CSBS RISK REPORT

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CONFERENCE OF STATE BANK SUPERVISORS

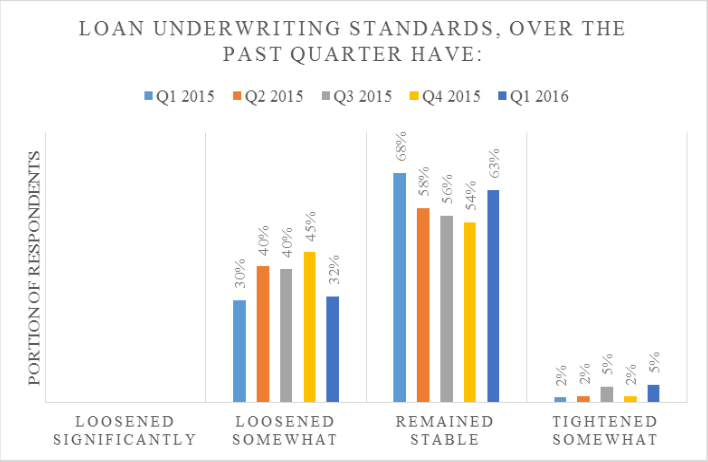
Key Findings

In their inaugural quarterly survey of 2016, state examiners report general stability in many state banking trends identified in prior quarters, but with some notable exceptions. The survey, which collects examiner observations about balance-sheet trends, risk management practices, and challenges experienced during the examination process, highlighted the following trends:

- **Underwriting standards might be shifting.** Fewer examiners report a loosening of credit standards from the prior quarter (Figure 1).
- **Loan concentration of commercial real estate is increasing.** These loans include acquisition, development and construction loans.
- **Agriculture markets are experiencing general stress,** including greater use of carry-over debt.
- In certain areas, **examiners are increasingly focusing on multi-family housing markets**.
- **The economies of many oil, gas and energy production regions are slowing,** raising questions about local municipal debt markets.

As these 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.

Figure 1



Quarterly Changes

While a majority of respondents indicate that underwriting standards remain stable compared to the past quarter, a declining number report that standards have loosened. This could suggest that the credit market has begun to tighten. As with all metrics, the results differ by geographic region. For example, compared to other districts, a greater portion of examiners in CSBS Districts 1 and 2—the Northeastern and Great Lakes/Upper Midwest regions, respectively—report that standards are looser. That said, a single quarter might not be indicative of a sustained shift in underwriting standards.

Another key ingredient of risk assessments: examiner observations management's credit risk practices. Over the past quarter, approximately 70 percent of respondents believe these practices are "adequate given the risk profile of the institution," while 23 percent observe these practices are "beginning to show signs of weaknesses." The district where the highest portion of examiners report signs of weakness is District 4—the Great Plains, Dakotas and Texas. The responses of the two previous questions tell a similar story: where there appears to be credit risk building in certain industries, such as agricultural production or oil or gas extraction, banks have modestly tightened or maintained their underwriting standards. Contrast this finding with observations from the other districts, and it suggests tightening of credit standards is less common, particularly in the coastal areas.

Beyond the credit underwriting aspects of risk management, examiners continue to observe high demand for out-of-area participation credits. Historically these types of credits exhibit higher-risk characteristics. And this quarter represents the fourth consecutive quarter where more 30 percent of respondents nationwide observe an increase in demand for these types of credits. Examiners cite the competitive market and, until recently, relatively weak loan demand locally as reasons explaining a greater demand for out-of-area participation credits.

