CRE CREDIT STRESS UPDATE

by Steve Brown

Ask anyone and they will tell you that driving a car around the warning signs and into a flooded area is a bad idea. Yet despite the risk, many people still try to cross these roads. Much can also be said of the proposed interagency guidance on CRE issued earlier this year. In it, the regulators seemed to be in the early stags of putting up warning signs along this road. Now, following an extensive letter campaign from bankers, regulators seem to be getting ever closer to issuing final guidance. Given the complexity of the issue and the high degree of bank interest, we thought many of our readers might like an update. The points that follow are from various regulatory sources. While not intended to be a complete update, some things stand out. 1) Regulators are concerned about an upsurge in credit losses. This is particularly true given the cyclical nature of the CRE sector, high historical loss levels reached in the 80's and 90's, low overall reserve levels, extremely competitive pricing and lower core deposit to asset ratios. As such, regulators felt reiterating their position was important at this juncture. 2) Regulators expect banks with CRE loan exposure in excess of 300% of capital to have robust risk management processes and carry capital commensurate with the risk taken. The concept of stressing credit on a portfolio basis is consistent with best practices in regards to safety and soundness. This is true irrespective of loan type, concentrations or the creditor's source of repayment. 3) Regulators have expressed worry that the pending adoption of Basel II will add further competitive pricing pressures to independent banks. It is believed that banks with a vigorous risk management platform stand a better chance of competing against national banks (particularly when you consider the larger banks may end up being able to hold lower capital amounts for a given loan and therefore offer even lower pricing). 4) Technology has evolved over the years and banks now have off the shelf risk management applications (i.e. credit scoring, ALM, etc.) available to improve overall risk analysis. While many banks admittedly don't yet have complete data on their core systems, the process is underway. 5) Regulators indicate that loans on owner occupied projects are excluded from the measurement and some single family residential construction loans that are pre-sold might also be excluded. 6) While many argue that different CRE loan sub-types act differently and should be excluded from the calculation of 300%, the regulators have done some analysis. While admittedly simplistic, an extensive 20Y correlation analysis is high enough, such that the regulators feel aggregating CRE is appropriate for the calculation. 7) Regulators have reiterated that heightened risk management expectations (including stress testing) is not a new concept and has been well communicated. 8) Regulators stress that appropriate risk management and capital levels are essential elements of a sound CRE lending strategy and that capital adequacy will be evaluated on a case by case basis. 9) Regulators indicate that banks can pursue a variety of approaches to adhere to the guidance, including less quantitative approaches if there is not enough market data available or the relevant geographic market is small. 10) Regulators reiterate that even smaller banks must have clear and coherent methods for evaluating the various potential outcomes associated with their CRE concentrations and exposures. The bottom line is that we are now past the 90 day point, so banks should expect the guidance to flood out shortly. We will report on the final proposal as soon as it becomes available.

ALLL VALIDATION UPDATE

Bankers should note we are assisting many banks in calculating the appropriateness of their ALLL, as part of a comprehensive risk management process. In short, credit stressing under one set of rule books helps validate ALLL (i.e. FAS 5, FAS 114, JPS), while it supports portfolio credit risk exposure analysis (i.e. incorporates a 25Y history and various micro components within the analysis) under another set. For banks interested in loan credit stressing, or seeking ALLL validation, give us a call and we would be happy to assist.

BANK NEWS

Acquisition

Atlantic Southern Financial Group ($388mm, GA) will acquire Sapelo Bancshares ($52mm, GA). Terms of the transaction were not disclosed.

Battle of the Giants

Bank of America ($1.45T, NC) is poised to take over Citigroup's ($1.63T, NY) position as world's largest bank by market value. BofA's market cap is now $231B compared top Citi's $234B, achieved in large part as BofA has spent more than $90B on acquisitions since 2001.

Construction

The FRB is reporting that as of the end of the 1Q, banks in the 12th District saw the construction portion of their overall loan portfolio grow to 17.5% overall. This is a 27% increase over the same period in 2005.