Can Be Too Much If Not Managed Properly

by Steve Brown

There is a saying that you can "never have too much of a good thing." Although we don't know where this saying comes from, it is clearly not true. We all overindulge at times - sweets, fast food, TV, social media and spirits quickly come to mind. But, when it comes to banking, we especially need to be sure we don't have too much of a good thing.

Data shows that commercial real estate (CRE) lending has rebounded to levels not seen since before the Great Recession. As you would expect, this trend hasn't gone unnoticed by regulators. As a practical matter, if your bank has loan concentrations (particularly in the area of CRE), you've got work to do before your next exam.

First, we'll provide some context. Regulatory concern over CRE concentrations has been on the rise for some time. In December 2015 regulators stated that they planned to pay special attention to banks with higher CRE concentrations, pointing to guidance issued back in 2006. In that guidance, regulators defined high concentrations as CRE loans making up 300% or more of total capital and where growth had increased 50% or more during the prior 36 months. They also focused on construction and land development loans comprising 100% or more of total capital. Following the recession, regulators determined that banks with high CRE concentration levels were significantly more vulnerable to failure, so as you would also expect, regulators determined to be more proactive going forward.

Flash forward to the 2016 summer edition of the FDIC Supervisory Insights. It included an article about recent Matters Requiring Board Attention (MRBA) that had surfaced, with a special focus on activities recorded in the last 2Ys. The report showed a disturbing trend. Namely, in the last 2Ys, the percentage of loan-related MRBA's related to the risk of loan concentrations increased from 12% in 2014 to 24% in 2015. Given this, it's no wonder bankers are on edge.

The upshot is that banks with CRE concentrations should expect greater scrutiny during upcoming regulatory exams. To prepare, here are a few areas to focus on:

For starters, establish, document, and have proper board or committee approval of loan policies, underwriting standards, credit risk management practices and concentration limits. This is extremely important, as regulators will be looking closely to see whether your standards have loosened and whether you are granting a large number of exceptions.

Next, be sure to establish a robust lending strategy. It should include a process for assessing when that strategy should be changed in light of changing market conditions. It is a good idea to provide metrics to assess as well.

Third, review your strategies to ensure capital adequacy is maintained. Consider growth plans and their effect on capital, as well as stress test the portfolio. Be sure to quantify the potential impact of changing economic conditions on asset quality, earnings and capital.

Finally, be sure you maintain a loan loss reserve and procedure that is consistent with the level and nature of inherent risk in the portfolio. Make sure you provide the board and management with metrics to identify, measure, monitor, and manage concentration risk. Regulators want to know the board is in-the-know and that there has been, and continues to be, appropriate oversight.

Before your next exam, we would also recommend you take the time to bring your entire team back up to speed on existing guidance. Our Risk Consulting Division is available to help with your exam preparation if requested, so please feel free to reach out if we can assist or you have further questions.

BANK NEWS

Wells Fargo

As this saga continues to play out, news reports indicate Senator Warren has written a letter to the bank indicating it is difficult to believe new CEO Sloan "had no knowledge of or bears no responsibility" for the sales practices issue that cost Stumpf his job and that the resignation of Stumpf is "not enough" for lawmakers.

Biz Startups

Research by the Census Bureau finds the share of companies that are less than 1Y old is about 8% vs. double that level back in 1975 and about 12% in the 1980s. Analysts point to shifting demographics and higher regulatory costs as possible reasons for the sharp decline.

Shadows

CNBC reports researchers indicate shadow banking has jumped 25% in size since the credit crisis and today poses a substantial risk to investors. Analysts say greater regulation after the crisis has pushed activities outside the banking system and added to the potential risk of spillover into the broader system (as these firms are not regulated).

Rate Hikes

Fed Chicago President Evans said in a speech that he expects 3 rate hikes by the end of 2017.

Classes

Pew Research finds the level to be considered middle class (an income that is two-thirds to double the median household income) is as follows: 1 person ($24,173 to $72,520); 2 people ($34,186 to $102,559); 3 people ($41,869 to $125,608); 4 people ($48,347 to $145,040).

Yields

JPMorgan reports the total amount of negative yielding bonds worldwide has reached the lowest level since it began tracking the data (now at $10.7T).

Rising Risk

Research by Aite Group projects card-not-present fraud will rise from $3.2B in 2015 to $7.2B by 2020 - a 125% increase over 5Ys.