Decision of the

Supervision Appeals Review Committee

In the Matter of ***

Case No. 2024-02

I. Summary

*** (Bank) asked the Supervision Appeals Review Committee (Committee) to review the appropriateness of the Asset Quality Rating and a Matter Requiring Board Attention (MRBA) regarding Commercial Real Estate (CRE) concentration risk management arising from a ***, 2023 Examination conducted by the FDIC. As described further below, the Committee finds in favor of the FDIC Division of Risk Management Supervision (RMS).

II. Background and Procedural History

The 2023 examination of the Bank by the FDIC concluded in the release of a Report of Examination (2023 Report), which assigned CAMELS/composite ratings[1] of 2-3-2-2-2-2/2. The 2023 Report included a MRBA focused on enhancing the Bank's concentration risk management practices. Specifically, the Bank was instructed to perform CRE stress testing that measures the impact of changing economic conditions, develop formal procedures governing the stress testing process, segment the CRE portfolio based on common risk factors, establish more specific diversification risk standards based on broader commonalities such as property types, geographic markets, or economic sensitivities, and update concentration reports.

By letter to the RMS Director (Director) dated January 2, 2024, the Bank requested a review of the Asset Quality Rating and MRBA regarding CRE concentration risk management in the 2023 Report. The Director concluded that the Asset Quality Rating and CRE MRBA were appropriate and consistent with regulatory guidance.

The Bank appealed to the Committee to review the appropriateness of the Director's determinations with respect to the Asset Quality Rating and CRE MRBA.

In accordance with the FDIC's *Guidelines for Appeals of Material Supervisory Determinations* (*"Guidelines"*),[2] the Committee has reviewed the appeal for consistency with the policies, practices, and mission of the FDIC, and the reasonableness and support for the positions of the

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[1] The FFIEC Uniform Financial Institutions Rating System (UFIRS) is used by the federal banking agencies to assign a composite rating based on an evaluation and rating of six components of an institution's financial condition and operations. These component factors address the adequacy of capital, the quality of assets, the capability of management, the quality and level of earnings, the adequacy of liquidity, and the sensitivity to market risk (CAMELS ratings). Evaluations of the components take into consideration the institution's size and sophistication, the nature and complexity of its activities, and its risk profile.

[2] FDIC Guidelines for Appeals of Material Supervisory Determinations.

parties. The Committee met to consider the appeal and hear oral arguments from the parties on June 5, 2024.

III. Discussion

Asset Quality Rating and CRE MRBA

The Bank operates out of *** in *** and specializes in CRE lending to ***.

The Bank has developed its own methodology for measuring and managing risk. The Bank models the net liquidation value of individual loans to aggregate and measure risk, which the Bank argues provides a more accurate way to measure and evaluate risk for its unique business model than the metrics used by the FDIC. The Bank states that the loans are protected with collateral that has a liquidation value in excess of the loan principal, and therefore, risk is minimal. The Bank also utilizes Small Business Administration or U.S. Department of Agriculture loan guarantees for a significant portion of its loans. The Bank contends that reliance on the FDIC's metrics would not accurately assess risk, and would negatively impact the Bank's customers.

The Bank claims that it has managed CRE concentration risk and its loan portfolio risk in a safe and sound manner, as supported by its history of charge-offs. The Bank provided data showing that historical levels of non-owner occupied (NOO) CRE loans have not correlated with losses at the Bank. The Bank agrees that its NOO CRE portfolio needs further subcategorization, and states that it has accomplished this by breaking the portfolio into categories of office, retail, residential, multifamily, industrial, hospitality, entertainment, and other. The Bank also asserts that its designated lending area in *** has not historically experienced real estate bubbles or large real estate devaluations, and the Bank's loan collateral practices show its asset quality strength over the last twenty years. The Bank explains that it performs a stress-risk analysis at a very granular level and adjusts its analysis for any changes in real estate market values.

The Bank contends that it has a Senior Loan Committee consisting of mostly board members that meets weekly and limits underwriting risk, stress tests loans to verify sufficient collateral, monitors appraisal accuracy, limits non-collateral loans, and monitors its loan portfolio by using three types of testing which measure liquidation risk.

For these reasons, the Bank requests that the Committee order RMS to adjust the Asset Quality Rating to "2" and to remove the CRE MRBA.

RMS asserts that the Asset Quality Rating and the CRE MRBA provided in the 2023 Report are appropriately supported by the record. The 2023 Report identified a high level of inherent credit risk in the loan portfolio along with weaknesses in CRE concentration risk management practices, as well as a failure to formally document support for the Allowance for Credit Losses (ACL). The Bank's level of adversely classified items was elevated at *** of Tier 1 Capital and ACL, and past due and nonaccrual loans were well above peer levels at *** percent of gross loans. RMS acknowledges that the Bank has historically experienced low levels of loan losses, but notes that changes in CRE portfolio composition over time and weaknesses in risk

management practices may impact future outcomes. RMS asserts that loss histories and data cannot predict future economic conditions that may develop and the possible effect on the Bank's asset quality and financial condition.

RMS states that CRE concentration risk management practices are inadequate, given the size of the NOO CRE concentration at *** percent of Tier 1 Capital and ACL and the overall concentration in CRE at *** percent of Tier 1 Capital and ACL. RMS notes that measuring liquidation value in excess of loan principal is a method of measuring risk, but does not replace the need for portfolio-wide stress testing, diversification standards, and portfolio segmentation. RMS asserts that recommendations to address CRE concentration risk management weaknesses have been made in every report of examination since 2016, and while the Bank has made some improvements, continuing weaknesses supported an escalation to a MRBA in the 2023 Report.

