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Concentrations of Credit Web Conference
A Web and Telephone Seminar

Concentration of Credit Comptroller's Handbook

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Tim Wilson: Again, welcome to today's Concentrations of Credit Web Conference, presented by the Office of the Comptroller of the Currency. It's my pleasure at this time to present our moderator for today's program, Jennifer Kelly, your Senior Deputy Comptroller for Midsize and Community Bank Supervision. Jennifer, welcome. It's my pleasure to turn the program over to you.

Jennifer Kelly: Thank you Tim, and good afternoon everyone. Thank you very much for joining the call today. We have over 1100 registered sites, which tells us that there's a lot of interest in hearing more about the recent update of the OCC's handbook, covering concentrations of credit. That's good news from our perspective, since we also consider it a topic worthy of significant attention, given the experiences of the past few years.

As we've evaluated the lessons learned from banks that have struggled, and in some cases failed, due to the excessive risk created by significant credit concentrations, it was clear that we needed to do a better job of ensuring banks have sound risk management processes, as concentrations are being built. Towards that end, we revised the handbook that is available to both examiners and bankers, to expand and clarify our guidance on this important topic.

We're going to start the call with a presentation summarizing the points covered in the handbook, and then we will transition into a Q and A session that Tim mentioned previously. The presenters you're going to be hearing from in the first part of the call are Brent Spencer, the Acting Director for Commercial Credit Policy. Franc Plonkey, a Credit Risk Specialist who works with Brent in the policy area, and Matt White, a National Bank Examiner, with experience examining

both Community and Midsize Banks. Without further ado, I'll turn the phone over to Brent to get the program started.

Brent Spencer: Thank you Jennifer, and thank you all for taking time out of your busy schedules to participate on today's web conference. At the end of today's presentation, we'll be glad to answer any questions. So we do encourage your participation. Franc will assist us throughout the presentation, as we describe various examples to illustrate practical application of credit concentration risk management principles.

If you look at today's agenda for the presentation, we're going to be focusing on key concepts that are taken directly from the Concentrations of Credit Handbook. And by way of background on the next slide, you will see that credit concentrations can elevate risk that may not only impact credit, but also funding and other operational areas. An analysis of bank data from the most recent economic downturn, clearly indicates that banks with high concentration levels experienced more adverse conditions, resulting in a disproportionate failure rate, as opposed to banks without these similar concentrations. As a result, appropriately managing concentration risk is fundamental to sound risk management.

If you will look with me on slide number four, risk management of credit concentrations is not a new concept. There has been supervisory guidance in place since 1990 with the Comptroller's Concentration Handbook and the OTS Asset Quality Examination Handbook, dating back to 2005. The Concentrations of Credit Handbook released just this past December of 2011, updates and replaces these handbooks and is applicable to all National Banks and Federal Savings Associations. This updated handbook does emphasize risk management of credit concentrations that would include commercial real estate and other credit types.

If you'll turn to slide number five, throughout this presentation, we will emphasize certain aspects of risk management that may now be more relevant when we consider the impact of recent economic events. As we discuss generally understood concentration risk management concepts, we will point out areas that may resonate more when looking back to how economic conditions affected some financial institutions.

Throughout this presentation, we will use the term "banks" to mean National Banks and Federal Savings Associations. The Interagency Guidance on Commercial Real Estate Concentration Risk Management and the Office of Thrift Supervision, CEO Memorandum number 252 that were announced in December of 2006, also emphasized sound risk management for banks with commercial real estate concentrations. The Interagency Guidance did not require

concentration limits, but the guidance did describe the need for appropriate risk management practices.

Now these risk management practices that were outlined included portfolio management, stress testing and sensitivity analysis, management information systems and other risk management practices. Portfolio management included the evaluation of real estate lending correlations as one of the practices for managing risk within loan portfolios. These risk management concepts continue to be relevant, and are further expanded upon with the updated handbook. In addition, the Comptroller's Loan Portfolio Management Handbook, dated April of 1998, and the OTS Asset Quality Handbooks, described stress testing as sound risk management practices and we continue to address these concepts with the updated handbook.

While risk management practices of correlation analysis and stress testing are not new, the impact of recent market events has highlighted the usefulness of these practices as tools in an effective risk management program for banks of all sizes.

If you'll turn with me to slide number six. Existing regulatory guidance defines a concentration to include direct, indirect or contingent obligations exceeding 25% of the bank's capital. Capital being tier one capital plus the allowance. This measurement includes both outstanding balance and un-funded commitments. As you'll note on the next slide, this measure alone however, may not capture pools of individual transactions that may perform in a similar manner, due to common characteristics or common sensitivities to various economic, financial or business developments.

As a result, a concentration exposure may exist, even if individual pools represent less than 25% of capital. Even if underwriting is sound on an individual transaction, the pool may have heightened risk due to the influence of a common sensitivity to economic conditions. As by way of an example, a concentration could be defined by the interdependence of a common source of repayment for different loan types.

On slide number eight, you'll note that it's important to recognize how concentration risk may extend beyond the loan portfolio. The recent market events highlighted the interdependence of credit and liquidity risk. Credit concentrations in acquisition and development lending, often led to higher credit problems, which in turn, adversely influenced liquidity risk. Therefore, the board and management must ensure an effective risk management program is in place to govern concentration risk, as noted with slide number nine.

The objective for concentration risk management is to ensure the systems and practices are effective for identifying, measuring, monitoring and controlling risk, and the potential impact on the bank's capital, earnings and operations.

On slide number ten, we discuss the issue of governance as well. When establishing or enhancing an existing concentration risk management program, one critical function will be in how the concentration analysis results are used. With the appropriate concentration analysis, the results can be used to facilitate other functions within a bank, such as for planning and the qualitative analysis that goes into the allowance for loan and lease losses.

Board reports should include a well supported analysis of concentration risk and can include estimates of the impact on the bank's operations, earnings and capital. Board reports could also include any back testing that may have been performed. Franc, could you comment on some of these concepts and with some type of illustration of how concentration risk may influence balance sheet components and as a planning consideration?

Franc Plonkey: Sure Brent. Concentration analysis can be applied to the allowance for loan and lease loss methodology to segment loan pools for accounting standards codification 450-20 purposes. This is because concentration pools tend to have similar characteristics, which can result in similar loss rates. Further, concentration analysis can be applied to strategic planning, to determine anticipated risk management and resource needs, or evaluate potential risk exposure from growth plans. Banks can also use concentration analysis to assess potential impacts on liquidity and determine anticipated capital needs.

Brent Spencer: Thanks Franc. If you'll turn with me to slide number 11, adequate policies and procedures for the level of risk are really foundational elements for sound governance. Risk management practices should be consistent with the bank's own policies and procedures and be supported with the appropriate controls. The loan review function and the audit functions can be effective control functions for assessing the quality of concentration risk management, and to ensure that the practices are consistent with the board's own approved policies. The updated handbook emphasizes the importance of concentration risk management when concluding on the bank's capital, asset quality and management component ratings.

The starting point for effective concentration risk management is really just to identify the concentration exposures. We do have several slides that provide information on how to identify concentrations, and they begin with slide number 12. As noted with this slide and previously as we commented on in slide number six, the existing

regulatory guidance defines a concentration to include direct, indirect or contingent obligations that exceed 25% of the bank's capital.

