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Financial Community

The CEIS Quarterly - Q3 - 2018

New York, August 14, 2018 — CEIS Review Inc. is a Commercial Loan Portfolio Consulting firm serving the needs of Commercial Lending Institutions. In this issue of our newsletter, we discuss results of the Fed's survey on bank lending practices, and how to get the most out of your Institution's Stress Testing program.

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ON MY MIND...

CEIS' President, Joe Hill, shares his thoughts

The Federal Reserve issues a survey to Senior Loan Officers on a quarterly basis (1) to monitor banks' lending practices over the past three months, including key factors like changes in loan underwriting standards and observed factors in market demand. In this summary, we focus on the Fed's assessment of responses received from 72 U.S. banks.

COMMERCIAL & INDUSTRIAL (C&I) LENDING

Overall, C&I loans to businesses of all sizes reflected eased standards and terms. A moderate fraction of banks reported eased standards on C&I loans to large and middle-market firms, and a modest fraction reported eased standards when lending to small firms. Meanwhile, banks reported stronger demand for C&I loans among small firms.

Over the past three months, banks eased most terms on C&I loans to firms of all sizes – below are some details on how terms have eased:

- Significant share of banks increased the maximum size of credit lines
- Significant share of banks narrowed loan rate spreads, a strong indicator of bank profitability, on loans to large and middle-market firms; for loans to small firms, a moderate net fraction of banks reported narrowed loan rate spreads
- Moderate share increased the maximum maturity on loans to small firms
- Moderate share of banks reduced the cost of credit lines and premiums charged on riskier loans, and eased loan covenants on such loans

Notably, nearly all banks cited increased competition among other lenders as a reason for easing. A significant fraction of banks also cited the following as important reasons for the easing: a more favorable economic outlook, increased tolerance for risk, and increased liquidity in the secondary market.

A modest net percentage of domestic banks reported stronger demand for C&I

(1) <https://www.federalreserve.gov/data/sloos/sloos-201807.htm>

(2) <https://www.federalreserve.gov/data/sloos/sloos-201807.htm#ftn2>

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loans by small firms, while demand for large and middle-market firms was little changed; getting into the details, for a modest share of banks the actual number of inquiries from potential borrowers rose. Banks that reported stronger C&I loan demand cited the following as important reasons for stronger demand: increases in customers' accounts receivable, inventory, and merger or acquisition financing needs, as well as increased customer investment in plants or equipment. Banks that reported weaker C&I loan demand cited the following as important reasons: increases in customers' internally generated funds, reduced customer investment in plant or equipment, and customers' borrowing having shifted to other lenders.

COMMERCIAL REAL ESTATE (CRE) LENDING

"Overall, CRE loans to businesses reflected unchanged standards and terms."

Overall, CRE loans to businesses reflected unchanged standards and terms. Among banks reporting unchanged CRE lending standards overall, a modest share reported tightening standards for the Multifamily Residential segment. Meanwhile, banks reported weaker demand for CRE loans among small firms. Breaking it down by sector, a moderate share reported weaker demand for Construction and Land Development, while a modest share reported weaker demand for Multifamily loans.

TRENDS

Regulators have been tracking how lending standards in banking have changed since 2005; below are some observations on these trends.

Banks reported current lending standards for all categories of C&I loans as being eased overall since 2005. A significant share of banks reported easier lending standards on loans (non-syndicated) to large and middle-market firms, while a moderate fraction of banks reported relatively easier standards on loans (non-syndicated) to small and very small firms. Both investment-grade and below-investment-grade syndicated C&I loans are currently at the easier ends of their respective ranges since 2005.

Conversely, standards on most major categories on CRE loans were reported as being at a relatively tighter end of the range from 2005 to present day.

Breaking it down by sector, significant percentages of banks reported tighter standards for Construction and Land Development loans, while a moderate percentage of banks reported tighter standards on loans secured by Multifamily Residential properties. On net, lending standards for Nonfarm Nonresidential properties were reported as being around the midpoint of the range on balance since 2005. Though, year-over-year, domestic banks' current levels of CRE lending standards appear generally less tight. ■

*Joseph J. Hill
President & CEO*

How Banks Can Get More Value Out of Conducting Stress Tests

Financial Institutions conducting stress tests to satisfy Regulators' queries on reserves and capital can generate additional benefits from this process. Incorporating some of the findings from the stress tests into strategic plans, forecasting, and other risk management processes can provide more value.

It is a good way for banks to get more bang for their buck – in fact, now that the concepts and processes of stress testing are becoming more universally understood, regulators' focus is often shifting from implementing stress testing to more qualitative issues, such as integrating results with capital planning and embedding the stress testing inputs, analysis and outputs into overall risk management and planning processes.

There are six major ways financial institutions can get more value out of their stress testing processes and results.

“Looking at stressed loss rates in combination with profitability or return measures can help identify segments where the risk-reward balance is not there. That information can be used in strategic planning.”

