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Bank Insights

Regulators to Banks: CRE Lending May Lead to More Required Capital

Be prepared to raise additional regulatory capital if your bank can't prove to examiners that your CRE concentrations are well-managed – and can also withstand an economic downturn.

Regulators **announced** in December that they "will pay special attention to potential risks associated with CRE lending" in 2016.

Banks that don't have adequate risk management practices and capital strategies to quantify and manage CRE concentrations will likely be required "to raise additional capital to mitigate the risk associated with their CRE strategies or exposures," regulators advised.

Banks whose strategic plans call for an increase in CRE lending should stress test their portfolios to see if they have sufficient capital under severe economic scenarios.

The CRE warning is broad: Banks that will come under regulatory scrutiny do not need to have exceeded **concentration** limits. Banks must merely be contemplating an increase in CRE loans, have already increased CRE lending or "operate in markets or loan segments with increasing growth or risk fundamentals," regulators said.

Under **joint regulatory guidance** issued in 2006, examiners will subject a bank to increased supervision if their total reported loans for construction, land development and other land represent 100 percent or more of the bank's total risk-based capital, or total commercial real estate loans represent more than 300 percent of capital, and the outstanding balance of the CRE loan portfolio has increased by at least 50 percent during the prior 36 months.

Acquisitive banks should take special notice of the concentration warning. Many potential acquisitions will also result in a crossing of the 300 percent threshold, especially if they are cash-heavy transactions and are dilutive to tangible book value. There are already rumblings that the CRE focus will result in more intense regulatory scrutiny during the M&A approval process. Look for regulators to make an example of a bank or two to send a message to the market. It is highly recommended that acquiring banks be prepared to demonstrate in their regulatory application that they have the infrastructure from a capital management and risk management perspective to manage concentration risk.

Regulators emphasized in December that banks need the right strategies "to ensure capital adequacy and allowance for loan losses" that support a bank's lending strategy and are consistent with the level of CRE risk in their portfolios. The regulators advised banks to perform "market and scenario analyses" to quantify the potential impact of changing economic conditions on asset quality, earnings and capital – in other words, forward-looking capital stress tests.

What Regulators Look for in CRE Portfolios

Examiners look at a bank's CRE loan portfolio for indications of best practices to mitigate risk, including:

- ✓ Diversification across property types
- ✓ Geographic dispersion
- ✓ Underwriting standards
- ✓ Levels of pre-sold units or take-out commitments
- ✓ Liquidity

Source: 2006 Interagency CRE Guidance

Regulators noted that competitive pressures are contributing to "historically low capitalization rates and rising property values." In a downturn, those higher initial collateral values would fall. Regulators noted that the quality of CRE portfolios remained strong, based on non-performing loans and charge-off rates. Because of those "reassuring trends" in asset-quality metrics, regulators said that many banks are increasing their concentration levels. But they are also decreasing their underwriting standards, with less-restrictive loan covenants, extended maturities, longer interest-only payment periods and limited guarantor requirements.

The CRE levels are of utmost concern because post-mortem reviews of community banks that failed during the 2008 financial crisis showed similar concentrations – yet regulators did not act in time to save the banks. Congress and watchdogs will be monitoring how regulators react to an impending CRE crisis this time around.

An overlooked Government Accountability **Report**, which was issued in June, discussed the failure of regulators to oversee rising CRE concentrations at banks prior to the financial crisis of 2008. The 71-page report, "Lessons Learned and a Framework for Monitoring Emerging Risks

Inside this issue:

- Regulators Outline Successful Risk Management Practices *(p. 2)*
- CRE Concentrations by the Numbers *(p. 2)*
- How Forward-Looking Risk Analytics Became an Essential Community Bank Tool *(p. 2)*

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and Regulatory Response," discussed how bank supervisors embraced forward-looking supervision as a solution. It revealed that the GAO would monitor how bank supervisors monitor warning signs in the future.

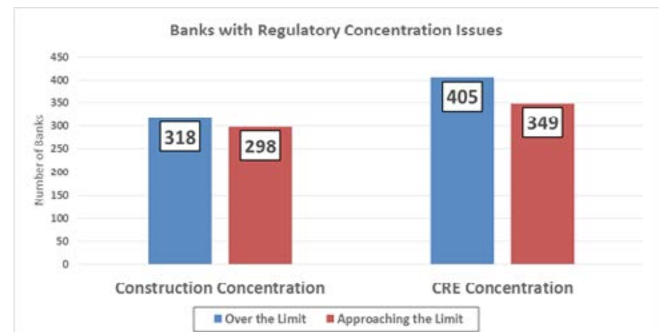
The GAO report offers some clues about how forward-looking bank supervision will affect banks. Regulatory staff, for instance, told the GAO that they had previously been reluctant to downgrade the management component if earnings and capital were strong, a mistake it now realized. Examiners are now directed to use the management score in the CAMELS composite to reflect a bank's underlying risks. Federal Reserve staff told the GAO that "the stress test is the best way to communicate to bank management that risks have built up and need attention, because it is data driven." ▪

Regulators Outline Risk Management Practices of Successful Banks

The December regulatory statement on CRE challenges outlined how banks can survive an economic downturn, even with concentrations. The regulators advised that they expect bank boards to be involved in setting proper risk management policies and procedures. Boards of directors or the appropriate board committee must approve concentration limits and review credit risk management practices and underwriting standards.