Now the size of the portfolio when measured against capital is only one consideration, but it may not be the only determination of risk when measuring concentration risk. The level of risk is going to be a function of the portfolio size and the potential volatility in a portfolio. The appropriate risk management therefore considers the risk and not just the size of the portfolio.

On slide number 13, you'll see that there are several measures that can be considered when identifying concentration risk. These measures may include static measures, such as historical loss rates, or even dynamic measures, such as the change in historical loss rates. Management can assess the underlying volatility of each potential concentration, based on a multiple of factors.

A key point that we want to emphasize is that risk management processes need to be sufficiently reliable for determining concentration risk, and not exclusively conclude that concentration risk is only evident when the portfolio is more than 25% of capital. Various loan pools may represent different levels of concentration risk, and therefore may require different levels of analysis and supervision.

Franc will describe the comparative example on the next slide, to illustrate concentration identification.

Franc Plonkey: A good illustration of these concepts is to compare two hypothetical loan pools. The first is pool A, which has geographically diversified and soundly underwritten first mortgages. This pool is assumed to have predictable losses, even though it's a broad pool and represents a large percentage of capital. On the other hand, pool B is a narrow pool of geographically concentrated construction and development loans. While this pool may equal a lower percentage of capital than pool A, it could have a more unpredictable performance. Clearly, these pools would represent two very different risk profiles.

Brent Spencer: So what we're really talking about with identifying concentrations, is about trying to understand the behavior of loan portfolios and to consider grouping loans into various pools based on how they may react to various market influences.

Franc Plonkey: Yes. This is further explained in the Correlation of Pools section of the handbook. Please turn to slide 15. Another way to understand the behavior of the loan portfolio would be for management to consider combining size thresholds with credit risk benchmarks. This concept is important, given that changes in market conditions may impact certain pools more slowly or rapidly than other pools. The

handbook distinguishes between static metrics and dynamic metrics to identify a concentration.

An example of the static metrics is the use of a specified, constant level of special mention or classified assets within a pool. Alternatively, an example of a dynamic metric would be to use the change in special mention or classified levels, relative to capital, in order to evaluate emerging risks.

Brent Spencer: Thanks Franc. As you can see from these examples, the identification and understanding of concentration risk can be much broader than just identifying a concentration exposure by industry type when you measure it against capital, and come up with that 25% ratio.

If you turn to the next slide, concentration limits should be established to control concentration risk and reduce the potential for losses. Franc, if you wouldn't mind, provide us with an example of concentration limits that may be useful for managing concentration risk.

Franc Plonkey: Sure Brent. Establishing concentration limits can be an effective risk management practice to control potential losses. Banks can use limits correlated to loan loss levels that would impact key balance sheet items or trigger critical stress events. For example, banks could establish a limit based on a percentage of earnings. Banks could also set limits based on losses that would reduce the allowance for loan and lease losses or capital by a certain percentage.

Limits could be set to correspond with losses that would force a dividend reduction, or a credit rating downgrade. Banks could also consider triggers that would increase funding costs, damage reputation or limit strategic opportunity. Further, a combination of these considerations might be appropriate for more complex banks, especially if they have multiple concentrations or correlated exposures. The key point is that limits are designed to ensure earnings and capital risk exposure is appropriately controlled.

Brent Spencer: We also provided some useful benchmarks on slide number 17 that you could consider. And on slide number 18, we've talked about correlations and we would like to just briefly discuss correlations and the concepts that are exhibited within the handbook. The correlation of pools is an important consideration for effective concentration risk management. The correlation of pools section of the handbook highlights the importance for understanding how various loan pools may perform in a similar manner, resulting in higher concentration risk.

Correlation further demonstrates how credit concentrations may not be limited to certain industries or product types. As a result, a

concentration risk may be embedded across product lines. The degree of concentration risk may depend on how correlated product types are to various market and economic conditions. Concentration risk due to correlated products could also result in layered risk to be assessed within other functions of the bank.

For example, liquidity risk may be increased with assets that are highly correlated during an economic downturn. Franc, could you provide an example to describe how concentration risk may be evidence, regardless of loan pool size and how product correlation may influence risk?

Franc Plonkey: Absolutely Brent. Slide number 19 illustrates examples. During the recent downturn, some banks had exposure to both mortgage backed securities and construction and development loans. As the real estate market deteriorated, both asset classes experienced losses which caused more stress on liquidity, earnings and ultimately capital.

Brent Spencer: That example clearly demonstrates how various assets are impacted and risk to the bank extends beyond loan quality. Another risk management practice when determining overall concentration risk is to consider how a pool of loans may respond to stress conditions. For example, individual loan transactions within a loan category or loan pool, may be soundly underwritten. But the entire loan pool may exhibit higher risk not evident within each transaction. This could be due to the correlation with other loan products.

If you'll turn to slide 20, after concentration risk is identified, including potential risk due to correlations, the board and management can determine their risk mitigation strategies. The list on slide number 20 provides some examples of risk mitigation strategies. The list is not all inclusive and not all are required. The key is that the board and management adopt a risk mitigation strategy that fits their bank. There is not a prescribed strategy.

For example, management may consider tightening underwriting standards for a highly concentrated loan product that is exhibiting increasing risk due to local economic conditions. Additional mitigation strategies could include increased credit monitoring or reducing exposure limits where concentration levels exceed board approved risk limits.

Depending on the risk tolerance and risk management systems capabilities, management may choose to mitigate high risk by holding additional capital. Once concentration risk is identified, it is important that management apply the appropriate risk mitigation strategy that aligns with their desired risk appetite. Risk mitigation will also be influenced by the information systems capabilities of the bank, for measuring and reporting.

Now we recognize that risk mitigation strategies will vary according to bank size and complexity. While there is not a one size fits all risk mitigation strategy, a key point is that the board and management have a well thought out strategy for managing their bank's concentration risk.

On slide 21, you'll see that we have some bullet points about MIS. Effective concentration risk management requires accurate and reliable information in order to provide meaningful concentration reporting. Therefore concentration risk management should be supported with the appropriate MIS, or Management Information Systems.

Franc Plonkey: Absolutely Brent. MIS is now already demonstrated in other areas of the bank. For example, MIS is generally well seasoned for measuring and monitoring loan performance at the transaction level and at the portfolio level. Other common MIS are established for other asset categories, bank operations, financial performance and compliance. Concentration risk management depends on appropriate MIS, tailored to the level of risk, size and complexity of the bank.

Brent Spencer: You can turn to slide number 22. Most banks have established MIS capabilities for overall risk management of various functions within the bank. And the 2006 Interagency Guidance on commercial real estate risk management included a section on MIS as a key to effective portfolio management. Therefore, we expect that most banks are very familiar with some level of concentration risk management MIS. We do encourage you to review this section of the updated handbook, as you consider your existing MIS capabilities and your overall business strategies.

Concentration risk has been, and will continue to be evident in most banks. This is noted on slide number 23. In fact, by the very nature of the business and geography, concentrations may exist for a bank. We recognize this. Our supervisory expectations continue to emphasize risk management. The board and management are responsible for ensuring the bank has an effective process to identify, measure, monitor and control concentration risk.

