

Breakout III: Why Smart-focused M&A Loan Review is Critically Important Now

#A0BA23

David Ruffin

*IntelliCredit, A Division
of QwickRate*

BankDirector.

AOBA Conference

Why Smart-Focused M&A Loan Review is More Critical Now

January 30, 2023



David Ruffin,
Principal



Today's Presenters



David Ruffin

- Principal, IntelliCredit™
- 47 Years in Banking
- 16 years as Chief Credit Officer / Commercial Lender
- 3,000+ Loan Reviews
- ~350 Capital Raise or M&A Due Diligences
- Former Co-Founder of Credit Risk Management
- Prolific author and speaker on credit risk topics

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We make them simple, easy to use and affordable – for huge time savings.





Due Diligence and Credit Intelligence Solutions

Intuitive. Practical. Affordable.

Cloud-Based Applications

Portfolio Analyzer

Delivers insightful analysis of loan portfolio and loan data

Smart Loan Review™

Revolutionary online solution that expedites the entire loan review process, making it simple, organized, retrievable online — and fast

Loan Review Services

IntelliCredit Experts conduct your review

IntelliCredit specialists perform a thorough, efficient loan review — through the use of our proprietary technology

Online. No installation. No software integration. Hosted by AWS (SOC2 compliant).



Credit quality is at generationally high metrics . . . so let's take a look.