RMS asserts that the Bank's current stress testing methodology does not quantify the impact of changing economic conditions on asset quality, earnings, and capital, and the Bank's CRE portfolio segmentation does not sufficiently segment NOO CRE loans by common risk characteristics. In addition, RMS notes that the Bank's diversification standards are too broad, which do not capture potential risks based on similar characteristics within the NOO CRE portfolio or provide appropriate limits to CRE portfolio segments to guide the overall CRE lending strategy. RMS notes that additional segmentation completed after the 2023 examination will be considered as part of the next examination, and may demonstrate progress toward addressing the CRE MRBA.

RMS acknowledges that the Bank's risk mitigation practices provide value as part of a risk management framework, but contends that these practices do not replace the need for appropriate portfolio-wide stress testing, diversification standards, and portfolio segmentation, improved policies and reporting, and sufficient support for reserves.

Committee Findings

The Committee has acknowledged in the past that assigning supervisory ratings "inevitably involve a degree of subjectivity and judgment on the part of examiners." A bank seeking the Committee's review of a rating or a MRBA must present sufficient evidence to demonstrate that the rating assigned was not appropriately supported by the record or that its assignment is inconsistent with FDIC policy or practice. For the reasons set forth below, the Committee finds that the Bank did not present sufficient evidence to overturn the Asset Quality Rating or CRE MRBA assigned pursuant to the 2023 Report.[3]

1. Asset Quality Rating

The asset quality rating of a bank reflects the quantity of existing and potential credit risk associated with the loan and investment portfolios, other real estate owned, and other assets, as

[3] *See* FDIC Risk Management Manual of Examination Policies.

well as off-balance sheet transactions.[4] The asset quality of a bank is rated based upon, but not limited to, an assessment of evaluation factors listed in the FDIC Examination Manual.[5]

An asset quality rating of 3 is assigned when asset quality or credit administration practices are deemed less than satisfactory.[6] The manual states that a 3 rating is warranted when "the level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern" and "there is generally a need to improve credit administration and risk management practices."[7]

The Bank has not presented sufficient evidence to demonstrate that an asset quality rating of "3" is not appropriately supported by the record. While the Committee recognizes that the Bank's CRE portfolio has not experienced significant historical losses, the concerns identified regarding the Bank's CRE risk management practices support an asset quality rating of 3. Accordingly, the Committee finds in favor of RMS on the asset quality rating.

2. CRE MRBA

MRBA are a subset of Supervisory Recommendations,[8] which are FDIC communications intended to inform an institution of the FDIC's views about changes needed in its practices, operations, or financial condition.[9] A principal purpose of supervisory recommendations is to communicate supervisory concerns to a bank so that it can make appropriate changes in its practices, operations or financial condition and thereby avoid more formal remedies in the future,

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[4] *Id*. section 1.1-24.

[5] These factors include the adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices; the level, distribution, severity, and trend of problem, classified, nonaccrual, restructured, delinquent, and nonperforming assets for both on- and off-balance sheet transactions; the adequacy of the allowance for loan and lease losses and other asset valuation reserves; the credit risk arising from or reduced by off-balance sheet transactions, such as unfunded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit; the diversification and quality of the loan and investment portfolios; the extent of securities underwriting activities and exposure to counter-parties in trading activities; the existence of asset concentrations; the adequacy of loan and investment policies, procedures, and practices; the ability of management to properly administer its assets, including the timely identification and collection of problem assets; the adequacy of internal controls and management information systems; and the volume and nature of credit-documentation exceptions. *Id.,* section 1.1-24.

[6] *Id.,* section 1.1-25.

[7] *Id.*

[8] FDIC Statement of FDIC Board of Directors on the Development and Communication of Supervisory Recommendations (July 27, 2016).

[9] *See* the Report of Examination Instructions, section 16.1.

such as enforcement actions.[10] A MRBA is defined as an issue or risk of significant importance that requires board attention.[11]

Existing supervisory guidance states that banks with significant concentrations in CRE are expected to conduct portfolio stress tests of these exposures as part of their ongoing risk-management activities.[12] These risk assessments should be based on assumptions regarding potential adverse external events, such as changes in real estate or capital markets prices, or unanticipated deterioration in a borrower's repayment capacity.

The Committee agrees that stress testing is an important element of a strong credit risk management program, and that it is most valuable when conducted over a range of economic conditions and on a portfolio and segmented basis. The need for improvements in the Bank's stress testing program suggested by RMS are supported by the record, and are consistent with existing supervisory guidance. Accordingly, the Committee does not find sufficient evidence to overturn the issuance of the MRBA.

IV. Conclusion

The Committee recognizes that the Bank has a unique business model serving ***, and believes that the FDIC's supervisory approach should be sufficiently flexible to allow for a diverse banking sector with a range of different business models, including the one the Bank employs. Nonetheless, for the reasons described above, the Committee does not find sufficient evidence to overturn RMS's determinations.

[10] *Id*.

[11] *Id*. Examples of MRBAs: Emerging issues in which the board needs to be more proactive in establishing policy and risk management parameters; policy weaknesses that, if left unaddressed, could increase the institution's risk profile or, adversely affect the condition of the institution; ineffective management; repeat examination recommendations or regulatory, audit, or risk management criticisms that have escalated in importance; enforcement action provisions requiring continued attention (these should be included in one summary bullet point); or significant noncompliance with laws, regulations, or the bank's own policies.

[12] *See* Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, and Office of the Comptroller of the Currency, Joint Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (December 6, 2006). *See also* FDIC Supervisory Insights, Stress Testing Credit Risk at Community Banks (May 8, 2023).