San Francisco Region Community Bankers Workshop 2026

Asset Quality

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Asset Quality

The Paddle of Your River Raft

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Agenda

- Regulatory Issues
- CECL Refresher
- CRE Underwriting and Stress Testing
- References
- Q&A

Recent Changes

Call Report Changes

FIL-30-2025: Revisions to the Consolidated Reports of Condition & Income (Call Reports) & the FFIEC 002 Report

- Only need to report loan modifications to borrowers experiencing financial difficulties for a 12-month period after being modified.

Interagency Guidance on Leveraged Lending Rescinded

Consider principles for safe and sound lending when managing risks associated with leveraged lending:

- Manage the risks, primarily credit and liquidity risks, and tailor risk management practices based on the quantity of inherent risk
- Leveraged lending activities should clearly align with the bank's risk appetite
- Have effective risk management and controls for the pipeline, including loans held and those distributed
- Each bank should determine its own definition of a leveraged loan
- U/W criteria should be consistent and consider a loan's purpose and sources of repayment and the capacity to de-lever
- Conduct an analysis of a leveraged borrower's past and current performance compared with projections, as well as the assumptions on which projections are based
- Monitor a leveraged loan throughout its life cycle
- When purchasing participations, make a thorough independent evaluation of the transaction and risk involved before committing funds

Other News and Notes

8/7/25 Executive Order "Guaranteeing Fair Banking for All Americans"

3/13/26 Executive Order "Promoting Access to Mortgage Credit"

FIL-45-25 "Agencies Issue Proposal to Focus Supervision on Material Financial Risks"

Regulations and Guidelines Related to AQ

Appendix A to Part 364: Safety and Soundness Standards

II.C. Loan documentation. Establish and maintain loan documentation practices that:

- Enable the institution to make an informed lending decision and to assess risk, as necessary, on an ongoing basis;
- Identify the purpose of a loan and the source of repayment, and assess the ability of the borrower to repay the indebtedness in a timely manner;
- Ensure that any claim against a borrower is legally enforceable;
- Demonstrate appropriate administration and monitoring of a loan; and
- Take account of the size and complexity of a loan.

Loan Documentation Examples

- Credit Approval/Review Memos
- Financial Statements/Credit Checks
- Appraisals/Collateral Inspections/Evaluations
- Recorded Mortgage/Deed of Trust/Security Agreement
- Guarantee/Ownership Info/Borrowing Authorization
- Loan Agreement/Modification
- Title Policy/UCC-1 Filing
- Insurance/Tax Info
- Borrower Correspondence File
- Use of Funds/Construction Draw Requests

Appendix A to Part 364: Safety and Soundness Standards

II.D. Credit underwriting. Establish and maintain prudent credit underwriting practices that:

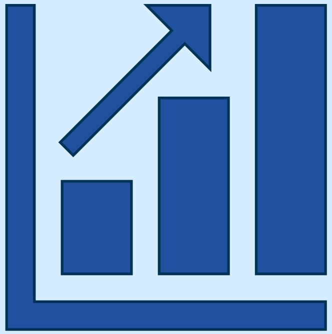
- Are commensurate with the types of loans the institution will make and consider the terms and conditions under which they will be made
- Consider the nature of the markets in which loans will be made;
- Provide for consideration, prior to credit commitment, of the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's character and willingness to repay as agreed;
- Establish a system of independent, ongoing credit review and appropriate communication to management and to the board of directors;
- Take adequate account of concentration of credit risk; and,
- Are appropriate to the size of the institution and the nature and scope of its activities.

Appendix A to Part 364: Safety and Soundness Standards

II. G. Asset quality. Establish and maintain a system that is commensurate with the institution's size and the nature and scope of its operations to identify problem assets and prevent deterioration in those assets.

- Conduct periodic asset quality reviews to identify problem assets;
- Estimate the inherent losses in those assets and establish reserves that are sufficient to absorb estimated losses;
- Compare problem asset totals to capital;
- Take appropriate corrective action to resolve problem assets;
- Consider the size and potential risks of material asset concentrations; and
- Provide periodic asset reports with adequate information for management and the board of directors to assess the level of asset risk.