A key point that I want to reiterate is that while individual transactions may be prudently underwritten, collectively the transactions may be sensitive to similar market or economic events. As a result, concentration risk may be evident in the portfolio, while risk is effectively managed at the transaction level. And this concentration of risk may be evident within loan pools that represent less than 25% of capital.

On slide number 24, the OCC expects that the board and management understand concentration risk that is specific to their

bank and their business strategy, and to ensure the concentration risk management processes are commensurate with the level of risk presented. Appropriate risk management methodologies may need to consider loan pool correlation risk. The scope of the data collected and analyzed for managing concentrations, should be proportionate to the amount of risk to the bank's earnings and capital. Examiners will assess management's assumptions for reasonableness and accuracy when used for concentration risk analysis and modeling.

When concentration risk management is weak, examiners will require management to take corrective action, and will consider concentration risk management in ratings conclusions.

Franc Plonkey: Please turn to slide 25. In many banks, high losses during the recent economic downturn were correlated with concentration levels. While this was particularly evident in banks with high construction and development portfolios, banks also experienced unexpected losses from concentrations in other areas too. The OCC determined that a basic stress testing tool may have been helpful when assessing risk within balance sheet correlations.

Brent Spencer: And as noted with slide number 26, stress testing can be integrated into the concentration risk management system in a variety of ways. Management can use stress testing to facilitate their understanding of relationships between different assets. Stress testing can be used to identify correlated pools of assets or even measure the relationship between the pools. Management can also use stress tests that are designed to measure loss exposure and evaluate allowance adequacy.

It is also important to consider any stress testing results to enhance strategic and capital planning, as well as liquidity planning and to control current and emerging risks.

Franc Plonkey: Banks should also consider the qualitative factors that incorporate management's experience and judgment in evaluating all risks. A qualitative assessment is especially critical in evaluating risks that cannot be reasonably quantified.

Brent Spencer: That's a very good point Franc, to consider the qualitative analysis as well. Banks may use a variety of methodologies to evaluate concentration risk. Regardless of the methodology chosen, the banks need to look closely at the "what if" questions and incorporate the answers into their own risk management process. As a reminder, the scope of stress testing should be based on the risk characteristics of the concentration and potential capital and earnings exposure.

This is noted with slide number 27. Examiners will assess concentration risk management, including the need for stress testing,

when it's applicable, considering the level of concentrations and the overall risks and complexity of the bank. And as noted with slide number 24, corrective action will be required for weak risk management. The use of stress testing is considered a tool for managing concentration risk, not a requirement. The absence of stress testing will not necessarily result in a matters requiring attention, as long as risks are effectively managed.

On slide number 28, fundamental to applying stress testing as a risk management tool, is really to understand your bank's key vulnerabilities. Focusing on portfolio segments that might be the most vulnerable to economic or market influences will facilitate risk mitigation strategies.

Franc Plonkey: Absolutely Brent. Here is a brief example to illustrate the link between risk management and vulnerabilities. A strong and established pool of multi-family projects may not need the same level or frequency of stress testing when compared to a pool of new multi-family projects.

Brent Spencer: That's a good example, Franc. And the OCC thought that a stress testing tool would be useful for examiners, and will also make this tool available to banks. To provide information on the commercial real estate basic stress testing tool is Matt White. Matt.

Matt White: Thank you, Brent. As we had previously discussed, stress testing is not a new concept from a regulatory perspective. In fact, OCC Advisory Letter 97-3 lists portfolio stress testing as one element of an effective loan portfolio credit risk management process. But certainly since the 2006 Interagency Guidance on Concentrations and Commercial Real Estate Lending, there have been more active discussions regarding the need for portfolio stress testing, especially in institutions with high concentrations of commercial real estate.

A common response we have received has been, "can you provide us with an example of a portfolio level stress test?" So the objective in building this tool was to provide specifically to community and midsize bankers and examiners, a relatively simple tool for performing a portfolio stress test of income producing commercial real estate. It is important to note that this tool, much like many of the other tools we have provided in the past, represents just one approach to portfolio stress testing.

There are other methods, both less and more complex in nature, that may be more appropriate based on the size and portfolio composition of your bank. However, this tool is a functional example of one way to perform portfolio stress testing, which we believe you may find useful.

Slide 30 provides a bit more detail about the specifics of the tool. It was initially built off the OCC's single loan sensitivity analysis

worksheet for income producing CRE, which was made available to National Banks through our National BankNet system, approximately in 2005. We've noted that many of our banks currently use the sensitivity worksheet at initial underwriting and during post-funding reviews, to test the vulnerability of the borrower's repayment capacity and collateral value, given changes in drivers like rent rates, vacancy rates and cap rates.

The portfolio stress test tool essentially follows the same approach, but the user is able to enter multiple borrowers and then aggregate the results of each borrower sensitivity test. This is sometimes referred to as a "bottom up" approach to portfolio stress testing. The tool is different from the sensitivity test workbook in that it estimates the potential allowance reserves needed for each borrower, given changes in the same repayment and collateral value drivers.

It considers several factors in estimating the potential reserves needed for each borrower. But generally speaking, it first considers the borrower's stress repayment capacity. If the stress repayment capacity is insufficient, the tool estimates the potential additional allowance allocation by using either the stress collateral values to measure the collateral deficiency, or a user defined historical loss rate for problem loans.

The tool then aggregates the calculated reserves needed for each borrower, and based on the size and composition of the sample used in the test, estimates the potential allowance reserves needed on a portfolio level, which is then used to quantify the impact of the stress test on the bank's financials, namely earnings and capital.

Lastly, there are two versions of this tool. A banker version, which we intend to release to National Banks and Federal Savings Associations through our National BankNet system, and an examiner version. The primary difference between the two versions is that the examiner version will contain preloaded financial information and economic assumptions.

Field testing is currently underway with several community banks piloting the banker version of this tool. We are receiving ongoing feedback from these banks, and we will continue to make any necessary changes to the tool based on that feedback prior to the release. We hope to have this process completed over the next few months. And now, I will turn it back to Jennifer.

Jennifer Kelly: Okay, thank you very much Matt, Brent and Franc. And Tim, if you could give people instructions for the question process and then throw it back to me and we'll do some of the online questions.

Tim Wilson: Okay, very good. If you do have a question, all you need to do is press star one on the touchtone keypad of your telephone. That's star followed by one, and then we'll put you into our question queue and when your turn comes up, I'll call on you by the city you're located. Or if you prefer, as many of you have, simply click on the general chat tab toward the bottom of your screen, then type in your question on the bottom line and then either hit enter or click on the send button. But either way, by telephone press star one, or type it in, in the general chat tab and we'll address your question as time permits. But Jennifer, as we wait for folks to population the phone queue, I'll pass things back over to you.

Jennifer Kelly: Okay, thank you. And I just wanted to mention that we actually have a few other experts who are joining the presenters, and they will be helping field the questions. Those include Darrin Benhart, who's the Deputy Comptroller for Credit and Market Risk. Gary Scott, the Senior Thrift Advisor for the Southern District, and Tony Jardieu, our Commercial Credit Lead expert for the Southern District. I just want to mention that both Gary and Tony transferred to the OCC from the OTS last July, and are on hand to help us address any Thrift - specific topics that you might want to talk about.

