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State of North Dakota
DEPARTMENT of FINANCIAL INSTITUTIONS

A MESSAGE FROM COMMISSIONER ENTRINGER

Thanks to the suggestion of one of the State Credit Union Board members we are reinstituting the newsletter but each newsletter will be specific to credit unions; I hope you find value in these communications. My message this quarter is regarding loan file documentation and lessening of credit standards. In late October, I attended Eide Bailly's Annual Bankers Seminar and had the opportunity to listen to Dr. Scott MacDonald's presentation on Aggregate Bank Performance. One of the slides hit me as particularly relevant to banking in North Dakota; the data presented showed the relationship of the Net Percentage of Domestic Respondents Tightening Standards for Commercial Real Estate Loans and the Net Percentage of Domestic Respondents Reporting Stronger Demand for Commercial Real Estate Loans. The respondents who indicated stronger demand for commercial real estate loans amounted to 40% while the respondents indicating tightened standards for commercial real estate loans was -20%! This tends to illustrate what a short memory we have related to the problems which caused much of the recent banking crisis! In our examinations our staff is noticing a continued high degree of technical exceptions while reviewing loan files and I am also hearing anecdotally that credit standards are being relaxed in some of our markets. What concerns me is that there appears to be a correlation between the data in Dr. MacDonald's presentation and the information we are noticing in our examinations. I would encourage you to be diligent in obtaining appropriate loan documentation for your loans as we all know it is much easier to obtain before the money goes "out the door"; also I would encourage you to maintain strong lending standards in your policies and procedures so we don't have a repeat of the recent banking crisis.

In closing I would like to wish you all a very prosperous New Year!

EXAMINATION THEMES OF 2013

With 2013 in the record books, now is a good time to look back and evaluate the themes that developed during the 2013 examination cycle. The goal is to be as transparent as possible, and in doing so, hopefully allow you to avoid some of the problems experienced by others. While a wide range of issues have been addressed during examinations conducted in 2013, three categories have emerged as the most frequently sited concerns.

1. Credit Administration
2. Allowance for Loan and Lease Loss Funding and Funding Methodology
3. Growth as it relates to strategic planning

Examination Themes Continued

Credit Administration

Loan documentation and analysis, particularly among the Agricultural and Commercial loans is an area that has often been sited as having weaknesses. The credit presentation and loan file need to clearly tell the reader why the credit makes sense. This includes, in part, discussion on sources of repayment, how the funds will be used, some element of stress testing of the cash flow position, an evaluation of the strengths and weaknesses of the business, a credit grade assignment, and documentation to evidence security in the collateral.

Part of credit administration includes sound policies. Frequent weaknesses noted include business loan policies that do not address: the types of loans granted; credit underwriting and monitoring; loan modification; concentration risk; participation loan policies; and discussion on credit grading and how it relates to the Allowance for Loan and Lease Loss Funding Methodology.

While the credit administration standards are not new, two factors have come together to make them examination issues. The first is staffing growth has not kept pace with the growth in loan portfolios. The end result is too few people are being tasked with administering too many credits. The other factor resulting in examination criticism is a renewed commitment on the part of regulators to ensure loans are underwritten to minimize risk. A number of Letters to Credit Unions and Regulatory Guidance Memos have been issued in the past few years that reemphasized the need for sound credit standards. If you have not already done so, we encourage you to review these documents at:

- http://www.ncua.gov/Resources/CUs/Pages/LTCU2013.aspx
- http://www.nd.gov/dfi/news/pubs/index.html.

Allowance for Loan and Lease Loss Funding and Funding Methodology

In the past five years, loan portfolios have increased in size by 58%. Maybe more interesting than overall growth has been the growth in agricultural and commercial loans, which increased by 104%. With the growth and shift into member business loans, we have noted that some institutions have not kept their Allowance for Loan and Lease Loss funding and funding methodology in sync with their changing risk profile. On average, the Allowance for Loan and Lease Loss account represents 1.18% of total loans for North Dakota state chartered credit unions. Some institutions are well below this average while at the same time their risk profile is rising. In our examinations we have criticized the environmental factors applied, the classification / credit grading process, and the overall reasonableness of funding.

Growth and Strategic Planning

North Dakota Financial Institutions have experienced tremendous growth, both in terms of deposits and loans. A numbers of institutions have struggled to balanced that growth with sufficient staff changes or earnings levels. We have criticized strategic plans for not sufficiently addressing the need for staffing to properly administer credits, or when capital positions have deteriorated, strategic growth plans or adherence to the plan have been criticized.