Commercial Real Estate Concentrations

San Francisco Bankers' Forum March 10, 2014

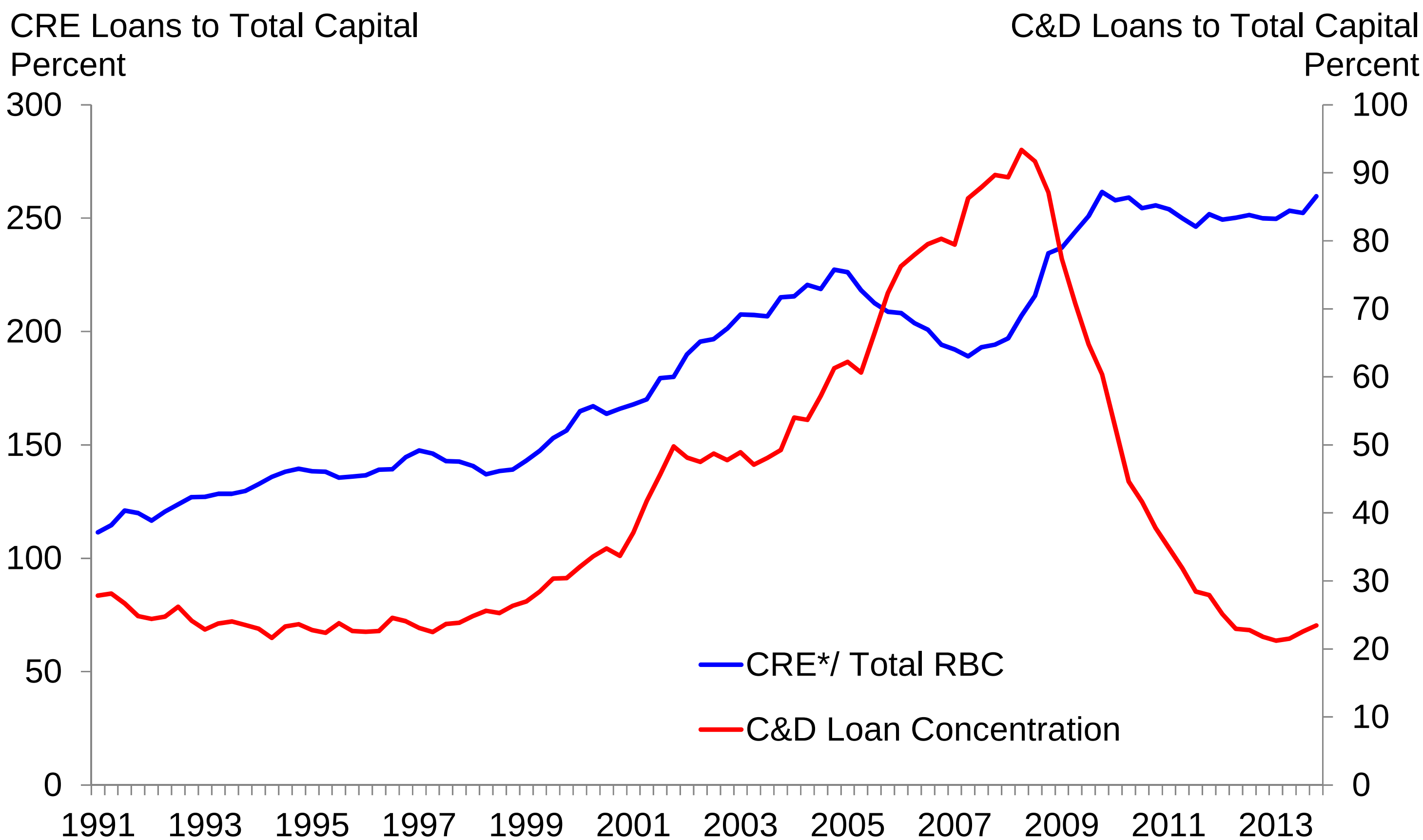
Teleconference Objective

After participating on today's call you will:

- Become more familiar with a key risk facing many banks in the Region
- Learn about credit survey trends
- Takeaway lessons learned from the last crisis
- Understand regulatory expectations for mitigating concentration risk