So I'm going to start things off by throwing the first question to Darrin, and it's one that we hear often. Aren't you just rolling your expectations for stress testing in large banks down to community banks?

Darrin Benhart: Thank you Jennifer. This is Darrin. That's an excellent question, because it gives us an opportunity to clarify our views on stress testing. We think stress testing, as you just heard, is part of a sound risk management framework and gives management the ability to understand the key vulnerabilities in their portfolios. Stress testing and stress testing tools like the one Matt just discussed, are just one way for you as bankers and our examiners, start to quantify risk, rather than just rely on qualitative hypotheses about the impact of potential exposures.

Let me also clarify that we do not, to get directly to the question, we do not expect banks under $10 billion to comply with the proposals for the more complex, holistic stress tests required and been established by Dodd-Frank for those banks greater than $10 billion. I think it's important that, banks under $10 billion, know where the key risks are and focus efforts in those areas. Just a few of the benefits include help with strategic direction, understanding risk tolerances and having factual information to discuss with your examiners and your board.

For those reasons, we think a basic understanding of the key vulnerabilities is important and the use of a stress testing tool is one way to understand and monitor the risk levels. I'll end by saying, we

don't want a compliance exercise resulting in a piece of paper you all pull out for us during exams. That is why any analysis should meet management and the board's needs. Less complex operations can quantify risk using very basic tools, while more highly concentrated or complex operations may need to do more complex analysis.

Jennifer Kelly: Okay, thank you Darrin. One of the questions that just came in that I'll just quickly respond to was, someone suggested we provide a link to the handbook section that we're discussing today. So we will send out a message to everyone who's registered after this call and give you a link, so you can easily find the handbook.

Onto other questions. I'll throw this one out and you all can decide who'd like to take it. To complete the proper identification of correlated credit within a loan portfolio, would a banking institution be better served to obtain national industry statistics by NAICS code and apply the applicable correlations to the individual bank's loan portfolio? Or calculate credit correlations from internal, historical data and apply those findings over the entire loan portfolio? And the questioner ended by stressing that they're a $1 billion bank that does not have statistical staff or complex software packages. So to keep that in mind when you're responding to the question.

Brent Spencer: This is Brent. I'll touch upon that very quickly. I think the question really hits to a key point, and that is about understanding their own bank's vulnerabilities and where the key risks are within that bank. And sometimes that's best understood by knowing what their loss history is, knowing how they have managed portfolios, — what mix of loans they have in their portfolio and how the loan portfolios have behaved to various economic conditions or various stresses on those portfolios.

So I think to answer that question, clearly there needs to be an understanding of what the bank's own portfolio has within them and the behavior of that portfolio. But we don't want to complicate the process. Again as Darrin mentioned, this is not meant to be a complicated exercise. We don't expect banks to go out and, create new analytical tools to do this. It's really just about understanding your own balance sheet. And if the simple process is to use some of the NAICS codes to link different portfolios, then that may be acceptable. But I think underlying all of this is just taking a look at the assumptions and how are you viewing that. Franc, do you have anything you wanted to add to that specific question?

Franc Plonkey: I would really just add that it depends on the size and complexity of the bank and what those vulnerabilities are. In some institutions, it may be advantageous to supplement internal information with industry observations or external information otherwise. But in every bank, management's experience, your understanding of the portfolio and

your risks, as well as the history through various cycles that you've experienced, is critical to being able to understand where these risk management systems might need to be enhanced.

Jennifer Kelly: Okay, let me throw out one more question, then I think we have a few questioners queued up on the phone. So we'll take those after this. We've gotten several questions that have related to exactly what capital calculation they should be using when they're calculating their concentrations. In other words, is it Tier 1 plus all of the allowance or just the qualifying allowance? Different questions like that.

Brent Spencer: That's a good question, and typically, what we have always used in the past as a benchmark, is to use Tier 1 capital plus the entire allowance. Again, that calculation focuses on the 25%, and we want to have a little bit of a shift here in understanding that there may be correlations that may not be 25% of capital. So it's about understanding the risk in the portfolio as well.

Jennifer Kelly: Thanks. Tim, do you want to give us one of our callers on the line please?

Tim Wilson: Okay, certainly. And let's go to Marlow, Oklahoma right now and we'll go to David's location. And you can go ahead with your question.

Marlow: Okay, thank you for taking my call. We've got some church loans that are—we actually have two. We have two church loans. One is considered a commercial loan right now. The other one is construction. They have loan to value of 60% or less, and—but they exceed more than 25% of our capital, Tier 1 and Tier 2 capital. So two church loans, less than 60% loan to value and they—between the two of them, they exceed 25%. Would that be a concentration of credit?

Franc Plonkey: It would be a concentration of credit, clearly. You have two loans that make up a significant amount of capital. The critical thing here, and the application of the handbook that we're talking about, is to take a real close look at the dynamics of those loans and ultimately the risk to capital. You mentioned one thing that might mitigate some of the risk to capital in the loan to value. But then there are other impacts, the flow of money through the churches, etc.

So you really want to look at other things besides just the collateral value and go on to the source of repayment and whether those are correlated, to ultimately determine your risk.

Jennifer Kelly: Okay, thanks for the question. Tim?

Tim Wilson: All right, let's take another call, and for that we'll go to Columbia, North Carolina and Jennifer's location.

Columbia: Thanks. I'm actually in South Carolina. I'm, a Gamecock, not a Tar Heel. So I won't take too much offence to that. But my question is just in terms of, we're a $4 billion community bank that's headquartered down here in South Carolina. Have done a couple of assisted deals on that side. But as we have continued to grow and as you guys well know, I mean, coding gets to be more of an art a lot of times than a science. And in terms of—we believe in a lot of cases that less is more. And when you're a real estate lender that the NAICS coding just isn't necessarily the best fit for looking at your concentration management, understanding of course our objective is to cut it a couple of different ways, but kind of as one slice of it. And your thoughts on institutions maybe developing their own kind of concentration coding, that are maybe some industries or things that are important to them, to kind of minimize those options and get a better batting average of the coding?

Brent Spencer: Right, I think that gets back to what our first question had to do with, whether you use NAICS codes or whether you use some of your own internal data. And you hit upon a really good point there and that is, when you looked at some of these loan pools that—by specific NAICS codes, you may not have identified a concentration. Yet when we looked at the last downturn, a lot of these products were correlated simply because they were tied to the residential markets which were impacted.

And so you're absolutely right, and it's more a matter of understanding your own balance sheet and how you can look at the risk within the portfolios and how your product lines are correlated.

Columbia: Thank you very much. I appreciate it.

Tim Wilson: And we thank you for that call. And Jennifer, do you want to take more calls or go with another web question?

Jennifer Kelly: Why don't we take one more call, and then we'll go back to some of the online questions we've received.

Tim Wilson: All right, if you have a question, either press star one to ask it by telephone, or click on general chat and type it in. Let's go to Reston, Virginia for our next question and go ahead, your line is open.

Reston: Thanks very much. Can you tell us how the examiners will identify additional correlations or concentrations when they start to come on site? We have a—we are a $750 million bank, and we think we have a fairly good handle on the concentrations we have in our portfolio. I'm just wondering how they're going to look for additional ones.

