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Insufficient Stress Testing Leads to Increased CRE Concentration Risk Management Warnings

While commercial real estate lending is increasing, underwriting standards have been decreasing. Many banks are not following best practices for managing concentration risk, particularly in stress testing, Office of the Comptroller of the Currency Thomas J. Curry **warns**.

As a result, the OCC elevated CRE concentration risk management to "an area of emphasis" in its latest Semi-Annual **Risk Perspective**. The OCC says that CRE portfolios have seen rapid growth, "particularly among small banks." The decision to emphasize CRE concentration risk management follows a **statement** from all three prudential regulators late last year that they would "pay special attention to potential risks associated with CRE lending" in 2016. Regulators said they could ask banks to raise additional capital to mitigate the risk associated with CRE strategies or exposures.

"At the same time we are seeing this high growth, our exams found looser underwriting standards with less-restrictive covenants, extended maturities, longer interest-only periods, limited guarantor requirements, and deficient stress testing practices," Curry said in announcing the new emphasis.

Proper stress testing is crucial to managing CRE concentrations, Invictus Consulting Group Co-founder Adam Mustafa cautioned banks in a June webinar. "Stress testing is the right tool for the job. It's the tool, not the job," Mustafa said. "Most banks think of it as an end game. Think of it instead as a tool to provide insights and the ability to show regulators that you can handle CRE concentrations and their impact on capital." Mustafa pointed out five ways banks are misusing stress testing. (See June issue of ***Bank Insights*** for more details.)

CRE concentration risk management best practices also include global cash flow analyses, an understanding of lifetime repayment capacities, proper appraisal reviews and ongoing monitoring of supply and demand. Banks must ensure that they have the right policies, underwriting standards and risk management policies to let the board monitor the concentration risk and understand the CRE limits. Appropriate lending, capital and ALLL strategies are crucial.

The OCC reported that at the end of last year, 406 banks had CRE portfolios that had grown more than 50 percent in the prior three years, and more than 180 of those banks had at least doubled their CRE portfolios.

CRE Issues to Watch

- ✓ Rising interest rates may put pressure on CRE debt service and capitalization rates
- ✓ Multi-family prices might weaken and vacancies may rise
- ✓ Underwriting standards may continue to decline, as competition increases

Source: FDIC New York Regional Office

Community banks, particularly in the East, have CRE past-due rates higher than in many parts of the U.S., according to a Federal Deposit Insurance Corp's New York regional office **teleconference** in July. The FDIC also reported that the multi-family market "may be approaching oversupply," especially in some metro urban areas and in New York. The OCC said multi-family lending is "a significant concentration (25 percent or more of capital) and a fast-growing loan category for more than one in seven banks with growth of 10 percent or more."

Many banks in the U.S. have CRE concentration levels above the 300 percent level that often triggers regulatory scrutiny, particularly in New Jersey, Florida, California, Washington, Oregon and Arizona.

"Commercial property values have recently exceeded pre-crisis peaks," the FDIC noted. "Despite positive rent growth, net operating income has not kept pace with price appreciation, pushing capitalization rates below pre-crisis troughs." The FDIC also noted "strong inflows" from foreign capital into commercial real estate.

The OCC noted that apartments are "at a more advanced stage of the vacancy rate cycle than other commercial property types." The OCC expects the national apartment vacancy rate to increase by nearly 1 percentage point over the next two years. Markets with the most new construction could see higher vacancy rates and slower rent and net operating income growth.

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"Allowance for loan and lease loss (ALLL) levels and methods may not be sufficiently addressing the risks presented by loan growth, easing in underwriting practices, and layering of credit risk," the OCC reported. The OCC urged banks to "evaluate concentration risk management thoroughly."

