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A BANKER'S GUIDE TO EMBRACING VOLATILITY

2023 Crowe Financial Services Conference

Guide your organization through industry volatility

As of Nov. 3, 2023

EMBRACE VOLATILITY

It has been over a decade since the banking industry encountered prolonged, adverse economic conditions. During this session, recession-tested professionals share strategies and tactics for thriving in scenarios ranging from hard- to soft-landings and everything in between. This session is appropriate for both seasoned bankers seeking a "refresher" or less-tenured industry professionals needing an introduction to remaining resilient in an inherently volatile industry.

> "Unburdened with the experience of the past, each generation of bankers believes it knows best, and each new generation produces some who have to learn the hard way."
>
> - Irvine Sprague, former chairman of the Federal Deposit Insurance Corporation

1. THE LOAN PORTFOLIO
2. THE SECURITIES PORTFOLIO
3. OTHER ASSETS AND OTHER LIABILITIES
4. REGULATORY CAPITAL
5. THE KITCHEN SINK

THE LOAN PORTFOLIO

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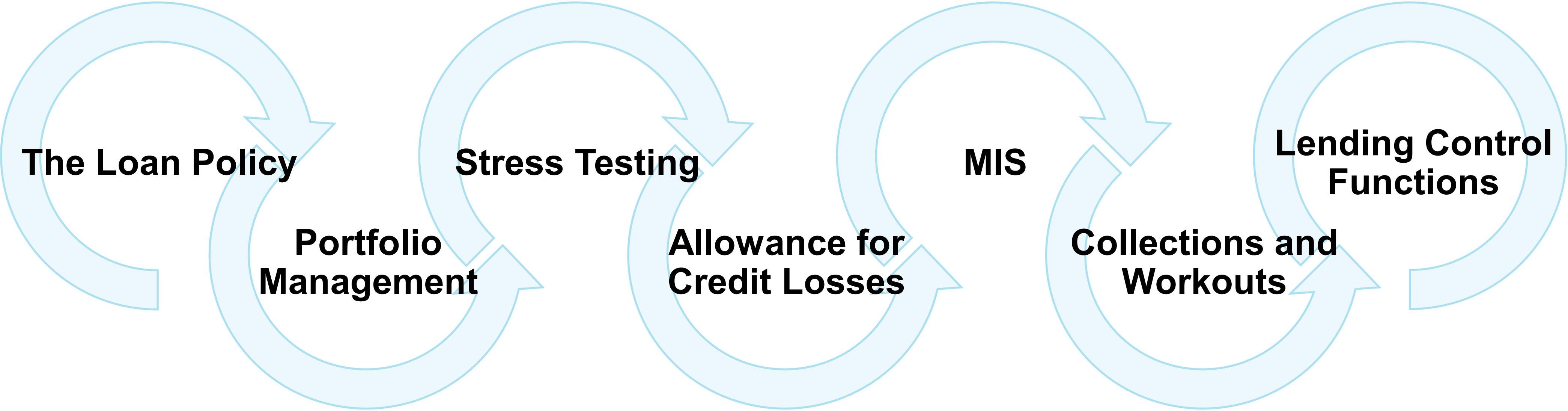
LOAN PORTFOLIO MANAGEMENT

LPM is the process by which risks that are inherent in the credit process are managed and controlled. To manage their portfolios, bankers must understand not only the risk posed by each credit but also how the risks of individual loans and portfolios are interrelated. These interrelationships can multiply risk many times beyond what it would be for the risk were not related.



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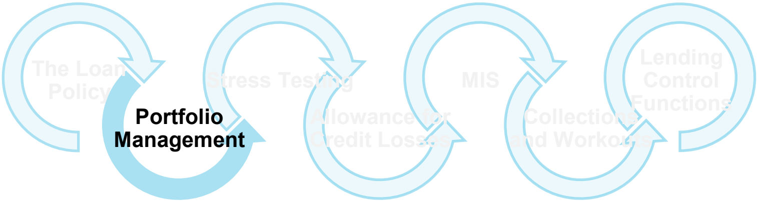
PORTFOLIO MANAGEMENT



OVERSIGHT

Risk Identification

Timely and accurate risk ratings (i.e., Substandard, Doubtful, etc.)

