



The Regulatory Environment

Today and Tomorrow

Presented by Dana Sumner, CEO & President

Board & Senior Management Understanding



Board of Directors

“A key principle in the member business loans and commercial lending rule (Part 723) is that a credit union’s board of directors is ultimately accountable for the safety and soundness of the credit union’s commercial lending activities. The board must remain adequately informed about the level of risk in a credit union’s commercial loan portfolio. The rule reinforces the fiduciary responsibility of a credit union’s board for maintaining the safety and soundness of the institution, hiring competent staff, establishing appropriate policies and procedures, and for providing adequate oversight.”

Senior Management

“A credit union’s board of directors relies on senior management to directly oversee risk management activities and verify they are consistent with board policy. It is essential that senior executive officers have a comprehensive understanding of the credit union’s commercial lending activities and the ability to adequately oversee the management of the risks associated with those activities. Senior executive officers must ensure the credit union implements appropriate risk management processes to measure, monitor and control risks. “



Policy Issues Seen in Examinations



8 Key Elements that Should be Contained Within Every Policy Per the NCUA's Online Examiner's Guide

- Types of commercial loans permitted
- Trade area
- Portfolio concentration limits
- Single borrower limits
- Qualifications and experience requirements for lending staff
- Loan approval processes
- Underwriting standards
- Risk management processes



Lack of Clarity in Policy on the Following Issues is Regularly Seen in Exams:

- Trade Area
 - Credit unions should be familiar with the influences on the trade area and develop policies to ensure they monitor and react to changes in the trade area.
- Portfolio Concentration Limits
 - Make certain the limits listed in policy (each one) match those being reported to the Board
- Qualifications and experience requirements for lending staff
 - Specific requirements for staffing the department with qualified individuals commensurate with loan volume, projected loan growth, trade area, complexity of the borrowing relationships, types of loans permitted, and any other unique influences on the credit union's commercial loan portfolio
 - Separation of Duties considerations



Lack of Clarity in Policy on the Following Issues is Regularly Seen in Exams:

- Loan Approval Processes
 - A credit union must establish a process that assigns credit approval authority to individuals or to committees that make such decisions commensurate with the individual's or committee's experience evaluating and understanding commercial loan risk
- Underwriting Standards
 - Analysis should include income and expense trends, debt service ability, balance sheet changes, and the impact of those changes on the borrower's ability to service debt.
 - The analysis should discuss the required evaluation of related parties and the influence those parties have on a borrower's ability to repay a loan.

Credit Approval Documents

APPROVAL



Credit Approval Documents

- Should be prepared before originating a loan, renewing a loan, conducting a periodic review, or performing a loan workout
- Provides the analysis and supports the lenders' approval or decline decision
- Is submitted to the appropriate approving authority and is the official record of the actions taken by the credit union
- Should be a stand-alone document
- Uses a standard format



Credit Approval Documents

- Summary cover page followed by a narrative
- Who is the borrower?
 - Site Visit
 - Type of entity
 - Management experience
 - Product, services, and how revenue is generated
 - Markets and competition
- Relationship loan summary
- Lists all loans in the associated borrower relationship
- Provides accurate level of risk associated with the borrower to the approving authority
- Certifies compliance with Section 723.8



Credit Approval Documents

- Borrowing request
 - Loan Amount, Purpose, Rate, and Term
 - Sources and uses of funds to complete the loan transaction
- Collateral description, valuation method, and value
- Identify the preparer and quality of the financial information
 - Years being analyzed
 - Quality of Financial Information

Credit Approval Documents

Financial Analysis

- Orderly/consistent presentation
- Analyze and explain trends

Income Statement

- Sales/Revenue Trends and why; % and \$'s
- Gross Profit Trends and why; % and \$'s
- Expense Trends and why; explain significant changes; % and \$'s
- Net Profit Trends; % and \$'s

