Interagency Minority Depository Institution Conference

Westin Hotel
Chicago, Illinois

July 16-18, 2008

Commercial Real Estate Breakout Session

Background

Recent History

- Dramatic Increase in Concentration Levels in Community and Midsize Banks
- Unprecedented Period of Strong Housing Demand and Appreciation in Values
- Intense Competition Among Banks

Regulatory Concerns

- Large CRE Concentrations Relative to Capital
- Risk Management Practices not Keeping Up with Exposure
- Easing of Underwriting Standards

Risk Management Issues

- Assignment of Risk Ratings
- Concentration Management
- Underwriting Processes
- Portfolio Management
- Collateral Valuation

Risk Rating Systems

- Importance of Reliable Risk Rating System
  - Provides Crucial Information for Portfolio Management
  - Prompt Problem Loan Identification
  - Maintenance of Appropriate ALLL
- Loan Officers Responsible for Rating Assignment
  - Internal Loan Review Tests the Process

Classification of Credits

- Rating based on expected performance
- Well-defined weakness may include slow sales activity
- Collateral protection not a substitute for ability to generate cash

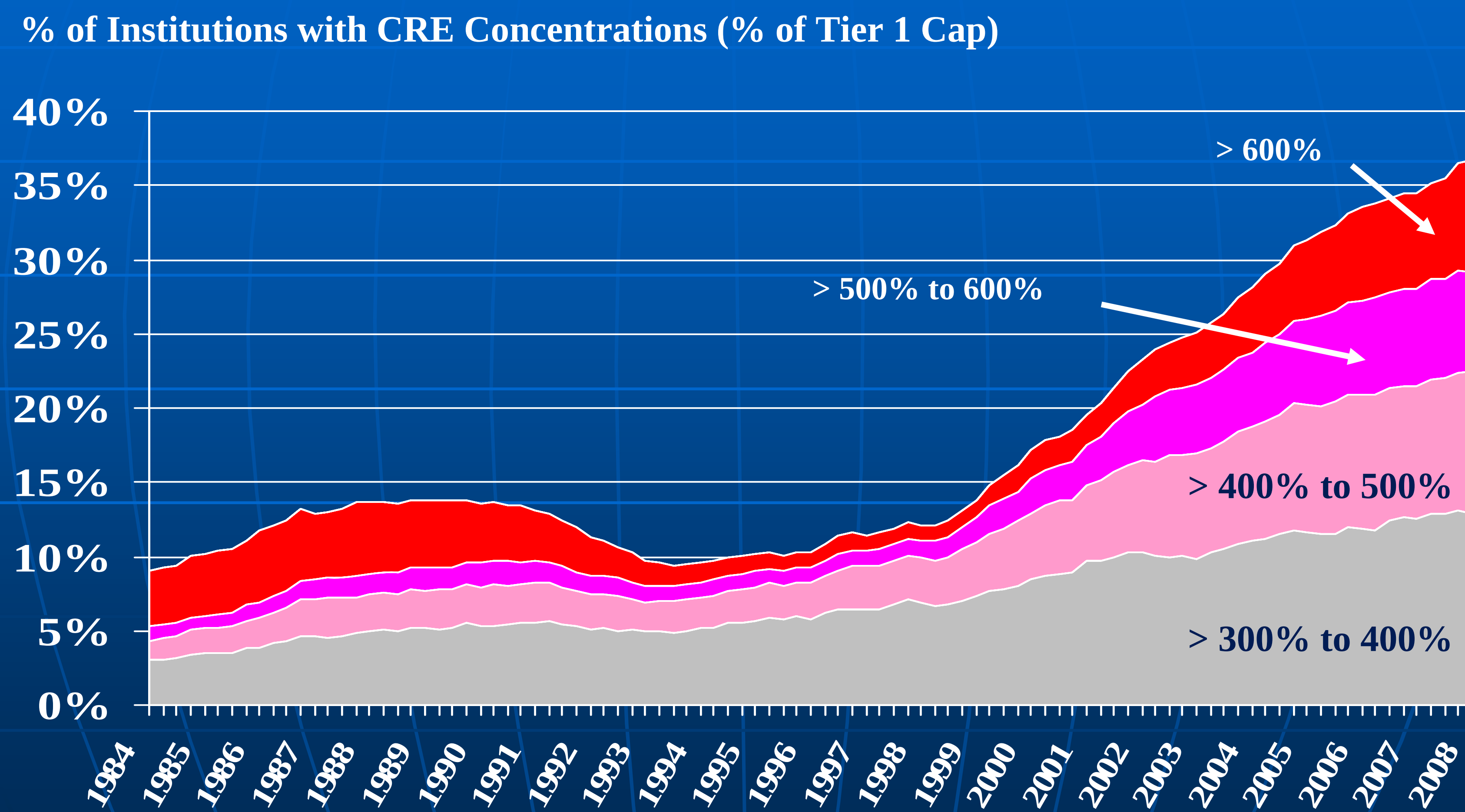
Accrual of Interest

- Based on Repayment Capacity not Collateral

- Expectation of Full Repayment of Principal and Interest in the Future

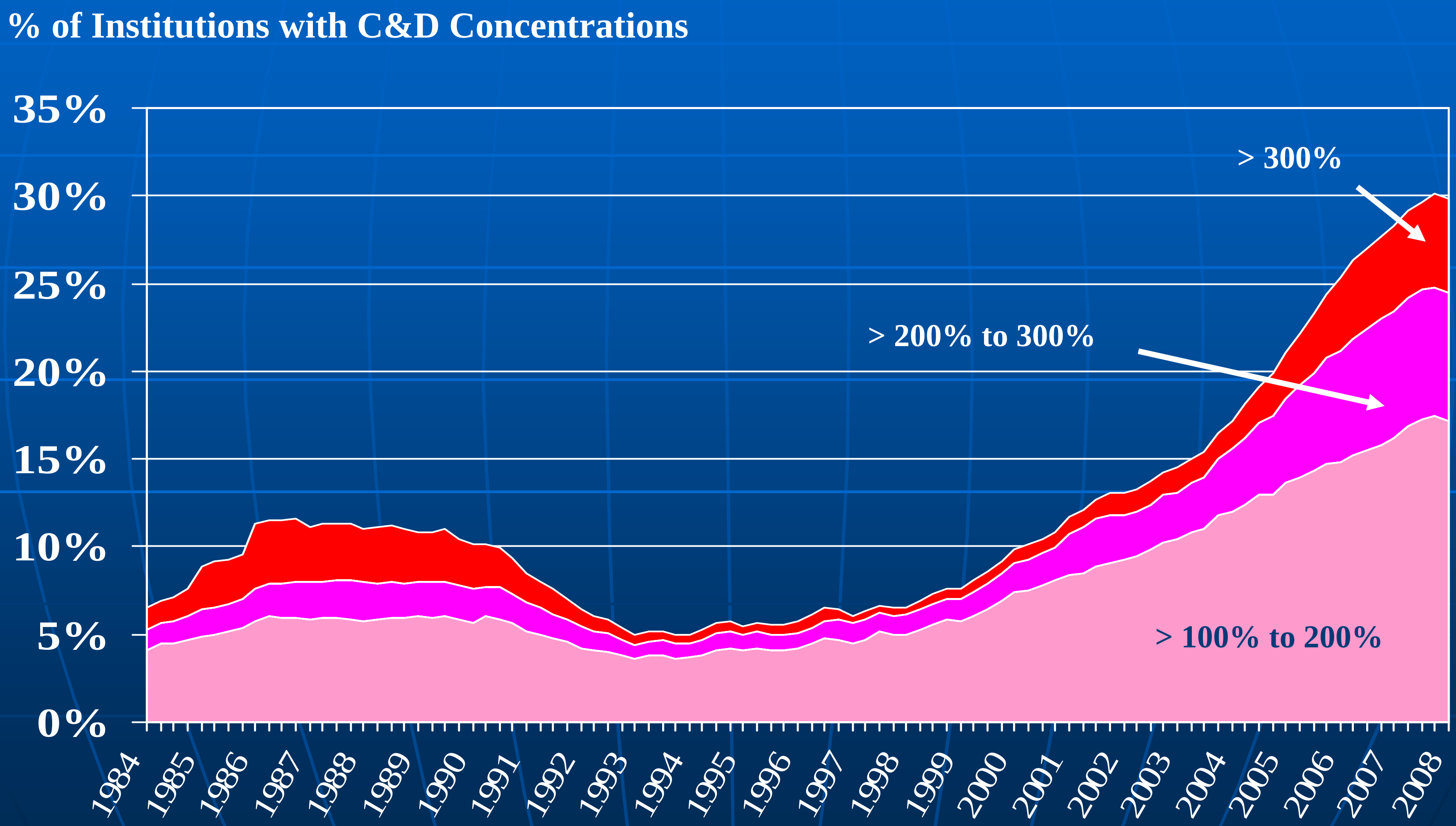
  - Nonaccrual Loan May be Current or have Remaining Interest Reserve