National and Regional 3Q '22 Credit Performance Metrics



Trifecta of Loan Quality: Banks <\$10B

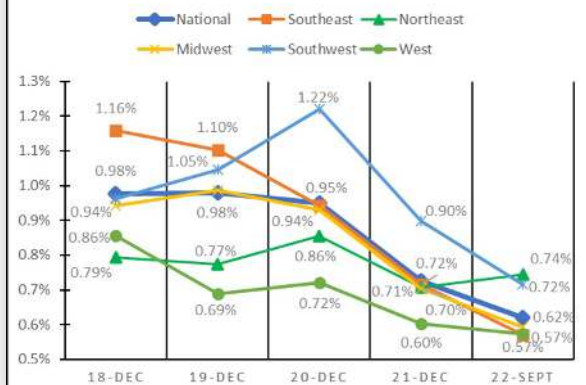


Q3 '22 Call Report Data QwickAnalytics®

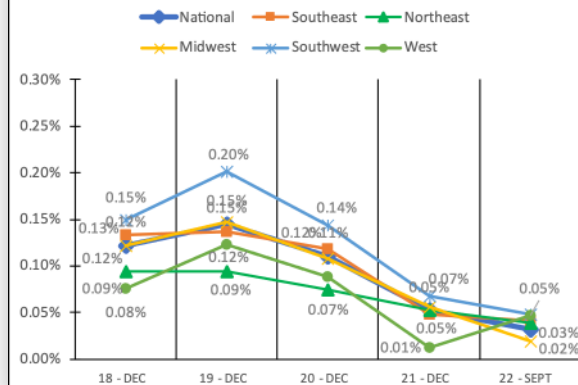


National / Southeast / Northeast / Midwest / Southwest / West

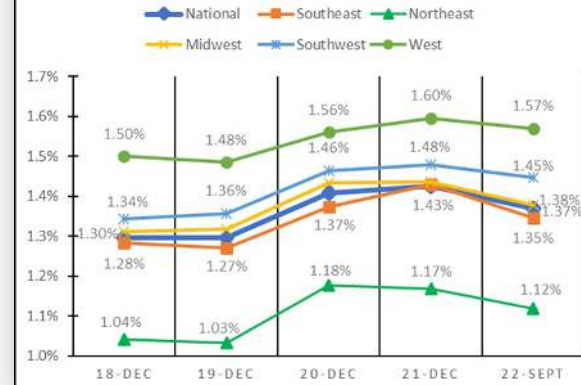
TOTAL NPL TO LOANS



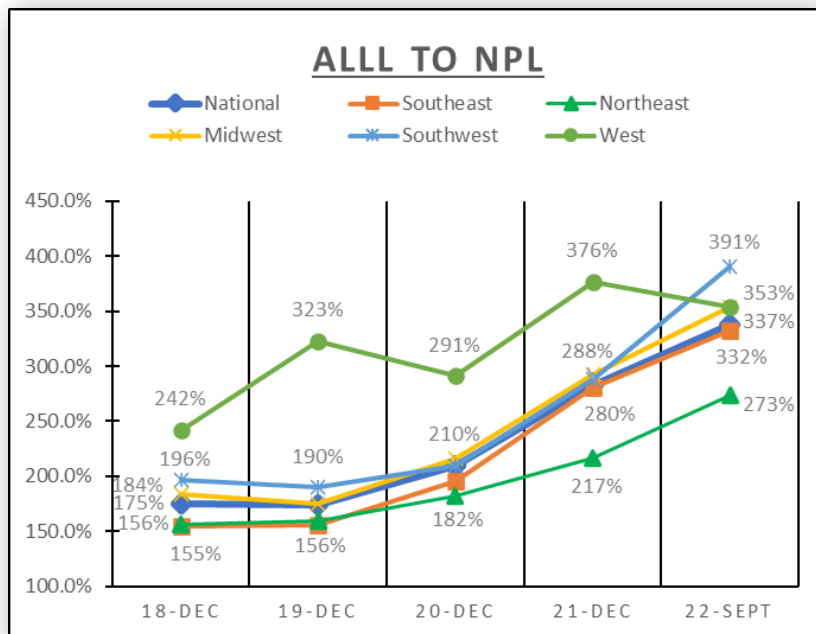
NET CHARGE -OFFS TO LOANS



ALL TO LOANS



Trifecta of Loan Quality: Banks <\$10B




QwickAnalytics®
Q3 '22 Call Report Data

National / Southeast / Northeast / Midwest / Southwest / West

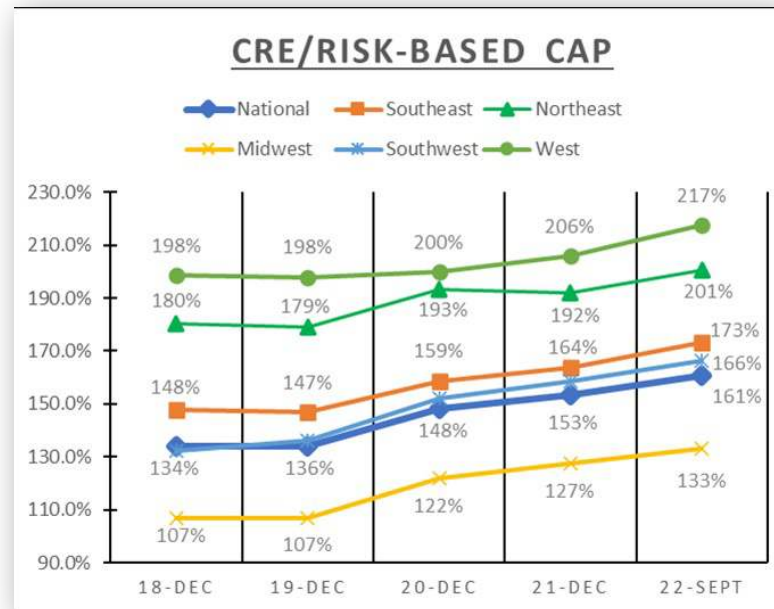
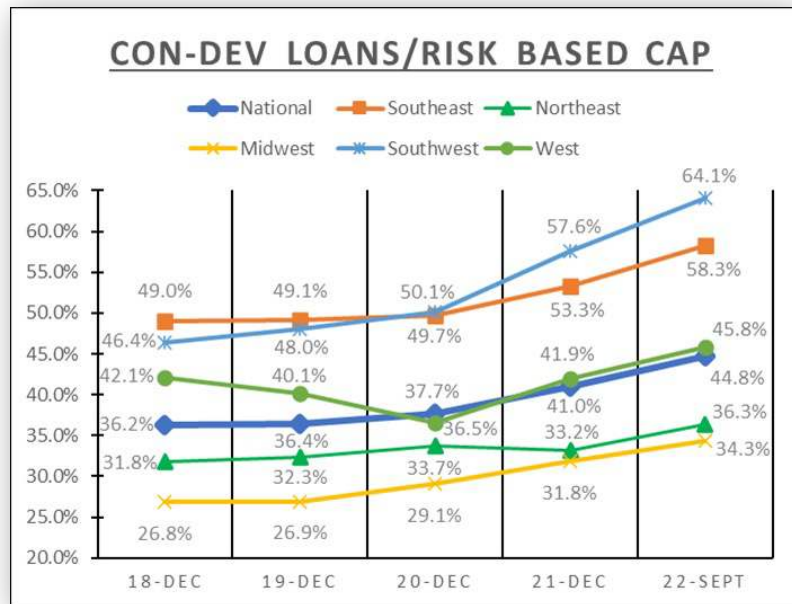
Regional CRE Concentrations: Banks <\$10B



Regulatory Guidance:
≤ 100% RBC

Q3 '22 Call Report Data

Regulatory Guidance:
≤ 300% RBC



266 National / 91 Southeast / 11 Northeast / 64 Midwest / 77 Southwest / 23 West

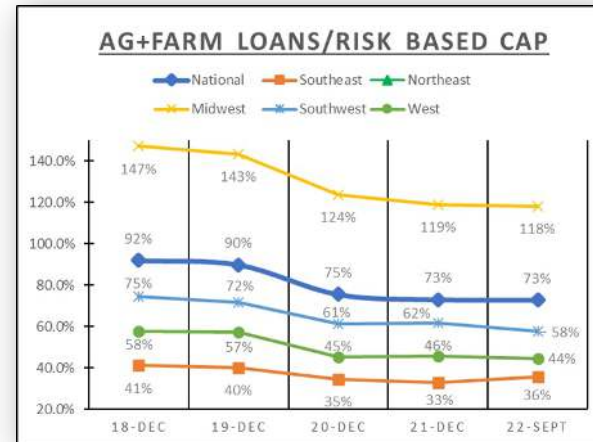
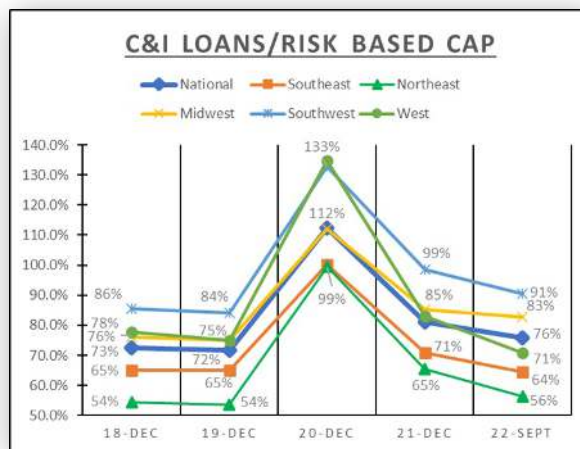
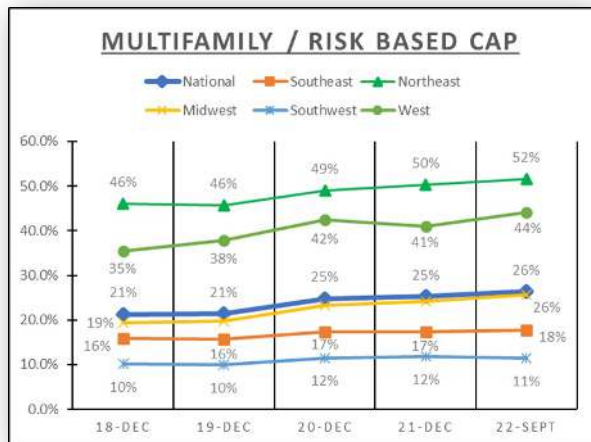
↑ 100%:

328 National / 60 Southeast / 69 Northeast / 108 Midwest / 44 Southwest / 47 West

↑ 300%:

Regional Other Concentrations: Banks \leq \$10B

National / Southeast / Northeast / Midwest / Southwest / West

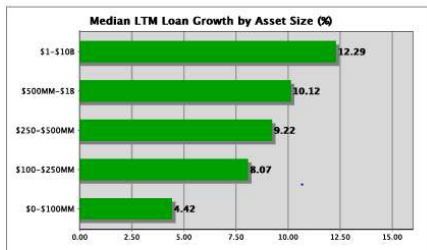
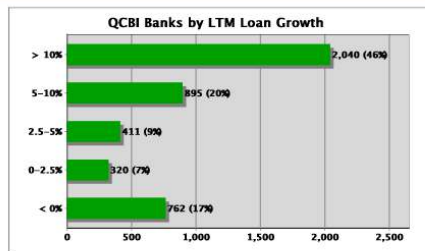
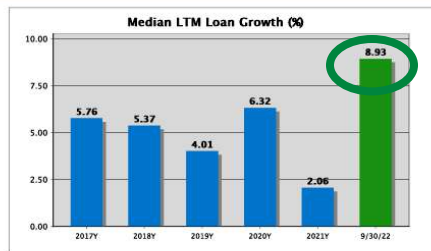


National Loan Growth Trends: Banks <\$10B

Q3 '22 Call Report Data

QwickAnalytics National Performance Trends Loan Growth Trends

U.S.
Banks
September 30, 2022



* LTM = Last 12-months (or "trailing" 12-months)