Substandard loans are often on nonaccrual

Applies to off-balance sheet exposures

Nonaccrual Status

Full collection of interest and principal is highly questionable

Nonaccrual loans will almost always be classified

Refer to Call Report Instructions

Exception Tracking

When aggregated, even well-mitigated exceptions can increase portfolio risk significantly

Segmentation + Diversification

Call code is generally not sufficient

Segmenting a portfolio and diversifying risk require comprehensive management information systems.

Concentration Management

If you owe the bank $100 that's your problem. If you owe the bank $100 million, that's the bank's problem.
J. Paul Getty

Risk-rating (i.e., substandard, doubtful) and accrual status may affect risk-weight for regulatory capital.

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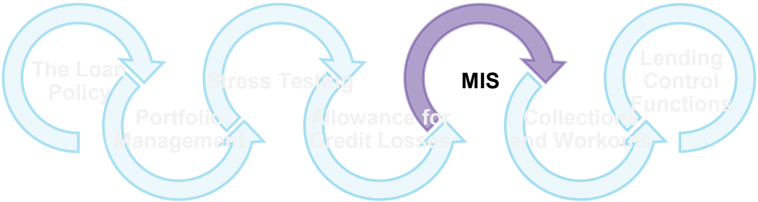
MANAGEMENT INFORMATION SYSTEMS



Credit-related MIS helps management and the board to fulfill their respective oversight roles. MIS-produced credit reports should ensure the board and management are receiving the right kind of information at the right time.

ACCURATE REPORTING

The best technology can be next to worthless if the data are not accurate. Only if data are updated periodically and out-of-date loan information is purged can MIS reports remain accurate and useful.

COMMON DATA INTEGRITY ISSUES

- Failure to report delinquency
- Incomplete or outdated information on loan participations
- Failure to archive note origination dates and amounts at renewal or modification
- Inaccurate underwriting exception capture
- Lack of clear reports and reporting lines
- Incorrect risk ratings or failure to archive risk ratings when a change occurs
- Omission of off-balance-sheet exposure

Pro Tip: Revisit Board and Senior Management reporting to ensure data is complete, concise, and relevant.

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ALLOWANCE FOR CREDIT LOSSES

ACL COMPONENTS

INDIVIUALLY EVALUATED LOANS	REASONABLE + SUPPORTABLE FORECASTS	Q-FACTORS	COLLATERAL DEPENDENT + VALUES

If a financial asset does not share similar risk characteristics with other assets, expected credit losses for that asset should be evaluated individually. Individually evaluated assets should not be included in a collective assessment of expected credit losses.

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ALLOWANCE FOR CREDIT LOSSES

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INDIVIUALLY EVALUATED LOANS	REASONABLE + SUPPORTABLE FORECASTS	Q-FACTORS	COLLATERAL DEPENDENT + VALUES

Generally, forecasts should address anticipated changes in the economic environment over a time frame that management can reasonably support. **Forward-looking information typically reflects management's expectation of changes to relevant macroeconomic data such as changes in unemployment rates and property values or other factors associated with the financial asset's collectability.** The factors that management considers in developing the forecast should be appropriate and **relevant**.

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ALLOWANCE FOR CREDIT LOSSES

ACL COMPONENTS

INDIVIUALLY EVALUATED LOANS	REASONABLE + SUPPORTABLE FORECASTS	Q-FACTORS	COLLATERAL DEPENDENT + VALUES

See what was trending in 2010 - Global

Consumer Electronics		Entertainment		Falling Searches	
1	iPad	1	Justin Bieber	1	Swine Flu
2	iPhone 4	2	Shakira	2	WaMu
3	Nokia 5530	3	Eminem	3	New Moon
4	HTC EVO 4g	4	Netflix	4	Mininova
5	Nokia N900	5	YouTube	5	Susan Boyle

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ALLOWANCE FOR CREDIT LOSSES

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COLLATERAL VALUES

The fair value of collateral may change over time. The most recent market value may differ from the fair value of the collateral as of the balance-sheet date. Management should adjust the value as necessary to reflect factors or events subsequent to the appraisal or evaluation date that affect the fair value of the collateral as of the balance sheet date.

COLLATERAL DEPENDENT ASSETS

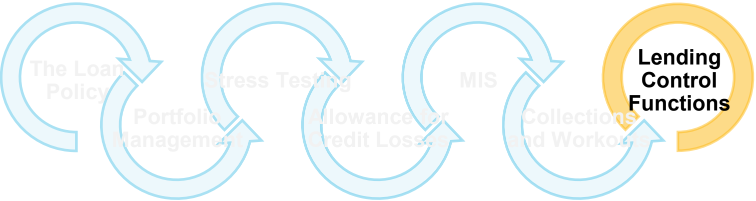
A financial asset for which the repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower, based on management’s assessment, is experiencing financial difficulty. For regulatory reporting purposes, the ACL for a collateral-dependent loan is measured using the fair value of collateral, regardless of whether foreclosure is probable.