Appendix A to Part 364: Safety and Soundness Standards



II. F. Asset growth. An institution's asset growth should be prudent and consider:

- The source, volatility and use of the funds that support asset growth;
- Any increase in credit risk or interest rate risk as a result of growth; and,
- The effect of growth on the institution's capital

Part 323: Appraisals

- Appraisals required for residential real estate transactions over $400,000; commercial real estate transactions over $500,000; and business loans over $1 million that are not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment; with some exclusions
- Appraisal must not be prepared directly for the borrower and must meet minimum standards:
  - Conform to the Uniform Standards of Professional Appraisal Practice (USPAP)
  - Be in writing and contain sufficient information and analysis to support the institution's decision to engage in the transaction
  - Be subject to appropriate review for compliance with USPAP
  - Analyze and report appropriate deductions and discounts for proposed construction, renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units
  - Be based on the definition of current market value in the regulation
  - Be performed by State licensed or certified appraisers in accordance with the regulation

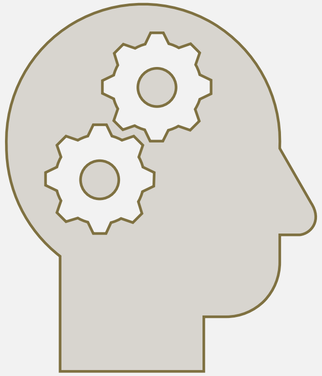
Part 323 Appraisals (common exam findings)

- Disbursing funds prior to reviewing appraisal
- Accepting appraisal prepared for another institution but not reviewing it
- Appraised value not based on realistic use or does not include appropriate discounts/deductions
- Appraisal is based on unsupported assumptions (i.e. overly optimistic assumptions relative to other appraisals from the market)
- Use of “abundance of caution” exception without support

Part 365: Real Estate Lending Standards

Maintain written policies.
Establish standards for portfolio diversification, underwriting, loan administration, and requirements for documentation, approval, and reporting.
Monitor conditions in the real estate market.
Reflect consideration of the Interagency Guidelines for Real Estate Lending Policies (i.e. Loan Portfolio Management, Underwriting Standards, Loan Administration, Supervisory LTV Limits, and exception and tracking process for Loans in Excess of the Supervisory LTV Limits)

Appendix A to Part 365: Guidelines for RE Lending Policies



Loan Portfolio Management Considerations:

- Geographic areas in which the institution will consider lending.
- Loan portfolio diversification and limits for real estate loans by type and geographic market (e.g., limits on higher risk loans).
- Appropriate terms and conditions by type of real estate loan.
- Loan origination and approval procedures.
- Prudent underwriting standards that are clear and measurable, including loan-to-value limits, that are consistent with supervisory guidelines.
- Establish review and approval procedures for exception loans, including loans with loan-to-value percentages in excess of supervisory limits.
- Loan administration procedures, including documentation, disbursement, collateral inspection, collection, and loan review.
- Real estate appraisal and evaluation programs.
- Monitoring and reporting.

CECL Refresher

CECL Overview

Expected Credit Losses

Recognize estimate of expected credit losses for the life of financial assets held at the reporting date

CECL applies to:

Loans held for investment	Held-to-maturity debt securities
Net investments in leases	Certain off-balance sheet credit exposures

All financial instruments measured at amortized cost

CECL Overview

Expected Credit Losses

Recognize estimate of expected credit losses for the life of financial assets held at the reporting date

CECL does not apply to:

- Available-for-sale debt securities
- Financial assets measured at fair value through net income
- Loans held for sale
- Trading assets

ASC Topic 326 does change the accounting for credit losses on available-for-sale debt securities.

CECL Methodology

Measure expected credit losses of financial assets

- Collectively for assets with similar risk characteristics; or
- Individually for assets with unique risk characteristics

Consider available information relevant to assessing the collectability of cash flows

- Historical credit loss experience of financial assets with similar risk characteristics
- Current conditions and reasonable and supportable forecasts, adjusted for qualitative factors

Adjust allowance levels over the life of the financial asset as facts and circumstances change

CECL Example

$4 million loan to refinance apartment building originated 10/1/2021, matures 10/1/2026:

- Historical loss rate of 50bps on similar loans and forecasts similar economic conditions over the life of this loan.
- In early 2022 expectation for lower loss rate over life of loans due to lower interest rate environment and better economic conditions, results in lower q-factor adjustments and less allocated ACL.
- In mid 2022 expectation for higher loss rate over life of loan due to higher interest rates and lower NOI, results in higher q-factor adjustments and more allocated ACL.
- What adjustments to loss rates would you make when the loan renews?

ACL Estimation Considerations

Evaluate on a collective basis

Similar Risk Characteristics

- Credit scores or ratings
- Risk ratings or classifications
- Financial asset type
- Collateral type
- Size
- Effective interest rate
- Term
- Geographical location
- Industry of the borrower
- Vintage

ASC Topic 326 does not prescribe a process.

