About CEIS Review Inc

- Independent consulting firm serving lending institutions regarding loan portfolios since 1989

- Experience providing the following services:
  - Loan Review Programs
  - Due Diligence
  - Loan Loss Reserve Methodology Validation or Refinement
  - Loan Portfolio Stress Testing
  - Consulting
    - Process Reviews
    - Loan Policy Review and Development
    - Loan and Credit Seminars
Agenda

1. Why the current concern about CRE concentrations?
2. Regulatory focus and areas of concern
3. Elements of an Effective CRE Risk Management Framework
CRE Concentrations – “In the News!”

- December 2015 Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending

- OCC Semiannual Risk Perspective – Spring 2016
  - “… CRE concentration risk management moving from a monitoring status to an area of additional emphasis.”
  - “Easing standards are particularly evident…. increased risk layering is an additional concern.”
  - “CRE growth raises importance of concentration risk management…”

- “Yellen Eyes Commercial Real Estate Froth as Fed Weighs ‘17 Risks”
  Bloomberg, 2/2/17
Why are CRE Concentrations Such a Concern?

- CRE Concentration levels heading into the last downturn had an impact on bank failures

- Two Supervisory Tests

  1. Construction & Land Development (CLD) loans > 100% of RBC

  2. Total CRE (CLD, multifamily and non-owner occupied CRE) > 300% of RBC AND 36 month growth >50%
Failure Rates of Banks Meeting One or More CRE Concentration Criteria

- Both CRE Criteria: 20.6%
- CLD Criteria: 13.0%
- Both CRE and CLD: 22.9%
- Neither: 0.5%

Source: An Analysis of the Impact of the Commercial Real Estate Concentration Guidance – Keith Friend (OCC), Harry Glenos (OCC) and Joseph B. Nichols (Federal Reserve Board of Governors)
For Bank Failures, Location Mattered

# Bank Failures by State (2007-2013)

Total of 495 Failures

#1 Georgia (88)
#2 Florida (70)
#3 Illinois (56)
#4 California (39)
#5 Minnesota (17)

... much further down the list...

24. New York (4)
Why Did These Banks Fail?

- Many reasons, but.....for smaller banks, primary reason was overbuilding in real estate markets leading to excess supply
  - Fueled by availability of credit / loosening of underwriting criteria / disintermediation for developers as well as purchasers
  - Mainly Construction and Land Development but also residential real estate and other CRE categories

- Other Factors
  - Riskier funding sources (brokered deposits, etc.)
  - Fraud

- Inadequate levels of capital and reserves heading into the downturn
  Hello CECL!
What About those Four New York Bank Failures?

- Waterford Village Bank – 2009
  - 2007 de novo, $62 million in assets, undercapitalized
  - First in NY State to fail since 2004

- LibertyPointe Bank – 2010
  - $210 million in assets
  - Developer Shaya Boymelgreen
  - Rapid growth in multifamily and construction
  - 31% of portfolio on nonaccrual at time of failure

- The Park Avenue Bank – 2010
  - $509 million in assets
  - Fraud, rapid growth

- USA Bank – 2010
  - $191 million in assets
  - 2005 De Novo – rapid growth outside of plan
  - Construction – luxury spec homes
  - Reliance on brokered deposits
Regulators’ Current Concerns

Rapid growth in CRE / multifamily and concerns about underwriting

Includes banks based in NY State with <$50bn assets at 12/31/16. Excludes branches of foreign banks.
Source: Call Report data obtained via Sageworks Bank Information.
## Regulatory CRE Concentrations Among NY State Banks

<table>
<thead>
<tr>
<th>Date</th>
<th>Criteria</th>
<th>12/31/14</th>
<th>12/31/16</th>
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<tbody>
<tr>
<td>12/31/14</td>
<td>1</td>
<td>Banks with CLD &gt; 100% RBC</td>
<td>2</td>
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<tr>
<td></td>
<td>21</td>
<td>Banks with Reg CRE &gt; 300% of RBC</td>
<td>34</td>
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<td></td>
<td>14</td>
<td>Banks with Reg CRE &gt; 300% and 36 M Growth &gt; 50%</td>
<td>23</td>
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<td></td>
<td>1</td>
<td>Banks Meeting CLD and Both CRE Criteria</td>
<td>2</td>
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</table>

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Regulatory CRE Concentrations Among NY State Banks

NEW YORK STATE BANKS MEETING BOTH CRE CONCENTRATION CRITERIA

- <$1Bn, 15
- $1Bn to $5Bn, 5
- $5Bn to $10Bn, 2
- $10Bn to $50Bn, 1

Includes banks based in NY State with <$50bn assets at 12/31/16. Excludes branches of foreign banks.
Source: Call Report data obtained via Sageworks Bank Information.
Areas of Concern