CRE Concentrations Continue to Rise Despite Deteriorating Market Conditions



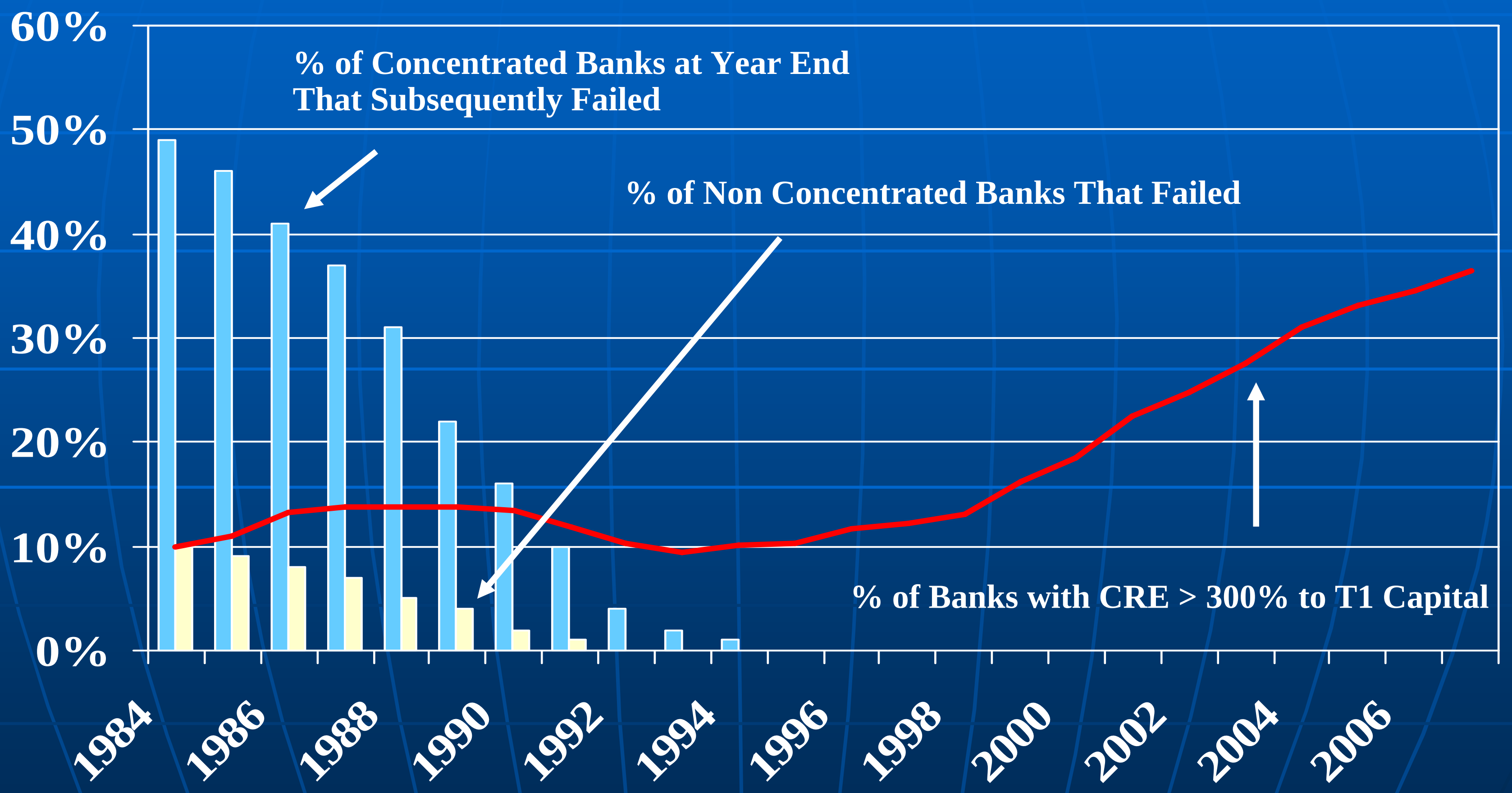
Source: Call and Thrift Financial Reports