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ACL Estimation Considerations

Individually evaluated assets should not be included in a collective assessment of expected credit losses.

Dissimilar Risk Characteristics → Evaluate individually

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CECL Example#2

$4 million loan to refinance apartment building originated 10/1/2021, matures 10/1/2026:

- Due to oversupply of newly constructed comparable buildings, borrower has lost tenants and vacancy rate has increased from 5% to 15%.
- Borrower defaulted on payments and bank granted 6 month forbearance and 2 percent rate concession 4/1/2024.
- Collateral originally appraised in 2021 at $5.3 million with a 75% LTV assuming 5% market vacancy rate, NOI of $213,000, and cap rate of 4%.
  - Should bank assumed $0 loss/reserve?
- Current cap rates are 7% and actual NOI is $181,000 resulting in a current value of the property of $2.6 million.

ACL Estimation Considerations

Items to Mention

- Methods are a starting point
- ASC Topic 326 does not require specific methods
- Banks should use methods consistently; however, management is not precluded from using a different method when it determines the method will result in a better estimate
- Different methods can be used for different asset types
- No one method is appropriate for every bank
- Management adjusts and evaluates results
- For financial and regulatory reporting purposes, ACLs must be determined in accordance with GAAP

ACL Estimation Considerations

Some Examples of Acceptable Methods

- Loss Rate
- Roll Rate
- Vintage Analysis
- Discounted Cash Flow
- Probability-of-Default and Loss-Given-Default

ACL Estimation Considerations

nature and volume of the bank's financial assets

existence, growth, and effect of any concentrations of credit

volume and severity of past due or adversely classified assets

Qualitative Factor Adjustments

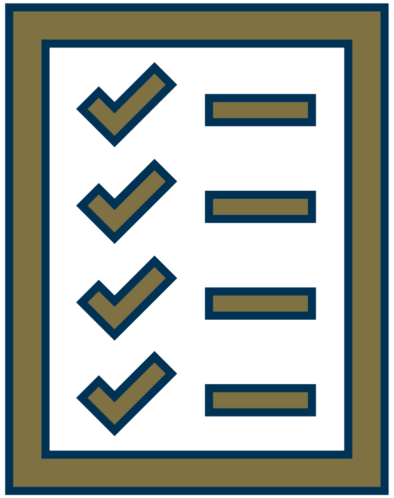
value of underlying collateral for loans that are not collateral-dependent

experience, ability, and depth of the bank's management and staff

actual and expected changes in the economic and business conditions and developments in which the bank operates

Quiz

What kind of Q factor adjustments would you make in the following circumstances?



1. Higher average DSC on newly originated CRE loans
2. Increased number of loan exceptions at UW
3. 25 percent YoY growth in C&I loans
4. Observed declining local collateral values
5. Retirement of Senior Credit Officers
6. Recession risk increasing

Commercial Real Estate

Core Financial Risks

Bankers involved in CRE lending are exposed to core financial risks – primarily credit and liquidity risks.

The key to prudent CRE lending is effectively managing these risks and appropriately tailoring risk management practices based on the risk of the CRE portfolio.

The goal of this presentation is to provide general principles for safe and sound lending when managing risks associated with CRE lending.

CRE Loan Underwriting Considerations

Establish adequate and appropriate:

- loan policies, underwriting standards, credit risk management practices, and concentration limits;
- lending strategies; and
- strategies to ensure capital adequacy and reserves support an institution’s lending strategy and are consistent with the level and nature of inherent risk in the CRE portfolio.

CRE Loan Underwriting Considerations

Common Underwriting Standards

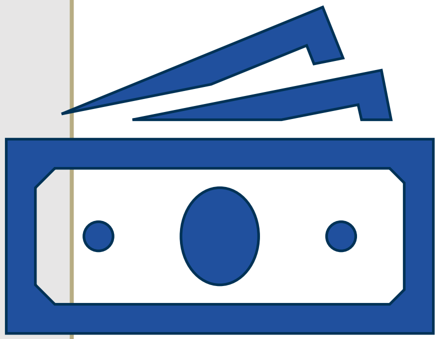
- ✓ Maximum loan amount by type of property
- ✓ Loan terms
- ✓ Pricing structures
- ✓ Collateral valuation
- ✓ Loan-to-Value limits by property type
- ✓ Feasibility study, sensitivity and risk analyses
- ✓ Minimum equity investment requirements
- ✓ Minimum standards for borrower net worth, property cash flow, and debt service coverage for the property