Matt White: This is Matt. I would say that I think the examiner's first order of business would be to have that discussion with you. Obviously you

have that institutional knowledge of your customers and your geography. So I think the very first starting point would be having the discussion with you about some of that knowledge that you've built around your concentrations and the correlations of those concentrations.

Darrin Benhart: This is Darrin. I'll just add to that, from a policy standpoint. We're not sending our examiners out there with cookie cutter marching orders. As Matt indicated, we're going to rely on what you have already. And I think our examiners, if they feel comfortable with that, will give a lot of credence to that. That's why we think it's important that you have a good concentration management process in place.

Jennifer Kelly: Okay, thanks Darrin. Let's go to a couple of these online questions, and I'd like to bring Gary and Tony into the conversation, because we've gotten one question that relates—is obviously from a Thrift. The question is, all of the OTS guidance dealt with CRE. And the topics discussed here also referred to CRE, meaning today we've been really focused on CRE in our discussion. So does this guidance also apply to, for example, they offered up single family, non-owner occupied duplex, three to four families? Maybe Gary or Tony could take that question, then if Brent or Franc or anybody wants to chime in, they can after the fact.

Gary Scott: Sure. Can you hear me okay?

Jennifer Kelly: Sure.

Gary Scott: Okay, well, I think that while the focus of a lot of the discussion in the presentation today has been around income producing property and CRE, the guiding principles within the handbook, can apply to any type of concentration. One of the areas for the Thrifts coming out of this most recent crisis that we paid a lot of time and attention to, of course, was in the area of single family mortgage lending and all of the various types of risks based on the underwriting criteria that was engaged by a variety of mortgage bankers.

And that flowed into such things as mortgage loan pipelines and the types of volumes that can go through a balance sheet in a pipeline type nature and present other types of risks, such as recourse risk, that we really haven't talked about. It's still—the guiding principles that come out of the handbook, can apply to those as well. And it all goes back to what level of capital and earnings might be the appetite of the board that they want to set limits on and accepting within the business model that they're utilizing. Tony, would you like to add to that?

Tony Jardieu: Thanks Gary. This is Tony Jardieu. The point that I would like to add is that regardless of the lending product, a primary focus of the

guidance that came out in '06 and the revised handbook section, is that the institution should have a strong, robust risk management system. And that is regardless of whether or not the focus is on commercial real estate lending or single family lending. And that's the big takeaway.

Jennifer Kelly: Okay, our speakers here are saying they think Gary and Tony have handled that question pretty well, so we'll move on. Matt, we've gotten several questions relating to the tool, so let me just throw those out. Several people ask, how and when will we get the tool? I don't know whether they submitted those questions before or after your section, but maybe you could talk about that. And then some people have asked if it's still possible to become a pilot for the tool or to get a beta version of it.

Matt White: I appreciate those questions. They are a little bit interrelated. I think maybe I'll answer the second question first. And that is that we're currently no longer seeking pilot banks to participate, and part of that comes back to our desire to try to get it into your hands as quickly as possible, again, given some level of testing from bankers themselves and being able to incorporate their feedback.

Our timeline is approximately June of this year, where we'll be looking to release both the banker version and examiner version.

Jennifer Kelly: And how do you plan to communicate that to the banks?

Matt White: The banker version will be released through our National BankNet system, and we'll be sending something out alerting that it is available at that point in time.

Jennifer Kelly: Okay, so stay tuned. We will—as soon as it's available, make sure that word gets out to everyone who's interested. Another follow-up question on the tool. Someone asked, what is the reason that banks will not have access to the same stress testing tool as examiners? Specifically, why are the economic data and assumptions omitted? As a small community bank, not including such data would make the tool more onerous to use.

Matt White: I certainly understand that question. It's a little bit of an easy one, in the fact that much of the economic data that will be incorporated into the examiner version of the tool comes from some of the vendors that we tend to use. And so, due to some licensing agreements with those vendors, we are not able to share that data. So unfortunately that will be stripped out. But again, the examiners will have access to the tool, to review and discuss some of those assumptions as well.

Jennifer Kelly: Okay, how are we doing? We've got a couple—sounds like we have a couple more people queued up on the line. Tim, could we take one of those?

Tim Wilson: You bet. And let's start first in La Mesa, California and Julia's location. And go ahead with your question.

La Mesa: Yes, I have a question specific to CRE concentration measurements. The first question is, the conflict in the guidance, where the new handbook for 2011 states to use Tier 1 capital plus all. And the 2006 bulletin refers to risk based capital. So specifically for the capital basis to measure the CRE concentration, which capital basis should be used? That's part one.

Brent Spencer: Yes, Julie, I would recommend using the Tier 1 plus the allowance.

La Mesa: Okay, and then the second part of my question is, with the CRE 300 and 100 limitations, is the owner occupied exclusion still allowable?

Darrin Benhart: This is Darrin. I can take that. First of all, we would say that they're not limitations. They're thresholds that require additional analysis and risk management. That's the way our examiners take a look at them. So that's the first part of the question. And then I'm sorry, could you repeat the second part?

La Mesa: When calculating those—the 300 and 100% of capital—

Darrin Benhart: The owner occupied, right. Actually owner occupied is still excluded from those. I think a lot of confusion through the last cycle came up regarding owner occupied. It has always been excluded from those ratios, although the issue came up because when you have an owner occupied that gets into trouble or is a criticized or classified asset, often you're relying on that real estate and/or the sale of the real estate.

So the risk becomes very similar if you actually have to liquidate the real estate. That's why there was increased emphasis on the owner occupied throughout the last cycle.

La Mesa: We're an SBA government guaranteed lender, and we make the majority of our loans in the 7A program as owner occupied—excuse me, as commercial loans to businesses on a cash flow basis. Which, we take a trustee on their owner occupied real estate where they run their business out of it. So that's the basis that we're asking the question.

Darrin Benhart: Yes and you are right there. In that case, the primary repayment source should be the cash flow from the business. So it's not directly tied to the real estate. But as I indicated, if the business does get into

trouble and you actually have to foreclose on the real estate, then you have OREO— and potential OREO risk, which is very similar to any other commercial real estate risk. That's where that transition occurs. But again, those are not part of the measurement of the 100 and 300 thresholds.

La Mesa: Okay, thank you.

Tim Wilson: And we thank you for that question. Let's take another call. We have Jacksonville, Texas, been waiting patiently. So let's go there for our next question.

Jacksonville: Yeah, I was just curious as far as a non-complex community bank is concerned. Would it be criticized for not using the tool?

Matt White: Yeah, this is Matt, and I guess the short answer to that is no. The tool is much like some of the other tools that we have provided. Again, just hopefully a helpful tool that can be used by bankers if you choose to. But there are certainly other methods to perform stress testings, other vendor tools that are out there, as well as just simple spreadsheets that bankers can prepare to analyze their concentrations risk. And again, if your bank does not have a concentration in income producing CRE, there may not be a need to perform portfolio stress testing of that portfolio.

Jacksonville: Thank you.

Tim Wilson: And thank you for the question. And Jennifer, shall we continue with phone calls or you want to take an email question?

