90 Day Note

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Notes from Loan Review

By: Robert L. Viering, Senior Consultant and Manager of Lending Services

2018 is now behind us and I wanted to give you some observations from our loan review practice. The following are our comments on credit quality that we have observed. Two of the most frequent topics/questions we hear about from our clients are: 1) annual reviews (frequency and level of detail) and 2) credit analysts (where do we find them, and how do we train them).

Credit Quality

With few exceptions, the banks we review have good credit quality. Charge-offs are minimal and non-performing loans are low.

CRE Loans: The majority of the loans we review are commercial real estate and they have shown few signs of weakness so far. Although the regulators have cautioned banks about liberalizing terms and reaching for loans, we fortunately saw little evidence of this happening with our client banks. However, we have been reminding our clients to be diligent in collecting and analyzing rent rolls for multi-tenant properties, especially those with chain stores as anchor tenants. We have had fewer risk rating differences this past year as this segment has been fairly stable. Stress tests we have run have shown few issues in this portfolio. We are somewhat concerned about future cash flow with rising rates. This is one more reason to review leases and rent rolls to see when leases are up for renewal and compare that to when the interest rate on a loan will reset.

C&I Loans: Commercial and industrial loans have also had few problems. The one issue we do note is that many banks are relying on tax returns alone. Many times these returns have been extended, meaning that the information they contain is nearly a year old by the time it is analyzed. These loans can be fairly volatile and are often impacted before some CRE loans when the economy turns. So, we do encourage banks to get more frequent financial information (which is usually not hard to obtain with so many companies using QuickBooks or similar accounting software). It is also important to get the borrower's balance sheet to analyze any items that may be a concern but may not be obvious from the income statement. Changes to accounts receivable, inventory, accounts payable, and accrued expenses are an important aspect of analyzing C&I borrowers. We also counsel banks to watch for analyzing cash based on financial statements from companies that regularly sell to other businesses or individuals on terms. Without accrual-based statements, these companies are very difficult to analyze. Overall, we have seen relatively few risk rating changes in this portfolio as the economy has been strong and businesses have been able to cash flow with few issues.

Agricultural Loans: The biggest area of concern we have seen are agricultural loans. This sector has been in a prolonged downturn and has been hit hard by recent trade disputes. We have found that many farming operations have made the adjustments necessary to get by in today's world, but those that are highly leveraged are having an increasingly difficult time. Dairy portfolios have been especially hard hit. So far many operations have gotten by with refinancing long-term assets, primarily real estate, to keep going. But, our concern is how many times an operation can refinance until there is no more room to loan against those assets. In the end, these operations need to find a way to break even to continue long term. The banks have been on top of this portfolio and the loans have been much more closely monitored and managed. Boards have paid an appropriate level of attention to this portfolio. We have done a much greater penetration of this portfolio for most banks with any

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degree of exposure to this segment. Stress tests we have run have shown few losses primarily because real estate values have been steady. We have seen a greater number of risk rating differences in this portfolio due to the volatility in this segment. However, the number and severity of these differences has not been a serious concern. This portfolio is more likely to have criticized assets in it due to the borrowers with consistently poor cash flow and increasing leverage. We have also noted a greater use of FSA guarantees this past year which we do encourage.

Annual Reviews

This has been a regular topic of discussion with many of our client banks. They are trying to determine how frequently an annual review should take place and the size of loans that are subject to review. With the infrequency of credit problems, we have seen banks lengthening out their reviews to two or more years for strong credits. We have also observed more banks raising the limit for reviews. These decisions are reasonable today, but the risk is that when the economy does start to decline, the bank may not recognize problems for a more extended period of time. We strongly encourage banks that have extended out reviews or increased the level for reviews to be ready to change the timing and level when there are declines in economic conditions, both local and national. It is during more volatile economic times, such as we see today in the agricultural sector, when risk ratings do not always keep up with emerging weakness.

Credit Analysts

We also hear frequently from banks that need to add credit analysts due to growth or turnover. They ask about where they can find analysts, especially more rural banks, and how they should train them if they lack experience. Good analysts are hard to find, especially in more rural areas. Most frequently we have seen banks train their own or, in some cases, change the level of annual reviews to fit the number of analysts.

Most community banks do not have a training staff and use on-the-job training and outside training, such as banking association training, both in-person, and more frequently today, webinars to train their analysts. Training a good analyst is a time-consuming but critical job. It is important to have individuals that are well-experienced analysts or loan officers that see it as an important part of their job to oversee the development of your credit analysts. Good credit analysts are an important part of a bank's credit quality process. They become even more critical when the economy eventually declines.