CRE Déjà vu SF Region

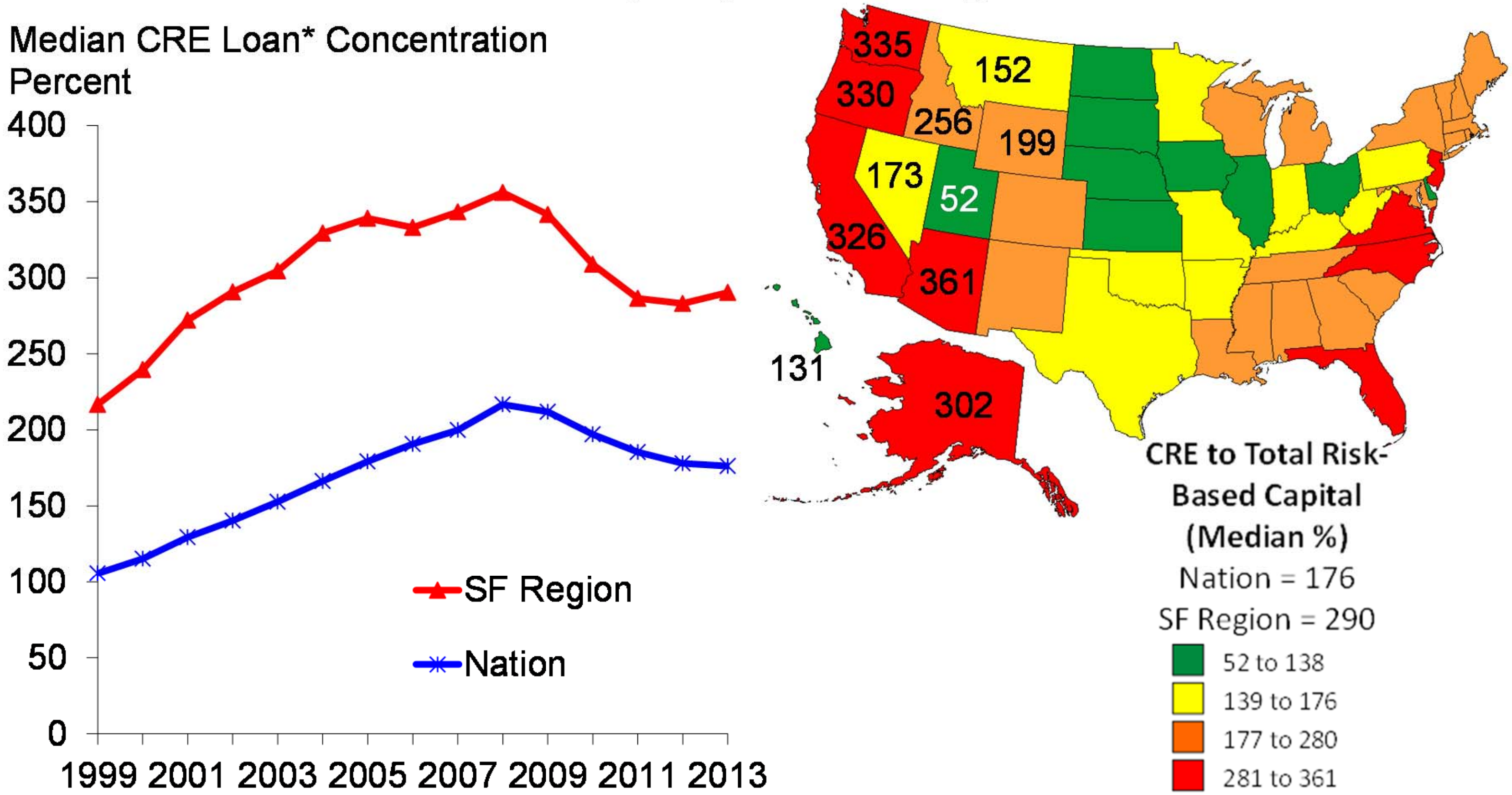
Median Commercial Real Estate (CRE) and Construction & Development (C&D) Loan Concentrations



Source: FDIC Bank & Thrift Call Reports. Quarterly data as of December 31, 2013.
*CRE excludes Construction & Development Loans.

