Credit Risk Ready Podcast

Host Linda Keith CPA with Ancin Cooley

Prudent Pandemic Loan Concessions: How Will the Regulators See It? How Can We Prepare?

Hi, this is Linda Keith CPA with Credit Risk Ready, a podcast where we interview senior credit and lending professionals from community financial institutions across the United States, their regulators, and banking advisors to better understand and mitigate credit risk.

Today we are going to report on how the regulators are approaching examinations with 2020 in the rearview mirror. Is it the same or different from past examinations? How will that change as we start into a recovery?

To help us with this topic we have Ancin Cooley, a former OCC examiner who now consults with financial institutions in loan review, director oversight, and a host of risk management services. Ancin's certified twice — I love that — as a CIA, certified internal auditor, and a CISA, certified information systems auditor. His firm is Synergy Consulting. Between his OCC experience working with banks from $100 million to $8 billion in asset size and his work for a regional accounting firm with the focus on internal audits, and loan and pre-regulatory examiner reviews, he is the right person to help us with how the examiners are thinking and acting now and next.

Hey, Ancin. Thanks so much for being here.

Ancin Cooley:

Hey, thank you for having me. When I started my practice originally, we said, "Well, how can we serve both credit unions and banks?" Right? So we started two firms. We have Synergy Bank Consulting and Synergy Credit Union Consulting.

As you mentioned, we do director training, enterprise risk management, and a host of other services that gives us a very unique purview in how both credit unions and banks interact with their examination teams. Either they're letting us know that they're coming in and some of the things they can do to get prepared, or do some kind of pre-examination review. Or we have an opportunity once under an NDA to look at their past examination results and give them some guidance on how they can cure issues or be better prepared for their next exam. Whereas other institutions don't get to see the actual examination reports, we get to see examination reports from different field offices from different agencies across the country, so I think this will be an interesting conversation.

Linda Keith:
Well, so let me just run through the cast of characters here. Because when it comes to the guidance we've gotten for pandemic recession, the OCC issued a bulletin in March 15, 2020, titled *Pandemic Planning: Working with Customers Affected by Coronavirus and Regulatory Assistance*. It said the OCC emphasizes that prudent efforts to modify the terms on existing loans for affected customers should not be subject to examiner criticism.

Just two days before that, the FDIC issued guidance that said the FDIC encourages financial institutions to work with customers and communities affected by COVID-19 in a prudent manner. The NCUA said the NCUA examiners will not criticize a credit union's efforts to provide prudent relief for members when such efforts are conducted in a reasonable manner with proper controls and management oversight.

Finally, the Federal Reserve during then saying, and actually a joint agency declaration, that the agencies encourage financial institutions to work with borrowers and will not criticize institutions for doing so in a safe-and-sound manner. The agencies view prudent loan modification programs offered to financial institutions' customers affected by COVID-19 as positive and proactive actions that can manage or mitigate adverse impacts on borrowers and lead to improved loan performance and reduced credit risk.

Ancin, I'm hearing words that are important, but don't feel precise like 'prudent,' 'safe and sound,' 'reasonable,' 'proper.' Aren't those more precisely sound or not?

Ancin Cooley:
I would say they're exactly what your perception of them are. It gives each examiner, each field office, each agency, the latitude to define what prudence means for that particular institution. You hear terms like, "Develop a policy and procedure prudent for the size and complexity of your institution." So, it's not a one-size recommendation. For example, if you're a financial institution that already has a significant amount of classified assets in its commercial lending portfolio and your capital has been deteriorating, well, what prudence means for you in allowing borrowers to have extensions and doing workouts, your prudence is different than an institution that has significant capital and institutions that have strong earnings. It's just one of those things where I think you have to work within the boundaries of what your capital looks like. I think, in my opinion, that's the barometer for it. Okay?

That also means that you're going to have to write out your thought processes. Tell them what you're going to do before you're going to do it and give them an opportunity to opine about it. But what I've found because of the way it's written, a lot of institutions didn't extend themselves out toward their customers because they were worried about bringing in loans that would deteriorate their asset quality. Then having examiners be okay with it today, but then two years from now, they haven't wanted their portfolio. They've forgotten about COVID, and they're coming down on me. So, there has been and is some skittishness around really leaning into that.