Market / External Conditions

- Increases in interest rates
- Sales prices continue to increase – sustainable?
- In some cases, disconnect between appraised values based on sales comp versus income approach
- Construction activity increasing supply – particularly in Multifamily
  - REIS data shows Northeast Multifamily completions exceeding absorption
- Impact of retail store closings
- Societal changes – trends in home ownership, impact of burdensome student loans
Areas of Concern

December 2015 Statement on Prudent Risk Management for CRE Lending

- Asset quality metrics still generally favorable (past due, nonaccruals, charge offs)
  - Though, CEIS beginning to see some uptick in criticized / classified levels, though still at low levels

- Regulators observing easing of underwriting standards
  - Extended maturities
  - Longer I-only periods, including for stabilized properties
  - Increases in limited guarantees or non-recourse lending
  - Greater number of policy exceptions
  - Insufficient monitoring of market conditions

- Reminder – need robust risk management framework to manage risks from higher concentration levels and growth
CRE Risk Management Framework

- CRE concentrations are often a “fact of life” for many community banks

- CRE concentrations are not necessarily a “bad thing”
  - Recognize, manage, monitor and mitigate risk
  - Get ahead of regulatory scrutiny

- 2006 Interagency Guidance on CRE Concentrations outlines the following components of an effective risk management framework:
  - Board and management oversight
  - Portfolio Management
  - Management Information Systems
  - Market Analysis
  - Credit Underwriting Standards
  - Portfolio Stress Testing and Sensitivity Analysis
  - Credit Review
CRE Risk Management Framework

**Board and Management Oversight**

Board and senior management must be informed and involved in strategy and risk appetite delineation.

- Establish appropriate portfolio limits
  - Use stress testing to evaluate / support
  - Lower limits for higher risk segments or sub-segments
    - Properties not yet stabilized; I-O, non-recourse, out-of-market, property type (hospitality, restaurants, etc.)

- Establish prudent underwriting criteria
  - DSC, LTV, guarantees, etc..
  - More rigorous criteria for higher risk situations (non-recourse, etc.)

- Receive meaningful ongoing information regarding portfolio quality, adherence to policy requirements

- Regular updates on market conditions
  - **Is the bank’s strategy (limits, underwriting criteria, tolerance for policy exceptions) still appropriate in current market conditions?**
CRE Risk Management Framework

Board and Management Oversight

- Strategy / Risk Appetite
- Ongoing reporting / monitoring
- Risk Identification
- Risk Mitigation / Controls
CRE Risk Management Framework

Portfolio Management

- Look beyond individual loan underwriting and risks

- Consider risk of concentrations, correlations
  - Cyclical portfolios
  - Correlation with non-CRE portfolios and tenant industry concentrations
  - Limits and sub-limits for higher risk segments

- Contingency planning – reduce or mitigate concentrations if CRE market conditions deteriorate
  - Individual participations or bulk sales
    - Can be difficult to accomplish if downturn is widespread
    - Need to monitor marketability of loans (i.e., are loans underwritten in line with or better than market conditions?)
  - Capital raising
    - Past success is good, but not always possible when most needed
  - Analyze potential portfolio run-off
    - If the bank ceased originations, how quickly would the portfolio decline?
    - Maturities, amortization
    - Increased monitoring and reporting when emerging issues noted
CRE Risk Management Framework

Management Information Systems

- **Meaningful on-going and ad-hoc reporting**
  - Different reporting needs for different audiences

- Provide information so that management and the Board can assess whether the Bank’s strategy remains appropriate.

- Identify trends in portfolio quality, identify vulnerable / higher risk segments and borrowers, compliance with policy.
  - Trends in risk ratings, past due, nonaccruals, policy exceptions, loans to one borrower, policy exceptions.
  - Structural elements (fixed / floating, I-O, nonrecourse, etc.).
  - Property type, geographic, tenant concentrations, developer concentrations

- Growth and “churn” can mask deterioration

- Monitor / get ahead of maturity concentrations

- Administration reporting
  - Borrowers with stale financials, covenant compliance, site visits, annual reviews, legal docs, borrower property tax monitoring
Management Information Systems - continued

- Reporting on new business / underwriting trends
  - New business, refinances and renewals
  
  - Vintage analysis can be especially useful
    - Look at trends in underwriting metrics (DSC, LTV, risk rating) and exceptions to policy by quarter of origination
    - Quickly shows whether bank is taking on more risk
    - **Is the Bank’s strategy (limits / policy) still appropriate?**