COLLECTIONS AND WORKOUTS

The Loan Policy
Portfolio Management
Stress Testing
Allowance for Credit Losses
MIS
Collections and Workouts
Lending Control Functions

SPECIALIZED WORKOUT UNITS

Specialized workout units can save a bank considerable money especially during an economic downturn. An effective workout unit can help craft a strategy to return a troubled borrower to financial health. Because of their proficiency with both rehabilitation and exit strategies, workout personnel should be closely involved in developing strategy for marginally rated borrowers or any problem loans that are supervised by the line account officer. An experienced workout unit can provide valuable guidance during initial underwriting and restructures that can help to ensure that the bank's return is maximized in the event of default.



LENDING AND CONTROL FUNCTIONS

THE LOAN POLICY

The primary means by which senior management and the board guide lending activities.

Independence

(Segregation of Duties)

Independence promotes objectivity.

Budget constraints can compromise the independence and ultimately the effectiveness of control functions.

Credit Administration

This function is responsible for the day-to-day supervision of the loan policy.

Loan Review

Objective reviews of credit risk levels and risk management processes are essential to effective portfolio management.

Audit

Banking agency S&S standards bank should establish a system of independent, ongoing credit reviews and the results of the credit reviews should be communicated to management and the board of directors.

THE SECURITIES PORTFOLIO

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THE SECURITIES PORTFOLIO

BACK TO BASICS

Investments, like loans, are extensions of credit involving risks that carry commensurate rewards. However, risks in the investment portfolio should be minimized to ensure that **liquidity** and **marketability** are maintained.

Bank management must recognize the **the investment account is primarily a secondary source for liquidity rather than chasing yield.**

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ASSET-BASED LIQUIDITY RESOURCES

1. Cash Flows
2. Pledging of Assets (including securities)
3. Reserve Balances
4. Liquidation of Assets

FDIC's Supervision of First Republic Bank

"Unrealized losses in securities that exceeded capital was a key factor in the loss of confidence and failure of SVB. First Republic's loan portfolio unrealized fair value losses garnered similar attention with news articles noting that the unrealized losses exceeded First Republic's equity levels. These fair value declines, along with First Republic's high level of uninsured deposits, were characteristics that appeared to cause depositors and the public to view First Republic similarly to SVB."[1]

(Dollars in Millions)	Amortized Cost or Carrying Value	Fair Value	Net Unrealized Gains (Losses) or Fair Value Declines
As of December 31, 2022			
Available-for-Sale Debt Securities	$3,817	$3,347	($470)
Held-to-Maturity Debt Securities	$28,348	$23,587	($4,761)
Loans, Net of ACL	$166,084	$143,925	($22,159)