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Linda Keith:
Well, I talked with some of these bank CEOs who some of them were almost like, you know, "We really don't know what the examiners are going to do, but this is the right thing to do. We're going to do it anyway." They were sort of stepping out counting on what the regulators were saying, that they were going to not overly criticize and so forth. But not really knowing what that meant and just having to decide, "This is what's right for our customers, our borrowers, our members. We're going to have to do it, even though we actually don't know how the examiners will see things later."

Ancin Cooley:
Exactly. I think the prudent thing to do is that I always advise my clients, "Allow your capital to be a barometer."

Linda Keith:
What do you mean by that?

Ancin Cooley:
Okay. For example, each regulatory agency, they have these risk-based capital parameters. Okay? If you're above 10%, you're well capitalized in the banking world. If you're above 7%, you're well capitalized in the credit union world. Okay? If you are a credit union that has 10% or 12% capital, you're in a better position to absorb credit losses than a credit union that's sitting at 7.5% capital.

Linda Keith:
Right.

Ancin Cooley:
Your prudence would be to look at, "How much can I extend, understanding —let me be technical — the probability of default, given me helping these particular borrowers that it's going to affect my credit, which will affect my earnings, which ultimately affect my capital?"

If you are a credit union that's sitting with 15% capital, then you have a lot more cushion to absorb losses and then, frankly, you should receive less criticism even if you make mistakes through COVID and overextend yourself. You can say, "Okay, Mr. Examiner. If I was to completely charge-off half of my classifieds, guess what I'm still going to be? More than well capitalized."

In the same way for a bank, if you're a bank sitting on 14% capital, you can do things for your community around programs that someone sitting at 8% can't. That's what I mean allowing your capital to be the barometer or your own canary in a coal mine. Just not always looking for examination approval, frankly.

Linda Keith:
Well, it's always been my suggestion that while pleasing these examiners might be one issue, we really need to be safe, sound, make loan decisions that make sense, and so forth. But what you've just said sounds exactly like it usually would be. Normally, yes, if I'm sitting at 7.5%, maybe I don't have as much cushion. But what is it then about the recession, the pandemic recession, that the regulators are saying they'll give more leeway to. Right? It's like, what are the regulators going to do that's above and beyond what they normally would do to work with these financial institutions? Or are they?

Ancin Cooley:

Frankly, I'm not seeing anything different than before. What I mean by that is this: if you are a financial institution that has deteriorating asset quality, deteriorating capital, and deteriorating earnings, you're going to get treated the same way you get treated any other time. I think that what they're asking you to do is before you make these decisions to do these modification programs, you have to spin within your budget, or operate within your wallet, if that makes any sense. They're saying be prudent. We encourage you to do it. But be prudent. Prudence typically means operate within your earnings levels and within your capital levels for you. Okay? Your particular institution. I think that's a good way for any institution to go about doing it.

I wanted to mention to you that like examiners on a monolith, each examination EIC is a different individual with a different personality. Although field offices attempt to have some consistency around what a 2 rating is, and a 3 rating is, and how they go about doing these things, that's typically the job of the field office analyst or the boss to make sure that the product, the report, is consistent, but often it isn't. You may have one field office that addresses and has prudence meaning one thing out of Wichita, if you will, and another group of examiners down in Florida doing something different.

As a bank or credit union, any financial institution, you can't use your examination team as a canary in a coal mine. Because the things that you were doing the last three years with the last EIC that you had, they could have been fine. You get a new EIC this examination and everything that you were doing last year could be problematic. You know what I mean? You have to have your own internal compass for when things are going left and right in the institution.

From my vantage point, I find the consistent thing to look at is your risks. Liquidity risk capital risk, interest rate risk, compliance risk, transaction risk, things of that nature, in relationship to how they put risk to your capital base.

Linda Keith:

Okay. Maybe the pandemic recession doesn't exactly change a lot. Except I do know that in some of those regulatory announcements they would say things like they wouldn't criticize you if you made adjustments for a short-term set back of a borrower. They kind of gave you that out, but that would mean that you, meaning the financial institution, have to have a real good understanding of, “How do we tell it's a short-term setback versus running down the drain?” Number one.