Jennifer Kelly: Well, I've got quite a few questions here, so why don't I go do some of those? One question was, would we adjust principal balances of government guaranteed loans, SBA, from the pool balances in calculating concentrations, as we do with legal lending limits?

Brent Spencer: Right, I think the prudent risk management practice would be to look at that entire pool and a mitigant to the risk in that pool, may be the government guarantees. Not necessarily that you would back out of the guaranteed portion. Because with that comes a number of other things, administering the portfolio, administering the loans in accordance with the guarantee program requirements. So, I would look at it on a holistic basis, but then understanding from a risk mitigation standpoint, the government guarantee may mitigate that somewhat.

Jennifer Kelly: Here's a question that it would be good to have some more conversation around. Please discuss the relationship of concentrations and expertise to manage, i.e., is it normal for a local

bank to be concentrated in local businesses, since that's where its expertise lies?

Brent Spencer: That's a very good question.

Franc Plonkey: I've thought about this question before we did this presentation today. We recognize and understand that community banks don't generally have the same geographic diversification, for example, as larger banks. And in a lot of cases, it may not even be prudent for smaller banks to lend out of their geographic area to a large extent, or beyond their expertise.

It might be necessary for these banks to hold more capital. However, there are other risk mitigation techniques that they can use to address their natural concentrations. And those may be necessary and more appropriate just increasing capital or used in conjunction with holding more capital. Ultimately your concentration MIS and the analysis that you use, should be able to segregate those loan pools. As we said earlier, using your expertise and experience and, judgment to determine how best to go ahead and mitigate those.

Jennifer Kelly: And here's a related question that I think you'll find dovetails into that. My rural community bank has a concentration in ag production and farmland loans. Ag production is about 13% of our loan portfolio. There's really no other industry in our area. Our ag portfolio is very strong on an individual basis. With a downturn in ag economy, overall we would be able to restructure the debts and still be well collateralized and expect good capacity in the next farming season. By being any more conservative in our lending, our earnings would really go down. Any comments regarding that scenario?

Brent Spencer: That's a very good picture of a lot of community banks that are serving their communities and their balance sheet reflects the customer profile that they have. And so, it sounds to me like within that question, they have thought about concentration risk because they've considered what happens if there's a downturn in the ag cycle.

And that's really what we're talking about here, is how will your bank's balance sheet be impacted if there's some type of adverse economic trend or impact? Whether that be a downturn in the ag industry or what other factors you have to consider. And it simply could be that in your case, if you have the ability to restructure some of these loans and you've got borrowers that have some equity, then you may be able to walk through that. In some banks' case, they may have to hold additional capital. So it's a very good question, and it sounds like you've given that considerable thought.

Jennifer Kelly: Exactly. I think that plays right into what we've trying to talk about here today, is think about it, face up to what the realities are, and have

a contingency plan if that happens. And that's exactly what the examiners are going to be looking for when they come into—as Matt said, to have the conversation with you about your portfolio.

Gary Scott Jennifer, this is Gary. If I could add a point, please.

Jennifer Kelly: Sure.

Gary Scott: For our smaller community banks, I think that it's important that everyone understands that an examiner realizes that for you, for the smaller community banks, it really boils down to a simple approach of knowing your borrower, knowing its primary source of repayment. Perhaps the vast majority of your loan portfolio is concentrated locally, but whether it's ag or whether it's some other industry, there may be major employers that are a common correlation to your borrowers that present a different type of risk. And for our smaller community banks, we find that to be a challenge that management has really drilled down to its local employers and the borrowers that they cater to, and who they are reliant in terms of their source of income.

Jennifer Kelly: Okay. Thank you. We continue to get a lot of questions about the appropriate capital calculation to use in calculating concentrations. One person said they don't include the allowance at all. Is that okay? Someone else pointed out that on the UBPR, the analysis of concentrations of credit uses RBC which excludes excess capital. Brent, maybe you just want to touch on this again, that there's really no one right way to do it, right?

Brent Spencer: Typically, that's right. I think the question really hits at managing the risk. So if we're getting a lot of questions about this, there are a number of metrics that a bank can use. They may want to use risk-based capital as a metric and use it consistently when measuring different portfolio characteristics. They may use Tier 1 capital plus the allowance, and use it consistently as a metric. And I think the important thing here, there's not a prescriptive requirement that says you have to use this kind of capital as a metric, but what I would encourage you to do is consider that our examiners will tend to use Tier 1 capital plus the allowance when analyzing concentrations. And so we're not saying you have to use that, but our examiners consistently use that. And whatever metrics you use, I would encourage you to use it consistently so that you can identify any potential variances from a directional standpoint.

Jennifer Kelly: Okay. Darrin, here's a question for you. I know, you have spent a lot of time talking to our fellow regulators, and we've gotten several questions about whether the FDIC has the same expectations for state chartered banks as the OCC has for nationally chartered banks and thrifts.

Darrin Benhart: Sure. I obviously can't speak for the FDIC. We have been having a lot of discussions around stress testing, as I indicated before. The large bank, greater than $10 billion, stress testing information went out, and that is an interagency document. We have been holding interagency discussions around making sure that everybody is on the same page regarding stress testing for community banks. Clearly, all the agencies are on the same page regarding the 2006 guidance on commercial real estate, which does specifically require stress testing if you exceed the 100 or 300 thresholds. Beyond that, I don't know that I can talk any further about exactly what the FDIC's views on stress testing might be.

Jennifer Kelly: Okay. But again, to go back to this, what we're talking about is risk management of concentrations of credit.

Darrin Benhart: Right.

Jennifer Kelly: The term 'stress testing' has become very loaded with everything that's gone on with the larger banks. That's why we started off with the first question Darrin answered. And what we're trying to stress here is it really is specific to the individual bank and looking at the size, the complexity of the bank, the risk profiles and determining what's appropriate there. Concentrations of credit are a fact of life for community banks. We understand that, and what we're really talking about is how to understand that risk and manage it appropriately.

Many banks did that very successfully coming through the last cycle; other banks did not do as well with it. And we're trying to reinforce the expectations now during good times, so that people are doing the right thing as they're booking the loans. And then when the downturn comes, the bank is well prepared to deal with it.

Okay, here's a question. Could you clarify the definition of non-owner occupied? Some have described by percentage of occupancy, others based on reliance of cash flow from the property finance. The concern is the level of this type of concentration and appropriately assigning it an appropriate code for concentrations. Okay, maybe Gary or Tony, would one of you like to take that?

Tony Jardieu: This is Tony. The guidance indicates that if more than 50% of the source of repayment is generated from non-affiliated or third party rental income, then it's non-owner occupied. It's an approximation based on the income generated. Another way of stating it is if rental income is less than 50% of the source of repayment, then it would be considered owner occupied. You can look at it either way

Darrin Benhart: And this is Darrin. Again, the Call Report is clearly the best source for the specific instructions around clarifying the owner occupied versus non-owner occupied.

Jennifer Kelly: Okay, thanks. Here's a question, and it's directed to the OCC. I'll let the folks here from the OCC start, but then I would encourage Gary and Tony to jump in. The question is, how does the OCC, instead of the OTS, view the QTL test for thrifts, especially when it comes to credit concentration?

Tony Jardieu: Darrin, do you want to handle that?

