves analyzing the market and the competition; seeking to offer products that better meet the needs of the bank's customers; and, increasing the focus of business development on relationship banking, where obtaining the total business relationship including both loans and deposits is stressed to front-line personnel. Liquidity and funds management also involves seeking various sources of secondary and back-up liquidity and actively monitoring and managing the liquidity of the bank on a daily basis.

These best practices are being shared with both bank management and with our examination and professional staff. Commissioner Braswell has indicated that he believes that there has never been a greater need for timely and effective communication with Department personnel both during the examination process and in other communications with the Department. If there are additional questions regarding any of these matters or if you would like to share additional best practices with the Department of Banking and Finance, please contact either George Reynolds, Senior Deputy Commissioner at (770) 986-1629 or Grace Lurry, Deputy Commissioner for Supervision at (770) 986-1646.