Credit Approval Documents

- Balance Sheet (BS)
 - Assets composition, changes/trends
 - Liabilities composition, changes/trends
 - Debt to Worth
 - Operating performance influence on the BS
 - Inventory, AP, AR Turns
 - Ratios (leverage, current, etc.)
- Cash flow and debt service calculation
 - UCA or Traditional

Credit Approval Documents

Guarantor Analysis

- Identify all sources of income and other financial influences or commitments
- Understand the make up of all the Assets and Liabilities
- Global Risk/Cash Flow Assessment: Global, at a minimum, should include an analysis of all entities that the Guarantor has a financial obligation or connection, such as loan guarantees, affiliates, associated, intercompany transactions, and cash calls.

Credit Approval Documents

Global Cash Flow purpose

- Eliminate intercompany/entity transactions and comingled funds for accurate relationship capacity
- Identify overall relationship ability to meet obligations
 - Identify weaknesses in the principal's operation
- Necessary to establish and define loan covenants
- Necessary to know your borrower



Credit Approval Documents

Information necessary for an accurate Global Assessment

(In a Perfect World Scenario)

- Related entities information
 - Debt schedules – Capitalized expenses
 - Full financial statements for the related entities
- Tax returns with all schedules including K1 and M1 for the less complicated
- Reviewed or better quality for the more complicated entities
- Consolidated/Combined and Consolidating/Combining Financial Statements



Global Cash Flow vs. Global Understanding



Global Cash Flow

A full analysis of the borrower and all guarantors which will identify other stresses on the guarantor that could ultimately impact the borrower.

At the very least, any entity guaranteed or that has a documented legal commitment for support—such as cash calls for limited partnership by the guarantor—should be included in the global cash flow.

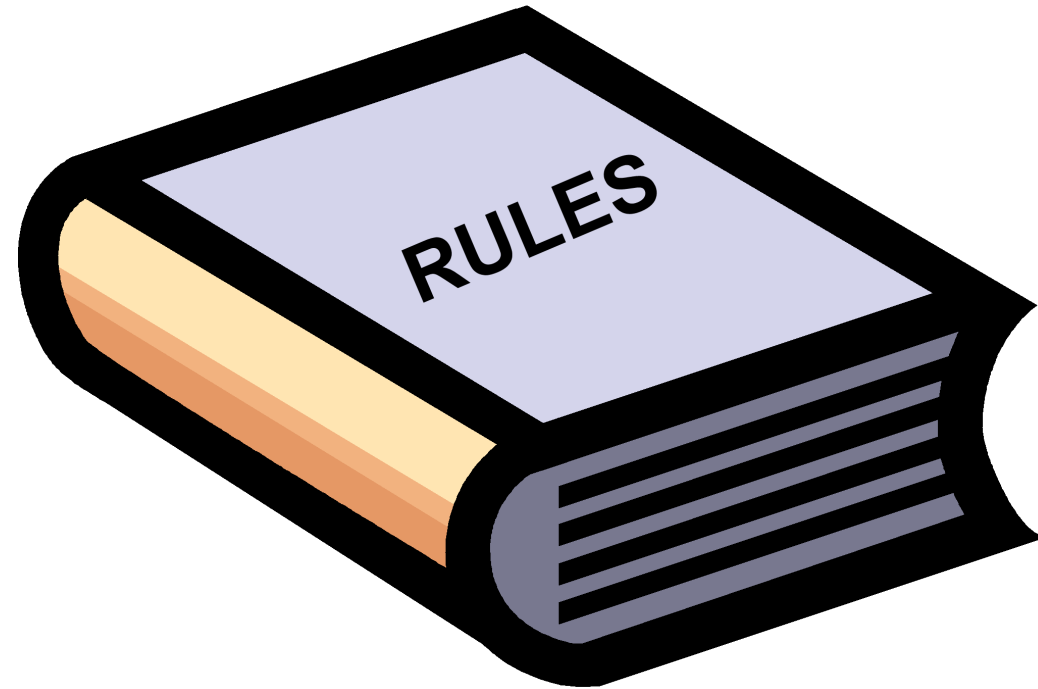


Global Understanding

Per **NCUA §723.4 (f)(2)** Thorough due diligence of the principal(s) to determine whether any related interests of the principal(s) might have a negative impact or place an undue burden on the borrower and related interests with regard to meeting the debt obligations with the credit union;



