Commercial Real Estate

FDIC Community Bank Advisory Committee

Agenda

- Lessons Learned from the Crisis
- Current Trends in CRE Lending
- Guidance on Commercial Real Estate (CRE) Lending
- Summary
- Questions

Lessons Learned from the Crisis

- FDIC Inspector General's (IG's) October 2012 Acquisition, Development and Construction Loan Concentration Study found many banks with a concentration in real estate loans successfully managed the risk in their portfolio by:
  - Implementing more conservative growth strategies.
  - Relying on core deposits and limited net non-core funding dependence.
  - Implementing prudent risk management practices and limiting speculative lending, loan participations, and out-of-area lending.
  - Maintaining stable capital levels and had access to additional capital if needed.
  - Being responsive to supervisory recommendations, actions, and guidance.

Lessons Learned from the Crisis

- Many institutions that failed:
  - Experienced rapid loan growth.
  - Did not recognize the growing risk exposure from their concentration in real estate loans.
  - Did not develop risk assessments that sufficiently considered economic conditions and likely performance under stress conditions.
  - Did not develop contingency planning that sufficiently reduced or mitigated concentration risk in the downturn.

Lessons Learned from the Crisis

- The IG's January 2013 *Study on the Impact of Failure of Insured Depository Institutions* found that high ADC or CRE concentrations or rapid asset growth contributed to failure in 95% and 69%, respectively of the Material Loss Reviews.

Table 6: Most Common Contributing Causes of Material Loss Failures

	FDIC	OCC	FRB
High ADC or CRE Concentrations	95%	86%	100%
Rapid Asset Growth	69%	82%	82%
Relying on Volatile Funding Sources to Support Growth	55%	27%	14%
Inadequate Loan Underwriting	70%	50%	23%
Inadequate Credit Administration Practices	71%	55%	27%
Inadequate Credit Risk Management	76%	77%	73%

Source: OIG analysis of 131 MLR reports for 142 institutions that failed from January 2007 through September 2011.

Lessons Learned from the Crisis

- Aggressive Growth Contributed to Failures
  - Banks with a 3-year average yearly **growth rate over 20%** entering 2008:
    - 37% remained satisfactorily rated as of year-end 2011.
    - 16% failed by year-end 2011.
  - Banks with a 3-year average yearly **growth rate between 0% and 10%** entering 2008:
    - 69% remained satisfactorily rated as of year-end 2011.
    - 2% failed by year-end 2011.

Source: FDIC Call Reports.

Lessons Learned from the Crisis

Likelihood of Failure for Community Bank CRE Specialists Compared to the Average Community Bank

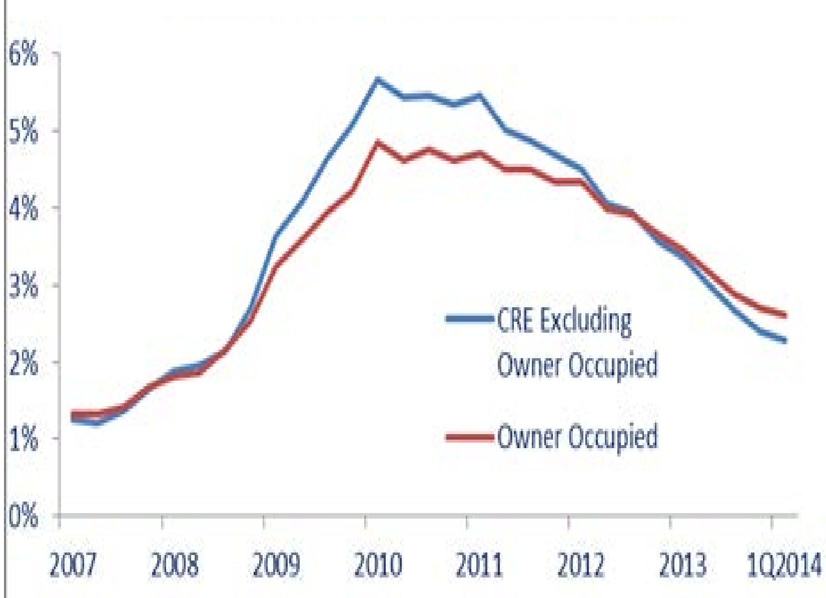
Likelihood for All Community Banks = 1.0

