

# The CEIS Quarterly

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## *On My Mind...*

### **CEIS' President, [Joe Hill](#), shares his thoughts**

With the current healthy lending environment, Banks are actively booking CRE and at some organizations increasing C&I transactions to grow their portfolios.



Competition for quality borrowers is stiff, as the community banking community broadly defined are not only competing against each other but also against the larger banks or nonbanking organizations involved in middle market lending. Typically larger or nonbank organizations have more flexibility in structuring transactions, in part because a potential loss would barely have a material impact in the larger picture.

Nevertheless, the importance of relationship lending, knowing the business of the borrower, and the personal attention provided to borrowers by the community bankers often provide the competitive edge. The account executive at the community bank should have an active and continuing interest in the borrower's business success, and truly understand the borrowers business and anticipate future needs. This professional capability has long been the differentiator and competitive edge in dealing with competition from any third party as well as defining the lender's reputation.

The competitive environment may lead to easing credit quality requirements and standards as well as concessions in pricing, structure and overall terms. There have been reports increasingly circulated evidencing these trends. At the risk of saying the obvious, loan and credit trends on new and renewed transactions at the portfolio as well transactional levels should be tracked and documented in a systematic and continuous manner by all lenders thereby allowing the timely identification of patterns that may warrant reconsideration in policies and practices. This includes identifying positives that are unique to a lender's market niche as well as negatives to be contained.

*Joseph J. Hill*

[New Off-Site Loan Review Options with the Federal Reserve for Community Banks with less than \\$50 Billion in Total Assets.](#)

[New MBL Rule Could Open up More Niche Lending](#)

[House Passes ICBA- Advocated Bill Improving Community Banks Access to Capital.](#)

[Guidance for Banks' Maintenance of Records, Records Retention & Examiner Access](#)



This quarter we would like to spotlight CEIS' Regional Executive [Dean Morgan](#). Mr. Morgan brings with him over 25 years of senior and executive level banking experience to CEIS Review. He has held titles such as Senior Loan Officer, SVP - Corporate Banking, and President & Chief Executive Officer. At CEIS Review, Dean is responsible for business development and engagement management throughout the Southern Region of the United States.

[To view Dean's full bio and his contact information](#)

## **Commercial Real Estate**

### *Concentration Risk Management*

#### **I) Introduction**

The risks posed by concentrations of credit risk in general, and Commercial Real Estate concentrations in particular, have long been an area of focus for bank regulators. In 2006, the FFIEC published the Interagency Guidance "[Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices](#)", which outlined regulators' expectations for a risk management framework to manage the risk associated with Commercial Real Estate (CRE) concentrations. In December 2015 the regulators issued the "[Statement on Prudent Risk Management for Commercial Real Estate Lending](#)" which served as a "reminder" regarding expectations for managing concentration risks. The regulators observed trends in the easing of CRE underwriting standards and made it clear to the banking community that regulators will be actively reviewing bank compliance with these requirements during 2016.

The purpose of this paper is to provide a high level summary of the 2006 regulatory guidelines and to review current areas of examination focus. The paper will provide an overview for those who are not directly involved in the

implementation of measures to comply with regulatory guidance on CRE concentration risk management and serve as an aide memoire to those who are. Those familiar with the guidance will be aware that there is a requirement for awareness and involvement of the Board of Directors in the process. This paper may be helpful in that context. It should be noted that detailed advice on the implementation of the measures outlined by the regulators is beyond the scope of this paper. Institutions seeking such assistance are encouraged to contact Liz Williams, Managing Director, CEIS Review (212-967-7380).

## **II) 2006 Guidance**

The 2006 Guidance<sup>1</sup> notes that the CRE sector is vulnerable to business cycles. Banks need to have appropriate risk management practices in place and adequate capital to manage through these cycles. Key elements of risk management include identification of concentrations, board/management oversight, active portfolio management, management information systems, market analysis, underwriting standards, stress testing/sensitivity analysis, and credit risk review. In summary, the Guidance noted that “regardless of its size, an institution should be able to identify and monitor CRE concentrations and the potential effect that changes in market conditions may have on the institution.”<sup>1</sup>.

### **Identification of concentrations**

Regulators have established two thresholds that will assist them in determining the level of a bank’s CRE concentration risk. They are:

1	<b>Construction, land development &amp; other land</b>	100% of risk-based capital
2	<b>Commercial Real Estate</b>	300% of risk-based capital <u>and</u> the concentration has increased by 50% or more in the last 36 months

The category “Commercial Real Estate” is intended to include properties where 50% or more of cash flow is from third parties or where bank depends on sale of the property or permanent financing for repayment. Specifically also included are loans to REITs and unsecured loans to developers if for real estate. Specifically excluded are loans secured by farm property, commercial owner-occupied premises and residences where cash flow comes from the resident’s cash flow. Regulators emphasize that the thresholds are not to be regarded as limits. The thresholds are intended to be benchmarks, above which the regulators would expect to see components of the risk management framework outlined in the Guidance. At the same time, a bank does not obtain exemption from potential supervisory attention by being below the threshold limits (i.e. the thresholds do not constitute “safe havens”).