Conclusion

Overall, our client banks are doing well and are well-managed. Third-party, independent loan review is a great way to assure that your loan portfolio is being well managed and the bank is prepared for your next regulatory exam. An outside set of eyes can be really beneficial. Feel free to reach out to me if you would like to discuss how Young & Associates, Inc. can help your bank manage its loan portfolio. You can reach me at 1.800.525.9775 or bviering@younginc.com. Our best wishes for a great 2019! ❑

Capital Market Commentary

2019 Forecast and 2018 in Review

By: Stephen Clinton, President, Capital Market Securities, Inc.

The stock market exhibited a high level of volatility in 2018. During the year, trade disputes with our neighbors and China caused uncertainty about future U.S. trade practices. The Fed continued raising interest rates. The government entered into a partial shutdown in December 2018. The Dow ended 2018 at 23,327.46, a decrease of 5.63% for the year. The broader S&P 500 index ended down 6.24%. These indexes recorded their worst annual performance since 2008.

The market correction in late December led to the decline in the stock market for the year. A major contributor to the correction was the choice by investors to move

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from investments to cash. In the final three months of 2018, investors moved $190 billion to money market accounts, the biggest deposit in money market funds since 2008. The movement to a higher cash allocation forced money managers to reduce their stock investments leading to a fall in stock prices.

The Fed, intent upon unwinding its easy-money policies, continued raising interest rates in 2018. Policymakers in December increased the central bank's benchmark interest rate to a range of 2.25% to 2.5%. This was the fourth rate hike of 2018 and the ninth increase since the Fed began raising rates from near-zero three years ago. During the latter part of 2018, the yield curve became partially inverted causing much discussion about whether this was a sign that a recession may be on the horizon.

Employment growth continued strong in 2018, with more job creation than the previous two years. There were 2.6 million new jobs created over the course of the year compared with 2.2 million in 2017 and 2.3 million in 2016. The unemployment rate in December 2018 was 3.9% with claims for new unemployment benefits falling to a level not seen since 1969. Wage growth, spurred in part by tight labor conditions, climbed in 2018 with hourly earnings increasing 3.2%.

As we enter 2019, there are a number of items worth monitoring:

Economic Growth – As the year ends and the U.S. economy enters its tenth year of expansion, there is considerable momentum heading into 2019. Economic activity during the second and third quarters grew at better than a 3.5% pace and appears to have performed solidly through the fourth quarter. The full year is expected to come in at approximately 3% annualized growth, making 2018 one of the best years of this expansion. We feel confident that the economic expansion will continue in 2019 and record the longest economic upswing on record, and predict GDP growth of between 2.0% and 2.5% in 2019.

Housing – Home prices continued to rise in 2018. The S&P/Case-Shiller National Home Price Index rose 5.2% in the 12 months ending in November 2018. The rising price for homes continues the trend of exceeding inflation and wage growth. Home sales in 2018 recorded the softest year for sales since 2015. A limited housing inventory, increased home prices, and rising interest rates negatively impacted the housing market. Additionally, the 2017 tax law reduced some incentives for homeownership. We expect home sales to remain subdued in 2019.

Industrial Production – U.S. manufacturing activity finished 2018 strong. Output at U.S. factories grew 1.1% in December, the biggest gain since February 2018. Capacity utilization was pegged at 78.7% in December, the highest reading in four years. This activity indicates solid domestic demand which outweighed softer export growth. U.S. auto sales topped 17 million vehicles for an unprecedented fourth straight year. These positive values, however, may not be good indicators for 2019. Some of the 2018 factory production may have been in anticipation of concerns over increased tariffs being assessed in the future. We anticipate modestly lower export activity in 2019 due to the strengthening value of the dollar and due to the uncertain outcome of the China trade negotiations.

Consumers – Consumer confidence decreased in January, making it the third month the index has declined. Consumer expectations regarding job prospects and business conditions weakened, but still suggest that the economy will continue expanding at a solid pace in the near-term. Consumers ended 2018 in a healthy financial position, but the three-month decline in consumer confidence is reflective of an increasing concern that the pace of economic growth may begin moderating in the first half of 2019.

Inflation – Low inflation, lower gas prices, and higher wages are increasing the spending capacity of American workers. In 2018, overall prices rose 1.9%. This falls below the Fed's target of 2%. The low inflation rate provides the Fed an opportunity to be patient about future rate increases and we anticipate no more than two rate increases in 2019. We anticipate that 2019 will move closer to a 2.3% inflation rate as oil prices increase (oil prices plunged more than 40% since early October 2018) and the impact of tariffs increase product prices.