- Policy Exceptions
  - Monitor trends in approvals with exceptions
  - Continue to track performance of loans approved with exceptions
  - Can inform evaluation of policies / underwriting criteria

- OCC “Risk Layering”
Management Information Systems - continued

- Level of detail appropriate for the audience

- Commentary / conclusions

- Need a data strategy
  - Which data points?
  - Process for collecting, updating and validating
    - Leverage on-boarding, annual review and loan review processes
  - Data can be used for many purposes
    - ALLL – Q factor analysis
    - Stress Testing
    - Hello CECL!
  - Continue to evaluate whether data and reporting are appropriate
CRE Risk Management Framework

Market Analysis

- Monitor conditions in CRE markets – new and long-standing presence
  - Demand
  - Vacancy Rates
  - Cap Rates
  - Rents

- **Does the Bank’s strategy remain appropriate in light of changing market conditions?**

- Can also “feed” stress testing analysis and assumptions

- Potential sources:
  - Publicly available data
  - Appraisers / appraisals
  - Tax authorities
  - Community investment groups
  - Brokers
CRE Risk Management Framework

Credit Underwriting Standards

- Consistent with the bank’s risk appetite
- Geography and property type
- Min / max requirements by property type
  - Loan / LTOB Amount, DSC, LTV
- Guarantees, with requirements for qualifying for non-recourse financing
- Financial information requirements – at origination and ongoing
- Global cash flow analysis
- Sensitivity analysis for key variables
- Rigorous appraisal review process
- Construction and renovation requirements
  - Feasibility studies, hard equity contribution requirements, inspections, pre-sale or pre-leasing, etc.
- Risk layering issues – requirements to qualify for more liberal structures
CRE Risk Management Framework

Portfolio Stress Testing and Sensitivity Analysis

- Key component of concentration management

- Excellent way to “justify” or support concentrations / limits
  - Capital adequacy – remain “well-capitalized” under stress
  - If not, evaluate strategy and mitigation efforts
  - Seeing cases where regulators require stress testing to support limit increases

- 2012 Interagency Expectations for Stress Testing by Community Banks
  - Stress test “…sophistication …should be consistent with the size, complexity, and risk characteristics of its [the bank’s] CRE loan portfolio.”
  - Reiterated that “all banking organizations, regardless of size, should have the capacity to analyze the potential impact of adverse outcomes on their financial condition....The agencies note that such existing guidance, including that covering interest rate risk management, commercial real estate concentrations, and funding and liquidity management (among others), continues to apply.”
CRE Risk Management Framework

Portfolio Stress Testing and Sensitivity Analysis

➢ “Bottom-up” Analysis
  o Best way to support / justify a concentration
  o Apply set of assumptions to a sample of individual transactions
    • Changes in interest rates, vacancies, rents, cap rates, property values
  o Determine impact on key ratios (DSC, LTV, etc.) for each transaction
  o Aggregate results at the portfolio level
  o Extrapolate results across portfolio (depending on sample size)

➢ “Top-down” Analysis
  o Segment the portfolio into homogeneous pools
  o Evaluate impact of a scenario(s) on each pool
  o Aggregate results for each pool at total portfolio
    o In each case, estimate impact on Tier 1 Capital (pre- and post- stress capital ratios)
CRE Risk Management Framework

Credit Review

➢ Ongoing Monitoring
  o Annual review requirements (or more frequent)
  o Site inspections
  o Accurate and timely risk rating system

➢ Independent Credit Risk Review
  o Internal or external
  o Expand beyond traditional “credit audit” assessments – include qualitative assessments of analysis, underwriting.
  o “Continuous monitoring” of new / renewed transactions and past dues
  o Identify emerging issues
  o Mechanism for follow up on issues
  o Board and management evaluate whether bank’s strategy remains appropriate
Summary – Key Points

➢ Goal: Identify, measure, monitor and manage CRE concentration risks

➢ Many elements of an effective CRE risk management framework may already be in place
  o Present holistic view of the framework for regulators

➢ Regulatory concentration criteria are not a “bright line”
  o Rapid growth alone is often drawing scrutiny

➢ CRE Concentrations are not necessarily a “bad thing”
  o C&I lending is complex – requires different skills / people

➢ Implications for the Allowance for Loan and Lease Losses
  o Segmentation, changes in market conditions, concentrations (borrower and portfolio), etc.

➢ Always ask…. Is the Bank’s strategy still appropriate?
ABOUT CEIS REVIEW

CEIS Review is an independent consulting firm serving the commercial and savings bank and credit union communities as well as those of other commercial lending institutions.


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