Higher Risk C&D Concentrations Have Grown Rapidly As Well



Source: Call and Thrift Financial Reports

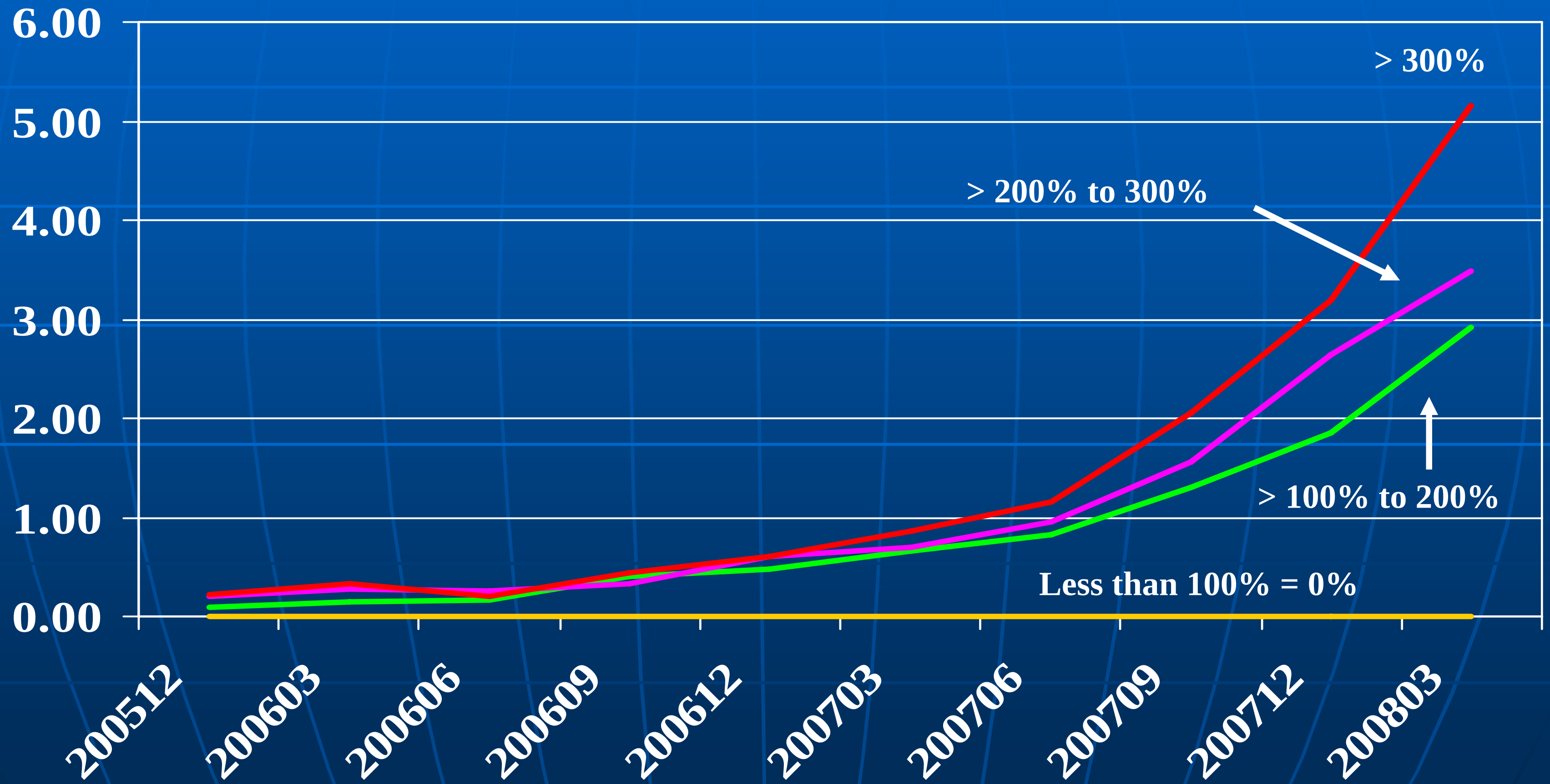
During the 80s RE Bust, Banks with CRE Concentrations Failed at Alarming Rates