U.S. Deficit – The U.S. deficit is at a six-year high and represents a 17% increase from last year. It is projected to climb to near $1 trillion by the end of fiscal 2019. Last year's tax cut permanently slashed the corporate tax rate to 21% from 35%

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and temporarily reduced individual taxes. The increase in the deficit is partially caused by lower income tax revenues due to the tax cut. Another factor contributing to the deficit is the Trump administration's increase in defense spending.

China – China's economic expansion slowed to its lowest pace in nearly three decades in 2018. One contributing factor for the slowdown is the trade fight with the U.S. Another cause of the decline for the world's second largest economy is softening wage growth and increasing household debt for Chinese consumers. An additional factor is the Chinese government's reduction of the use of debt by its government and the various business entities it controls.

Political Risks – There are a number of geo-political risks that could significantly change the outlook for 2019. Among these are the ongoing Brexit process, a weakening European economy, trade negotiations with China, and the political uncertainty in Venezuela. Furthermore, the dysfunction in Washington and the potential issuance of the Robert Mueller investigation report creates uncertainty.

Interesting Tidbits

Large Corporation Sales – More than a third of S&P 500 revenue is generated outside the U.S. About 10% comes from developing economies.

Federal Reserve Net Worth – The Fed is insolvent on a mark-to-market basis. In December, the Fed had $66 billion in unrealized losses on its portfolio of long-term mortgage securities and bonds. The $66 billion is 170% of the Fed's capital resulting in a GAAP negative net worth of $27 billion.

Bank Earnings – The 21 largest American banks earned $154.6 billion in 2018 and grew their common equity by a net $2.4 billion, implying that they gave the remaining $152.2 billion to shareholders in stock buybacks and dividends.

Merger and Acquisition Activity

Merger activity in 2018 was slightly higher than the activity in 2017. In 2018 there were 281 announced mergers of banks and thrifts compared to 267 deals in 2017. In terms of deal size, the total assets of sellers totaled $185 billion in 2018, compared to $147 billion in 2017. Pricing on 2018 bank sales improved from 2017's pricing, recording a median price to book multiple of 173% and a price to earnings multiple of 23.3 times. We anticipate that 2019 will see lower merger activity, due in part to the lower pricing on potential buyer's market prices.

Compliance in 2019

By: Bill Elliott, CRCM, Senior Consultant and Manager of Compliance Services

The United States Senate finally confirmed Kathleen Kraninger as the new head of the Consumer Financial Protection Bureau (CFPB), effective December 11, 2018. The result is that there is now someone at the helm, at least for the next five years. Mick Mulvaney has been the acting director (after a court fight about it) for the last year, and has implemented many changes in the approach of the agency.

It remains to be seen how Ms. Kraninger will manage the agency, but Mr. Mulvany instituted some general operational changes in how the CFPB functions.

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“In our review work, we have noted many banks that are struggling to handle the current level of regulation. If your bank is struggling, now is the time to work to resolve these issues, prior to the next round of regulation.”

They include:

- Measuring costs and benefits of new/updated regulations
- Determining what changes in regulations will have on the consumer’s access to products (the new rule concerning gift cards comes to mind)
- Looking at the impact on providers of financial services

Under Mr. Mulvaney, the CFPB changed its focus to follow the law, rather than to make new law. We will have to see if Ms. Kraninger will follow this approach, or decide to go down a different path.

In recent days, the Financial Services Committee of the House, chaired by Maxine Waters, has been making noises about banking in general. It remains to be seen as to whether they can accomplish much change at all, given the Republican majority in the Senate. My best guess is that all the political posturing will continue, with much noise from each side, and little happening of any substance.

This situation allows bankers to “take a breath” and make sure that all current requirements are met. In our review work, we have noted many banks that are struggling to handle the current level of regulation. If your bank is struggling, now is the time to work to resolve these issues, prior to the next round of regulation.