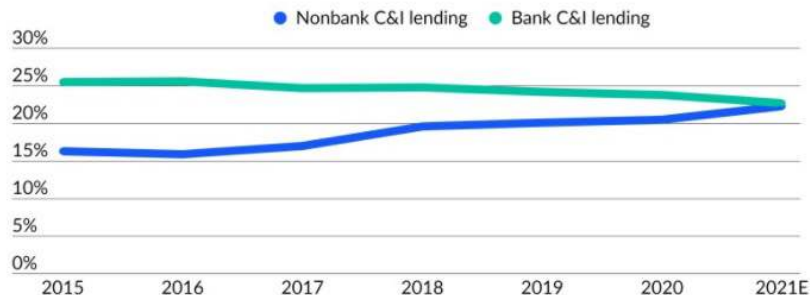
QwickAnalytics™

Banks losing ground to nonbanks

--American Banker article 10-4-2021

Neck and neck

While corporate bonds continue to account for the majority of commercial debt, nonbanks have almost caught up with banks in market share



Source: Autonomous Research

National Loan Growth Trends: All Banks



Quarterly Change in Loan Balances

All FDIC-Insured Institutions



Source: FDIC.

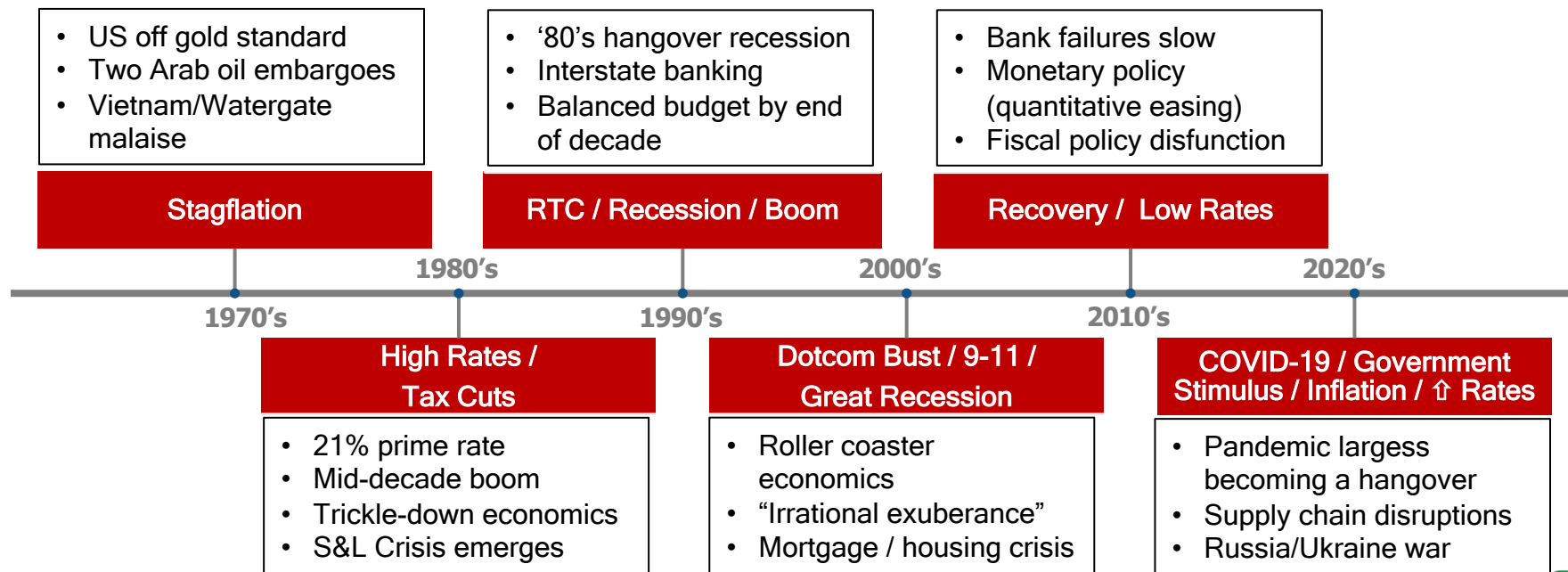


Reasons For Concern



Credit Cycles Over The Last 50 Years Hold A Pattern

► Credit stress always preceded by economic/political/financial turmoil!



Current Credit Concerns (General)



The COVID “sugar high” has turned sour (inflation / rates).

Benign credit quality metrics almost certainly cannot last.

Post-booking credit servicing is struggling.

Chasing loan growth now may be risky.

Regulators fear complacency. Overreaction may be worse.

Writing your own credit risk script critical in near term.

Current Credit Concerns (Due Diligence)



Large recent run-ups in loan growth, generally.

Disparities in risk grade distributions.

Sub-par post-booking credit servicing.

Specialty / exotic lending without equivalent risk protocols.

Disproportionate exposure to consumer-purpose lending.

Over-reliance on LTV's (collateral) v. DSC's (cashflow).

Other Current Credit*Concerns (Due Diligence)

