BE PREPARED FOR CRE STRESS

by Steve Brown

The Boy Scout motto is to "be prepared." If you have been to any convention recently attended by banking regulators, you know they are all very worried about stress in the commercial real estate (CRE) market. That makes sense when you consider how high exposures in the sector already are at banks across the country. Whether this concern is overblown, only time will tell, but suffice it to say that regulators certainly are worried and as such, bankers can expect a heightened focus during the next exam in this area.

A recent survey PricewaterhouseCoopers predicts the CRE market will not recover until 2012 and more specifically, office rents in major metropolitan areas may drop as much as 20% next year.

Property values have already fallen 36% from their peak reached in 2007 and companies show no signs of hiring any time soon. As unemployment inches higher, companies cut costs by reducing space and prices fall. This circular situation doesn't look like it will get better over the immediate term, so bankers will have to be better prepared, closely monitor customers and keep an eye on geographic trouble areas. In short, higher loan loss reserves are expected through 2010.

How bad are things right now? Well, the latest data shows CRE delinquencies among US banks reached 9.09% in 2Q, almost double the same period last year. Regulators are so concerned, the inspector general overseeing TARP even proclaimed CRE "might be the next proverbial shoe to drop, threatening to increase pressure on banks or small business alike." This pressure, along with strains already evident in the banking system has pushed FDIC Chair Shelia Bair to predict higher bank failures through 2010.

Overall, banks held $1.2T in CRE loans as of 2Q. While construction and land development are causing most of the current spike in CRE delinquency, regulators are also worried about future pressure that will come from the massive overhang of CMBS that need to be rolled over in coming years. Further, regulators are also worried because more than 50% of all banks with assets between $1B and $10B have CRE exposure in excess of 300% of capital, about double the level just 10Ys earlier. In addition, banks with assets less than $1B that have CRE concentrations above 300% of capital have nearly doubled over the same period. Absolute industry CRE exposure is the highest it has ever been, economic pressure is near record levels and bank earnings are in negative territory. This deadly triumvirate has regulators understandably worried.

To avoid regulatory problems and to make sure your bank is on its game, we suggest the following: perform stress testing; conduct 2x yearly outside loan portfolio reviews to surface issues before they become too large to handle; order appraisals as may be needed to ensure loans remain properly valued; incorporate economic factors affecting CRE loans; review concentration risk levels relative to capital, reserves and earnings; track credit migration and report monthly to the Board; periodically review loan terms, collateral value, occupancy levels, debt coverage and other factors; report any exceptions to policy promptly to the Board and develop contingency plans to reduce exposures in the event that becomes necessary.

No matter the state of your bank, capital level or customer base; CRE is a concern that has been highlighted by regulators so expect a closer look during the next review. Someone once asked Baden-Powell, the founder of the Boy Scouts, what they needed to be prepared for. He answered, "Why, for any old thing." Given the industry environment today, we couldn't agree more. Being prepared for the next exam and focusing on CRE risk is just a good idea.

BANK NEWS

Bank Closures (98 YTD)

On Friday, the FDIC closed: [1] Warren Bank ($538mm, IL) and sold it to Huntington National Bank ($51B, OH). Huntington will assume all deposits (for a 0.27% premium), 6 branches and about 15% of assets; [2] Jennings State Bank ($56mm, MN) and sold it to Central Bank ($431mm, MN). Central will assume all deposits (no premium), 2 branches and about 66% of assets. [3] Southern Colorado National Bank ($40mm, CO) and sold it to Legacy Bank ($201mm, CO). Legacy will assume all deposits (for a 1.00% premium), 2 branches and about 65% of assets.

FDIC

In a speech over the weekend, FDIC Chair Bair said unlike the past, bank creditors should be expected to share in some of the losses in a failed bank situation.

Yikes

The number of banks with 20% or more of their loan portfolio delinquent has reached an 18Y high. Meanwhile, noncurrent loans averaged 4.35% for all banks as of 2Q, the most in 26Ys.

Systemic Risk

FOMC Chair Bernanke told Congress that he thinks a broad-based oversight council of financial regulators should be set up to monitor systemic risk and that all systemically important financial firms should be subject to a consolidated regulator even if the firms do not own banks.