1. Manage concentration risk. One of the primary purposes of stress testing is to identify and measure risks associated with loan portfolio concentrations. In fact, stress testing is one of the best ways for a bank to justify why its commercial real estate concentration is acceptable. Over time, the institution may decide to re-evaluate its CRE limits if stress test results change, or it might use stress testing to evaluate potential changes in portfolio limits.

2. Identify vulnerable segments. Stress test results may reveal patterns whereby certain segments show up as underperforming. This could provide good insight into where a bank might want to revisit underwriting standards, cease originations in that segment, exit segments or consider other risk-mitigation efforts before conditions deteriorate. For example, if loans in the Retail income property segment consistently show higher losses and/or greater migration into criticized/classified rating categories, it may make sense to review the underwriting criteria for that segment for future originations, or consider heightened monitoring efforts or loan sales for the existing portfolio.

3. Evaluate business line risk/reward. One area where banks haven't truly leveraged their stress test results relates to making sure they get compensated for additional or higher risk. Looking at stressed loss rates in combination with profitability or return measures can help identify segments where the risk-reward balance is not there. That information can be used in strategic planning.

4. Identify vulnerable borrowers. It can be helpful to identify borrowers that essentially flunk most or all stress-test scenarios, even when their loans are currently pass-rated. This can give you a heads up that they may not be able to weather much stress or a downturn. Knowing which borrowers are more vulnerable could help the bank decide whether to press for additional financial information, schedule site visits or view any modification requests more critically. You want to have these borrowers on your radar.

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5. Assess impact of near-term increases in interest rates. Although forecasters have been predicting for years that rates will go higher, it does seem likely in the near term. Banks can find helpful information to shape their ALLL analysis by looking at how the portfolio could fare under a 50 or 100 basis-point increase and the resulting impact on any incremental provision needed. This could be something that you use in the evaluation of qualitative factors – how future losses might be different based on increases in interest rates.

6. Incorporate into capital-planning process. Regulators increasingly want to see that stress testing is a key component of the financial institution's broad capital planning process. Capital-planning really is a kind of iterative process – you make your risk-reward determinations, you make some assumptions, you stress those, you assess your capital adequacy under that scenario, and that may cause you to change some of your risk-reward assumptions and objectives."

Many banks have spent the last several years clarifying and implementing exactly what regulators require them to do related to stress testing portfolios, and it appears they have made great strides on those fronts. A recent survey (1) of financial institutions found that more than two-thirds of respondents reported examiners had no or few problems with their institution's stress testing practices.

Much like a person who benefits in multiple ways from exercise, financial institutions are also achieving side benefits when they incorporate the processes and results of their stress testing analyses into additional areas of the bank. If you'd like to learn more about how banks can generate more value from the stress testing process, please call 888-967-7380 or email us at info@ceisreview.com.

(1) <https://www.sageworks.com/pressreleases.aspx?article=321&title=Sageworks-Survey:-What-Examiners-Are-Examining&date=July-22-2015>

CEIS' Liz Williams to Speak at 2018 Sageworks Lending & Risk Management Summit

We are proud to announce that Ms. Elizabeth Williams will be speaking on "Model Validation – Getting the Most out of Your ALLL and Stress Test Validations" at the Sageworks Lending & Risk Summit in Chicago, IL this September 24-26.

Below is a summary of what she will be presenting:

"Model validation doesn't have to be a "check the box" exercise. Many banks have been working with their ALLL and stress test methodologies for years now and the process may have become somewhat routine. A validation is a good opportunity to make sure your assumptions and approach still make sense in today's environment. It will also give you a good sense of current areas of focus in regulatory exams as well as ideas for enhancing (and possibly simplifying!) your methodology based on industry best practices."

To register for this event, please visit the Sageworks website [here](#).



How Can We Better Serve You In Your CECL Transition?

At CEIS Review, we are always looking for ways we may be able to better assist our clients. With the forthcoming CECL Implementation in mind, we are reaching out to get a good gauge as to how banks are preparing for CECL.

If you would like to participate, please follow the link [here](#).

Related Links

- [OCC to Host Innovation Office Hours in New York](#)
- [FDIC Publishes 25th Anniversary Special Edition of Consumer Newsletter](#)
- [Federal Reserve Board Announces Termination of Enforcement Actions](#)
- [Bitmain's \\$40 Billion Plan to Cash Out of Bitcoin](#)
- [U.S. Budget Deficit Grows \\$77 Billion, Up 79% From Previous Year](#)
- [NY Fed Research Indicates Tariffs Could Slow Exports, Not Just Imports](#)
- [Overhaul Boosts Credit Scores of Millions of U.S. Consumers](#)
- ['Mega-Round' Investors Shower Start-Ups With Millions](#)

About CEIS Review

CEIS Review, Inc. is an independently owned financial consulting firm founded in 1989 to serve the needs of lending institutions with commercial portfolio related services.

Services include:

- Loan Review Programs
- Portfolio Acquisition review (Due Diligence)
- Structured Finance Review (Leveraged Lending)
- Commercial Portfolio Stress Testing
- ALLL Methodology Validation or Advisement
- Credit Risk Management Process Review

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