UNDERSTANDING REGULATORY DOTS & DASHES Â– CRE

by Steve Brown

Samuel Morse is credited with playing a critical role in the invention and commercial adoption of the telegraph. As the inventor of the "Morse Code," his dots and dashes changed the way people in the country communicated. Morse probably never envisioned, however, that the banking industry would ignore the path he had so meticulously laid down and instead adopt its own mysterious communication methods between bankers and regulators. Tantamount to dots and dashes, regulators are profuse publishers of documents filled with regulatory-speak. Their code, which can only be understood by bankers with extensive training, attempts to provide the industry with advance warning. In fact, regulators will very often telegraph certain concerns they see in the industry, which are likely to be the focal point of the next examination. It is this way right now with CRE lending and risk management in general. For years, regulators have published articles and alerts related to growing CRE exposures at independent banks. They have also examined countless financial institutions with such exposures and have compiled a list of best practices examiners will be looking for when assessing bank risk management and lending practices. To begin, bankers will need to beef up oversight practices. In general, examiners have found many banks still have inadequate oversight of construction projects, weak appraisal review programs, inadequate knowledge of lending markets and poor loan structuring. To mitigate risks, bankers should make sure policies establish diversification standards, include measurable LTV limits, provide guidelines for monitoring loan policy compliance and incorporate measurement of market conditions. Banks with high exposure to CRE must have formal measurement and monitoring systems that include adequate concentration risk reporting. In particular, regulators have said they will be looking to see whether banks have established limits by type and geographic area, as well as produce and provide reports to the board and senior management that enable them to make informed risk decisions. Regulators will flag banks without concentration reports, that utilize weak or nonexistent stress testing and that fail to track and report exceptions. Banks will also see increased pressure if they do not aggregate and report total exposure of all loans outside policy, or fail to adequately document assumptions and exceptions. In addition, regulators have warned bankers they will also be monitoring the timeliness of board reporting, whether banks are underwriting land loans based on "as completed" appraised value and whether commitment amounts are considered when computing LTV limits. Bankers should take care to differentiate land development loans from raw land or speculative investment land loans. Further, regulators are encouraging banks to produce and distribute detailed summary reports on construction projects. These should include a narrative, start date, percent complete, expected completion date, any absorption issues and repayment sources. Finally, examiners have said they will be looking closely to determine whether banks have placed undue emphasis on collateral value instead of cash flow, liberally used interest reserves, have structured loans with 2Y or shorter maturities secured by undeveloped land, or have originated unsecured loans or letters of credit for the purpose of investing in condominium projects. Over the past few years, regulators have been sending messages and telegraphing their expectations to bankers. One doesn't need a magic decoder ring or special training to understand the dots and dashes embedded within the message Â– banks should tighten up risk management practices.

BANK NEWS

M&A

The HC for Renasant Bank ($2.5B, MS) will acquire the HC for Capital Bank & Trust Company ($530mm, TN) for about $141.83mm, or approximately 4.34x book.

M&A

Southwest Bancorp Inc. ($2.1B, OK) will acquire Bank of Kansas ($74mm, KS) for about $15.25mm in cash, or roughly 1.94x book.

Failure

Marking the first failure of a bank since June 2004, the FDIC was named receiver of Metropolitan Savings Bank ($16mm, PA). Deposits of the failed institution were assumed by Allegheny Valley Bank ($366mm, PA) for a premium of 6%.

Housing Sector

A new survey finds 9% of 55 economists surveyed by USA Today feel the housing downturn ended in 2006, 42% expect it to end in the 1st half of this year and 45% anticipate it will take until the 2nd half to bottom out.

Mentoring

Companies seeking new ways to retain talented employees are boosting mentoring programs. In fact, roughly 50% of the 500 largest companies in the US now offer mentoring, up from only 10% in 2000.

No Cushion

A survey of American savings habits in 2006 finds 40% set aside no money for savings, while 25% saved less than they expected. In addition, an astounding 65% of those surveyed felt their finances were the same or possibly lower than they were in 2005.

Fewer Flippers

A study of CA loan sales finds homes owned for 6 or fewer months fell to 3.2% of all homes sold in 2006, down from 4.2% in 2005.

Weak Housing

Sales of new homes fell to their lowest level in 16Y in December, ending the year down just over 17% from 2005. The decrease was the biggest drop since 1990.