CRE Déjà vu

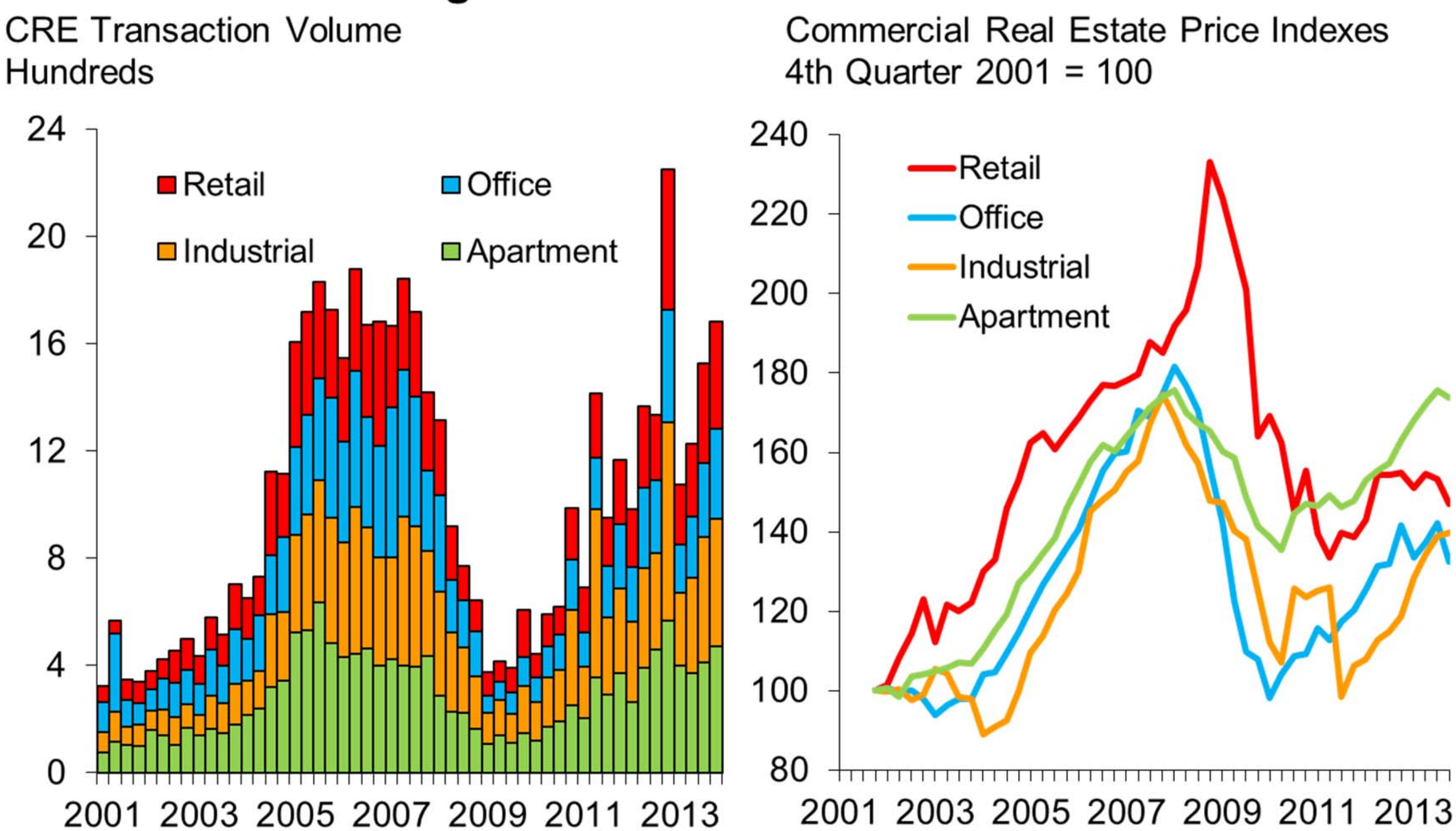
CRE Loan Concentrations Remain High in the West and Above the Nation in the Majority of the Region's States



Source: Bank and Thrift Call Reports (data as of December 31, 2013 for December of each year).
Note: *Includes nonfarm-nonresidential and multifamily mortgages plus construction loans and commercial real estate-purpose loans not secured by real estate.