The FDIC reported the most common weaknesses its examiners are finding in CRE concentration risk management:

- Insufficient stress testing
- Outdated market analyses that conflict with the bank's strategic plans
- Excessive limits
- Poor concentration reporting and board documentation
- Lax underwriting and insufficient loan policy exception programs
- Appraisal review programs without sufficient expertise or independence
- No CRE contingency plans
- Insufficient ALLL analyses that fail to consider CRE risks
- No CRE internal loan review
- Limited construction loan oversight

M&A can be an attractive solution to CRE issues for some community banks. Acquisitive banks, however, need to take special notice of the CRE concentration regulatory warning. Many potential acquisitions will result in a crossing of the 300% threshold, especially if they are cash-heavy transactions and are dilutive to tangible book value. Acquiring banks must be prepared to demonstrate that they have the capital management infrastructure to manage concentration risk. ■

How CRE Concentrations Led to a Bank Sale

Suffolk Bancorp, a $2.3 billion community bank in Riverhead, N.Y., announced in June that it was being acquired by People's United Financial Inc., a $39 billion bank in Bridgeport, Conn. A recent Securities and Exchange Commission **filing** detailed the role of CRE concentrations in Suffolk's decision to sell. The document noted that Suffolk's board of directors discussed its future and strategic plans in March, deciding that regulators were likely going to demand that the bank "limit further growth in CRE lending." Directors wanted to know how to maximize long-term shareholder value in light of the growth restraints that would accompany a pullback in CRE lending. Within two weeks, discussions with People's United were underway. At the end of April, Suffolk announced it was curtailing CRE lending, and that it expected the OCC to establish minimum capital requirements for its bank. By the end of May, three banks had expressed interest in Suffolk.

How Technology is Changing Bank Analytics

By Malcolm Clark and Lisa Getter, Invictus Consulting Group

How do you analyze a bank?

In the old days, it was a case of getting the most recent balance sheet and financials and "running a slide rule" over them. OK, so we graduated to calculators in the mid-1970s and spreadsheets in the 1980s, but the process did not really change much after that – and still hasn't, for many community banks, investment banks and advisors to the banks. And that's short-sighted.

Analyzing a balance sheet is something any bank director or executive should be able to do. They're just missing a trick.

After regulators started making bank Call Report data publically available, and the Internet allowed access to market and economic data, traditional bank analysis should have gone the way of the horse and cart. The cost of getting relevant data and running models has plummeted. Cloud-based computing power and data storage provide inexpensive ways for even community banks to reap the benefits of data and analytics without a huge IT department. The analytics can be far more useful today than was ever conceivable even just a few years ago.

This evolving technology can help bank analysts tap into data to create a whole new genre of analytics that take into consideration changes in the economic environment, regulatory capital adequacy and monetary policy. These actionable analytics can produce pragmatic, accurate and highly flexible historical and pro forma reports that can re-educate bank directors on how community banks are operating. They can aid with CECL-readiness, capital requirements and M&A positioning, and provide road maps for effective conversations with regulators.

Yet financial reporting in the community bank market is essentially static: Calculating ratios using historical data from annual reports and Call Reports. Traditional financial reporting offers limited insight into understanding future implications of a bank's strategic plans. The 2008 financial crisis showed the failure of using legacy analytics. Now that we are years into an unprecedented period of artificially low interest rates, new analytics are needed even more. Regulators have recognized this, and their own pendulum has shifted toward forward-looking risk analytics. Bank examiners are often armed with an analysis of the bank before they even walk into the door. Smart banks should have access to those same types of analytics.

Conventional analytics are not only limited, but can lead to the wrong diagnosis. This is especially true in an M&A context.

Community bank directors should be asking their analytical teams about trends, economic projections and how they will affect the bank, for themselves, their competitors and their acquisition targets. They should understand how their loan portfolios will behave under stress, so they can document the impact on regulatory capital.

In today's environment, models can simulate how a bank (or a merger) will perform under various scenarios. With the right technology, multiple scenarios can be run relatively easily on the bank itself, its competitors or an entire short-list of potential targets. Such scenario analysis will give bank directors a much better feel for the risks in their bank, their competitive positioning, or the value of a potential acquisition.

Regulators are encouraging financial innovation, yet financial reporting has generally remained the same for decades. When data was scarce and difficult to come by, checking a bank's latest financial statements was all anyone could do. That excuse holds no longer.

Done right, a bank's analytics should allow for comparisons among state or regional average banks, and even among hundreds of banks in the U.S. They should also be able to show the evolution of the bank over several years, and how that compares to any other bank in the country. The analytics should be easy to understand and actionable for the executive team and the board as well.