Source: FDIC's Supervision of First Republic; September 8, 2023

[1] FDIC's Supervision of First Republic; September 8, 2023

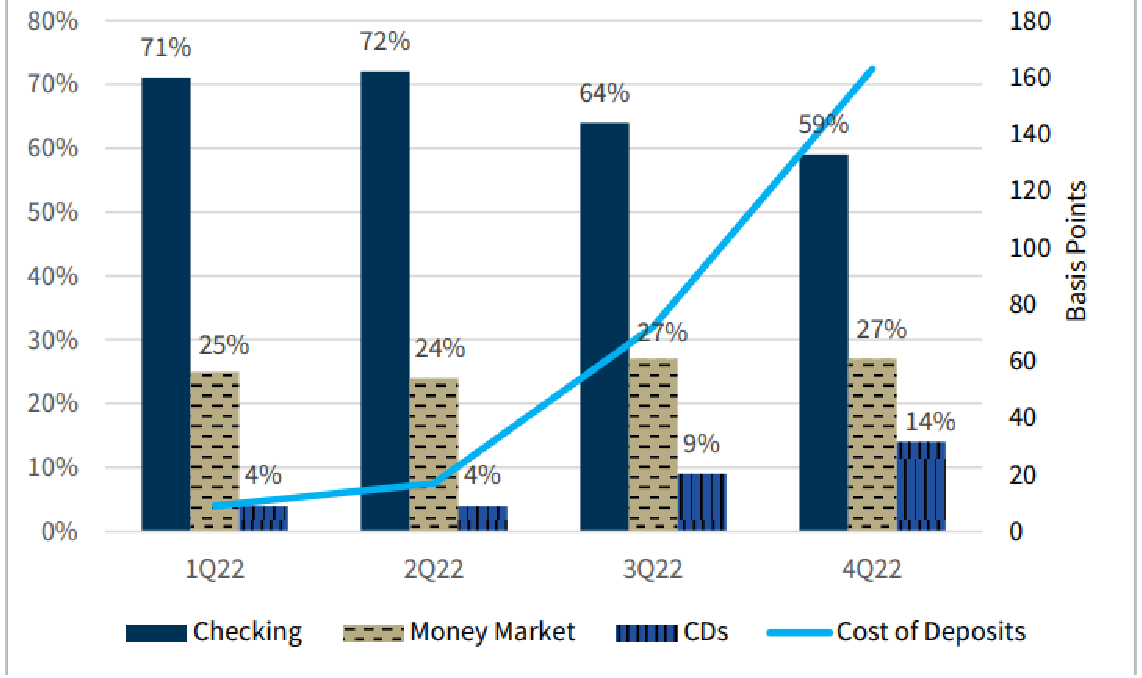
LIABILITY-BASED LIQUIDITY RESOURCES

1. Retail Deposits
2. Wholesale Funding
3. Funding from the financial markets

FDIC's Supervision of First Republic Bank

"First Republic could have possibly engaged in hedging activities to offset interest rate risk. FDIC examination officials told us that, consistent with its overall philosophy of not engaging in overly complex strategies or transactions, First Republic did not engage in hedging activities. FDIC officials opined that *by the time the need for hedging became evident, such derivatives contracts may not have been available on a commercially reasonable basis to the bank.* Additionally, the size of First Republic's SFR loan portfolio, an asset concentration for the bank, may have made hedging options financially impractical."[1]

Figure 4: First Republic Deposit Mix and Average Cost of Deposits -- 2022



Source: FDIC's Supervision of First Republic; September 8, 2023

[1] FDIC's Supervision of First Republic; September 8, 2023

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REGULATORY CAPITAL

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REGULATORY CAPITAL

Adequate capital levels enable banks to meet the credit needs of their communities and promote the stability of individual banks and the federal banking system. Federal laws and regulations also require banks to meet minimum regulatory capital standards. These requirements generally serve as a restraint on excessive risk-taking and expansion activities, promote safety and soundness in the banking system, and protect the Deposit Insurance Fund.

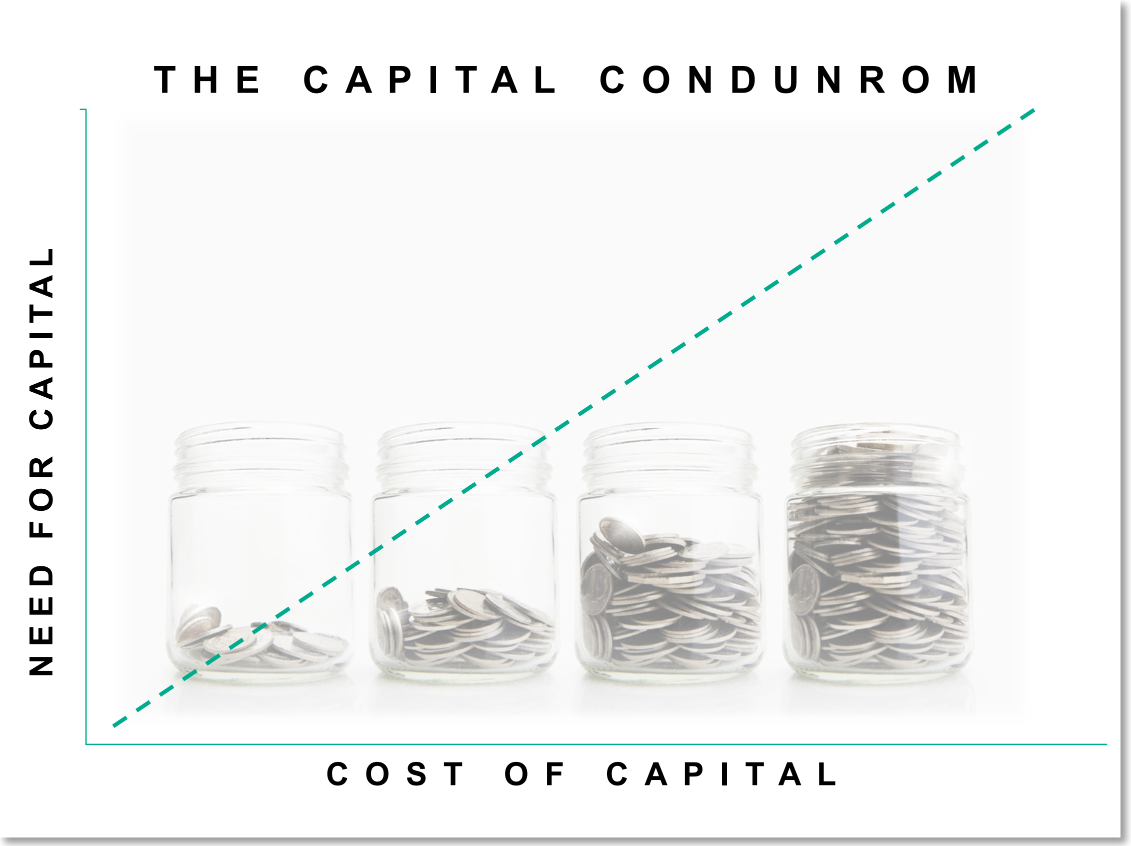
Banks are expected to hold capital commensurate with the nature and extent of the risks to which the bank is exposed and for the bank's management to have the ability to identify, measure, monitor, and implement adequate controls over the bank's risks.