CRE Trends

San Francisco Region Commercial Real Estate Sales Slow from a Year Ago As Prices Continue to Increase



Source: Real Capital Analytics (data through fourth quarter 2013).
Note: Prices indexed to 4-quarter moving-average prices for each property type.

Credit Survey Trends

FDIC Credit and Consumer Products/Services Survey Responses in 2013 versus 2012 show:

- **Lower level of banks need improvement** in CRE management (20% compared to 25%), although more “2” rated banks have issues than before
- Stabilizing CRE markets, stabilizing and strengthening property values, and unsold supply that more reasonably meets demand

Credit Survey Trends

- January 2014 Federal Reserve "Senior Loan Officer Survey"
  - On net, domestic institutions ***eased standards*** for most types of CRE loans and experienced stronger demand

- January 2014 Office of the Comptroller of the Currency "Survey of Credit Underwriting Practices 2013"
  - Increasing percentage of banks ***eased standards*** for commercial construction and non-construction CRE due to:
    - Competition
    - Risk Appetite
    - Change in Strategy
    - Product Performance
    - Increased Liquidity

Lessons Learned from the Crisis

- Many institutions **failed to recognize the growing risk** in their portfolios
- Risk assessments did not sufficiently consider conditions and likely performance under **stress conditions**
- **Contingency planning was insufficient** to reduce or mitigate concentration risk in the downturn
- Lesson learned: Management should assess **both financial and managerial impacts of downturns**

FDIC Issuances related to CRE Concentrations

- Appendix A to Part 364 of the FDIC Rules and Regulations *Interagency Guidelines Establishing Standards for Safety and Soundness*
- Appendix A to Subpart A of Part 365 of the FDIC Rules and Regulations *Interagency Guidelines for Real Estate Lending Policies*
- FDIC Financial Institution Letter 104-2006 *Joint Guidance on Commercial Real Estate*
- FDIC Financial Institution Letter 22-2008 *Managing Commercial Real Estate Concentrations in a Challenging Environment*
- Winter 2007 <u>Supervisory Insights Journal</u> *Managing Commercial Real Estate Concentrations*
- Summer 2012 <u>Supervisory Insights Journal</u> *Stress Testing Credit Risk at Community Banks*