Successful banks also:

- ✓ Conducted global cash flow analyses based on reasonable assumptions of rent and other items to ensure borrowers could repay their loans;
- ✓ Performed stress testing of their CRE loan portfolios to quantify the impact of changing conditions on asset quality, earnings and capital;
- ✓ Had lending strategies and limits for concentrations, as well as a method to assess whether those strategies would work in different market conditions;
- ✓ Gave boards adequate reports on those lending strategies so they could assess how they would change in a downturn;
- ✓ Continued to monitor a borrower's ability to service debt as loans converted from interest-only to amortizing payments, or as interest rates rose;
- ✓ Implemented procedures to monitor the volatility in supply and demand for CRE during business cycles;
- ✓ Maintained management information systems that gave the board and management enough information to identify, measure, monitor and manage concentration risk;
- ✓ Had processes to review appraisal reports to support appropriate market value conclusions.



How Forward-Looking Risk Analytics Became an Essential Community Bank Tool

Actions by regulators in the waning months of 2015 should serve as notice to community banks that ignoring forward-looking analytics will lead to lower CAMELS scores, more examiner scrutiny and higher regulatory capital requirements. The new current expected credit loss model (CECL), which is expected early this year, is also a forward-looking tool.

Amid signs that community banks are again accumulating higher concentrations of risky commercial real estate loans, regulators are reminding banks that stress testing is indeed required to manage concentration risk in their portfolios and to develop realistic scenarios for interest rate risk management. (See "Regulators to Banks: CRE Lending May Lead to More Required Capital," p. 1).

The large banks have already adopted forward-looking risk analytics and are using the results with regulators. Although community banks are not subjected to the same stress testing requirements as the large banks, the regulatory trend is in the same direction. Those community banks that fail to incorporate new analytics into their risk management systems will find it increasingly difficult to communicate effectively with regulators, who are using forward-looking risk analytics themselves.

Regulatory Paper Trail

The Federal Deposit Insurance Corp. quietly began training its examiners for a new "forward-looking supervisory

approach" as early as 2009. Examiners were **taught** to "carefully assess the institution's overall risks, and base ratings not on current financial condition alone, but rather on consideration of possible future risks." The FDIC said it would use both on-site and off-site reviews and "accurate metrics" to identify risk in balance sheets.

The FDIC's 2015 annual performance **plan** discussed the need "to implement more forward-looking supervision techniques" for well-rated banks, including those with CAMELS composites of 2, so it could spot deficiencies before they require formal action.

The FDIC has also **proposed** changing the way it assesses deposit insurance for community banks. The forward-looking proposal counts construction and development loans as higher risk under a new loan mix index, which could lead to higher assessments.

The Federal Reserve hinted early in 2015 that it was using forward-looking risk analytics to ferret out weaker community banks. The Fed ended the year by **announcing** it had made its supervision framework "more forward-looking and data-driven." The new program includes the use of forward-looking metrics to target high-risk banks "for enhanced supervision," while identifying "low-risk" banks that would merit more of a "streamlined supervisory approach."

The Fed program will include an outlier list and a watch list that would identify banks "with expanded or new areas of risk-taking" and flags those in the early phases of financial trouble. The algorithms used in the data modeling were first tested on community banks, the Fed wrote, but they are now being expanded and customized for all banks. Some metrics are still being developed and full implementation is not expected until 2017.

OCC Embraces Forward-Looking Analytics

The OCC issued a memo to examiners in 2011, noting that one of the tenets of good forward-looking supervision is assigning an adverse rating to the management component of a CAMELS composite before a bank had deteriorated financially, a 2013 OCC audit **revealed.** The memo noted that the M score should focus on actions and results, not commitments.

Of all the regulators, the OCC has been the most vocal in advocating for forward-looking community bank analytical tools. It issued **guidance** for community bank stress testing in 2012, reiterating that "some form of stress testing or sensitivity analysis of loan portfolios on at least an annual basis" was a key part of sound risk management for community banks. In June 2012, the OCC also issued **revised guidance** on capital planning. The document said capital planning must be "forward-looking in incorporating changes in a bank's strategic focus, risk tolerance levels, business plans, operating environment, or other factors that materially affect capital adequacy."

