CSBS RISK REPORT

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Key Findings

Trends identified in the first quarter of 2016 largely continued through the second quarter, according to members of the CSBS Risk ID Team. The primary findings of this quarter include:

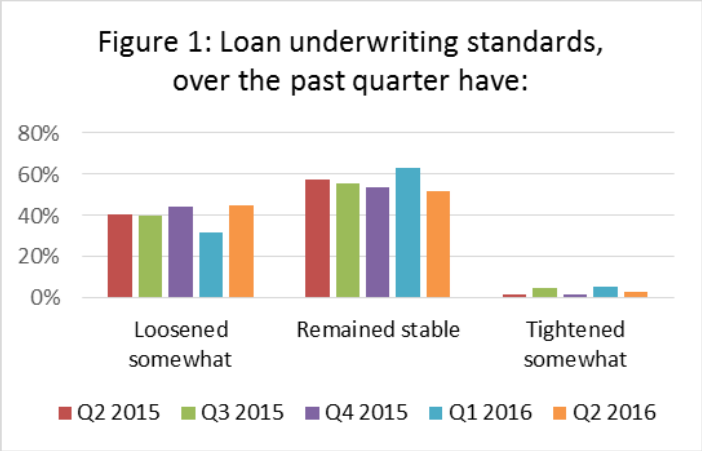
- **Underwriting standards seem to be loosening.** In the first quarter, we reported that a smaller portion of examiners observed a loosening of underwriting standards and that such an observation may have marked a shift to more conservative underwriting practices. It seems likely that the first quarter was an outlier, with second quarter results suggesting loosening standards has continued.
- **Commercial & Industrial delinquencies are up.** Reports suggest that banks continue to pursue commercial & industrial loans over other types in many areas, while delinquencies are rising.
- The loan type known as **Acquisition, Development, and Construction (ADC) is being seen in increasingly concentrated levels** in certain markets.
- **Virtual ATMs/Interactive Teller Machines** are becoming an increasingly common technology investment.

As these and other issues are researched over the coming months, readers of this series should expect periodic ***Spotlight*** publications, which will provide deeper analysis and perspective on each topic.

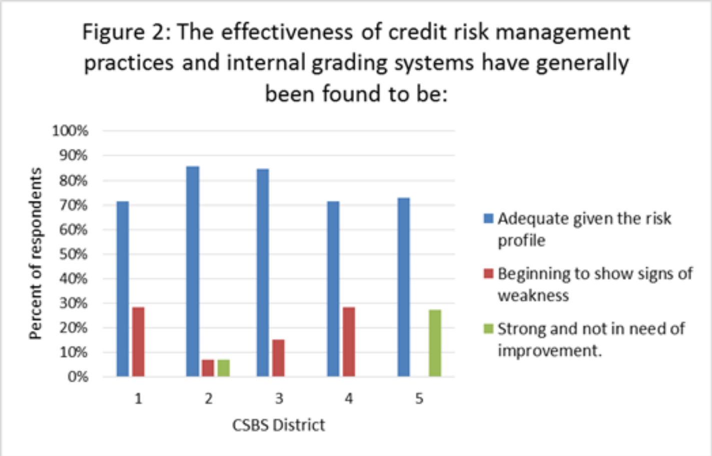
Quarterly Changes

Last quarter's suggestion that underwriting standards may be tightening has not held true this quarter.

While no respondents reported that underwriting standards had *loosened significantly*, a higher portion reported that they had *loosened somewhat.* Figure 1 illustrates that nationwide, this quarter's results contain the highest portion that indicated a loosening of these standards.



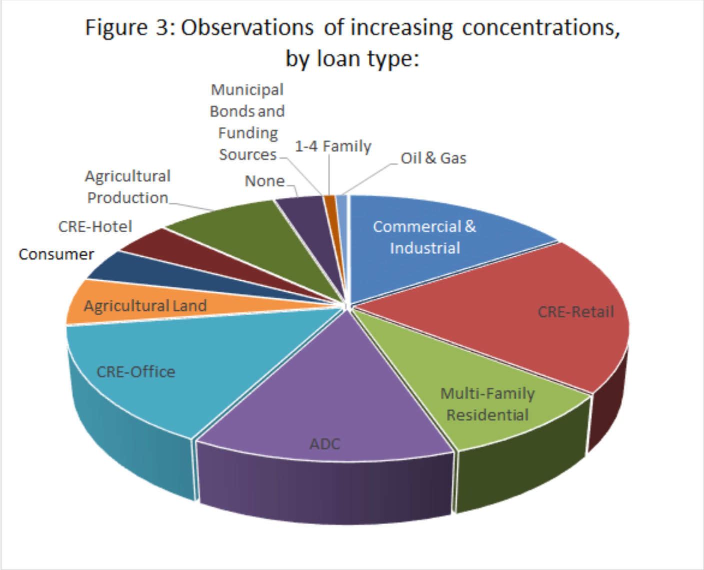
On a district level, a majority of examiners from districts three and five reported that underwriting standards loosened, at 71 and 67 percent respectively. This compares to much lower portions in the other districts, such as district one where 14 percent reported an overall loosening of underwriting standards. In comments on this topic, examiners point to competitive markets as one reason for the increasingly relaxed standards. In other comments, examiners indicated that these shifts are taking form through the easing of guarantee requirements, lengthening of terms, and a greater willingness to approve exceptions to loan policy parameters, such as debt service coverage ratios and loan-to-value limits.