Number two, because I work primarily in the loan origination space. I work with lenders and credit analysts in making the decisions in the first place for, in this environment, reaching out to their current borrowers and considering adjusting, restructuring, et cetera. We need to document really well. Not just what we thought and decided, but even when was this and what was happening in your local economy at the time? Is this an industry that was getting back on its feet? Were you in your third set of shutdowns? In other words, the examiners, even though they lived through this as well, they don't have the same knowledge of what that industry in your location might have been facing at that very time. I just feel like the lenders and the credit analysts have to be sure that the documentation is there to give the examiners context to decide whether it's prudent.

Ancin Cooley:
I'll give an example. My cleaners just went out of business. I liked the guy. You know what I mean? He put a sign on his door saying that he was not able to sustain himself through COVID. I didn't know he was having problems. I just walked out and the people were cleaning his shop out. I felt a little bad because I didn't know. Him and I never spoke. He didn't know what I did for a living. I imagined to myself, before COVID, business was booming. I said him, I said why did he not avail himself of a lending opportunity to help him make it? Because I would ideally think that a lender would be able to look at his financials and see prior to the pandemic his income was robust. Then he had a steep decline, right? Through COVID, so why not offer him a low-interest working line of credit to help him sustain himself through this period knowing that once this subsides, he'll be on the other end of it. You'll be able to term that out or he'll be able to pay that down, and now you have yourself a new customer.

If I'm an examiner, what I would do is did the bank or credit union establish criteria for making those decisions? Meaning was the business sustainable and profitable before the pandemic, one? Or are they in an industry that will not recover due to COVID? No, it's just it seems like a slump. Once people start coming back to work, he'll have his walk-through traffic. He's right in front of the train station and things of that nature. Two, do we have any collateral? Do we have any guarantee if we go through those primary, secondary, and third sources of repayment? Now you've made a prudent decision. You give this person an extension.

Now, on the opposite end, if he had declining income, he was already a pastwatch or special mention going into COVID, then, in my opinion, the COVID just exacerbated a problem that was already there. In my opinion, that may not be as prudent in the decision to make. The COVID just pushed him over the side and then that wouldn't be a prudent decision to make. That's how I would distinguish between the two using that as an example.

Linda Keith:
It sounds like at the loan management level, setting some criteria that gives guidance to our originators about, "Here are the kinds of things we'll look at. We need three years pre-COVID, strong, you know, financials," or whatever the requirements are. Now your loan originators have some teeth to go out with rather than just, "Gosh. I think this is a good business. They've been there for a long time." You know, kind of the feel. That they actually have some criteria they can apply and then document.

Ancin Cooley:
Right.

Linda Keith:
So that now the examiners can see, "Here was the criteria they were provided. Here's the criteria they met. Here's how they documented it. Yeah, that sounds like it meets their definition of a prudent action, which I can agree sounds prudent to me." Is that kind of what we're trying for?

Ancin Cooley:
Yeah. Also just being about analysis and not just looking at payments and things of that nature, or cash flow. Looking at the industry. Looking at the type of business. Will the industry sustain itself?

Let me be whimsical. If this was a bar or some kind of business that prided itself on close talking and touching, you know, The Close Talking and Touching Bar. Well, going forward, The Close Talking and Touching Bar may not be a profitable business going forward. We may not want to give them this line of credit because that business model in and of itself may not be sustainable, as much as we like the business. Going forward, it may not be a sustainable business model.

Linda Keith:
It's sometimes so hard to make that judgement call, you know? You almost feel like you're bringing your personal preferences for what kind of bar will succeed or not. You're trying to figure out,"Okay. Is this just my point of view, or is it really a trend?"

Ancin Cooley:
That's an interesting point that you made. This is pretty a good separate segment. That's why you have to do biased audits of your credit analysts and loan officers. Meaning, unbeknownst to you as a credit manager and CEO, you could have credit analysts and loan officers that have biases towards certain businesses and certain industries that you may be unaware of. But it's showing up in their analyses and how they communicate. The only way to test that is to give them the same credit. Have them all do an analysis and look at the same credit and see if they all come up with the same, not that they should, but what would different results they come up with.

For example, you might give them a water park. You might have one guy, gray haired, long in the tooth. "Yuck. I hate water parks. I remember one back in '82 that went under." You might have someone else that just might be looking at it just on the numbers, the industry, and the progress, and might give you a different result.

