CEIS REVIEW INC.

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Consulting Services to the Financial Community

The CEIS Quarterly - Q1 - 2018

New York, February 14, 2018 — CEIS Review Inc. is a Commercial Loan Portfolio Consulting firm serving the needs of Commercial Lending Institutions. In this issue of our newsletter, we discuss CEIS' Remote Review capabilities, and then we take a closer look at what loan types are actually included when determining a CRE Concentration, and share some best practices in managing identied concentrations.

ON MY MIND…

CEIS' President, Joe Hill, shares his thoughts

As we look forward to the new year, it is only natural to also look back at the past and evaluate decisions we've made over the past year. While it is easy to get caught up in the status quo of the day, especially if that status quo is working well, CEIS Review has always followed the guiding principle to periodically reflect and evaluate our processes and offerings to determine any appropriate refinements or modifications that will enrich our Client's engagements.

"We have made enhancements to our systems and processes surrounding Remote Review Capabilities."

With this philosophy in mind, we have recently made enhancements to our systems and processes surrounding our **Remote Review Capabilities**. More specifically, we have enhanced our encrypted engagement infrastructure to be more adaptable to how Institutions provide confidential financial information to CEIS.

The second area of improvement which we have undertaken revolves around our **Stress Testing services**. We have brought another subject matter expert on board to specifically work on our stress testing offerings and processes, and we are currently evaluating ways in which to enrich the Stress Testing service for our clients. The aforementioned professional brought on board is Mr. Dean Giglio, Managing Director – Stress Testing. Dean is an analytical Senior Level Credit Risk professional with over 25 years of Credit Risk Management experience, and is a versatile subject matter credit expert who blends his technical proficiency and his business savvy to create objective, meaningful, and timely actionable results from his analysis, and we are looking forward to his contributions to our Stress Testing programs development.

Our mission has always been, and continues to be, to be the preeminent provider of Independent Commercial Loan Review programs, granular in-depth Loan Portfolio Stress Testing engagements, and concise and encompassing ALLL Methodology Validations for our clients.

Regardless of the service a client has engaged CEIS to perform, our ultimate directive is to assist in enabling our Clients success. ▪

Joseph J. Hill
President & CEO

Mr. DEAN P. GIGLIO

CEIS Review is proud to introduce the newest member of our team, Mr. Dean Giglio, Managing Director - Stress Testing to the Leadership of CEIS' Stress Testing Team.

CEIS Review is proud to introduce the newest member of our team, Mr. Dean Giglio, Managing Director responsible for Loan Portfolio Stress Testing and related engagements for CEIS' Client base.

Dean brings with him over 25 years' of Senior Level Credit Risk Management experience, with specialization in several aspects of Risk – Credit Risk Underwriting, Auditing, Controls, Data Management, and Credit Decisioning. In his most recent position at GE Capital, he provided strong leadership as Vice President – Risk Data Leader, managing Credit Modeling and Stress Testing Risk data.

Mr. Giglio obtained his Bachelor of Science in Accounting from St. John's University. In addition, he has completed a formal credit training program, Advanced Risk Analysis certification, Advanced Project Management training, and is a certified Six Sigma Green Belt with a focus on Basel, KYC/AML Management

Our Stress Testing team's leadership is now comprised of Ms. Elizabeth "Liz" Williams - Managing Director, Special Projects & "Complex" Reviews, Mr. David Vest - Managing Director, Stress Testing, and Mr. Dean Giglio - Managing Director, Stress Testing. With the addition of Dean to the Stress Testing team, CEIS is even more capable of handling client request and refining our stress testing offerings.

OWNER OCCUPIED REAL ESTATE AND CRE CONCENTRATIONS
By Ms. Elizabeth Williams, Managing Director, Special Projects

"Owner occupied CRE is not within the scope of the regulatory CRE Concentration guidance. However, concentrations of credit risk can exist elsewhere in the loan portfolio, including in (or within) the owner occupied CRE segment."

Owner occupied CRE is not within the scope of the regulatory CRE Concentration guidance. However, concentrations of credit risk can exist elsewhere in the loan portfolio, including in (or within) the owner occupied CRE segment.

There's been lots of discussion lately about CRE Concentrations and "best practices" for managing concentration risk. We have heard from a number of institutions on this topic. Increasingly, we have been asked whether Owner Occupied CRE should be included in calculating whether or not a bank has a CRE Concentration per the regulatory requirements. This article provides some insight on this topic.

CRE Concentrations Defined

As a refresher, the "regulatory" definition of a CRE concentration is outlined in the 2006 Interagency Guidance – Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, which is referred to here as "the Guidance". The Guidance specifies two tests which regulators will use as a preliminary step to identify institutions that may have a CRE concentration:

1. Total construction, land development or other land represents 100% or more of total risk-based capital (loans associated with Call Report category RC-C, 1a.)

OR

2. Total CRE Loans (Call Report categories RC-C 1a, 1d and 1e and Memo Item #3):
   a. Represent 300% or more of total capital, **AND**
   b. Have increased by 50% or more during the prior 36 months.

It's important to note that these are not "bright line" tests, meaning institutions with ratios below the indicated thresholds are not necessarily exempt from the guidance. In particular, the growth test alone appears to be drawing scrutiny.

The "Scope" section of the Guidance defines "CRE Loans" as including all of the following:

- Construction loans (including 1-4 family residential and commercial construction loans) and other land loans;
- Loans secured by multifamily properties;

- Loans secured by nonfarm nonresidential properties where the primary source of repayment is derived from rental income associated with the property (i.e., 50% or more of the primary source of repayment comes from third party, unaffiliated rental income) or from proceeds of the sale, refinancing or permanent financing of the property.