Source: Call and Thrift Financial Reports (Year-end Data)

Banks Concentrated in C&D Lending are Evidencing Higher Levels of Deterioration

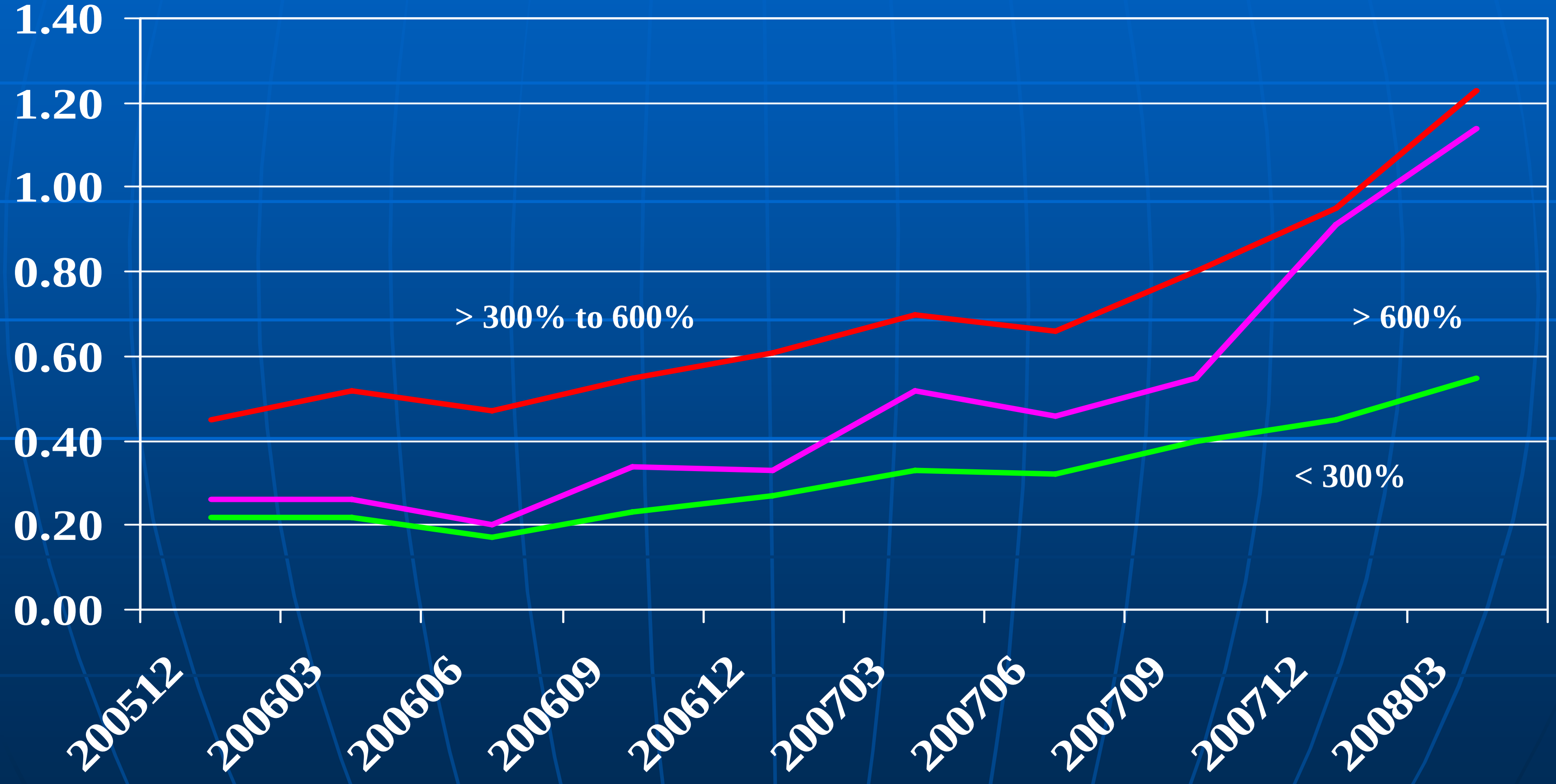
Median Past Due C&D Loans (%) by Concentration Level