RAISING CAPITAL

Considerations related to raising new capital

There is often a lag between the creation of risks and when those risks begin to affect a bank's financial performance. By the time the bank faces deteriorating credit quality, increased loan charge-offs, strained funding, increased processing errors, or other financial performance measures, the underlying causes are already well established and difficult to reverse quickly.

Furthermore, **once weaknesses materialize, it may be difficult, or more expensive, to raise capital.** Capital alone does not mitigate excessive risk-taking or unsafe and unsound practices that deviate from sound governance, internal controls, risk management principles, or supervisory guidance.



RAISING CAPITAL

Considerations related to increasing regulatory capital

Capital Injections	Subordinated Debt	Change of Control	Balance Sheet Contraction
In order for such capital to be included as regulatory capital at the subsidiary level, the instrument purchased by the holding company must meet the regulatory capital criteria for CET1, additional tier 1, or tier 2 capital.	• HoldCo Liquidity and debt levels • HoldCo Enforement Actions • Tier 1 vs. Tier 2 Capital • High Debt Service Obligations	Raising capital can trigger a change of control. Changes of control have accounting, regulatory capital, and licensing/application implications.	• Asset Sales • Asset Run Off • Liability Paydowns

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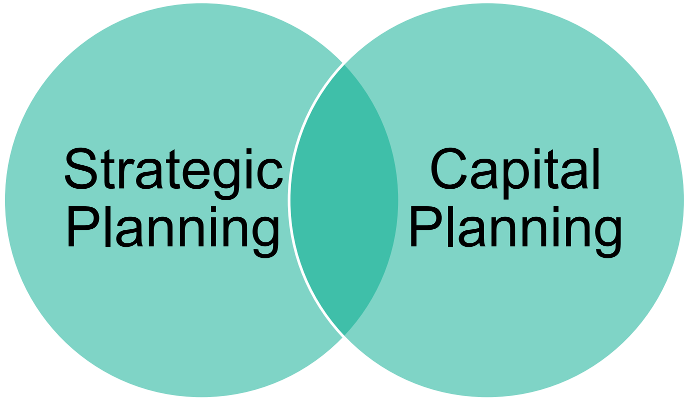
CAPITAL PLANNING

Capital planning is a ***dynamic*** and ***ongoing process*** that, to be effective, should be forward looking in incorporating changes in a bank's strategic focus, risk tolerance levels, business plans, operating environment, or other factors that materially affect capital adequacy.



Capital planning helps the bank's board and senior management

1. Identify risks, improve their understanding of the bank's overall risks, set risk tolerance levels, and assess strategic choices in longer-term planning.
2. Identify vulnerabilities such as concentrations and assess the impact on capital.
3. Integrate business strategy, risk management, and capital and liquidity planning decisions, including due diligence for a merger or acquisition.
4. Have a forward-looking perspective on the bank's capital needs, including capital needs that may arise from rapid changes in the economic and financial environment.

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QUESTIONS?

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