

## Navigating Through CRE Risk

*By Jeremy D. Taylor*

Recent price declines in commercial real estate are estimated at 15% or more – comparable to housing but without the same headlines. With CRE a small-bank mainstay, regulators are taking notice. Mindful of the experience of the early 1990s when CRE over-lending culminated in a wave of bank failures, the Interagency Guidance Statement of December, 2006, proscribed tightened risk management practices at high-CRE institutions. It was issued at a time when market conditions were still relatively buoyant – but excesses already beginning to show.

That guidance was refreshed by a March, 2008 FDIC Financial Institution Letter whose title included reference to a “challenging environment” and whose message was sober but nuanced. It reiterated the need for a structured and disciplined approach to managing CRE concentrations, while trying not to discourage banks from making new such loans.

Words have now become actions. A recent ABA Banking Journal survey of community bankers placed CRE at the top of the list of primary examiner focus, cited by 39% of respondents, up from second place (27%) in the 2007 survey.

So, what’s a banker to do? The first thing to emphasize – as do regulators – is that there are sound reasons why CRE is an attractive and profitable business for so many institutions, and one critical to the economy’s ability to rebound from its doldrums. The December, 2006 Guidance, while identifying threshold exposure levels (as a percentage of capital) triggering increased regulatory scrutiny, explicitly backed away from putting formal caps on CRE exposure. However, it needs to be handled with care. Here are a few (of many) things to consider:

### **Market understanding**

Two things are different. First is the fact that a property’s prospects depend so critically on location-specific supply/demand conditions. Second is the long gestation period for development and construction, meaning that supply/demand balances can become imbalances by completion. The message: Collect detailed data by locale, by its major industries/employers, by project type, etc. Keep it current, make it broadly available. Generate summary reports highlighting vulnerabilities, to accompany required reporting on internal concentration limits, underwriting exception approvals and supervisory LTV limits.

### **Underwriting**

1. Have a robust risk-grading system that ties, even if just loosely (e.g., guidance templates), to key measures like LTV and DCR.
2. Subject market demand assumptions to skeptical scrutiny, including stressed scenarios.
3. Pay close attention to loan structures that combine leverage with features that may shield sponsors or compromise guarantees.
4. Also watch purchased participations from out of market, where the bank lacks critical, first-hand familiarity.

## **Monitoring**

Develop a risk-grading system that's not just accurate at inception but that's also responsive to changes in creditworthiness over time. It should use fresh market data sources, supplemented by site visits, to stay abreast of a project's current and potential competition. Perform loan- and portfolio-level stress-tests on vacancy rates, interest rates, sales prices, etc., to verify debt-servicing capacity (as projected cash flows change) and collateral support (as estimated valuations change), to help identify where management (pre-)attention is most needed.

## **Appraisals**

Recognize the risks of valuation bias that can arise in a competitive industry reliant on the goodwill of the institutions (and the lending staff within them) that contract for their services. Yes, the appraisal industry is now more heavily regulated, but the underlying business model (e.g., how they get paid) remains unchanged.

## **Capital**

It's there to absorb unexpected losses, in particular, the really bad years when everything "hits the fan." Average loss experience, covered by the ALLL, is not extremely high (annual average net charge-offs of 0.45% for ADC, 0.24% for other CRE, going back to 1992, versus over 1% for both C&I and personal loans). But CRE's year-to-year variability (i.e., standard deviation of losses) is relatively high, and its co-variability (i.e., everything getting into trouble together) even more so. And that's what capital is really there for: to cushion against the effects of correlated credit losses. Small institutions are especially vulnerable because their size precludes significant geographic or other diversification. Hence, the capital adequacy concerns of regulators as CRE softens.

A key challenge for many institutions is that tightening controls on CRE lending will trim originations – thereby aggravating cyclical pressures on earnings. To the extent that diversification opportunities are constrained for smaller banks with high CRE dependence, close attention to the issues raised above becomes all the more critical.

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