Source: Call and Thrift Financial Reports

Non-C&D CRE Credit Quality Has Slipped but Remains Relatively Strong

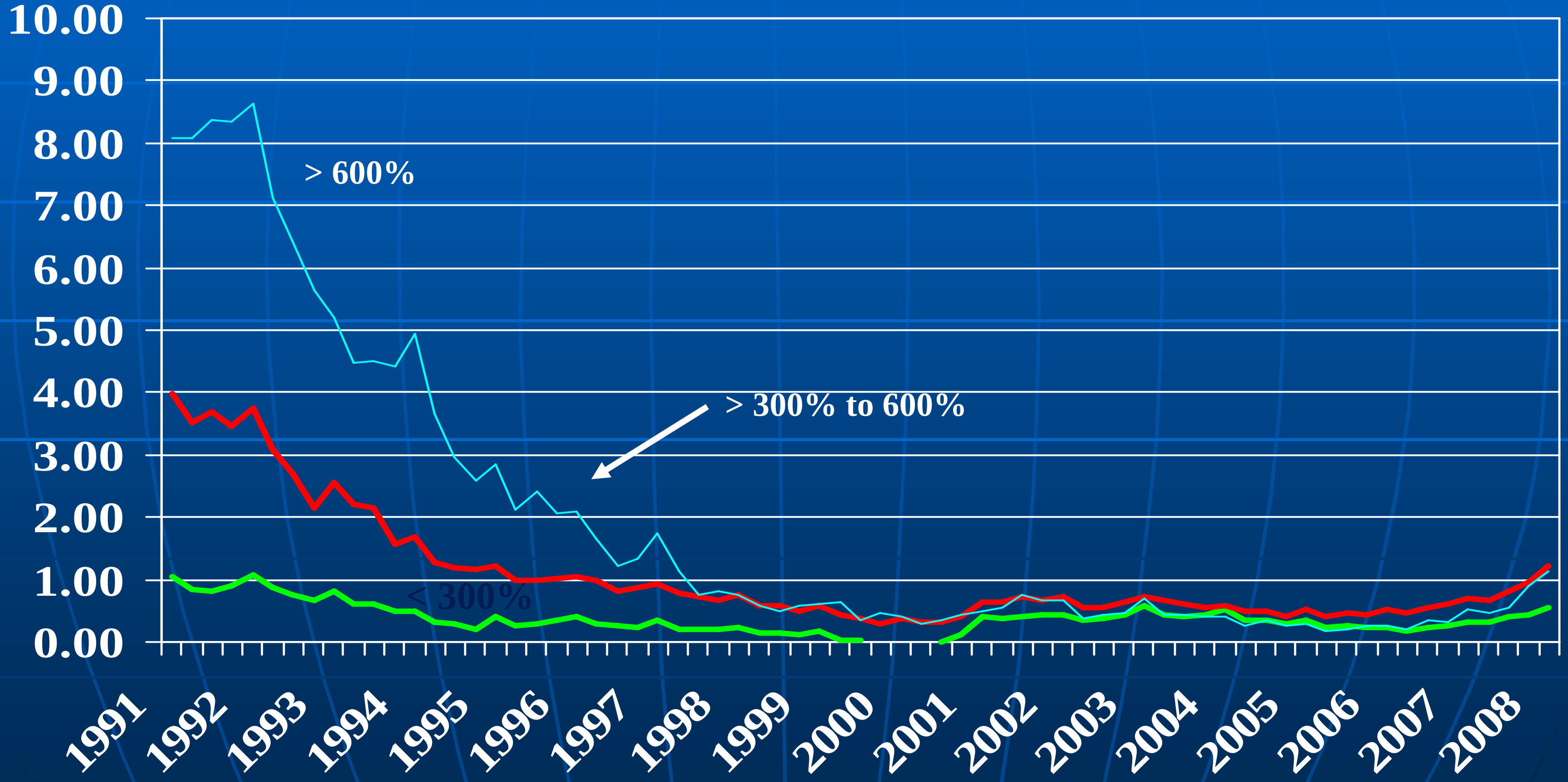
Median Past Due CRE (excluding C&D) Loans by Concentration Levels (%)



Source: Call and Thrift Financial Reports

Highly Concentrated Banks Had Greater Problems During the Last RE Downturn

Median PD CRE (ex C&D) Loans by Total CRE Concentration Levels (%)



Source: Call and Thrift Financial Reports

What Are Interest Reserves?

- Provide funds to service debt
- Generally result in the capitalization of accrued interest into the balance of the loan
- Most commonly used with ADC loans

Interest Reserves: Bank Policies

- Board should define appropriate use of interest reserves in Loan Policy
- An interest reserve policy should conform with Appendix A to Part 365, which requires standards "for the acceptability of and limits on the use of interest reserves"
- At a minimum, policies covering interest reserves should address:
  - Renewals
  - Extensions
  - Conditions of default
  - Type of loans suitable for interest reserves

Interest Reserves: Risks

- Masks or obscure the borrower's willingness and/or ability to repay the debt
- Loans with internally funded interest reserves do not automatically register early warning signs
- With little potential for monetary default while an interest reserve is in effect, some lenders have been slow or resistant to recognize and evaluate the financial risks that ADC projects pose
- In some cases, lenders eagerly extend, renew or restructure the term of certain ADC projects, providing additional interest reserves to keep the credit facility current

OCC’s 1985 Examining Circular

- OCC’s EC-229, Guidelines for Capitalization of Interest on Loans:
  - Was the need for an interest reserve anticipated in the original loan approval?
  - Is the loan well secured by collateral or by the guarantee of a financially responsible party?
  - Is full repayment of the loan based upon a reasonably ascertainable future event?
  - Can the borrower obtain funds from sources other than the existing lender at similar rates and terms?
  - Is there little or no doubt as to ultimate full collection of the loan, including interest?