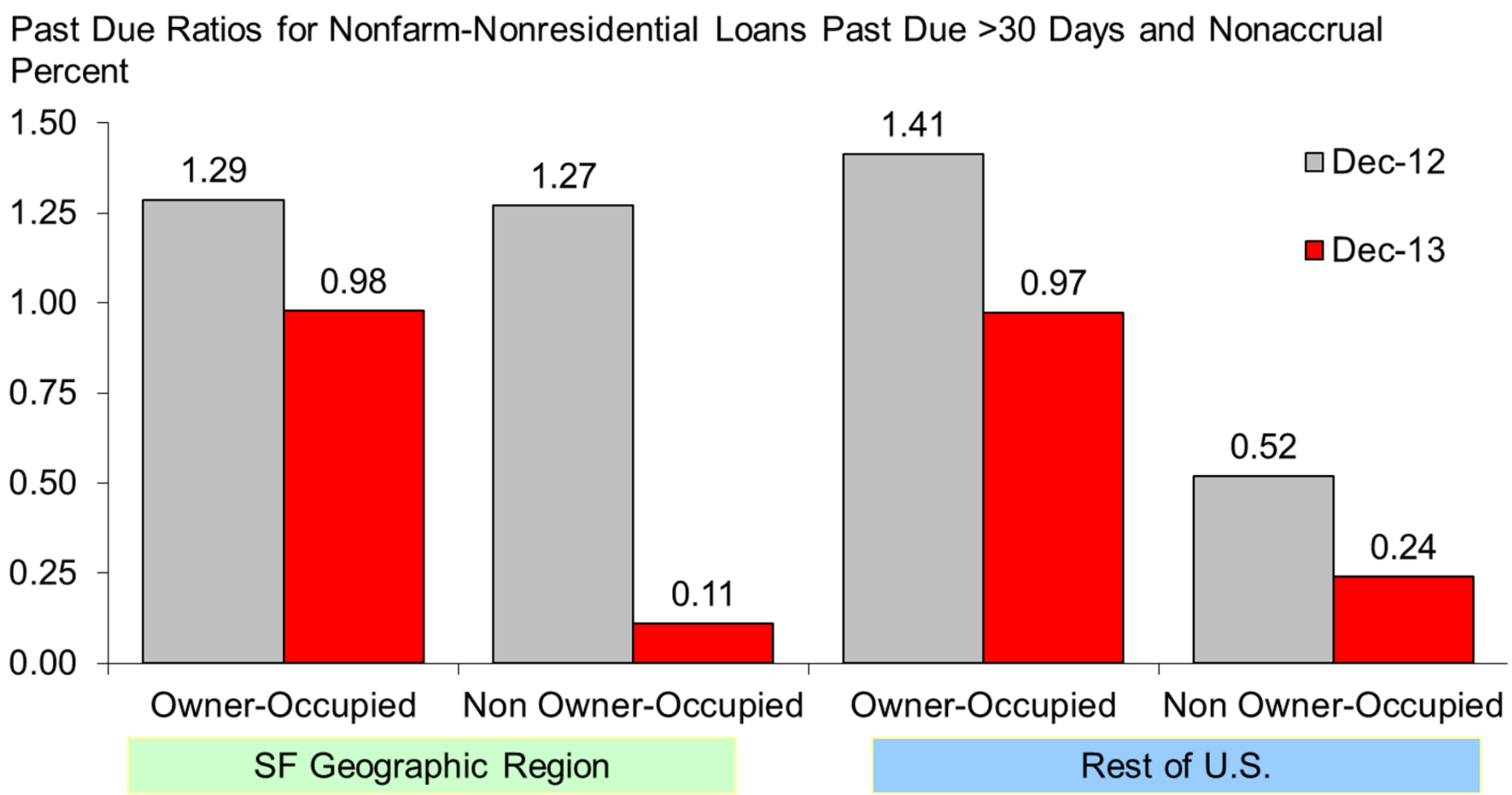
Fundamental Principle

It is management's responsibility to identify, measure, monitor, and control concentration risk

- Numerical indicators are solely for examination staff as a **"preliminary step"** in identifying institutions that *may* have concentration risk
