

# INTEGRATING SPECIFIC RISK ANALYSIS INTO PORTFOLIO MANAGEMENT AND PORTFOLIO STRESS TESTING

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# Defining Measures of Portfolio Asset Quality that can be integrated into the ALLL

The elements for effective portfolio management and a defensible Loss Contingency (FAS5) and Loss Impairment (FAS114) analysis is defined in MFB Bank Policy,

“Bank management will establish:

asset quality goals annually based upon a range of performance consistent with high performing commercial banks and the Bank’s actual ratios at the beginning of each year.

a peer analysis for the asset quality measures and a quarterly market analysis for the asset concentration measures.

The variance to goals, and quality and rate of trends will provide the input to qualitative factors considered in the ALLL”

# ALLL Reserve Analysis

First a model top determine the appropriate FAS5 reserve must be refined.

At MFB the following qualitative analysis factors are incorporated into the ALLL FAS 5 calculation:

- Portfolio Quality Factors (updated monthly)
- Historical Loss Factors (updated quarterly)
- Micro-Economic Factors (updated monthly, if measured data materially changes)
- Asset Concentration and Trends (updated quarterly)

# ALLL FAS5 Calculation and Modeling

## Portfolio Asset Quality Measures

Measure	MFB Goals	Peer Group	Comparison of rate/direction of trend to goals and peers for the last three quarters		
			Q3	Q2	Q1
PD>30-89 days/TL	XX%	XX%	XX	XX	XX
NA Loans/TL XX%	XX%	XX%	XX	XX	
PD>90days +NA/TL	XX%	XX%	XX	XX	XX
ALLL/TL	XX%	XX%	XX	XX	XX
Chg/TL	XX%	XX%	XX	XX	XX

## Portfolio Asset Concentration Measures

CRE Non OCC/Total Capital	XX%	XX%	XX	XX	XX
Total CRE/Total Capital	XX%	XX%	XX	XX	XX

# Each Portfolio of Assets should have its own Loss Contingency Analysis

- ▣ Consumer revolving
- ▣ CRE
- ▣ Residential

# Stress Testing

- ▣ “What if” manipulations of any component of the FAS5 calculation can enable portfolio stress testing.
- ▣ At MFB this what if analysis takes the form of two relevant scenarios for the CRE portfolio.
- ▣ Each scenario is considered each month and the impact of this “stress” highlighted in the asset quality reporting to management and the directors.

# CRE What if Stress Testing

- ▣ Specific % deterioration in Micro-economic factors
  - Cap rates
  - Vacancy
- ▣ Deterioration in portfolio quality factors
  - 30-89 day delinquencies
  - NPA
- ▣ Asset concentrations by type and geographic area impact the weighting of stress measure

***Excerpts from the Asset Quality Report highlighting the Stress Testing***

“The net allocation recommended to the ALLL at 5/31/10 is \$34,386. Two stress tests on the portfolio were conducted as detailed on the attached Summary ALLL Analysis. The most relevant stress given the prevailing portfolio characteristics, loan types, sizes, and product concentrations suggest a potential net allocation to the ALLL at 5/31/10 of:

Scenario A (NPA increase to X%, X% specific reserves)

Net Allocation	\$574,587
Variance to actual recommendation	\$540,201
Total Risk Based Capital:Risk Wtd Assets	11.10%

*Current delinquencies and watch list suggest elevated probability of scenario A compared to 1<sup>st</sup> Qtr FY10 stress tests. The risk migration trend suggests elevated probability of further deterioration in NPA statistics despite the net impact of certain liquidations and recoveries during the next 60 days.*

Scenario B (X% economic factor deterioration and X% increase in 30-89 day delinquencies)

Net Allocation	\$63,073
Variance to actual recommendation	\$28,687
Total Risk Based Capital:Risk Wtd Assets	11.93%

*Lowered potential of further economic deterioration suggests lowered probability of scenario B”*



***Determining the Relevant “What If” Stresses will be based on identifying loan type and geographic concentrations.***

*Identify concentrations:*

*Asset type*

*1.a.2 ADC*

*1.e.2 CRE – Investor Owned*

*Office*

*Hospitality*

*Etc*

*Geographic area (for MFB)*

*CRE 78.35%*

*1.e.2 Anne Arundel County 5.29%*

*Analyze a portfolio of CRE by either type or geographic area or both that represents a relevant concentration of credit*

*For example 1.e.2 Office Buildings, in Montgomery County which might represent a concentration of credit within a hypothetical portfolio*