For the New Year

Other compliance issues that many expect we will be dealing with in 2019 are the following;

- Small Dollar Lending rules are due in January. We will have to see exactly what impact, if any, the rules will have for banks.
- Collection rule changes are coming, as most complaints that the CFPB receives are on this issue. While some readers may not be subject to the Fair Debt Collection Practices Act, it may be worthwhile for all banks to pay attention to any changes, as many of these changes will address modern technology. The updates will include new requirements for using voicemail, text, and email as collection tools.
- The year 2019 will also include changes to HMDA. Rather than change the regulation, the CFPB issued an interpretive rule in response to the aforementioned law that was passed in May 2018. During 2019, the agency will have to update the regulation itself. The CFPB will also be considering changes regarding reporting open-end lines of credit.
- Small business lending data collection is also still on the horizon. Although it was to be accomplished by now, the CFPB has taken its time on this “short-form HMDA for Commercial Loans” that was dictated by the Dodd-Frank Act. Although the CFPB has delayed implementation, this issue seems to have “moved up the list” and bankers will have to face these changes in the next couple of years.
- The Dodd-Frank Act changed UDAP to UDAAP by adding “abusive” as a category under the law. The CFPB has never created any additional regulation to discuss this issue, but it appears that it will begin considering how to do so in the next few months.
- Regulation CC (Expedited Funds Availability Act) has been a source of conversation for several years now. There finally is movement to deal with this regulation. It certainly needs to be completed, as much of the current regulation describes a world that no longer exists. After threatening to do something with this regulation for some time, the CFPB and the Federal Reserve Board added additional items in a new proposal, while indicating that the other changes proposed in 2011 may or may not be implemented. We will just have to wait and see what form the final regulation takes.
- For now, nothing is happening with overdraft issues. It is unclear why the CFPB has backed away, but some of their reluctance may have to do with bills that are pending in Congress. Whether any of the laws pass Congress and get signed into law by the President remains to be seen.

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Conclusion

This is just a snapshot of what is to come or may come. With the revolving door leadership in the CFPB and the general disarray in our nation's capital, bankers will need to be prepared (as we have been for years) for changes to occur. So, those banks with strong systems in place to manage change need to keep those systems in place. Banks that do not have strong systems should consider improving their operations, because additional changes appear inevitable.

Should you require any assistance with any of these or any other compliance issues, please contact me at 1.800.525.9775 or bille@younginc.com – we stand ready to assist you. ❑

Keeping Decisions Open Zaps the Team

By: Mike Lehr, HR Consultant

Making decisions is hard. Even the easy ones are. That's because decisions close the door on issues. They say we're doing this, not doing that, or moving onto something else. Keeping an "open door" to an issue is so much easier. After all, it keeps our options open. Yet, doing so zaps the team.

Consider this. I once worked for an executive who frequently said, "Let's research this more." Our manager though was very good at moving the executive to decisions. For one project though, the manager requested extensive information so the executive would approve the project. Finally, at a team meeting one of us asked, "Are you really going to use all this?" The manager responded, "No, of course not. I'll need probably only 20% of it." Exasperated, our team member responded, "Then why do we need to do all this?" The manager replied, "Because, I don't know which 20% I'm going to need to get [Executive] to make a decision."

As another consideration, it is not unusual for business leaders to express pride over their people's speed of execution. In one case, an owner bragged that his team produced something in under two months. After being pressed further though, he disclosed that the decision to move forward took a year and a half.

What goes unnoticed in many timetables on such projects is how long it took to give the team a "go" decision. They remain open decisions about issues that repeatedly show up on some agenda. They not only consume time, they create uncertainty, vagueness, volatility, and complexity in the bank's entire decision-making process.

Think of all the unclosed decisions as gunk in a water pipe. Throughout the bank hierarchy managers and other employees make decisions. To make good ones, they need to consider context. That context includes any open issues. "If this happens, I might need to do this. If not, I'll need to do that." To resolve this, they hedge. They make mealy decisions, not confident ones. This zaps the team's commitment. They make decisions in a context of uncertainty as to what might come down the pike, in a context of vagueness that outstanding issues might contradict one another, and in a context of complexity as to what all the open issues mean as a whole.

Then, finally, volatility comes into play when a crisis hits. It forces decisions on the bank. This easily produces knee-jerk and whip-saw decisions.

Now, decisions don't need to collect like exercise equipment and kitchen utensils, and tools collect with some. It can be as simple as saying, "Let's close that issue for now and review it again in a couple years." Other times, it can be as simple as saying, "No."

Too many times, in trying not to damage someone's enthusiasm or in keeping our options open, those options paint a picture of indecisiveness and lack of confidence. This zaps the team. After all, it's well known in psychology that too many options breed indecision. Humans have limits on about what they can think.

Thus, closing decisions unclutters the team's minds. It removes the gunk from the decision-making pipes. So, commit today. Close out three decisions that have been on the docket for a couple of months. You might need to do more cleaning than that, but remember, humans have limitations on what can be running through their minds at any one time.

For more insights and guidance on how to get your people to make better decisions, you can reach Mike Lehr at mlehr@younginc.com. ❑

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