



2018 Bank Study Project Class of 2020

CREDIT RISK MANAGEMENT

Gary Higgins

NOTES:

1. Please use 8 1/2" x 11" paper (or paper folded to that size).
2. Attach the **Freshman Cover Sheet – Class of 2020** from <http://www.gsblsu.org/students-3/> as the first page of your project.
3. Please staple your project or use a binder clip. **DO NOT** use paper clips. or any kind of folder or binder.

Complete and mail by October 15, 2018

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CREDIT RISK MANAGEMENT

2018 Session

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Introduction

After completing this assignment, you will have a better understanding of the credit risk management process of your bank. Importantly, the final part of the assignment is to make any appropriate recommendations or observations regarding the credit risk management process based your project.

In order to allow each participant to complete a project that most closely aligns with their job duties, areas of interest relative to the credit management process of their bank, or anticipated job duties in the future there is a choice of two options for completion.

Depending on the project selected, you will have an enhanced understanding of:

Option 1

- The Strategic Credit Risk Management process
- Tolerance for risk and potential for volatility in portfolio credit quality and earnings
- Policies, procedures, systems and controls to manage portfolio credit risk
- Aggregate Risk Determination predicated on the Quantity of Risk and the Quality of Risk Management

Option 2

- The causes and consequences of recent community bank failures (2008 – 2012)
- A broader awareness of analysis that has been completed regarding the economic factors during that period (2008-2012)
- Key credit risk management controls within your company and how they function
- The ways in which the key credit risk management controls will serve to protect the quality of the loan portfolio within your company
- Develop a personal point of view on any anticipated potential future areas of concern for the banking industry and your company during the years 2019 – 2021

Project Resources and Information Needed

For **Option 1**, several templates are available at the GSBSLU website to facilitate completing the credit risk assessment (the Excel version of information provided in class). To access the template, go to www.gsblsu.org. An instruction sheet is provided on the first tab to facilitate entering data into the template. You may also obtain Loan Quality information for your institution, with supporting information available from the UBPR/UTPR.

(www.ffiec.gov/ubpr.htm)

If you are a regulator or do not work for a financial institution and select Option 1, attempt to gather the information from a bank you have examined, or from regulatory reports, e.g. examination reports, and the Uniform Bank Performance Report (UBPR). Alternatively, you might ask one of your fellow students to share information on his/her bank. To protect the confidentiality of the information, it is not necessary that regulators disclose the name of the bank.

The goal of Option 1 is to establish a broader knowledge of your company. Please use your best efforts to complete all recommended templates with available information. However, when the requested information is not available please note that in your comments and proceed with your best efforts/estimates. The overall goal is to increase awareness of your company and this can be accomplished using best efforts/estimates, when necessary.

I. Executive Summary [5%]

Briefly, describe the current situation in your institution regarding credit risk management. Using GSBLSU experience, comment on the quality and completeness of these activities. Also, briefly summarize your career and current job responsibilities along with information regarding your institution's age, size, ownership structure, footprint covered, and primary lending activities (e.g. agriculture, energy, commercial real estate, etc.).

II. Construct and Assess an Aggregate Credit Risk Profile [95%]

A: Construct a Quantity of Risk Profile for your bank [40%]

The Quantity of Risk Profile utilizes summary loan portfolio information which should be available from the senior credit officer or senior lender in your bank, as well as from the UBPR or UTPR. (NOTE: If the information requested is not readily available, do the best you can as noted earlier. However, be sure to describe any shortcomings to the complete analysis; whether you believe it might be beneficial for your bank to develop more comprehensive portfolio information; and what information additions you believe will be helpful).

1. Use the Transaction Risk Profile (Directional Assessment) template to array the loan portfolio by Risk Rating in a format that displays:
 - a) The % of total loan portfolio by Risk Rating in each Rating Category for the bank as a whole. Ideally, Risk Ratings will be assigned to Commercial & Industrial (C&I); Commercial Real Estate (CRE); Agriculture; Consumer; and Residential Permanent Mortgage Loans.
 - b) NOTE: If certain categories of loans are not assigned a Risk Rating in your bank, use your best judgment to assign Ratings. Be sure to describe the methodology used for your assessment.
 - c) Also NOTE: The Transaction Risk Profile template provides a choice among four Risk Rating scales. If your bank uses a different methodology, use the closest scale provided and state in the paper how you assigned the categories.
2. Include a table in the paper of your bank's major lines of business expressed in dollars (\$); as a percentage (%) of total portfolio outstandings; and as a percentage (%) of bank capital (Tier 1 + ALLL).