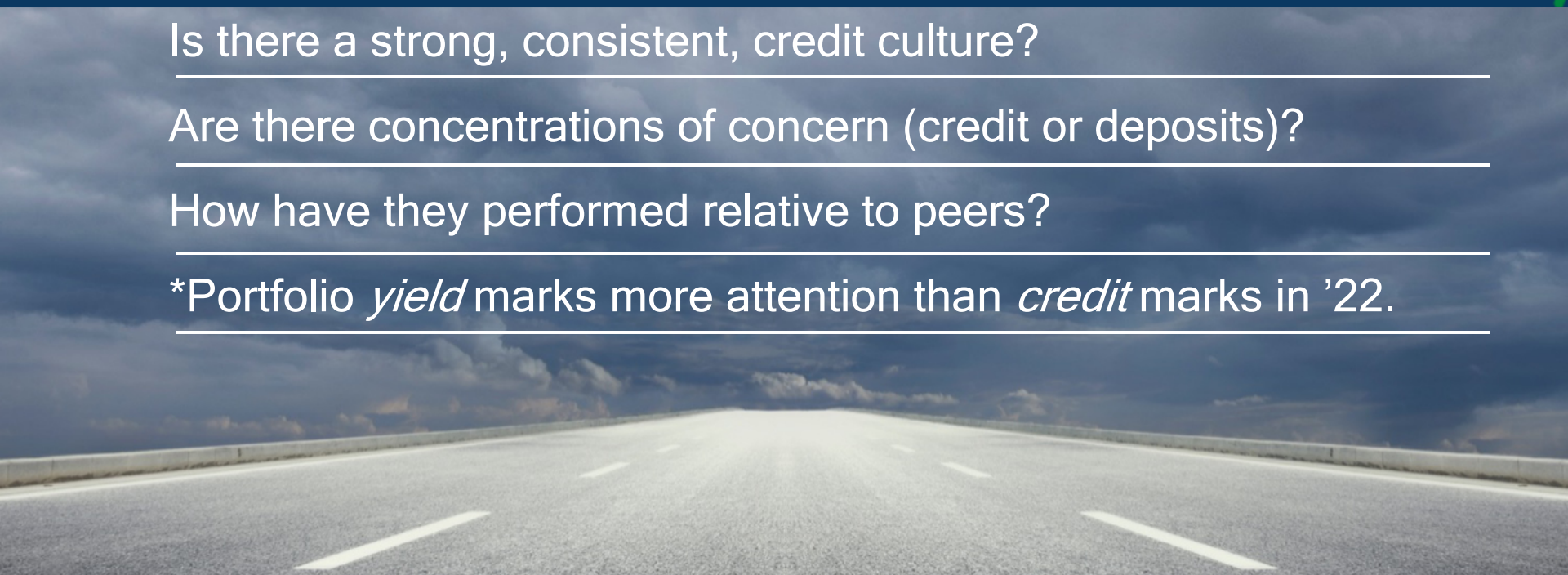


Is there a strong, consistent, credit culture?

Are there concentrations of concern (credit or deposits)?

How have they performed relative to peers?

*Portfolio *yield* marks more attention than *credit* marks in '22.



Current Credit* Concerns (By Industry)



Highest Risk: CRE Office & Retail / Consumer / Small Business

Moderate Risk: CRE Hospitality / Specialty Lending

Lowest Risk: Agriculture

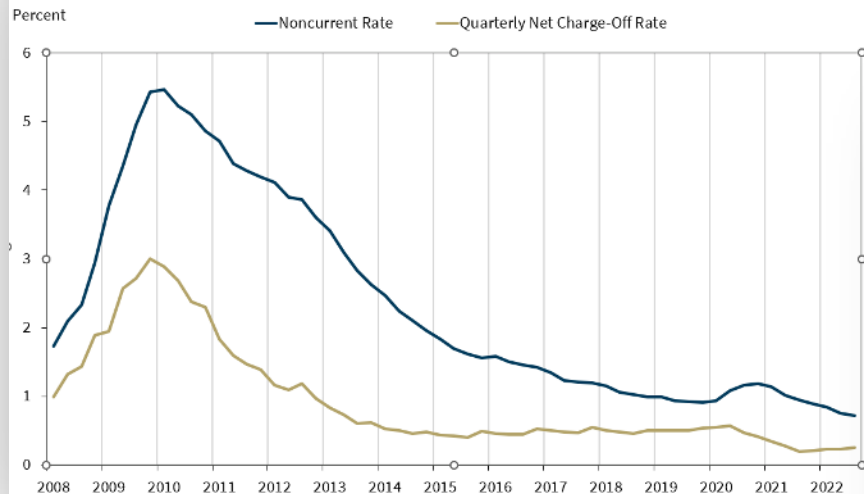
*Based on recent regulatory commentary / our DD & LR findings



Source of the Complacency



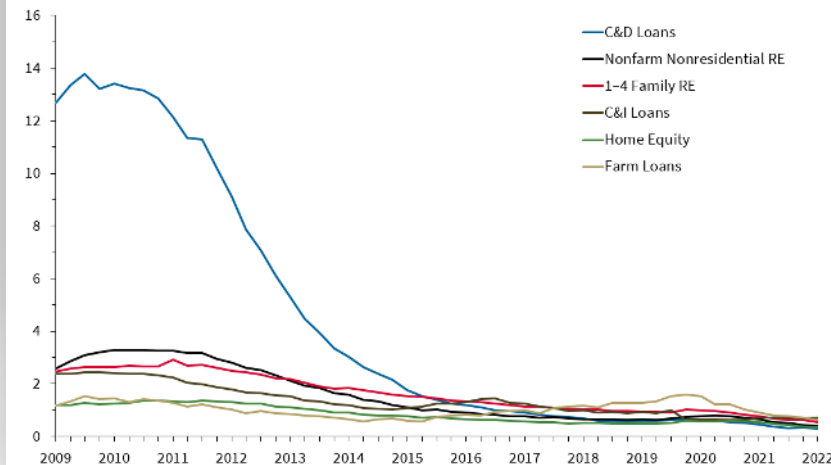
Noncurrent Loan Rate and Quarterly Net Charge-Off Rate



Source: FDIC.

Noncurrent Loan Rates for FDIC-Insured Community Banks

Share of Loan Portfolio Noncurrent
Percent



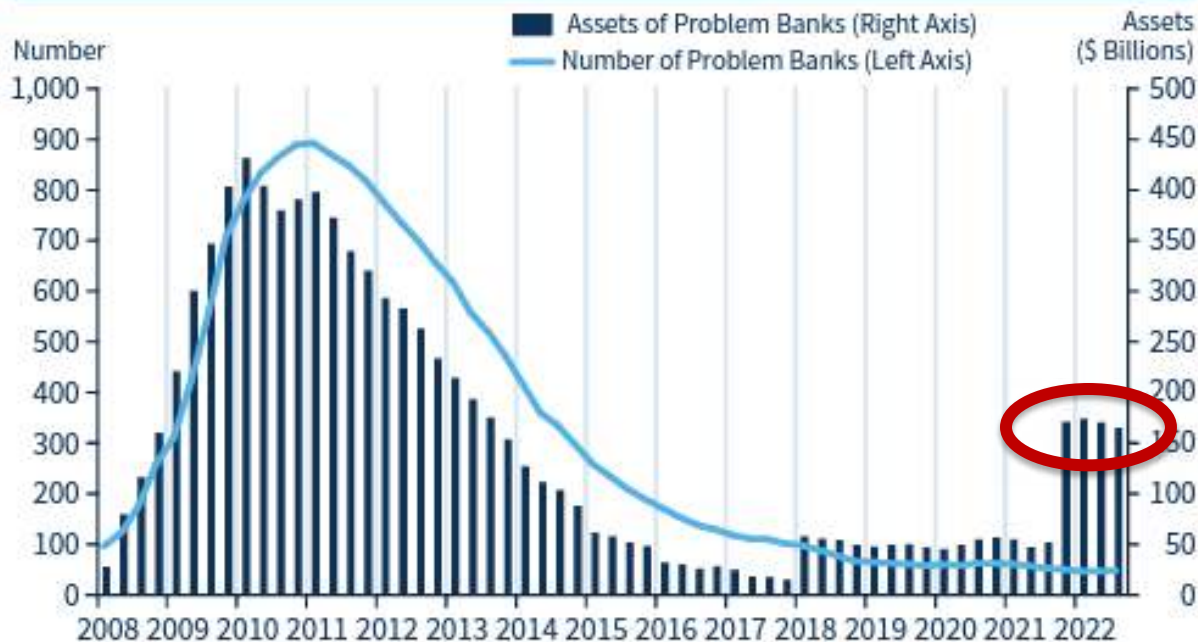
Source: FDIC.