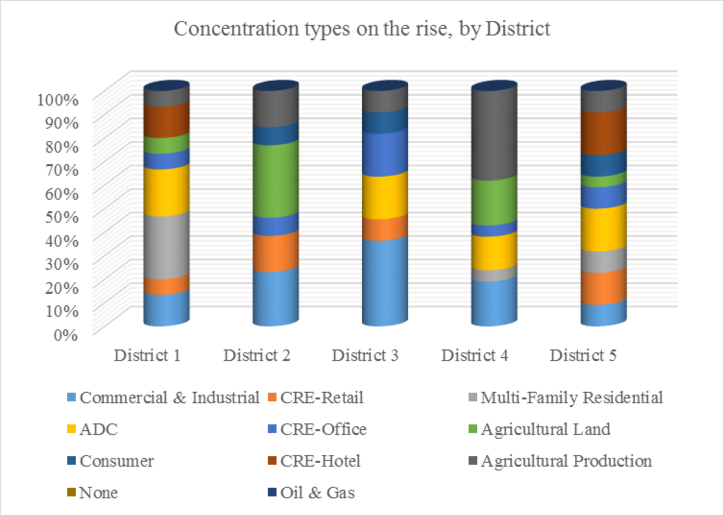
As the credit market strengthens in many regions, examiners are monitoring concentration risk in certain asset types. As Figure 2 illustrates, there are several loan types for which concentration levels are on the rise. Across most CSBS districts, examiners observe concentration levels rising in CRE-Retail, Agricultural Production, and Commercial & Industrial loan types. In all but District 2, examiners report rising concentration levels for Acquisition, Development and Construction loans.

Further, examiners from District 1 report growing exposure to the multi-family market and, in certain markets, express concern over the potential for overdevelopment. (The term *concentration* reflects the volume of certain loan types in bank portfolios.)

In all districts, but especially Districts 2 and 4, examiners point out the modestly increasing risk profile of agricultural credits, both in land purchases and production of crops or livestock. While the U.S. agricultural market is large and diverse, examiners note that the general trend over the past 24 months suggests that farm incomes fell as commodity prices declined.

Risks on the funding side of the balance sheet remain relatively stable, though in a handful of cases examiners report an increase in the use of noncore funding sources. Presumably, this reflects a return to more normalized loan demand in many markets. However, as the FDIC's Quarterly Banking Profile data shows in Figure 3, both large and small banks maintain historically low levels of net loans and leases compared to deposits.

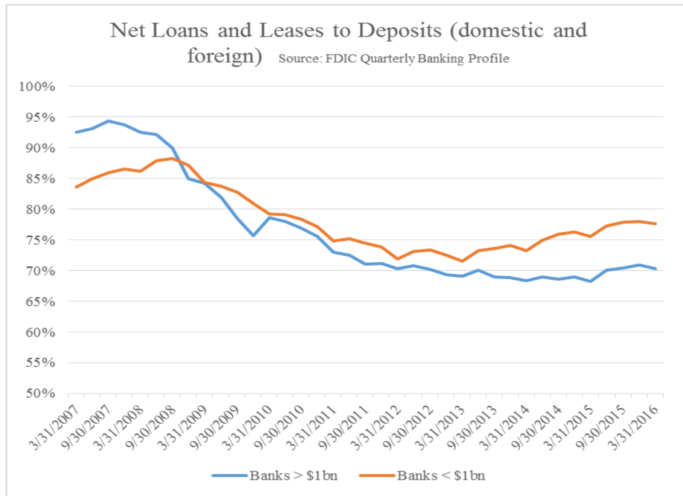
Figure 2



Examination Challenges

When asked which aspects of the examination process present challenges to banks, examiners describe challenges similar to previous quarters. An oft-cited challenge is accurately identifying and reporting of high-volatility commercial real estate, known as HVCRE. This risk weighting category was introduced with the revised regulatory capital standards (Basel III), which went into effect for most institutions on January 1, 2015 and first reported in the March 31, 2015 reporting period. HVCRE remains a significant challenge for examiners and banks alike. As a resource to correctly identify this category of commercial real estate loans, CSBS has produced an examiner job aid, available publically on the [CSBS Examiner Job Aids website](#).

Figure 3



Lastly, examination hours are increasingly dedicated to information technology and cybersecurity reviews. This increase responds to a growing number of cyber incidents and dependence on information technology systems. Quarter over quarter, examiners report an increasing focus by bank management. For instance, fully 95 percent of this quarter's survey respondents report that bank management's focus on cybersecurity preparedness is increasing, with more than a one-quarter reporting a rapid increase in focus. With the FFIEC Cybersecurity Self-Assessment Tool and other available resources, it is likely the focus on cybersecurity will remain high for examination teams and bank management staffs.

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 states and CSBS.

Figure 4