- a) NOTE: This may be found in the UBPR:
 - a. % and \$ of Average Gross Loans (page 7A of the UBPR-- Analysis of Credit Allowance and Loan Mix-- has % of Avg. Gross Loans for major loan categories)
 - b. Major loan categories as a % of Total Capital may be found on page 7B of the UBPR (Analysis of Concentrations of Credit).
 - b) REMEMBER: If an industry within a Line of Business is => 20% of Capital, that industry should be identified separately to be used with the Intrinsic Risk Scoring Worksheet.
 - a. NOTE: Owner Occupied Commercial Real Estate should be included in C&I and broken down by respective industries (if possible).
 - b. Examples of Industries within Lines of Business (See 3c below for sample Lines of Business):
 - i. Within Agriculture:
 - 1. Dairy
 - 2. Row Crop
 - ii. Within CRE (Permanent):
 - 1. Multi-family
 - 2. Strip Retail Centers
 - 3. Office
 - 4. Warehouse
 - c. As with Transaction Risk, if all data are not available, do the best you can. Comment on what is available, how you used that information, and whether you believe additional bank-wide tracking might or might not be beneficial. Provide reasons for your assessment.
3. Use the information contained in the Line of Business/Industry table to determine how many Intrinsic Risk Scoring Worksheets should be completed.
- a) One Intrinsic Risk Scoring Worksheet will be completed for each Line of Business (excluding Industries within that Line of Business that =>20% of Capital—i.e. Tier1 + ALLL).
 - b) One Intrinsic Risk Scoring Worksheet will be completed for each Industry that =>20% of Capital.
 - c) If a line of business has minimal outstandings (i.e. <5% of the loan portfolio) combine the outstandings for all similar lines of business and intuitively assign an Intrinsic Risk Score.

NOTE: Examples of lines of business include:

- :Consumer
 - Direct
 - Indirect
 - Home Equity
 - Credit Card
- :Commercial and Industrial (C&I)
- :Real Estate
 - Commercial Construction

B. Construct a Quality of Risk Management Assessment: [40%]

STEP 1: Using the Strategic Credit Risk Management Visual provided, plot points on the Visual or describe the position on the respective continuum for Stated Priorities/Culture, Observed Risk Strategy, and Implemented Risk Controls where you see your bank.

STEP 2: Discuss the relationship between the Stated Priorities/Culture in your bank and the Observed Risk Strategy.

- a) Describe the Stated Priorities/Culture for your bank.
- b) Describe the Observed Risk Strategy (based on your assessment of the Quantity of Risk)
- c) Are the two consistent?
- d) If not, what do you believe may be the reasons?

STEP 3: Discuss the Implemented Risk Controls in your bank focusing on the Visual continuum of Behavior Influencing through Behavior Controlling

- a) Describe your assessment (and reasons for that assessment) of the appropriateness of the Implemented Risk Controls given the Observed Risk Strategy

STEP 4: Discuss the Loan Portfolio Management Tools utilized in your bank as outlined in the Quality of Risk Management hierarchy

- a) Provide an assessment (and reasons for that assessment) of the appropriateness of the 6 Loan Portfolio Management Tools utilized given your bank's Observed Risk Strategy and Implemented Risk Controls
- b) What steps would you recommend to better monitor, manage, or reduce the portfolio risk revealed in the profile?

C. Aggregate Risk Determination and Loan Portfolio Management Conclusions: [15%]

- a. Combine the determined Quantity of Risk assessment with the determined Quality of Risk Management assessment (similar to the quadrant combination used in class. (You do not have to create a visual—just state the conclusions for each category. For example: Quantity of Risk-- Moderately High: Quality of Risk Management— Moderately Weak)
- b. Based on this combination, provide a conclusion (and your reasons for that conclusion) of the efficiency and effectiveness of the Credit Risk Management system in your bank
 - i. If the CRM system is appropriate, what makes it so?
 - ii. If your CRM system has identified weaknesses, what are they and what solutions would you recommend?

Please note the **percentage of each section allocated to the total grade**. Grading will be in conformity with the Graduate School of Banking Policy. A grade of less than “C”, will require the submission to be redone by the student.

Option 2

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II. Analysis of Recent Bank Failures (20%)

Outline the Causes and Consequences of Recent Community Bank Failures for the period 1/08 – 12/11. Utilize available reference materials such as the United State Government Accountability Office report GAO-13-704T, and An Analysis of the Impact of the Commercial Real Estate Concentration Guidance NR-OCC-2013-59a, or other relevant information.

III. Credit Risk Management Controls (40%)

Highlight three separate Credit Risk Management Controls used within your company that contributes to asset quality of the loan portfolio. Examine how these controls operate and the ways in which they help your company protect the loan portfolio. Please discuss the following aspects for each control, as appropriate (please note not all aspects will be applicable to all controls...so use what would apply):

1. General description of the control with anticipated outcomes / goals
2. Accountable individual(s) or team(s) responsible to execute the control
3. Scope of the control
4. Frequency at which the control is performed or applicable
5. Type of documentation / communication supporting the control
6. Tracking process to record any exceptions / improvement opportunities / suggestions for improvement identified by execution of the control
7. Validation steps to internally test / monitor the effectiveness of the control
8. Level (High, Medium, or Low) of third party (external to your company) review to opine on the control effectiveness

IV. Potential Areas of Concern 2019-2021 (15%)

Using the observations from Part II of this exercise, key national/regional/local indicators, and/or any factors you consider relevant state your personal point of view on any potential future areas of concern for the banking industry during the years 2019-2021 (please limit your comments to no more than three concerns). Discuss any potential impact of these concerns on your company.

V. Credit Risk Management Recommendations (20%)

Based upon your observations and findings in the prior sections, note the existing credit risk controls which should serve to protect your company over the next five years. Please note any

recommendations you would make to modify the Credit Risk Management controls used by your company, if any.

Please note the **percentage of each section allocated to the total grade**. Grading will be in conformity with the Graduate School of Banking Policy. A grade of less than “C”, will require the submission to be redone by the student.