Early Signs of Stress...



Number and Assets of Banks on the “Problem Bank List”

All FDIC-Insured Institutions



Source: FDIC.



Loan Review

Best Practices For M&A

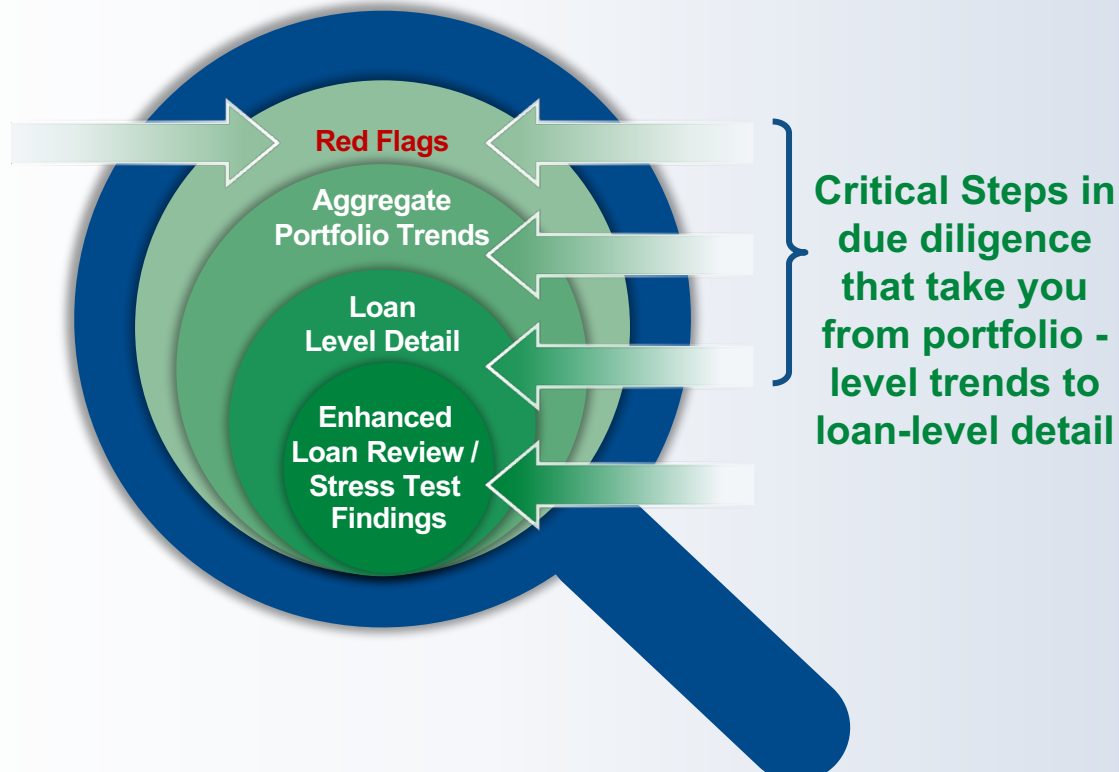


Let's Start With A Critically Informing Concept . . .



Public Data

Non-Public Data



Remember:

- The external stakeholders see a target through the lens of public (call report) data.
- Only with non-public, idiosyncratic loan data can you discern the whole story.

1 Emphasize Experience



Credit Analysis / Decisioning / Review Pyramid

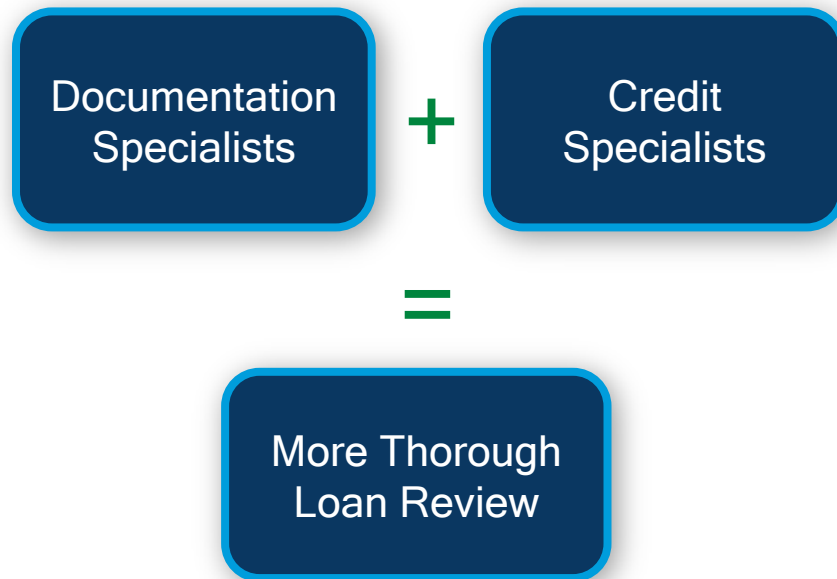
- Utilize reviewers that have *been there / done that*
- The power of *persuasion*
- Require bios during RFP process



2 Use Bifurcated Document And Credit Review



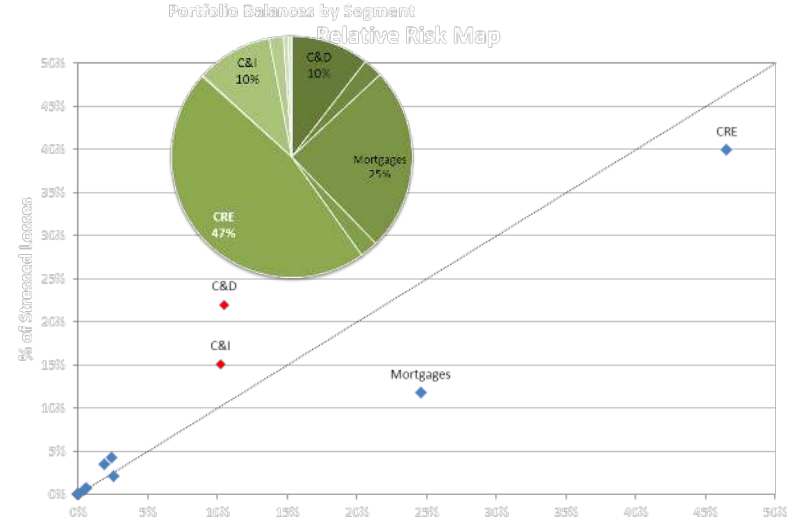
- Back-shop staffing crisis adding to more technical/documentation exceptions
- Documentation problems exacerbated by credit defaults
- Get the best of both, distinct expertise



3 Start With Smart, Informed Sampling / Portfolio Diagnostics (Business Intelligence)



- We're different from the Great Recession where only one industry (1-4 family housing) was the focus
- Data mine all aspects of the broader portfolio, loan review findings, and annual reviews
- Ferreting out hotspots will be the name of the game for perhaps years to come
- Early detection: reduced losses



While balances and risk are correlated – they are not one in the same.