Darrin Benhart: Sure. Again, we recognize that Thrifts have certain requirements related to the Qualified Thrift Lender test. I think the way we are looking at it, is that we acknowledge that realizing Thrifts are going to be more concentrated in mortgages and residential because that's part of their charter. But we do think that there are still ways that Thrifts should be looking at, understanding and being consistent in their assessment of those concentrations. I don't know if Gary and Tony want to jump in and add something additional there.

Gary Scott: Well, I would just say that again, historically, the OTS' perspective was that it was the agency regulating a charter that was primarily housing-driven, in all of its products. And while there was a certain level of acceptance of having a higher level of concentration in the single family lending arena, the one thing that has been painfully clear from the most recent crisis is that the institutions need to look under the loan for potential layered risks that might be within the portfolio based on the underwriting criteria of the bank.

And while I think that's there been a large departure from a lot of the lax underwriting that occurred, particularly in the shadow market, that that's a lesson learned coming out, and the Thrifts that do have a concentration of single family mortgage loans today, and are the survivors, and the underlying risks of those portfolios are not as great.

Jennifer Kelly: Thank you. I think we're got some callers queued up. Tim, do you want to give us one of those?

Tim Wilson: You bet. We have a couple of folks in the queue. Let's go first to Van's location in Vancouver, Washington.

Vancouver: Yeah, I was wondering if the hotel loans are considered in the owner occupied pool? You mentioned the Call Report, call instructions, but I don't see the term owner occupied anywhere in the call instructions or glossary, so struggling a little bit with that.

Darrin Benhart: This is Darrin. I think the owner occupied—and you're going to challenge me now on the Call Report instructions, but I'm fairly certain they show up on a memorandum schedule and I know they're broken out separately on the Call Report. So again, we can certainly research that for you and get you the information on the Call Report

instructions relative to owner occupied. Regarding hotels, maybe Gary or Tony can help me out here on where exactly hotels fall in that.

Tony Jardieu: Thanks, Darrin. This is Tony. Hotels typically are looked at as a non-owner occupied loan for concentration purposes.

Vancouver: Okay. SBA treats them as owner, but regardless, you guys have to treat them as non-owner.

Tony Jardieu: Yes, they are reported as non-farm, non-residential, commercial real estate.

Vancouver: Right. But then there's this sub-category in the Call Report for owner occupied.

Tony Jardieu: Right. But they wouldn't, be reported as owner occupied.

Vancouver: Okay. Thank you.

Tim Wilson: And we thank you for the question. And why don't we take one more call? We go next to Bluffton, Ohio. And let's go ahead and open up that line. Go ahead with your question.

Bluffton: Our question's been answered. Thank you.

Tim Wilson: Okay, thank you. Then we'll move along to El Campo, Texas. And your line is now open. Go ahead, El Campo, Texas.

El Campo: A question for clarification purposes, I understand that any owner occupied commercial real estate would not be included in the 100, 300 threshold bucket?

Darrin Benhart: That is correct. This is Darrin. That is correct.

El Campo: Okay. Thank you very much.

Tim Wilson: And thank you. We have one more call, so why don't we take that in our phone queue. We'll go to San Jose, California, Allen's location. And you can go ahead with your question right now.

San Jose: Yes. It's Al Williams here. Trying to see if the panel could comment on the types of economic or other stress variables that they've seen applied in just regular commercial and industrial, not real estate orientated lending. My quandary is taking, you know, sort of big time type data, unemployment and some of the other kinds of economic data, and then relating that into different concentrations that a C&I lending bank might have.

Franc Plonkey: This is Franc. I can try to address that somewhat. C&I is such a broad category that it's really difficult to understand it as a concentration in general. Really, C&I is made up of a lot of loans that may have multiple concentrations within it. So to determine what kind of variables one would want to take a look at with regard to those, you really need to break the whole category down more specifically into industries, whether that's using NAICS codes or some other method. And then taking a look at those industries and what might impact them.

Darrin Benhart: And this is Darrin. I think you're right, many people struggle with taking broad, economic indicators like GDP or unemployment or those types of things and correlating them back to their individual portfolios. Often what we see, and especially at smaller, less complex institutions, is that it is fine to kind of jump to the key drivers of the lending. Matt talked about, on the commercial real estate, looking at stressing NOI. On the commercial side, you could look at stressing revenues or stressing expenses. Again, it's basically taking what you probably already do and underwriting the credit. You do 'what if' scenarios on that, trying to apply that at more of a portfolio level to understand what the implications for any specific group of loan and what the implications might be on that, as Franc indicated.

Tim Wilson: And with that, no other folks in the phone queue, but Jennifer, I'll be sure to let you know if we do have another caller.

Jennifer Kelly: Okay, thanks, Tim. Let's go back to some of the online questions we've received. Back to you, Matt. Someone asked whether the tool that you are discussing can be applied to agriculture or other loan types, or is there a tool being developed for other types of loan pools?

Matt White: Yeah, great question. Currently, the tool is very specific just to income producing commercial real estate. Having said that, certainly this is, again, just an actual example of one method to do portfolio stress testing. So to the extent it serves as an example of one method, certainly some of the techniques, the methodologies that are used within the tool, might be able to be applied to other portfolios.

With respect to other tools in development, currently the focus is primarily on income producing CRE, but certainly, there is interest in—based on the reception of this tool, other potential tools that we may be able to be providing.

Jennifer Kelly: But we have it have for individual loans, right?

Matt White: Yeah, great point. We do currently have what's on the National BankNet system, a single borrower agricultural sensitivity test. So again, it's not going to be a portfolio test, but it is going to provide

pretty granular level detail for the agricultural borrowers, which of course can be aggregated to get at a portfolio stress test.

Jennifer Kelly: And we did have one question that came in about—someone apparently isn't familiar with National BankNet and was asking how they could get access to it. And if you go to our website, there's information on there about how you go about getting in touch with the right people to get granted access. It is a secure website, so there's a process you have to go through to register and get access. So if there's no one in your bank that's familiar with that, please go to our website and look up National BankNet and you'll find the information you need there.

Matt, one other question. Will there be a place in the tool to put in economic issues such as unemployment, etcetera?

Matt White: Within the tool, it really, as Darrin mentioned, kind of jumps right to the key drivers. And for income producing CRE, the key drivers that are used, are rental rates, vacancy rates, cap rates, NOI and interest rates. So there is not a link back to the macroeconomic indicators such as GDP and unemployment.

Within the banker version of the tool, the assumptions are not pre-loaded so these are going to be available for you to design and develop. And of course, that link is going to be the important part, but that link between the macroeconomic data and the more granular level key drivers can be derived from vendor data or just your own understanding and analysis of your local economies.

Jennifer Kelly: Okay. We're continuing to get questions that people are unclear about the definition of owner occupied. Does anybody want to take another crack at—they said that they were not clear from the explanation. So could we just walk through that one more time, of how we would—how they should define things as owner occupied?

Brent Spencer: Yes, I'll respond to this, and then Darrin may have something he wants to add to that. But I think if we back up a little bit, I think what we're really trying to get at here is just understanding a risk within the loan portfolio and what are those factors that may influence different loan products on a pool basis? On the question about owner occupied, for example, for the hotel loans, well clearly, from a hotel lending perspective, even though the owner may reside there and - there may be an owner occupied element to that, from a concentration standpoint, I think it would be prudent to look at those as non-owner occupied.