	2006-10	2011
1. All CRE Specialists	2.3	3.4
C&D < 10%	1.0	1.7
C&D > 10%	3.0	**8.5**

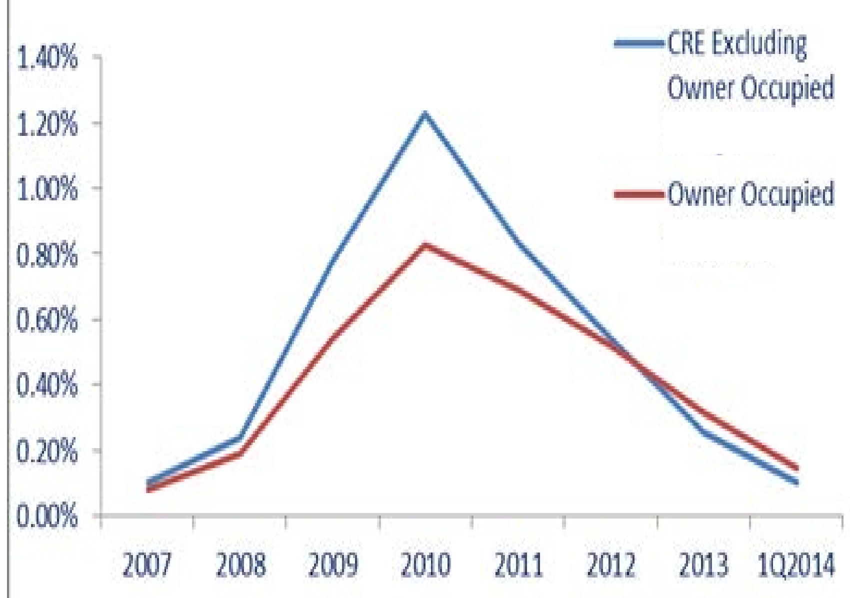
Source: FDIC Community Banking Study (2012).