But if they all look at the same credit, it gives the credit department manager and the CEO an opportunity to see how different analysts approach problems. If that's either leading to missed opportunities or us having concentrations of credit in certain areas where everybody is comfortable with. For example, everybody is comfortable with, I don't know, multi-unit CRE with doctors and dentists in it. Right? Because it's easy to do. But what happens when you put a core C&I deal in front of somebody where it's not secured by the collateral. You really have to look at their AR and their accounts payable. You start getting different results because you're tapping into the differences in skill sets in your credit team.

Linda Keith:
What's interesting to me as I listen to you, Ancin, is that this is always an issue and it might be exacerbated with this need now to decide whether a business that is having a tough time is a short-term problem or longer-term problem. Because my bias now against gas stations, or water parks, or whatever might come in.

I know when I'm talking training on tax return analysis with lenders, one of the things I have fun with is that we have one example that has some lottery winnings, you know? It's not a bunch of money and we figure it's nonrecurring. Then I say, "If it was gambling, would you feel differently about it?" A bunch of people admit that if they've got somebody that's got a lot of gambling going on, that they have an opinion. I said, “But you're okay with somebody who owns a really expensive boat and spends every bit as much money out boating?

Ancin Cooley:
Right.

Linda Keith:
Right? It's a hobby. It costs the same amount. This person, again, has good credit, so it's… There's no evidence that they actually are being harmed by gambling. It just helps the lenders realize, “Wow, that's right. I had that bias. If I see gambling, I immediately start moving in a direction that is not necessarily supported by the information in front of me.”

Ancin Cooley:
Absolutely. Absolutely.

Linda Keith:
Having to make this decision now in the pressure cooker of the pandemic and, you know, lenders are used to having to deal with businesses that are going downhill for whatever reason. So, these ideas that you have to have these conversations sometimes with the business about how you can't extend the line of credit, or increase it, or whatever, that's not new. But in the very face of their partner died of COVID five months ago, their kids are still at home, and whatever, it's just the stakes are so much higher that it feels like there would be some pressure beyond prudence to encourage people to try to help, especially in smaller communities. These local businesses who, through absolutely no fault of their own, they're losing their business.

Ancin Cooley:
I think there's an opportunity for community banks and smaller regional institutions to lean into that lending space between the $50,000 and $1,000,000, where a lot of small businesses have been left out there as larger institutions like Chase and Wells Fargo have said. I think it's not as profitable for them to really engage in that small business lending space because of the analysis and the monitoring that has to be done. A lot of them have exited that space, and as such, there's been a lot of small businesses that don't have access to the same type of lending that they used to. I think that showed itself during the pandemic, when people did not have access to these sorts of lines of credit and working capital that they would have needed to sustain themselves outside of the money that they received from the government.

Linda Keith:
Gee, Ancin, then the bunch of them couldn't even get PPP loans.

Ancin Cooley:
Right.

Linda Keith:
Because they didn't happen to be with the bank that was really doing it or doing it as quickly, and by the time they got in line, but it was too late. It was just a zoo. In some cases it had to do with which financial institution you were with, not whether they qualified, not whether it makes sense for them.
They just weren't in the right place at the right time, because for whatever reason the bank they were with didn't move quickly enough.

Ancin Cooley:
Absolutely. Absolutely.

Linda Keith:
Yeah. Well, so this has been a fascinating conversation for me. I'm an examiner myself from my background, not in the banking space. I was with the Washington State Auditor's Office. I understand how examiners think, and I understand words like 'prudent.' It's the only thing we can use really, because an examiner at that level can't be specific about what you need to do. But does need to keep reminding the financial institutions, from the board of directors all the way down to the loan originators, that it is our job to maintain safety and soundness while meeting the needs of our customers and our borrowers, including in a really difficult time.

I would just reiterate from a loan origination side you need to document your thinking. You need to explain why you're making these decisions. Then really what you said, Ancin, at the loan management side, you need to help with, "What are the criteria that our loan originators should be looking at that will help them make the case that it would be some kind of exception or that we will offer?"