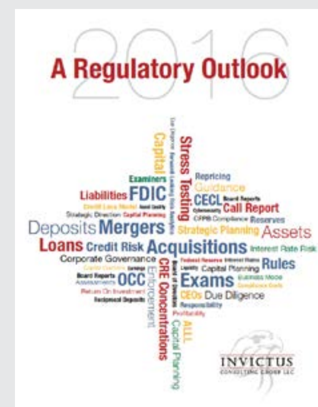
Then, in December of 2015, the OCC **announced** that it had updated its guidance for its Risk Assessment System to clarify the "forward-looking elements" of both the system and CAMELS. The guidance "broadens the concept of risk" to include its impact on a bank's projections. It also expands the definition of strategic and reputation risk assessments to include both the quantity and quality of risk management. The guidance notes that under the new definitions, "financial condition includes impacts from diminished capital and liquidity," and that capital includes potential impacts from losses, reduced earnings and market value of equity.

Community banks need to be proactive to ensure they are ready for examiners armed with forward-looking risk analytics. Even if your bank doesn't have CRE concentrations, use forward-looking risk analytics to stress test your capital, your strategic plans and any potential acquisition you might be considering. Present the results to regulators. Invictus' clients that have used stress testing results with examiners have seen their capital requirements decrease and their management piece of their CAMELS composite increase.

Forward-looking risk analytics are here, and their use will only expand. Embrace them to smooth the regulatory path, and give your bank a competitive edge in the marketplace. ▪

Editor's Note: *This Bank Insights article is adapted from a forthcoming Invictus Consulting Group white paper. For more information on Invictus' forward-looking risk analytics and how they can help your bank, please contact George Dean Callas at* **gcallas@invictusgrp.com**.

Regulatory Handbook Available on Invictus Website



Essential Reading for Bank CEOs and Boards: In case you missed it, the Bank Insights' 2016 Regulatory Outlook is now on the Invictus **website**. The special report outlines regulatory expectations in areas ranging from strategic and capital planning to CECL to cybersecurity.

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Read Between the Lines

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

FDIC Removes Reciprocal Deposit Clause in Proposed Small Bank Assessment Rule

The Federal Deposit Insurance Corp. board has revised its proposed **rule** for small bank assessments, changing the section that treated reciprocal deposits like brokered deposits. Hundreds of bankers and trade groups had opposed it, saying it would amount to a new tax on small banks. The new proposal also alters the one-year asset growth measure so it increases assessment rates only when one-year asset growth reaches 10 percent. The proposal does not change the loan mix index, which uses historical charge-off rates to identify loan types with higher risk.

Regulators Endorse 18-Month Exam Cycles

At least 617 more community banks will be eligible for 18-month exam cycles, under an interim final **rule** approved by the FDIC board in January. The rule came about after Congress included the provision in a highway bill in December. It will allow "well-capitalized and well-managed" banks with assets of less than $1 billion to benefit from 18-month rather than 12-month exam cycles. "While the 18-month cycle will reduce the burden on well-managed community banks and thrifts, it will also allow the federal banking agencies to focus our supervisory resources on those institutions that need it most—those that present capital, managerial, or other issues of significant supervisory concern," Comptroller Thomas J. Curry **said** in voting for the rule. "We don't have unlimited supervisory resources, and it's important that we manage those resources wisely."

GAO Tries to Determine Dodd-Frank Impact on Community Banks

The Government Accountability Office attempted to quantify how the Dodd-Frank law has affected community banks, but concluded it was too difficult and – too soon – to come up with reliable numbers, according to a December **report**. Community bankers and trade groups told the GAO they had an increased compliance burden because of the Dodd-Frank law and a decrease in lending. The GAO looked at Call Report data and found that since 2010, small banks tended to have more employees per every million dollars in assets than larger banks, higher non-interest expenses by a percentage of assets than larger banks, and fewer mortgages on their balance sheets. But the report concluded it was too early to attribute those findings to regulations. Regulators told the GAO "it may be too early to assess the full impact of the Dodd-Frank Act rulemakings and while they have heard concerns about an increase in compliance burden, they have not been able to quantify compliance costs." They also said the compliance activities do not appear to have reduced community bank profitability.

FDIC Study Finds that Closely-Held Community Banks Outperform when Managers and Owners Overlap

An FDIC **study** that looks at the organizational attributes of about 1,350 community banks in the Kansas City, Dallas and Chicago regions found that closely held banks in which key managers are also owners outperform other closely-held banks that have no owners in management. The study, which surveyed bank examiners, found that the vast majority of closely held banks were controlled by groups with family or community ties, and many of the owners were also serving on the bank boards. In 48 percent of the closely held community banks, the key bank officer was a member of the primary ownership group. The closely held banks were generally smaller than widely held banks, more concentrated in rural areas and twice as likely to specialize in agricultural lending. Succession planning remained an issue for closely held banks, which led the study authors to conclude that their "recipe for success" may prove difficult going forward.

New York to Impose Criminal Penalties on Bank Officers

The New York State Department of Financial Services is beefing up its money laundering and anti-terrorist **rules** by mandating that senior bank officials sign an annual certification that attest the bank is compliant with a new transaction monitoring program and watch list. Filing incorrect or false annual certifications will result in criminal penalties. Officials said the rules will be based on each bank's risk assessment.

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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