"While the Guidance references the combined Call Report category 1e (nonfarm nonresidential), which was the only such Call Report category available at the time of publication, the Scope definition clearly states that Owner Occupied CRE is ***excluded*** *from the scope."*

The Guidance goes on to state: "Excluded from the scope…. are loans secured by nonfarm nonresidential properties where the primary source of repayment is the cash flow from ongoing operations and activities conducted by the party, or affiliate of the party, who owns the property."

Note that the definition above references Call Report item 1e in Schedule RC-C (Loans and Leases), which is the category for nonfarm nonresidential. Some have interpreted this reference as requiring the inclusion of Owner Occupied CRE in the concentration test above. However, it's helpful to recall that, at the time this guidance was published in 2006, the Call Report included a single category for loans secured by nonfarm nonresidential property, which was Call Report item 1e in schedule RC-C. The bifurcation of the nonfarm nonresidential category into Owner Occupied and Other (RC-C 1e.1 and 1e.2, respectively) sub-categories did not occur until 2007, with some banks not required to report at this level until 2008.

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CRE Concentrations - Risk Management

The intent of the 2006 Interagency Guidance is to outline regulators' expectations for risk management practices to ensure that CRE lending is pursued in a safe and sound manner. In late 2015, the regulators re-enforced these expectations with the Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending. The 2015 Statement discussed regulators' concerns regarding loosening of underwriting criteria and reiterated the importance of establishing a comprehensive risk management framework to manage the risk associated with CRE concentrations, including:

- Board and management oversight;
- Portfolio management;

- Management information systems;
- Market analysis;
- Credit underwriting standards;
- Portfolio stress testing and sensitivity analysis; and
- Credit risk review function.

For a deeper-dive on "best practices" associated with the above, please refer to CEIS' earlier article on *CRE Concentration Risk Management.*

Back to Owner Occupied CRE…

"Some of CEIS' client banks and other institutions have noted recent increased regulatory scrutiny of owner occupied CRE."

Some of CEIS' client banks and other institutions have noted recent increased regulatory scrutiny of owner occupied CRE. This may be due to the following:

- Past perceptions of lower loss rates for owner occupied CRE have not necessarily been borne out by Call Report data. A recent Community Bank Connections article published by the Federal Reserve included data for the Fifth District Community Banks, which showed that owner occupied CRE loss rates were not significantly lower than loss rates for other CRE loans in the Fed's Fifth District.
- Many institutions have expanded their owner occupied CRE lending, often in an effort to reduce their regulatory-defined CRE concentrations.

But, if the Guidance excludes owner occupied CRE, then we don't have to worry about that, right?

Not exactly!

The Guidance addresses a specific type of concentration risk (CRE). However, concentrations in general can represent risks to the safety and soundness of an institution. While there isn't a single Interagency publication addressing broader concentrations of credit risk, each regulator has published information on its own expectations regarding management of concentrations. These include:

- OCC: Comptroller's Handbook – Concentrations of Credit;
- FDIC: RMS Manual of Examination Policies – Loans 3.2-57 Concentrations
- Federal Reserve: Commercial Bank Examination Manual – Concentrations of Credit 2050.1
- NCUA: Supervisory Letter: Concentration Risk and NCUA Examiner's Guide – Commercial and Member Business Loans (and subsections)

In addition, the Interagency Policy Statement on the Allowance for Loan and Lease Losses identifies the effect of concentrations and changes in concentrations as a Qualitative or Environmental factor which should be considered in establishing an appropriate ALLL.

The Federal Reserve's definition of a concentration is fairly representative:

"A concentration exists when loans possess similar risk characteristics. These may include concentrations based on geography, industry, related borrowers or other parameters."

"A concentration of credit generally consists of direct or indirect (1) extensions of credit and (2) contingent obligations that, when aggregated, exceed 25% of the bank's capital structure."

A concentration exists when loans possess similar risk characteristics. These may include concentrations based on geography, industry, related borrowers or other parameters. To the extent that the owner occupied portfolio itself represents a concentration, management should evaluate whether there is an appropriate risk management framework and sufficient capital to support that level of concentration. Concentrations within the owner occupied portfolio should be carefully evaluated as well (industry, geographic, etc.). ▪

Related Links

- CEIS article – CRE Concentration Risk Management
- CEIS webinar
- 2006 Interagency Guidance – Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices
- 2015 Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending
- OCC: Comptroller's Handbook – Concentrations of Credit
- FDIC: RMS Manual of Examination Policies – Loans 3.2-57 Concentrations
- NCUA: Supervisory Letter: Concentration Risk
- NCUA Examiner's Guide – Commercial and Member Business Loans (and subsections)
- Interagency Policy Statement on the Allowance for Loan and Lease Losses
- Community Bank Connections, Second Issue 2017 – Managing Risks of Commercial Real Estate Concentrations

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About CEIS Review

CEIS Review is an independently owned financial consulting firm founded in 1989 by proven commercial lenders who specialize in commercial loan portfolios.

Services include:

Loan Review Programs
Portfolio Acquisition review (Due Diligence)
Structured Finance Review (Leveraged Lending)
Commercial Portfolio Stress Testing
ALLL Methodology Validation or Advisement
Credit Risk Management Process Review
Training Workshops

For information, email Justin J. Hill at justinjh@ceisreview.com

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