And so what we're looking at is the risk, and can the owner cover the risk - is that source of repayment sufficient at the transactional level to sustain that loan? And then to collectively look at that on a more

macro level, and you combine it on a pool basis. Darrin, did you have something you want to add to that?

Darrin Benhart: No. Like I said, we'll see if we can't get the Call Report instructions up here, see if we can specifically find that. As I think that Tony indicated before, there is a criteria in there around the 50% as a rule of thumb, benchmark as to whether it's owner occupied or non-owner occupied. But we'll see if we can't find the Call Report instructions' specific words here before we get off the phone.

Jennifer Kelly: Okay. Gary and Tony, I've got another question for you, and anybody else who wants to weigh in is welcome to do so. We are about a $250 million FSB with 2 branches, 12 percent tangible capital, 40 percent risk-based capital, no CRE loans. All our loans are 1 to 4 family, with 28/36 debt ratios and one non-accrual loan. We have no PMI loans. All our loans are within a 20 mile radius. How do we gauge loan concentration risk?

Gary Scott: Well, it'd be nice if all of us were in that situation. But obviously, the business model that this institution has is one—it is highly concentrated on single family mortgage loans, but the underwriting and the risk criteria for them have been taken into consideration. Because of that, the risk profile of that portfolio is obviously less, and our examiners would have a higher appetite for that concentration.

But that does not alleviate the institution's obligation to maintain the appropriate records to show those underlying risks of the portfolio and be able to demonstrate to the examiners why there is a lesser of a risk profile within that particular portfolio. Just because it is single family portfolio that is prudently and conservatively underwritten, does not in and of itself give a carte blanche ability to not document the underlying drivers of those borrowers.

Jennifer Kelly: Okay. Anything anybody wants to add? All right, thank you. Here's a question regarding participation credits. Would the originator be expected to include the sold and unsold credit in their concentration review?

Brent Spencer: For a bank that purchases a credit, we're looking at the two pieces there. You purchase a credit, obviously it's going to be something you hold, so you're going to be including that in your concentrations. That part that you sold, if it's sold without recourse, and wouldn't be included as part of your concentration because it wouldn't be included as part against your legal lending limit, for example. So no, it would not.

Jennifer Kelly: All right. Let's see, more questions. Historically, what areas other than CRE issues have motivated this extensive analysis?

Brent Spencer: I'll take a jump at that real quick. As far as analyzing concentrations, one of the things, as we pointed out, it's interesting because we actually have been talking about concentrations for many years now. The original handbook was dating back to 1990, and I recall having conversations with bankers many years ago just about potential risks in their portfolios due to maybe a large employer in town or due to products—a high level of hotel lending in one portfolio. So I think we've been talking about concentrations for quite some time, and I don't know that we're asking for a different type of analysis. But I think what we're asking for is just for the banks to really understand the key vulnerabilities in their portfolios and understand concentrations in their portfolios.

And I think clearly that the events of the market over the last few years have really indicated and highlighted some concerns around concentrations. And we've seen a number of banks that had sound underwriting at the transaction level, and then really didn't correlate product types and didn't correlate different loan pools. And as a result, when the economy turned down and the housing turned down, those banks were adversely impacted. Probably more so than those banks that better understood their correlations in different types of loan products. So that's what we're asking banks to look at.

Jennifer Kelly: I think Franc's got some clarification here.

Franc Plonkey: I do. One of our bankers emailed us the location of the owner occupied definition within the Call Report instructions. And those can be found at Call Report Schedule RC-C-6. RC-C Loans and Leases, page 148 of the instructions.

Jennifer Kelly: We appreciate the help from the audience.

Jennifer Kelly: I think maybe we have one more caller in the queue, Tim?

Tim Wilson: Yes, we do. And for that we'll go to Glens Falls, New York. And go ahead with your question.

Glen Falls: Yes. Has anyone developed any kind of metric for stress testing medical?

Franc Plonkey: Not that I'm aware of.

Brent Spencer: I'm not aware of a specific metric. That sounds like something interesting that you could share with us.

Glen Falls: No, it's probably—you know, after commercial real estate, I guess it's probably the biggest area a lot of banks talk about, and if you're trying to stress test your portfolio, whether it's hospitals, doctors' offices, you know, what do you do? Do you say if they have a 2% cut in Medicaid,

if something changes in the government area, that to me is a hot area. And I don't know really how to address that. I'm waiting for the examiners to come and say, 'How are you addressing that?'

Brent Spencer: That's a really good point and it probably gets back down to, how do you stress the ultimate source of repayment? How are those loans being repaid? And if there are common sources of repayment, maybe that's something that should be looked at.

Darrin Benhart: And this is Darrin. I think that gets back to a point maybe not specific to medical, per se, but all of the assumptions that you do in a stress test in some form or fashion probably aren't going to play out exactly the way you would think in a stress scenario. I think the real value can be in implementing and doing something consistently. And then as you see changes in the risk, whether it be external factors or internal to your marketplace, etc, changing those variables and looking at the stress over time to see the movement or change in the risk, or how much the risk changes with the change in any given variable. More broadly, that is the real value in any kind of a stress or scenario analysis. Doing it once and getting one answer in and of itself would be informational, but looking at a time series can definitely, be more powerful.

Jennifer Kelly: Okay. Well, thank you very much. Tim, is it all right if I go ahead and wrap up?

Tim Wilson: You bet. I think we're good on this end.

Jennifer Kelly: Because we want to honor the ninety minutes that you all allocated to this, we didn't get a chance to get to all the questions. I tried to the extent possible to group questions that we were getting together into similar topics so we could cover as much territory as possible. But we will go through all of these questions and use them to develop some more Qs and As that we will be sharing with you, because clearly this is a topic of great interest, and we want to keep those lines of communication open.

What I want to stress in closing, again, and you've heard us say it over and over again, that this is not a one size fits all process. We've had to speak somewhat in generalities today, given the fact that we have a very large and diverse audience listening. And what we've been trying to say is that the expectations that the examiners will be talking to you about will vary based on your bank's risk profile and the complexity of its business model.

If you aren't clear on what the expectations are for your institution, I'd encourage you to get in touch with your local field office. You don't have to wait for your next exam. Your ADC or your portfolio manager

are available for that kind of discussion at any time. All you have to do is get in touch and ask.

Thank you for taking the time to participate today. I'd like to encourage you to take a few minutes when that evaluation pops up and give us some feedback. That will help us make future webinars as beneficial as possible. And certainly, if you have suggestions for other topics that you'd like to have addressed through this type of forum, please note them on your evaluation form. Thank you very much, and goodbye.

Tim Wilson: And thank you, Jennifer. And that concludes today's Concentrations of Credit Web Conference presented by the Office of the Comptroller of the Currency.

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And as Jennifer mentioned, as I end today's webinar, your computer will go to an online evaluation form for today's program. We appreciate your comments and suggestions so that we can bring you quality future programming. If you prefer, there's also a paper form in your handouts that you can complete and then fax into us. We thank you for joining us today, and hope you enjoy the rest of your day.

[End of Recording]