OCC's 1985 Examining Circular

- If answers are predominantly affirmative, then use of interest reserves and interest capitalization may be appropriate

- Interest capitalization and income recognition should not be permitted for Call Report purposes on nonaccrual, value impaired, Doubtful, or Loss loans
  - Presumption against capitalization and income recognition on loans classified Substandard

Fundamental Loan Administration Practices

- Risk rating system
- Sound ALLL analysis
- Good credit files
- Sound appraisal practices
- Independent loan review

CRE Lending Policy

Minimally, policy should address:

- Maximum loan amount by type of property
- Loan terms
- Pricing
- Loan-to-value limits
- Collateral valuation
- Minimum initial investment/hard equity
- Minimum standards for borrower net worth, cash flow, and debt service coverage.

Board Expectations

- Establish limits on aggregate CRE exposure as well as sub-limits by loan type, property types and geographic markets
- Set CRE limits reflective of lending staff expertise, financial resources, and lending markets
- Ensure policies and controls in place, including lending limits, underwriting standards, collection efforts and policy exceptions.

Basic Concepts for Concentrations

- Concentration strategy should be approved and monitored by management and the board
- Contingency plan in the event something goes wrong
- Acceptable level of capital in consideration of the risk undertaken

Stress Testing and Sensitivity Analysis Guidance Expectations

The commercial real estate (CRE) guidance states:

- Institutions should perform portfolio-level stress tests to quantify the impact of changing economic conditions on asset quality, earnings, and capital
- Institutions should consider the sensitivity of portfolio segments with common risk characteristics
- The sophistication of stress testing should be consistent with the size, complexity, and risk characteristics of the CRE portfolio.

Stress Testing and Sensitivity Analysis
The Stress Test Process

Setting up a process:

- Begins with management buy-in
- Segment the portfolio by common factors
- Determine the variables to be stressed
- Determine the scenarios

Stress Testing and Sensitivity Analysis
The Stress Test Process

Common stress testing assumptions and questions:

- Collateral based scenarios
  - Property cap rates increase causing collateral value to decline and loan level LTV ratios to increase
    - If property values decline by 10% or 20%, what is the bank's increased exposure?
  - Vacancy rates increase causing NOI and DSC to decrease
    - How far must vacancy rates rise before a given loan falls below a 1.0x DSC ratio?

Stress Testing and Sensitivity Analysis
The Stress Test Process

Incorporate conclusions into strategic decision making

Strategic Planning

- Should earnings and growth forecasts be adjusted given the base scenarios and stress results?
- Should our risk tolerances be adjusted?

Capital Planning

- How will our capital adequacy be affected under various stress scenarios?
- Are contingency plans in place to ensure capital remains appropriate for the level & nature of risk?

Risk Management

- Which products and markets are most at risk in a stressed environment?
- To what extent will our asset quality be adversely affected?

Individual Lending Decisions

- Do we have the ability to strengthen or restructure individual credits that may be at risk?

When should a bank obtain a new appraisal for an existing credit?

- **Policy:** A bank's policies should address the situations when a new appraisal or an updated collateral valuation should be obtained for an existing credit, including:
  - ✓ Moving a loan to workout status
  - ✓ Declining market conditions
- **Loan Agreement:** for a higher risk credit or a long term commitment, a bank may wish to include an option for a new appraisal at the borrower's expense during the term of the loan.
- **Loan Refinancing**: A subsequent transaction (even with the advancement of new monies) may be exempted from the appraisal requirement, but a bank must obtain or perform an evaluation. If there has been obvious and material changes in market conditions or physical aspects of the property that threaten the adequacy of the bank's collateral protection, the transaction does not qualify for exemption and the bank must obtain an appraisal.