Different types of real estate carry different risks. Banks need to be able to segment portfolios by stratifying the portfolio by risk characteristics and by sensitivity to economic, financial or business developments in order to be able to measure and manage risk. In this connection, it is worth noting that the widely accepted industry definition of a concentration is one that exceeds 25% of the institution’s capital. However, clearly a much larger percentage may well present little threat to the organization while a smaller one may contain substantial embedded risk. Materiality is therefore an important consideration in defining concentrations and the risk they pose. Also, banks should be alert for correlation of risk between segments and be ready to combine those segments for risk management purposes<sup>2</sup>.

### **Board and Management Oversight**

Guidance emphasizes the importance of both management and the Board being involved in the process. The Board should establish policy guidelines and lending strategy for Commercial Real Estate lending (by type of property/transaction if appropriate). It should ensure that the strategies mesh with the bank’s overall plan. The Board should require management to implement procedures and controls that will ensure adherence to those

<sup>1</sup> [2006 Interagency Guidance on Concentrations in Commercial Real Estate Lending.](#)

<sup>2</sup> For guidance on defining concentrations, banks should consult [OCC Comptroller’s Handbook – Concentrations of Credit.](#)

policies and strategies. It should also require management to provide ongoing information that identifies and quantifies CRE risk and changes in CRE market conditions. The Board and management should then use this information determine whether the Bank's strategies and policies (including limits and sub-limits) remain appropriate in light of current market conditions.

### **Management Information Systems**

In order to be able to identify, measure and monitor CRE risk a bank will need to have adequate management information systems in place. The MIS must be able to report necessary information on both a periodic and an ad hoc basis. The system needs to be reviewed from time to time to make sure that it remains adequate in light of changes in policy, changes in the complexion of the portfolio and of changes in the market.

Specific data the regulators indicate should be captured include property type, geographic market, tenant concentrations, tenant industries, developer concentrations and risk rating. They suggest also loan structure (fixed/adjustable), purpose, LTV, DSC, policy exceptions, borrower concentrations (including affiliated loans.) Given the regulators' current focus on potential easing of underwriting standards, reports highlighting trends in key metrics by origination quarter or "vintage" are useful tools to demonstrate monitoring of this issue. Banks are also instructed not to ignore derivative risk. A process should be in place to ensure that periodic and hoc reports from the MIS are formally reviewed. The system should provide the means of reviewing both current data and the extent to which measurements have changed over time, including risk rating migration.

### **Market Analysis**

The regulators note that "the important objective is that an institution should have the information necessary to assess the potential effect of market changes on its CRE portfolio and lending strategy." They observe that a bank needs to be able to "demonstrate that it has an understanding of the economic and business factors influencing its lending markets." The bank will be expected to analyze the market by property type and by geography. This is particularly important when the bank is planning to enter new markets but is also critically important in assessing changes in market conditions in areas where the bank has long had a presence. Market data will also be used as a factor in sensitivity analysis and stress testing. Market risks that Guidance focuses on specifically include demand, changes in cap rates, vacancy rates and rents. Banks are encouraged to tap such sources as publicly available statistical data, appraisers, agents, tax authorities, contractors, investors and community development groups.

### **Credit Underwriting**

Underwriting policies should reflect the bank's appetite for risk. They should be clear and precise, and compliance should be measurable. Policies should address internal factors such as historical experience, staff capabilities and technological resources, and external factors such as market position, the bank's existing/future trade area, and trends in lending and funding.

Policies should specifically establish the maximum exposure by loan amount and by type of property, as well as appropriate loan terms, pricing, LTV, requirements for feasibility studies and/or sensitivity/stress testing, minimum hard equity contribution from the borrower, minimum borrower net worth, cash flow and debt service coverage, and collateral valuation (i.e. compliance with appraisal regulations). Analysis should address the overall financial condition of the borrower as well as focusing on the specific project. Where construction loans are concerned, controls should be in place to make sure equity is contributed and maintained, and an inspection process should document construction progress, track pre-sale/pre-leasing and exception monitoring and reporting.

Policies should include exception-handling procedures. Permitted exceptions should be infrequent, with documentation of appropriate mitigants and should be approved at the required level. Exceptions to policy should be reported regularly to the Board and senior management. This reporting should include trends in the level of exceptions and percentage of new / renewed underwriting with exceptions.

## **Stress Testing/Sensitivity Analysis**

While most banks include some level of stress testing as part of the underwriting process for individual loan exposures, banks with CRE levels in excess of the regulatory thresholds are expected to analyze the impact of changes in market conditions or interest rates on the portfolio as a whole. Of course, the complexity of stress testing/sensitivity analysis should reflect the complexity and riskiness of the portfolio. The analysis can help to identify the effect of potential market conditions on portfolio segments and especially the more vulnerable segments. It should focus on the overall effects of changing market conditions and their impact on asset quality, capital and earnings. Analysis of capital levels in stressed scenarios can provide significant support for justifying an existing CRE concentration, or for supporting a proposed increase in such a concentration.