Lessons Learned from the Crisis

Past Due and Non-Accrual (PDNA) Rates



Charge Off Rates



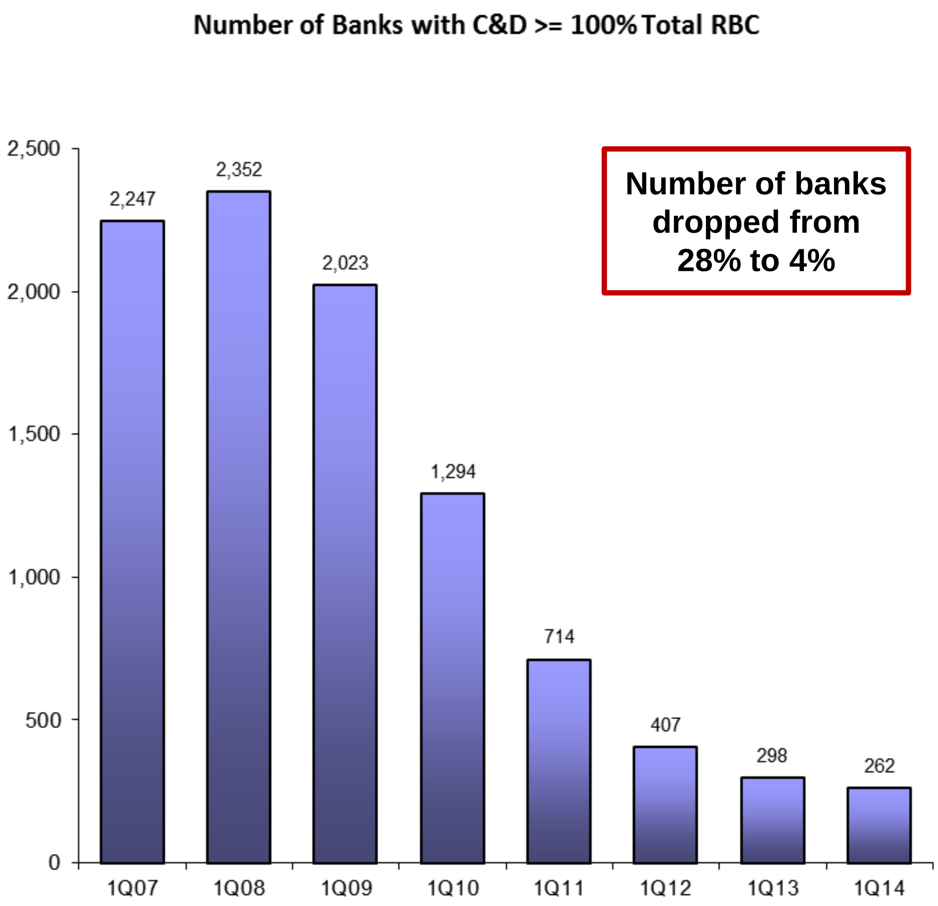
Source: FDIC; aggregate ratios annualized as of 1Q 2014.