CRE Loan Underwriting Considerations

Loan Underwriting Exceptions

- Documentation
- Approval
- Monitoring
- Reporting
- Trend Analysis

CRE Loan Underwriting Considerations



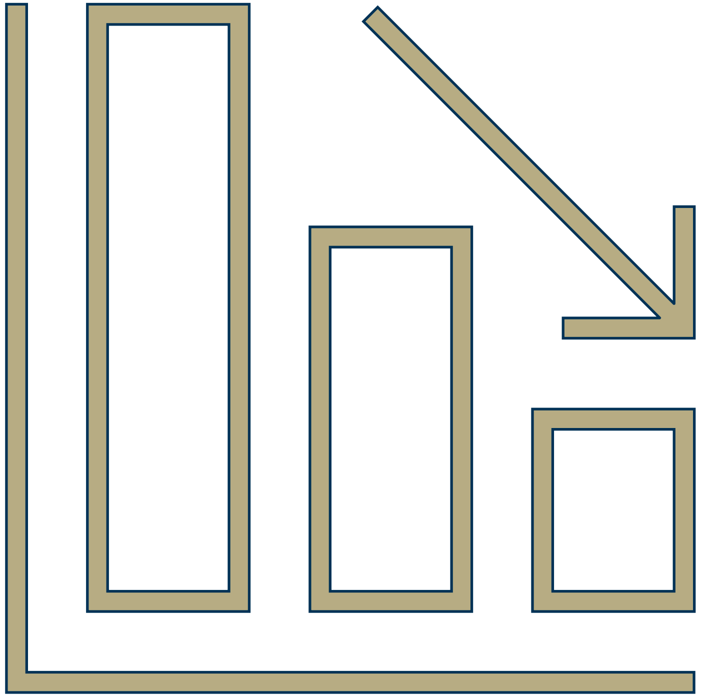
Global Cash Flow Analysis

- Use reasonable rental rates, sales projections, operating expenses.
- Measure sufficient repayment capacity to service all loan obligations.
- Assess the ongoing ability of the borrower and the project to service all debt as loans convert from interest-only to amortizing payments or during periods of rising interest rates.

CRE Loan Underwriting Considerations

Consider monitoring the potential volatility in the supply and demand for:

- Lots
- Retail and Office Space
- Multi-family units



CRE Loan Underwriting Considerations

Consider implementing processes for reviewing appraisal reports for sufficient information to support an appropriate market value conclusion based on:

- Reasonable market rental rates
- Absorption periods
- Expenses

CRE Stress Testing

Stress Testing

CRE portfolio stress tests quantify the impact of changing economic conditions on asset quality, earnings, and capital.

The sophistication of the tests should be consistent with the complexity and risk characteristics in the portfolio.

Focus on the more vulnerable segments of the portfolio, considering prevailing market environment and the bank's business strategy.

Stress Testing

Forward looking quantitative evaluation of stress scenarios that could impact the bank's financial condition and capital adequacy.

Based on assumptions about potential adverse external events such as:

- Changes in real estate or capital markets prices.
- Unanticipated deterioration in repayment capacity.

Most useful when customized to reflect the bank-specific characteristics.

May be used to evaluate whether existing financial and operations resources are sufficient to withstand an economic downturn or unexpected event.

Stress Testing Types

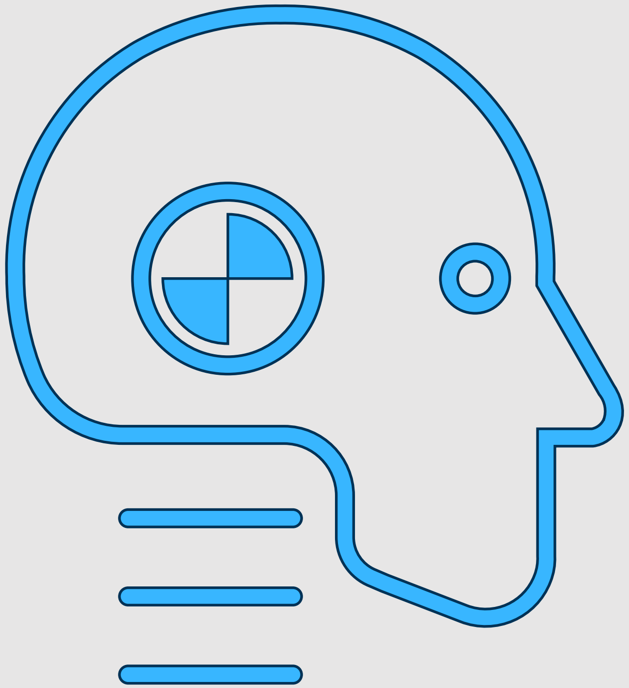
Transaction Sensitivity Analysis

Stressed Portfolio Loss Rates

Scenario Analysis

Loan Migration Analysis

Reverse Stress Testing



Using Stress Test Results

May be incorporated into the overall risk management and strategic planning processes.