[illegible]

Risk Grade Migrations

The screenshot displays the 'What-If Scenario' tool within the 'What-Grade Distribution' window. The tool is used to analyze the impact of different tax scenarios on a household's income tax liability.

Top Section: Input Fields

- File Name:** 171110110
- Video Log:** F-HAL CASE
- Value Type:** Balance
- Help:** Actual Payable

Table: What-Grade Distribution

The table lists various income tax items and their associated values for two scenarios: '15% OFF' and '15% ON'.

| Item | 15% OFF | 15% ON |
|-----------------------------------|---------|--------|
| 1-1 Family Member Contribution | \$0 | \$0 |
| 1-2 Other Contribution (Landlord) | \$0 | \$0 |
| 1-3 Family Member Contribution | \$0 | \$0 |
| 1-4 Family Member Contribution | \$0 | \$0 |
| 1-5 Family Member Contribution | \$0 | \$0 |
| 1-6 Family Member Contribution | \$0 | \$0 |
| 1-7 Family Member Contribution | \$0 | \$0 |
| 1-8 Family Member Contribution | \$0 | \$0 |
| 1-9 Family Member Contribution | \$0 | \$0 |
| 1-10 Family Member Contribution | \$0 | \$0 |
| 1-11 Family Member Contribution | \$0 | \$0 |
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| 1-13 Family Member Contribution | \$0 | \$0 |
| 1-14 Family Member Contribution | \$0 | \$0 |
| 1-15 Family Member Contribution | \$0 | \$0 |
| 1-16 Family Member Contribution | \$0 | \$0 |
| 1-17 Family Member Contribution | \$0 | \$0 |
| 1-18 Family Member Contribution | \$0 | \$0 |
| 1-19 Family Member Contribution | \$0 | \$0 |
| 1-20 Family Member Contribution | \$0 | \$0 |
| 1-21 Family Member Contribution | \$0 | \$0 |
| 1-22 Family Member Contribution | \$0 | \$0 |
| 1-23 Family Member Contribution | \$0 | \$0 |
| 1-24 Family Member Contribution | \$0 | \$0 |
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| 1-52 Family Member Contribution | \$0 | \$0 |
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| 1-100 Family Member Contribution | \$0 | \$0 |
| 1-101 Family Member Contribution | \$0 | \$0 |
| 1-102 Family Member Contribution | \$0 | \$0 |
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| 1-106 Family Member Contribution | \$0 | \$0 |
| 1-107 Family Member Contribution | \$0 | \$0 |
| 1-108 Family Member Contribution | \$0 | \$0 |
| 1-109 Family Member Contribution | \$0 | \$0 |
| 1-110 Family Member Contribution | \$0 | \$0 |
| 1-111 Family Member Contribution | \$0 | |



Key to early detection:
RG migrations within *pass* categories!

4 Apply Technology for Efficient Delivery

- Documentation / Credit / Policy
- Quantification of pre/post levels: it speaks to the quality of the *credit process*

EXCEPTIONS PORTAL Legal Doc Exceptions Credit Exceptions Loan Policy Exceptions More SUMMARY OUTSTANDING CLEARED Loan Review 06/10/2020 05/18/2021

Highlighted items within the table(s) below do not represent credit servicing exceptions. However, Inizio/Credit recommends that the institution obtain the identified documentation / information to conform to the industry's best practices.

Outstanding Credit Exceptions Search exceptions Q Today's Date: 12/04/2022 Credit Exceptions Cut Off Date: 12/30/2022 Days Remaining to Clear Credit Exceptions: 26

| Required / Recommended | Reviewer Comments | Documents | Institution Comments | Status | Review Status |
|--|--|-----------------------|----------------------|---------------------------------------|---------------|
| <input type="checkbox"/> Required per Loan Agreement | ✓ | Upload / Download (1) | ✓ | Acknowledged & Tracked by Institution | 4 |
| <input type="checkbox"/> Required per institution Policy | ✓ | Upload | ✓ | Update | 4 |
| <input type="checkbox"/> Required per institution Policy | 1 Loan over balance threshold for PPS requirement | Upload | ✓ | Update | 8 |
| <input type="checkbox"/> Required per institution Policy | ✓ | Upload | ✓ | Update | 8 |
| <input type="checkbox"/> Required per institution Policy | ✓ | Upload | ✓ | Update | 8 |
| <input type="checkbox"/> Required per institution Policy | ✓ | Upload | ✓ | Update | 8 |
| <input type="checkbox"/> Required per institution Policy | ✓ | Upload | ✓ | Update | 8 |
| <input type="checkbox"/> Required per Loan Agreement | ✓ | Upload | ✓ | Update | 8 |
| <input type="checkbox"/> Required per Loan Agreement | 1 Annual rent rolls are required per the Loan Agreement; lost rent roll... | Upload | ✓ | Update | 4 |
| <input type="checkbox"/> Recommended | ✓ | Upload | ✓ | Update | 4 |

EXCEPTIONS PORTAL Legal Doc Exceptions Credit Exceptions Loan Policy Exceptions More SUMMARY OUTSTANDING CLEARED Loan Review 08/10/2020 06/18/2021

Credit Exceptions Summary

| Borrowers | |
|--|---------------|
| Number of Borrowers Reviewed | 22 |
| Number of Borrowers w/ Credit Exceptions (Pre-Clearing) | 5 |
| Credit Exception Rate (Pre-Clearing) | 22.73% |
| Number of Borrowers w/ Credit Exceptions (Post-Clearing) | 3 |
| Credit Exception Rate (Post-Clearing) | 13.64% |

Exceptions

| | |
|---|---------------|
| Total Credit Exceptions | 12 |
| Outstanding Exceptions | 8 |
| Cleared Exceptions | 4 |
| Percentage of Exceptions Cleared | 33.33% |

Outstanding Credit Exceptions

| Credit Exceptions | Total Exceptions | % of Exceptions |
|--|------------------|-----------------|
| Missing / Outdated Acct. Prepared Financials | 3 | 37.50% |
| Missing / Outdated Federal Tax Returns | 2 | 25.00% |
| Missing / Outdated Other | 2 | 25.00% |
| Missing / Outdated PPS | 1 | 12.50% |
| Totals | 8 | 100.00% |

Cleared Credit Exceptions

| Credit Exceptions | Total Exceptions | % of Exceptions |
|--|------------------|-----------------|
| Missing / Outdated Federal Tax Returns | 2 | 50.00% |
| Missing / Outdated Acct. Prepared Financials | 1 | 25.00% |
| Missing / Outdated PPS | 1 | 25.00% |
| Totals | 4 | 100.00% |