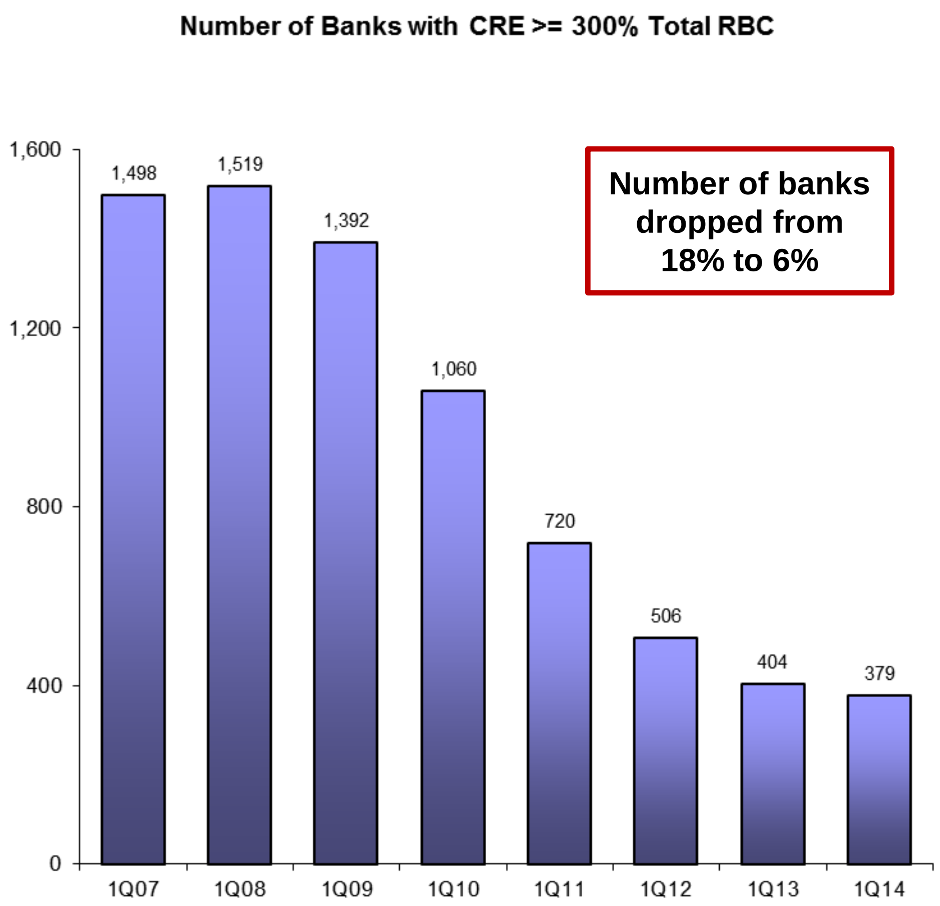
Lessons Learned from the Crisis

Comparing Past Due and Charge-off Rates on Owner Occupied and "Other" Loans Secured by Nonfarm Nonresidential Real Estate

- Data available since 2007 show past due and charge-off rates rose markedly for both loan types after the crisis, and have since receded.
- Past due and non-accrual rates have been consistently higher for loans secured by owner occupied CRE.
- Charge-off rates have tended to be higher for CRE loans secured by non-owner occupied properties, particularly in 2009 and 2010.