- ***There are no limits, safe harbors, or benchmarks***

Owner-Occupied Performance Metrics

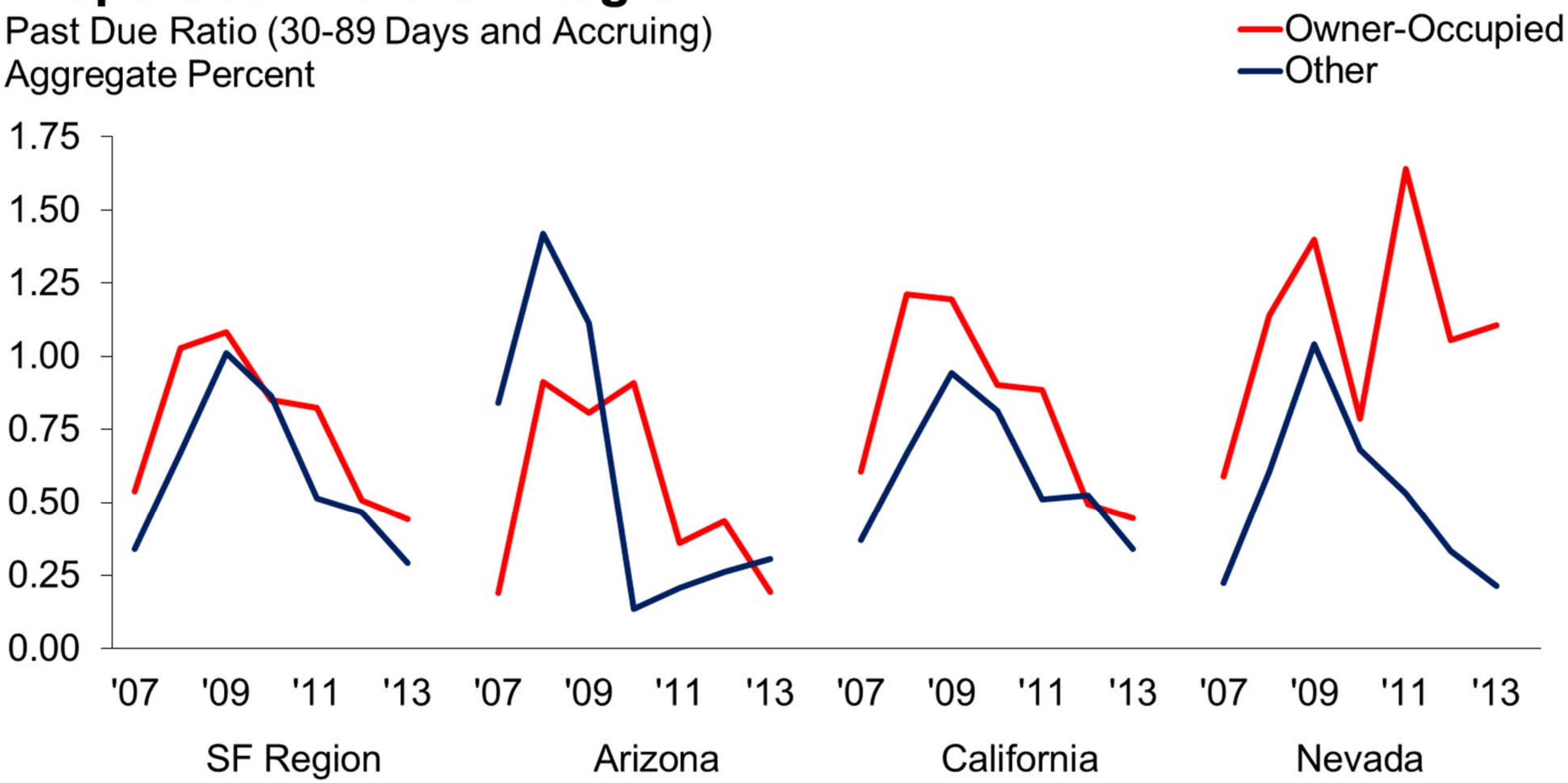
Delinquency Rates for Owner-Occupied and Non Owner-Occupied CRE Property Loans in the Region Declined.