5 Rate Underwriting And Servicing

- *Underwriting*, at inception, generally satisfactory
- Post-booking servicing is degrading industry-wide

EXCEPTIONS PORTAL

[Legal Doc Exceptions](#)
[Credit Exceptions](#)
[Loan Policy Exceptions](#)
[More ▾](#)
[SUMMARY](#)
[OUTSTANDING](#)

Borrower Underwriting Ratings Summary

| Underwriting Rating | Borrower Count | Borrower % | Loan Count | Loan % | Balance | Balance % | Exposure | Exposure % |
|---------------------|----------------|----------------|------------|----------------|----------------------|----------------|----------------------|----------------|
| Pending Completion* | 65 | 95.59% | 103 | 95.37% | \$114,260,113 | 96.92% | \$124,291,223 | 96.98% |
| Satisfactory | 2 | 2.94% | 4 | 3.70% | \$3,217,651 | 2.73% | \$3,461,251 | 2.70% |
| Weak | 1 | 1.47% | 1 | 0.93% | \$409,540 | 0.35% | \$409,540 | 0.32% |
| Totals | 68 | 100.00% | 108 | 100.00% | \$117,887,305 | 100.00% | \$128,162,014 | 100.00% |

*Note: Loans identified as "Pending Completion" have not yet been published to the portal

EXCEPTIONS PORTAL

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[Credit Exceptions](#)
[Loan Policy Exceptions](#)
[More ▾](#)
[SUMMARY](#)
[OUTSTANDING](#)

Credit Servicing Ratings Summary

| Credit Servicing Rating | Borrower Count | Borrower % | Loan Count | Loan % | Balance | Balance % | Exposure | Exposure % |
|-------------------------|----------------|----------------|------------|----------------|----------------------|----------------|----------------------|----------------|
| Pending Completion* | 65 | 95.59% | 103 | 95.37% | \$114,260,113 | 96.92% | \$124,291,223 | 96.98% |
| Satisfactory | 3 | 4.41% | 5 | 4.63% | \$3,627,192 | 3.08% | \$3,870,792 | 3.02% |
| Totals | 68 | 100.00% | 108 | 100.00% | \$117,887,305 | 100.00% | \$128,162,014 | 100.00% |

*Note: Loans identified as "Pending Completion" have not yet been published to the portal

6 Observe Pricing / Valuations / Vintages

- With the volatile rate environment, there should be congruence between risk and loan pricing
- With the recent spurt in loan growth, remember the lesson of loan vintages

| Loan Portfolio WAVG Interest Rate | | Pass Loans | | | | | Non-Pass Loans | | WAVG Interest Rate |
|-----------------------------------|-------------------------------------|------------|-----------|-------|--------------|------------------------|-----------------|-------------|--------------------|
| | | Ungraded | Excellent | Good | Satisfactory | Satisfactory/Monitored | Special Mention | Substandard | |
| FFIEC Code | Description | 0 | 1 | 2 | 3 | 4 | 5 | 6 | |
| 1A1 | 1-4 Family Residential Construction | -- | -- | -- | 5.50% | 5.01% | -- | -- | 5.16% |
| 1B | Secured by Farmland | -- | -- | 5.50% | 5.24% | 4.90% | -- | 5.32% | 5.08% |
| 1C1 | 1-4 Family Loans: Revolving | -- | -- | 6.08% | 5.90% | 6.75% | -- | -- | 6.04% |
| 1C2A | 1-4 Family Resi Mortgage: 1st Lien | 4.26% | -- | 4.38% | 4.42% | 4.81% | 4.58% | 5.65% | 4.50% |
| 1C2B | 1-4 Family Resi Mortgage: Jr. Lien | 5.00% | -- | 6.12% | 6.00% | 6.23% | -- | -- | 6.04% |
| 1D | Secured by Multifamily | -- | -- | -- | 5.21% | -- | -- | -- | 5.21% |
| 1E1 | Secured by OOCRE | -- | -- | 5.75% | 5.39% | 5.08% | -- | -- | 5.45% |
| 1E2 | Secured by Non-OOCRE | 5.75% | -- | 5.68% | 5.77% | 5.49% | 5.11% | -- | 5.62% |
| 3 | Agricultural Production Loans | -- | 3.50% | 6.75% | 5.68% | 5.87% | -- | 6.25% | 5.77% |
| 4A | Commercial & Industrial Loans | -- | 1.05% | 3.25% | 5.70% | 5.79% | -- | -- | 3.63% |
| 6C | Auto Loans | -- | -- | 5.04% | 6.43% | 6.95% | -- | -- | 6.48% |
| 6D | Other Consumer Loans | -- | 3.25% | 6.91% | 7.81% | 7.50% | 8.25% | -- | 7.04% |
| WAVG Interest Rate | | 5.00% | 1.24% | 5.13% | 5.24% | 5.23% | 4.73% | 5.77% | 5.04% |

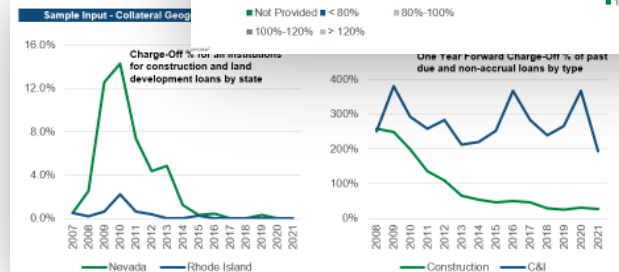
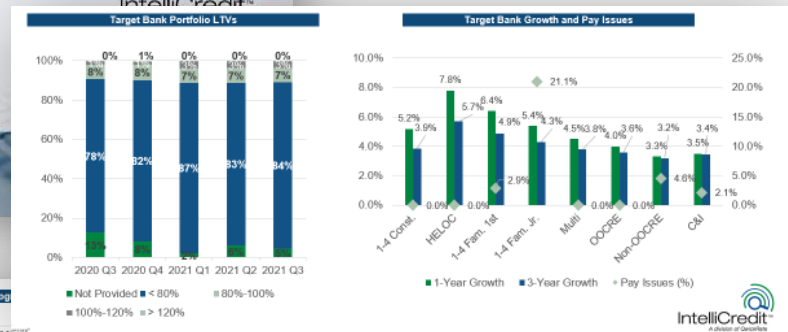
LOAN VINTAGES (PORTFOLIO)