Lessons Learned from the Crisis

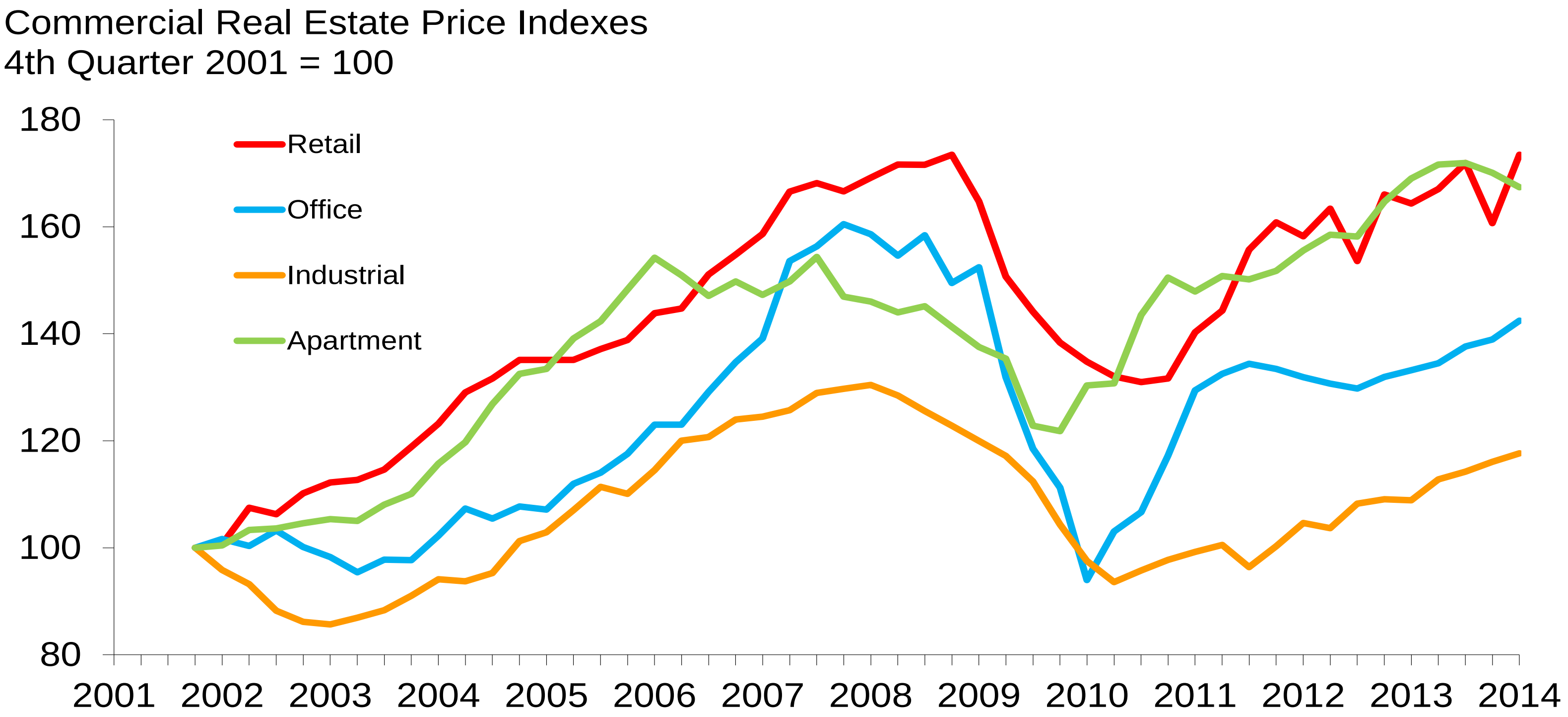




NOTE: Failed institutions included. CRE is defined as sum of C&D, Multi-Family, Non Owner-Occupied Nonfarm Nonresidential and CRE included in C&I. Owner-Occupied Nonfarm Nonresidential loans are excluded.