## **Portfolio Management**

Regulators expect to see strategies in place for managing the concentrations that have been identified. Such strategies may include adjustments in credit risk rating, contingency plans to limit or reduce exposure through sales, participations, and/or securitizations, as well as use of derivatives. Note that “if an institution depends on the secondary market as a means of reducing exposure, then it should evaluate the ability to do so and compare underwriting standards with those of the secondary market”.

## **III) December 2015 Statement**

The [Statement on Prudent Risk Management for Commercial Real Estate Lending](#) issued in December 2015 draws attention to growth in CRE portfolios, declining CAP rates and rising property values and the lack of negative signals from vacancy and absorption rates and levels of non-performing loans and charge offs. Regulators note that competition is driving easing of standards (covenants, maturities, IOs, limitations on guarantees). They observe increasing occurrence of exceptions at some institutions as well as insufficient monitoring of market conditions.

A large part of the statement is given over to reminding banks of the requirements under the 2006 guidance, noting that institutions which succeeded during the downturn had essentially complied with the Guidance requirements, including:

1	Adequate policies, underwriting standards, credit risk management standards, and concentration limits set at board level, lending strategies and monitoring of same, and strategies to ensure capital/ALLL adequacy appropriate to portfolio risk
2	Preparation of borrower’s global cash flow analysis based on reasonable rents, sales projections and expenses
3	Performance of periodic market and scenario analyses of CRE portfolio
4	Provision of appropriate periodic information to the Board for the latter to assess ongoing appropriateness of strategy and policies
5	Assessment of ability of borrower to P&I/m when IO converts to payout/absorb impact of rising interest rates
6	Implementation of procedures for monitoring potential volatility in supply/demand for/of lot, retail/office space and MF units
7	Implementation of systems which give management and the board sufficient information to identify, measure, monitor and manage concentration risk.
8	Appraisal review process to ensuring adequate information to support market value conclusion

The Statement then instructs banks to review CRE policies and practices and to maintain risk management practices and capital levels commensurate with the level and nature of CRE concentration. The Statement draws attention in particular to maintaining underwriting discipline.

The statement then notifies the banks that “During 2016 supervisors from the banking agencies will continue to pay special attention to potential risks associated with CRE lending.” When conducting examinations that include a review of CRE lending activities, the agencies will focus on financial institutions’ implementation of the prudent principles in the Concentration Guidance as well as other applicable guidance relative to identifying, measuring, monitoring and managing concentration risk in CRE lending activities. The agencies may ask financial institutions found to have inadequate risk management practices and capital strategies to develop a plan to identify, measure monitor and manage CRE concentrations to reduce risk tolerances in their underwriting standards or to raise additional capital to mitigate the risk associated with their CRE strategies or exposures.”

#### **IV) Current Areas of Supervisory Focus**

While regulators may review any bank portfolio for signs of CRE concentration, they expect particularly to focus on banks with CRE portfolios that have grown quickly, banks with CRE portfolios that include high risk segments, and / or banks whose CRE portfolios are approaching or have passed the regulatory thresholds. In assessing risk, regulators will focus on diversification, geographic dispersion, underwriting standards, guarantees, level of pre-sale/pre-lease or other identified take out, and portfolio liquidity (ability to reduce exposure). In particular, examiners are expected to focus on current market conditions and the quality of recent new / renewed underwriting, as well as on management’s and the Board’s efforts to monitor trends in this area.

Assessments of capital adequacy may have a particular role where compliance with CRE risk management guidance is concerned. Regulators will review the quality of the bank’s CRE risk management framework, encompassing the areas outlined in this paper, and assess the adequacy of capital levels relative both to (1) concentration levels and (2) to the bank’s management of this concentration risk.

Banks with significant growth in CRE and which either currently exceed the regulatory benchmarks for a CRE concentration, or which are likely to exceed these levels in the near future, are encouraged to review their policies and processes to ensure that their risk management framework includes the components outlined in the 2006 and 2016 regulatory publications. To the extent that some components have not yet been addressed, recommend documentation of a plan (including a timeline) for implementation.

[Christopher \(Kit\) Webbe](#)

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#### ***About CEIS Review***

[CEIS Review](#) is an independently owned consulting firm founded in 1989 by proven commercial lenders and specializes in matters related to the commercial loan portfolio.

Our core services are Loan Review, loan portfolio Stress Testing, Loan Loss Reserve Methodology Validation or Advisement, portfolio acquisition review (Due Diligence), Credit Risk Management Process Review, Structured Finance Review (Leveraged Lending), and commercial loan policies.

CEIS Review has provided consulting services to more than 200 banks domestically and abroad, thus solidifying ourselves as a proven and trusted resource within the banking community