

TNCUL CU Connect

**Hot Topics in Commercial
Lending**

March 11, 2022

Agenda

- IBS Overview
- Regulatory Environment
- Risks To Loan Growth/Quality
- Impact on Lending / Portfolio
- Comments & Questions

Services Offered

- ❑ Consulting
 - ❑ Commercial Lending Start Up
 - ❑ Market Evaluation
 - ❑ Hiring
 - ❑ Loan Policy
 - ❑ Credit Training
 - ❑ Sales Training
 - ❑ Board Training (Regs)
 - ❑ Participation Sales
- ❑ Commercial Loan Underwriting
- ❑ Loan Document Generation
- ❑ Appraisal and Environmental Management
- ❑ Loan Servicing
- ❑ Shared Lender Program

IBS History

- Formed 2008 & started operations in 2009 in Fort Mill, SC
- Wholly owned by 7 credit unions in the Carolinas
- Through 2013 had underwritten \$150 million in MBL
- At YE 2013 was servicing \$40 million portfolio
- Relocated office to Columbia, SC in November 2014
- Since 2014 have underwritten over 2100 loans totaling \$1.275 billion
- Credit union portfolios have grown from \$40 million to over \$610 million in that period
- Underwrote 422 loans totaling \$333 million in 2020
- Underwrote 342 loans totaling \$323 million in 2021
- Over \$610 million in portfolio underwritten by IBS
 - 99.8% rated Satisfactory or better
 - Of over 1500 loans only 7 not rated Satisfactory or better
 - No net charge off on a loan underwritten by IBS

Regulatory Environment

- Reg change took effect 1-1-2017
- Modifications to 1-1-17 Regs
 - Appraisals

Principles Based Regulation

- Purpose is to give credit unions more flexibility to implement principle-based risk management processes and policies and staff to maintain a comprehensive understanding of the borrower's financial capacity.
- Credit unions must establish risk tolerances at the relationship and overall portfolio levels to ensure that the risks taken are consistent with prudent standards within the managerial and financial capability of the credit union.

Board of Director's Responsibility

- Approve the commercial loan policy and review at least annually
- Ensure the credit union appropriately staffs its commercial lending program in compliance with 723.3(b)
- Understand and remain informed about the nature and level of risk in the commercial loan portfolio, including its potential impact on the credit union's earnings and net worth



Executive Management's Responsibility

- Understand the credit union's commercial lending activities
- Have comprehensive understanding of the role of commercial lending in the credit union's overall business model
- Establish risk management processes and controls necessary to safely conduct commercial lending activities

NCUA Expectations

- Underwriting analysis depth and content.
- Due diligence and risk evaluation requirements of principals of business borrowers.
- Financial projection analysis when historical results insufficient.
- No longer need to use industry ratios for real estate financing.
- Financial statement quality and verification expectations.
- Collateral perfection and valuation requirements, including LTVs appropriate for specific collateral type.

The New Commercial Loan Policy

- Must address:
 - Types of commercial loans permitted
 - Trade Area
 - Portfolio concentration limits
 - Single borrower limits
 - Qualifications and experience requirements for lending staff
 - Loan approval process
 - Underwriting standards
 - Risk Management processes
 - Annual Reviews, collateral inspections and revalued

Revising the MBL Policy Risk Management Process

- Use of loan covenants
- Frequency of financial reporting
- Frequency and depth of ongoing loan review and collateral value monitoring
- A credit risk rating system, at inception, and through life of loan; tracking migration of risk grades
- A process to track and report policy exceptions and loan covenants

Risk Management Reporting

- Reports for Management and Board of Directors
 - Past due
 - New & renewed loans
 - Collateral Segmentation – 100 codes
 - Industry Segmentation-NAICS
 - Purpose
 - Total Credit Exposure
 - Maturity Report
 - Risk Grade Segmentation/Migration
 - LOC & unused line

Post 1-1-17 Changes

- Message that examinations will be made based on the law and not on philosophical intent
- MBLs redefined
 - Loans secured by 1-4 family residential real estate
 - Loans secured by vehicles manufactured for household use
- MBLs don't count toward cap
- The cap is the lesser of 1.75 times the actual net worth or 1.75 times the minimum net worth per the risk based standards.

Post Reg Change NCUA Findings

- Lack of Board oversight & involvement relative to new rules
- Inadequate staffing & resources for oversight of 3rd parties
- Lack of ongoing credit administration of the portfolio
 - ARs, Management reports, Risk Grade migration
- Inadequate or delinquent ARs
- Lack of risk assessment & staffing relative to commercial lending & how it fits into the credit union's business or strategic plan
- Lack of personal guarantees with lack of evidence of risk mitigation



It's The Economy, Stupid!!

No, It's the Pandemic!!!

Now, it's both

No, It's the Pandemic/Economy

- Nationwide shut down
- Extended in some markets
- Huge impact on small businesses, home renters/landlords, and certain CRE products (retail, multi family, office, hospitality)
- Dire predictions for commercial RE
- Supply Chain problems still occurring
- 2021 Retail Sales rose 21.4% above its pre-pandemic Feb 2020 peak

No, It's the Pandemic/Economy

- Job quit rates in 2020 and 2021 were unprecedented while unemployment rebounded from the effects of the shutdowns and lay offs
- Businesses still can't fill open positions
- Inflation increasing since start of pandemic and was over 6% in 2021, forecast to hit 7% in 1Q22.
- Fed fund target rate remained low; 0%-.25%, but a rising rate environment is expected with 3-4 .25% bumps this year.

No, It's the Pandemic/Economy

- Pandemic redefined how and where employees work
- Office vacancies soared
- Migration from high cost areas to lower cost areas started before the pandemic and increased significantly
- Surge in demand for apartment development driven by major employers' announcements to bring workers back and absorption was over 600,000 units in the first three quarters of 2021
- Housing starts remained strong throughout the pandemic and home prices continued to go up.
- Brick and mortar retail making a slight recovery due to a move back to the suburbs
- Office vacancies starting to show improvement outside of gateway markets

Headwinds

- Divided country/government
- Continued effects of pandemic
- Trade Policy/Trade War
- Deterioration of business and/or consumer confidence
 - Both dipped at end of 2021
- Inflation could shoot higher
- Overheated job market
- Talking ourselves into a recession

Headwinds

- Slowdown of housing markets
- Irrational Exuberance/Equity markets
 - Tech, tech, and tech.
 - Oh yeah, and everything else.
- Growing budget deficits/debt
- Slower than expected global growth
 - China in particular (they sneeze....)

Sources: Wells Fargo Securities Economic Group, Regions Financial Corp. Economic Group, Wall Street Journal

So, What Does this Mean for Commercial Lending?

Underwriting

- Peel the onion all the way to the core
 - Get all the information up front
 - You know what credit needs and what they will ask for
 - Ask questions and get answers
 - Follow proper due diligence practices
 - Trust (?) but verify
- Loan policy is your bible. Use it like one.
- Dot the I(s) and cross the T(s). Then do it again.
- Remember you are the one fronting the \$\$ needed for the project

So, What Does this Mean for Commercial Lending?

Portfolio Management

- Review portfolio now
 - Annual Reviews
 - Yes, they are meaningful if done right.
 - Don't use it as a check mark on a list.
 - Do you have fully executed docs in file?
 - Are collateral docs in order and liens perfected and protected?
 - Recorded UCCs, recorded mortgages and AOR? Liens on titles?
 - Current insurance with CU as loss payee.
 - Have RE taxes been paid, or was collateral sold in a tax sale and you still don't know?
 - Have you inspected the collateral?
 - Take your attorney to lunch

Contact Information

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