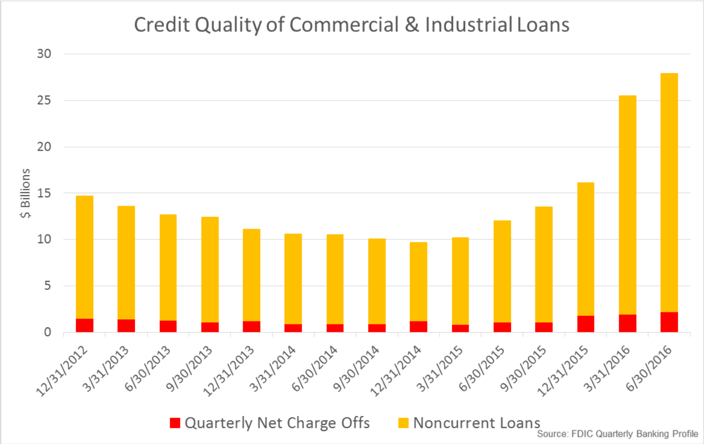
Despite these comments, examiners continue to report that the effectiveness of credit risk management practices remains generally adequate given institutions' risk profiles, as shown in Figure 2.

As was reported in previous quarters, a relatively high portion of examiners, 34 percent, observe that banks' appetite for out-of-territory lending increased from quarter to quarter. Exposures to these types of credits, which may include non-traditional lenders such as marketplace or platform lenders, remains a focus for regulators.

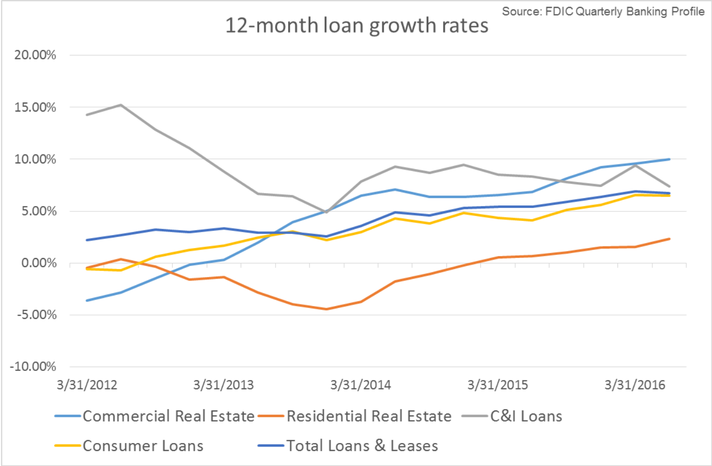
As loan demand has returned to more normalized levels across much of the country, examiners are closely monitoring concentration levels of key asset types. In the quarterly survey, examiners are asked for which loan types they observe concentration levels to be rising. Figure 3 below summarizes their responses.



As the figure shows, a significant portion, 13 percent, of respondents has observed ADC loans to be rising in concentration levels. Notably, other commercial real estate categories such as office and retail also appear to be increasing their concentration levels. For these reports, the term "concentration" is not defined, since different asset types are considered concentrated at different levels.



Commercial & industrial loans have long been viewed as relatively sound and growth in this loan category has been moderate over several past quarters. However, data from the FDIC Quarterly Banking Profile indicates that noncurrent loans are rising for this category, suggesting that some softening of this loan category may be taking place. In discussions, examiners have observed softening in certain markets, namely those affected by oil and gas price declines. Loan growth data from the same source reveals that commercial & industrial loan growth rates fell more sharply than other loan type categories over the second quarter of 2016.



Beyond the credit portfolio, tighter liquidity positions have been reported occasionally. For several quarters, the prevailing notion was that balance sheet liquidity had been abundant and was not a significant source of adverse examination findings. The return to normalized levels of loan demand observed in most markets appears to have depleted the substantial liquidity reserves and is thus commanding greater attention in the examination process.

Examination Challenges

Challenges have been reported most commonly in two broad examination topics: cybersecurity and future accounting rule changes. The challenges with these topics are faced by both examiners and bank management teams alike. From examiners' standpoints, the focus on information technology risks and cybersecurity reviews has increased the onsite time during some examinations. Tangential to the increased focus on technology risks, a substantial number of examiners reported that banks are now considering partnerships with entities engaged in the financial services technology industry, often shortened to 'fintech'. The specific lines of business subject to these partnerships vary and will be investigated and reported on further in future reports. The frequency with which fintech was mentioned this quarter is noteworthy and may be a developing trend for banks looking to outsource some aspects of their operation through technology platforms.

Examiners are also discussing the future impact the Financial Accounting Standards Board's (FASB) *Current Expected Credit Losses* standard will have on banks' methodology for allowances for loan and lease losses. While implementation for most banks will not take place until 2020, a significant amount of planning and preparation should be expected to be in a position to comply with the new standard.

About this Report and the CSBS Risk ID Team

Each quarter, members of the CSBS Risk Identification Team complete a standardized survey that collect observations on current risks, developing trends, and different aspects of the supervisory process. For comparison purposes, survey results are compared to prior quarters across CSBS districts. Further, throughout the quarter, team members raise issues and discuss observations that might not be collected by the survey. The results of all these activities are summarized in this report, and a particular risk often is the subject of a separate, periodic *Risk Spotlight*.

The CSBS Risk ID Team was created to leverage knowledge and skillset of state bank examination staff nationwide. The team has grown to more than 100 examiners, representing nearly every state banking department. The team is led by an Advisory Group, a subset of team members chaired by Lise Kruse, chief examiner of the North Dakota Department of Financial Institutions. Team findings are summarized in this report and provide a window into how state bank examiners see the risk environment affecting state banking institutions. The report also can be used to inform the policymaking, regulatory and supervision functions of state agencies and CSBS.

CSBS District Map