| Loan Vintages | Loan Count | Loan % | Balance | Balance % | Exposure | Exposure % | WAVG Risk Grade | WAVG Interest Rate |
|----------------|------------|----------------|----------------------|----------------|----------------------|----------------|-----------------|--------------------|
| 2000 and prior | 1 | 0.12% | \$8,343 | 0.00% | \$8,343 | 0.00% | 3.00 | 5.25% |
| 2001 - 2005 | 3 | 0.37% | \$596,572 | 0.18% | \$596,572 | 0.17% | 2.92 | 5.50% |
| 2006 - 2010 | 32 | 3.92% | \$7,587,706 | 2.25% | \$7,587,706 | 2.13% | 3.42 | 6.32% |
| 2011 - 2015 | 82 | 10.05% | \$33,643,669 | 10.00% | \$33,866,590 | 9.51% | 3.08 | 4.99% |
| 2016 | 52 | 6.37% | \$18,414,873 | 5.47% | \$19,422,020 | 5.45% | 3.07 | 4.75% |
| 2017 | 82 | 10.05% | \$31,237,711 | 9.28% | \$31,318,260 | 8.79% | 3.23 | 4.45% |
| 2018 | 103 | 12.62% | \$35,535,863 | 10.56% | \$36,519,695 | 10.26% | 3.37 | 4.89% |
| 2019 | 189 | 23.16% | \$61,616,318 | 18.31% | \$64,020,542 | 17.98% | 3.23 | 5.26% |
| 2020 | 272 | 33.33% | \$147,921,774 | 43.95% | \$162,762,396 | 45.71% | 2.94 | 5.08% |
| 2021 | 0 | 0.00% | \$0 | 0.00% | \$0 | 0.00% | N/A | N/A |
| 2022 | 0 | 0.00% | \$0 | 0.00% | \$0 | 0.00% | N/A | N/A |
| Totals | 816 | 100.00% | \$336,562,829 | 100.00% | \$356,102,123 | 100.00% | 3.10 | 5.04% |

7 Produce Comprehensive Reports & Defendable Credit Marks

A Good Loan Review . . .

- leaves behind substantive deliverables – not just a spreadsheet focused on downgrades to non-pass
- helps inform CECL
- brings a capacity to share *industry best practices*



8 Review Material Work-out Credits

- Required under current regulatory guidance
- Concern over lack of objectivity

Interagency Guidance of Credit Risk Review Systems *(Issued)*

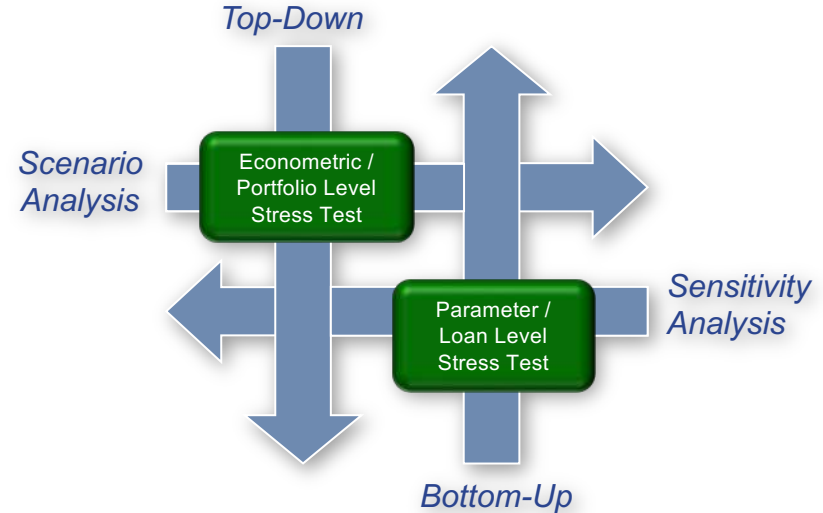
Regardless of structure (or size of the institution), an effective credit risk review system accomplishes the following objectives:

- ✓ Identifies loans with credit weaknesses
- ✓ Validates risk ratings
- ✓ Identifies relevant trends
- ✓ Assesses internal credit policies and loan administration procedures / compliance with laws and regulations
- ✓ Evaluates lending personnel, including their compliance with lending policies risk assessment
- ✓ Provides management and the boards of directors with portfolio quality assessments
- ✓ Onlines problem loan management plans
- ✓ Provides management with timely credit quality information for regulatory, reporting, and ALLL

Final Guidance Issued May 8, 2020

9 Companion With Stress Test

- Loan review arguably has the most “real-time” perspective of a borrower’s current circumstance, off-setting risks of relying on potentially out-of-date initial credit underwriting data
- A sensitivity stress test on a subset portfolio, concurrent with the broader loan review, is a good faith attempt at a loan level approach on a significant concentration



| Pre-Stress | | | | | |
|-----------------------|-------------------|--------|--------|-------|--|
| Debt-Service Coverage | CRE Loan-To-Value | | | | |
| | 60-69% | 70-79% | 80-89% | 90+% | |
| >1.75x | 5.0% | 45.5% | 38.0% | 7.5% | |
| 1.51x to 1.75x | 19.0% | 74.0% | 53.0% | 15.0% | |
| 1.26x to 1.50x | 22.5% | 58.0% | 60.0% | 12.5% | |
| 1.16x to 1.25x | 7.5% | 35.0% | 17.5% | 0.0% | |
| 1.01x to 1.15x | 0.0% | 5.0% | 25.0% | 0.0% | |
| <=1.0x | 0.0% | 0.0% | 0.0% | 0.0% | |

Note: Cell data represent the volume of loans, as a percentage of total risk-based capital, that meet the LTV and DSC criteria for that cell.

| Post-Stress | | | | | |
|-----------------------|-------------------|--------|--------|-------|--|
| Debt-Service Coverage | CRE Loan-To-Value | | | | |
| | 60-69% | 70-79% | 80-89% | 90+% | |
| >1.75x | 0.0% | 5.0% | 15.0% | 7.5% | |
| 1.51x to 1.75x | 0.0% | 7.5% | 45.0% | 12.5% | |
| 1.26x to 1.50x | 5.0% | 12.5% | 20.0% | 25.0% | |
| 1.16x to 1.25x | 0.0% | 20.0% | 17.5% | 12.5% | |
| 1.01x to 1.15x | 0.0% | 50.0% | 125.0% | 70.0% | |
| <=1.0x | 0.0% | 10.0% | 35.0% | 5.0% | |

Note: Cell data represent the volume of loans, as a percentage of total risk-based capital, that meet the LTV and DSC criteria for that cell.

10 Be Collaborative



Which means . . .

- no written material findings, downgrades, or recommendations without prior explanations from the review team
- deploying seasoned and persuasive due diligence review teams
- helping to avoid the most toxic of due diligence challenges: *too many credit surprises!*





Please Reach Out on any Credit
Portfolio Review Needs. Deeply
Experienced in M&A / Re-Caps.

Real-time combo:

Diligence Loan Review / Credit Marks / Portfolio Analytics



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Q & A