Current Trends in CRE Lending

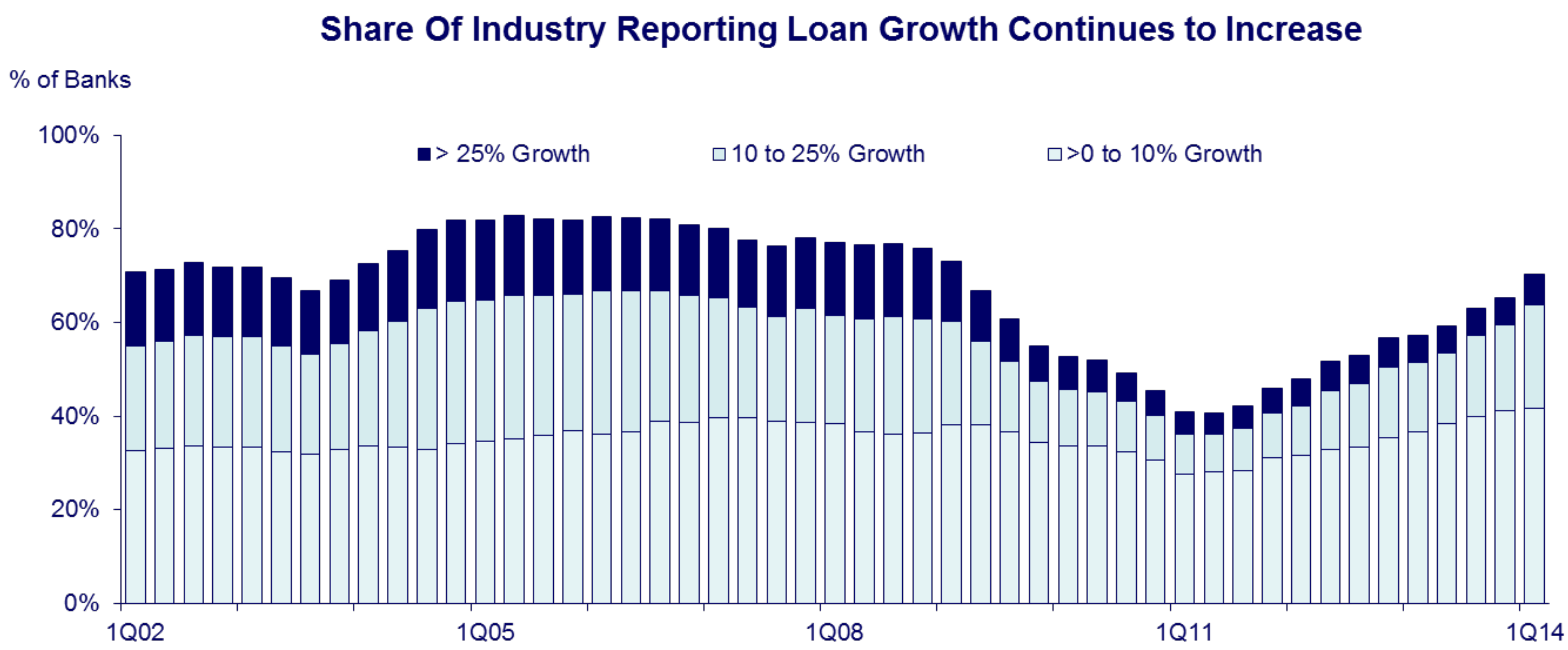
National Trends in CRE Prices



Source: Real Capital Analytics (data through first quarter 2014).
Note: Prices indexed to 4-quarter moving-average prices for each property type. Based on average prices for U.S. major markets.

Current Trends in CRE Lending

- As of 1Q2014, 70% of all banks reported positive YOY loan growth, highest since 1Q2009.



Source: FDIC.

Guidance on CRE Lending

- Agencies issued 2006 Joint Guidance on CRE Lending guidance due to:
  - Rising CRE concentrations could create S&S concerns in the event of a significant economic downturn.
  - Relaxing of underwriting standards due to competition.
  - Increasing number of banks lacked appropriate policies and procedures to manage risk in CRE concentrations.
  - Lack of adequate risk management framework for CRE.
- Excluded owner occupied CRE:
  - Secondary repayment source or abundance of caution.
  - Lower risk profile evidenced by lower charge-off rates.

Guidance on CRE Lending

- 2006 Joint Guidance on CRE Lending - thresholds are "preliminary step" to identify banks that ***may*** have concentration risk.
- **Thresholds:**
  - Loans for C&D loans equal 100% or more of total capital.
  - CRE loans (excluding loans secured by owner occupied properties) equal 300% or more of total capital **AND** the CRE portfolio grew 50% or more during prior 36 months.
  - Not viewed as a "safe harbor" ***if other risk indicators are present*** regardless of the ratios' measurement.

Guidance on CRE Lending

- Appendix A to Part 364 - Interagency Guidelines Establishing Standards for Safety and Soundness
  - Consider the size and potential risks of material asset concentrations.
  - Asset Growth – should be prudent and consider:
    - Source, volatility and use of the funds that support asset growth;
    - Any increase in credit risk as a result of growth; and
    - The effect of growth on the institution's capital.
- Part 365 – Institution’s policies and strategic plan should consider the need to avoid undue concentrations of risk.

Summary

- FDIC has not established a new concentration threshold for owner occupied CRE loans.
- Institutions need strong corporate governance to:
  - Manage concentration risk for all types of loans.
  - Maintain effective concentration risk management programs that:
    - Identify and monitor all concentrations.
    - Consider the trends in CRE portfolios.
- Institutions should remain diligent to prudently underwrite CRE and C&D loans.

References

- **FIL-104-2006, "Concentrations in CRE Lending,"** **http://www.fdic.gov/regulations/laws/federal/2006/06notice1212.html**
- **FIL-22-2008, "Managing Commercial Real Estate Concentrations in a Challenging Environment,"** **http://www.fdic.gov/news/news/financial/2008/fil08022.html#body**
- **Appendix A to Part 364, http://www.fdic.gov/regulations/laws/rules/2000-8630.html#fdic2000appendixatopart364**
- **Part 365 Subpart A Real Estate Lending Standards, http://www.fdic.gov/regulations/laws/rules/2000-8700.html#fdic2000part365.1**
- **Supervisory Insights, Managing Commercial Real Estate Concentrations, http://www.fdic.gov/regulations/examinations/supervisory/insights/siwin07/winter07.pdf**
- **Risk Weight for High Volatility ADC loans increases to 150% in 2015** **http://www.fdic.gov/regulations/resources/director/RegCapIntFinalRule.pdf**

Questions?