Bank analysts must take advantage of the sea-change in data availability and inexpensive processing power – realizing that analyzing that data and building the appropriate models may be beyond the ability or time commitment of many community bank analysis teams. If they can't build a model themselves, they can either collaborate with other banks that can, as the Office of the Comptroller advocated in 2015, or hire a third-party to help. ■

About the Expert

Malcolm Clark is Invictus Consulting Group's managing partner in charge of technology and product development. He has more than 25 years of experience in financial markets and technology, generally straddling the two disciplines. After developing technology for Morgan Stanley's New York and international repo desks, he moved onto the desk as a repo trader in London. He later joined CSFB with responsibility for both repo trading and developing repo technology. Subsequently he headed up the front office technology group in the Pacific region for CSFB in Tokyo, and then moved into Fixed-Income Research where he was a market strategist for the Japanese, Australian and New Zealand markets from Sydney. In 1999, he took a stake in Anvil Software in London. He ran sales, marketing and product strategy, overseeing international growth and the eventual sale of the company. He has a degree in economics from the Massachusetts Institute of Technology.

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Read Between the Lines

Each month *Bank Insights* reviews news from regulators and others to give perspective on regulatory challenges.

OCC Examiners to Focus on Credit Risk, Strategic Planning

Top priorities for OCC community bank examiners for the next 12 months include assessing the quality of credit risk management, particularly concentration risk management, loan growth strategies, ALLL methodologies and stress testing, the OCC revealed in its Spring Semiannual **Risk Perspective.** Expect examiners to also focus on strategic planning and whether your bank has adequate capital and succession planning. If M&A is part of your strategic plan, expect examiners "to assess the merger and acquisition processes and procedures." Also on the priority list is cybersecurity risk, BSA/AML compliance policies, and interest rate risk management. The agency said it is concerned about exposure to interest rate risk "from instability in the cost structure of the deposit base, especially at banks with concentrations in longer-term assets, including mortgage-backed securities and loans."

OCC Handbook Includes Stress Testing, Capital Planning Guidance

Stress testing is "an essential element of the capital planning process," the OCC reminds bank directors in its updated corporate governance **handbook**. "Banks can use stress testing to establish and support a reasonable risk appetite and limits, set concentration limits, adjust strategies, and appropriately plan for and maintain adequate capital levels," the handbook states. The guide also details the importance of enterprise risk management and why banks need a risk governance framework to manage risks.

FDIC Also Highlights Corporate Governance

Effective corporate governance programs translate into more profitable and resilient community banks, the FDIC tells boards of directors in its newest **video**. The video discusses strategic planning, risk appetite frameworks and the importance of hiring and retaining qualified executives.

Growing Credit Risk in Oil and Gas Exposures

The FDIC is **reminding** banks that they need to maintain sound and conservative underwriting standards and credit practices if they have oil and gas exposures. Since many oil and gas borrowers often have volatility, the FDIC said it expects banks to try to mitigate losses where possible. It suggests that banks that do lending for exploration and production use experienced staff that know how to put together appropriate structuring. The first quarter Shared National Credit **review**, which was released in July, also cited "growing credit risk in the oil and gas portfolio."

FDIC Looks at Appeals Process

The FDIC is accepting comments from banks about a **proposal** that would expand its appeals process to include compliance with existing formal enforcement actions. The FDIC says that the amendment would "enhance" a bank's ability to obtain an independent review of supervisory determinations. The FDIC also released a **statement** on guidelines it follows in the development and review of supervisory guidance.

FDIC Encourages De Novos

FDIC Chairman Martin J. Gruenberg **told** a House subcommittee that he expects renewed interest in de novo charters. The agency encourages investors to participate in pre-filing meetings with FDIC staff. "The FDIC remains supportive of the formation of new financial institutions and welcomes applications for deposit insurance," he said.

CFPB Updates Mortgage Protection Rules

Mortgage servicers will once again need to review their procedures for protecting struggling borrowers. The Consumer Financial Protection Bureau has updated its **rules** to make sure that foreclosure protections apply to borrowers, even in bankruptcy and after a borrower has died. The new rules also allow borrowers who have become current on their loans to gain protection again if they have future trouble. The rules, which are designed to avoid wrongful foreclosures, clarify when a borrower becomes delinquent. They require servicers to notify borrowers when loss mitigation applications are complete. ▪

About Invictus

Invictus Consulting Group's bank analytics, strategic consulting, M&A and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. For past issues of Bank Insights, please go to the ***Invictus website****.*

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