Ancin Cooley:
Right. Just one quick takeaway, you know, and it kind of just applies for the pandemic, or just in general. I've always been an advocate of showing your auditors or you review how the sausage is made in your loan credit memorandum. Meaning give the loan officer a page or a section within the loan approval memo to opine about the pros and cons from their perspective. But give the analyst in charge of that loan also an opportunity to opine free of any influence from the CEO or the manager so that they can say what they think about it. Even if they say something that is, I don't know, negative about the origination and then you still approve the loan, that's fine. But it gives me comfort that you all don't have a whole bunch of 'yes' people up and down your org chart.

When I see someone point something out and they had, one, the ability. They weren't bashful about it. They articulated. They made similar points that I would have made. Right? But then the committee, within their risk appetite, decided to accept the risk of the things that were noted. The loan officer made good points. It all comes together and you all approve it. It's fine, even if it ends up becoming a problem loan.

Culturally, the sweeping underneath the rug of disagreements or negative points around alone, I think it creates the wrong culture. Then on the back end it makes a reviewer feel like, "Well, did you realize that that was a potential pitfall?" Give everyone their space in your documents to speak their mind, unedited and untainted by other individuals in the org charts' opinions. Absolutely.

Linda Keith:
Right. So, both examiner and loan review would rather know there was a robust conversation and still made a decision than to wonder, "Were they even noticing this issue?"

Ancin Cooley:
Exactly. Let me see the sausage made.

Linda Keith:
I love it.

Ancin Cooley:
I feel more comfortable with the institutions that argue, and debate, and write down their thinking than the ones that make it seem like everything was hunky dory when they made their pool.

Linda Keith:
Yeah. Well, tell you, everybody, in the show notes we have some of the resources that Ancin can share with you. Especially the links to get in touch with him, both for bank and credit union needs. Because this particular area, understanding what the examiners want, what loan review wants, what they're going to be looking at, could very well shape what you do.

Actually, as soon as you get off this podcast, clear up the criteria and make sure that you, as an originator, understand, "What is the criteria? What are the circumstances in which we can make those prudent decisions that will help our borrowers and still pass muster with the examiners?"

Thank you so much.

Ancin Cooley:
Absolutely. Thank you for having me.

Linda Keith:
Thanks for joining us on the Credit Risk Ready podcast. Subscribe, comment, or share on social media to stay connected and spread the word. Join me next time as we bring our bank, our customers, and our communities through the recession safe and sound.

Take care.

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Resources

- Synergy Credit Union Consulting:
  https://syncuc.com
- Synergy Bank Consulting:
  https://synbc.com
- YouTube:
  https://www.youtube.com/channel/UC_dkqDh0BVb2aWXZi7DQ0xQ
- Linkedin:
  www.linkedin.com/in/ancincooley
- Interagency Credit Risk Review Guidance:
  https://www.federalregister.gov/documents/2020/06/01/2020-10292/interagency-guidance-on-credit-risk-review-systems

About Ancin Cooley

Ancin Cooley is certified and certifiable. He is a CIA (Certified Internal Auditor), CISA (Certified Information Systems Auditor), and is the founder and principal of Synergy Credit Union Consulting, Inc., and Synergy Bank Consulting, Inc. Synergy provides a suite of risk management services to financial institutions, which include loan reviews, information technology audits, internal audits, directors' exams, and regulatory compliance reviews.

He comes by that knowledge from a wealth of experience. Prior to founding the firm, he worked as an OCC examiner working with banks from $100 million to $8 billion dollars in total assets. He also worked for a regional accounting firm with a focus on internal audits and loan and pre-regulatory examiner reviews.

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About Linda Keith

Linda Keith, CPA, draws on her 30-plus years of experience consulting with and training lending institutions; background in public accounting; 15-plus years as CFO of the family residential construction company; and experience as an examiner with the Washington State Auditor's Office and as adjunct faculty in Accounting Principles and Managerial Accounting to help lending and credit professionals say "yes" to good loans.

Of course, you know those are not consecutive years or she'd be over 100 by now!

Linda is known by her clients to be both practical and funny. In fact, there is a movement afoot to change the 'P' in CPA to stand for 'Playful'. The fact is people absorb ideas and learn better when they are having a little bit of fun. So, Linda brings the fun along with her practical knowledge and depth of understanding to provide credit analysis training and presentations that make a difference.

She is the founder of Lenders Online Training, a virtual classroom approach to improving tax return and financial statement analysis capabilities; the host of the Credit Risk Ready Podcast; and a consultant/trainer on credit risk to banks and credit unions across the country.

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