Individual loan stress tests may be used to better understand a borrower's risk characteristics and position for unexpected adverse circumstances.

Stress tests can provide strategic value especially during the expansionary phase of business cycles.

Stress test results can be used in establishing risk tolerances and determining when mitigating actions are necessary.

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Common Stress Tests for Individual CRE Loans

- Debt-service coverage
- Loan-to-value ratios and capitalization rates
- Property net operating income
- Collateral value depreciation (regional and local)
- CRE sector performance (office, retail, multi-family, etc.)
- Interest-rate levels on variable-rate loans
- Contractual terms
- Occupancy status
- Lease rates
- Unit absorption rates
- Economic factors

Case Study - Individual Credit Stress Test

	Strong	Moderate	Higher-Risk
Loan Amount	$2,000,000	$2,00,000	$2,000,000
Original Rate	5%	5%	5%
Monthly Debt Service	$15,000	$15,000	$15,000
Monthly Income	$24,000	$20,250	$17,250
UW DSCR	1.60	1.35	1.15
Stressed DS w/ Rate + 3%	$20,000	$20,000	$20,000
Stressed DSCR	1.20	1.01	0.86

Case Study - Portfolio Stress Testing

12/31/25 Average Assets of $361,850, T1 Leverage ratio of 8%

	CRE Portfolio	T1 + ACL ($26,789 + 2,159M = $28,948M)	Portfolio ($167,284M)
12/31/2025	$149,401M	516%	89%
Repricing in next year	$104,581M	361%	70%
Reasonable Potential to Default if Reprice	$31,374M	108%	30%
20% Loss Given Default	$6,275M	25%	20%

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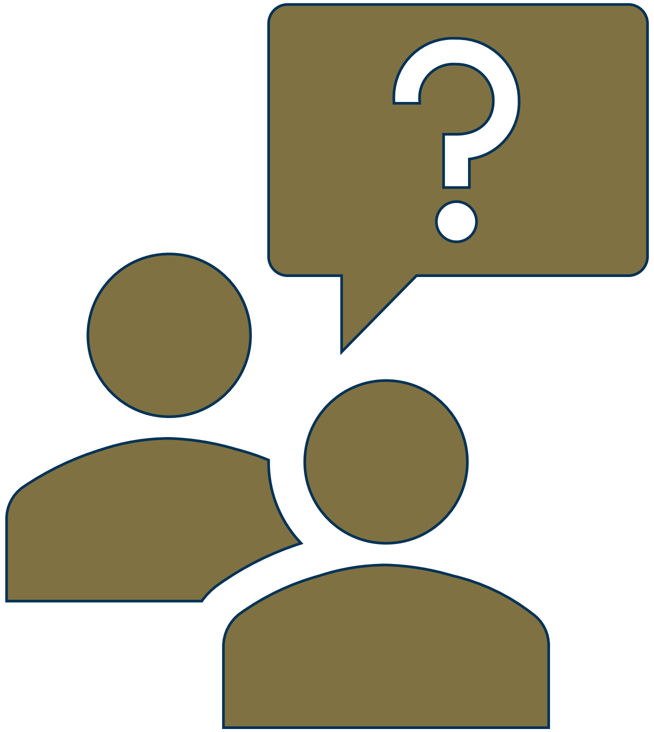
Case Study - Risk Limits

	12/31/25	$10,049M Loss	$6,275M Loss
Tier 1 Capital	$26,797M	$16,748M	$20,072M
Average Assets	$334,962M	$328,913M	$328,687M
Leverage Ratio	8%	5.1%	6.1%

Questions



Resources

- Annual FDIC Risk Review
- Quarterly Banking Profile
- The Fed Senior Loan Officer Opinion Survey on Bank Lending Practices
- Current Expected Credit Losses
- Credit
- Appraisal and Other Valuation Products
- Financial Institution Letters
- Press Releases