Loan Covenants



Loan Covenants

- Appropriate covenants assist in the management and control of risk within the portfolio
- Covenants can be both positive and negative

Loan Covenants



Positive

Things you want
you borrower to do



Negative

Things you don't want
your borrower to do

Affirmative and Negative Covenants

Outline desired actions by borrower:

- Performance standards such as Minimum DSCR must stay above 1.25
- Annual and interim Financial Statement submission requirement
- Periodic A/R, Inventory listing, and A/P aging statements

Outline prohibited/undesired actions by borrower:

- No additional debt without lender approval
- Restrictions of cash payouts to owners
- Prohibition of selling or pledging certain assets



Exceptions



What is a Loan Exception?

An exception occurs when you something in a loan request falls outside of the Credit Union's guidelines, but the CU moves forward with the approval.

- Should be reported to the Board of Directors
- Should not occur on every loan
- Different levels of exceptions
- Loan with Exceptions SHOULD be priced for the increased level of risk



Risk Rating Matrices



Credit Risk Rating Systems

- Formal, standardized process to identify and assign risk rating to each commercial loan in portfolio
 - Required per 723.2 and 723.4(g)
 - Used for pricing, ALLL, risk differentiation, and quantifying risk
 - Needs to be dynamic
 - Supports the risk profile/complexity of CU's portfolio
 - Tailored to a CU's loan products and membership mix
 - Promotes early detection of credit quality deterioration



Credit Risk Rating Systems

- Each CU should customize a system for its unique needs
 - Clear and precisely defined set of criteria for each risk rating
 - Blend of quantitative and qualitative factors with emphasis on the ability to repay
 - Guidelines to assign a rating at loan inception
 - Plan for ratings to be reviewed periodically (minimally at annual review) and at each major risk event



Credit Risk Rating Systems

- A credit's risk rating should determine how the relationship is administered.
- 80/20 Rule
- The ALLL must be directly correlated with the level of risk indicated by risk ratings.
- Risk trends within the portfolio are critical to credit risk management and strategic decision making.
- The system should be integrated into the CU's overall portfolio risk management.



Credit Risk Rating Systems

- All credit exposures should be rated.
- The risk rating system should assign an adequate number of ratings.
- Risk ratings must be accurate and timely.
- The criteria for assigning each rating should be clear and precisely defined.
- Ratings should reflect the risks posed by both the borrower's expected performance and the transaction's structure.



Participation Loans



The Importance of Diligence on Lead Lender

- Individual credit unions are expected to evaluate the originating credit union's financial condition and loan performance record.
- Your due diligence review must be independent of the originating credit union, though it may be outsourced to a qualified third party.



Diligence to be Completed on Participations Purchased

- You should conduct and document your own credit and risk analysis.
- It is the loan decision of your CU, so make certain you have current financial and collateral valuations.
- Ultimately, your institution assumes the risk associated with these products.
- Any decision to engage in a loan participation deserves the same consideration.
- Does your team have the experience regarding the types of loans being purchased?



Remember:

- The NCUA Online Examiner's Guide is a key tool in Commercial Lending Examination Preparation
- Review the “Commercial Lending Items Request List” contained within the NCUA Online Examiner's Guide > Commercial and Member Business Loans > Procedures for Conducting an Effective Commercial Lending Review
- If you have chosen to engage in lending outside of the “standard industry practices” (higher LTVs, non-recourse lending, etc.) be prepared to discuss your reasoning and make certain all files are documented with mitigants.

Last but not least, examiners are people too!