Source: Bank and Thrift Call Reports (data as of December 30, 2013 for December of each year shown).
Note: Excludes institutions open <= 3 years and industrial loan companies.

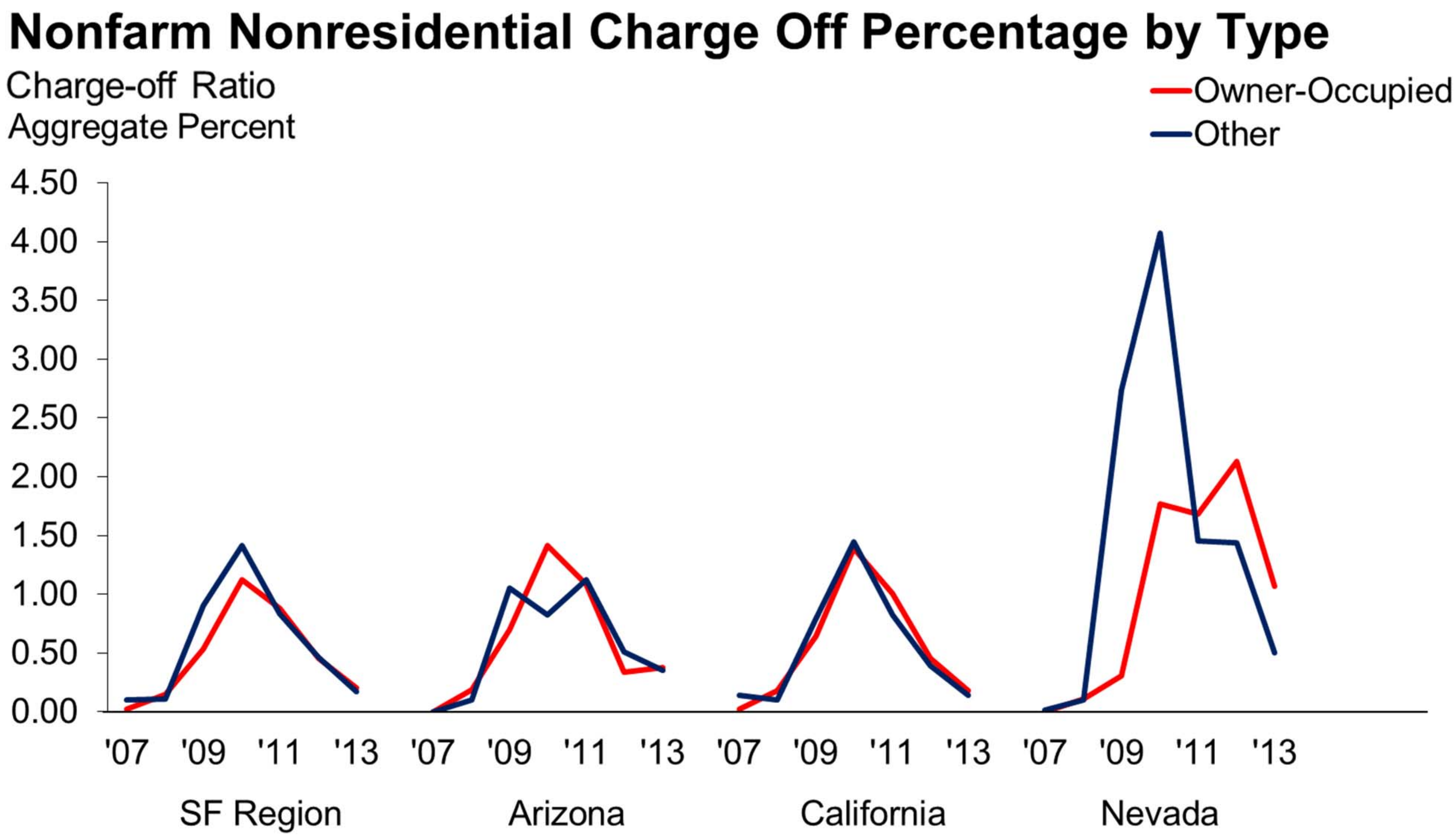
Owner-Occupied Performance Metrics

Past-Due Ratios Have Been Higher for Owner-Occupied Properties in the SF Region



Source: FDIC (data as of December 31, 2013).

Owner-Occupied Charge Offs



Source: FDIC (data as of December 31, 2013).

CRE Policy Expectations

- Regulatory guidance on all CRE lending, including the owner-occupied segment, can be found in Part 364 and Part 365 of the FDIC Rules and Regulations

- According to Appendix A of Subpart A of Part 365, **real estate policies should include**:
  - Geographic areas in which the bank will lend
  - Diversification standards and limits by type and geographic market
  - Prudent underwriting standards and exception monitoring
  - Regular portfolio monitoring and timely reports to the Board
  - Consider the need to avoid undue concentrations of risk
  - Regular monitoring of market conditions

- These requirements are **consistent with prudent risk management practices** and FDIC Financial Institution Letter 104-2006 *Joint Guidance on Commercial Real Estate*

Risk Assessment

An internal risk assessment is the starting point

Banks actively involved in CRE lending should conduct **ongoing concentration risk assessments** that:

- **Stratify** the portfolio into common risk characteristics or sensitivities
- Are **reasonable and supportable**
- Are used to **identify and monitor** risk, and **guide** strategic decisions and capital planning
- Are used to determine the **level of sophistication** needed for the risk management framework

CRE Risk Management Framework

An **effective CRE risk management framework** consists of seven elements:

- Board and management oversight
- Portfolio management
- Management information systems
- Market analysis
- Credit underwriting standards
- Portfolio stress testing and sensitivity analysis
- Credit risk review function

Risk Management Framework: Board Responsibilities

The board has the ultimate **responsibility** for the level of risk taken and should:

- Establish an overall CRE lending **strategy** consistent with
  - Capital and contingency plans
  - Financial condition and growth objectives
  - Stress test results
  - Sufficiency of staffing
- Establish **policies** and ensure appropriate **controls**
- Regularly review information **that identifies and quantifies** risk, including market conditions
- Regularly review and approve CRE risk limits in response to **changes in strategy or market conditions**

Risk Management Framework: Portfolio Management

Cyclical changes in market conditions can result in undue risk if not properly managed

- **Regularly evaluate the degree of correlation** between related real estate sectors
- Use correlation analysis to **inform and advise lending standards and concentration limits**
- **Develop appropriate strategies** to manage concentration levels, including **contingency plans**

Risk Management Framework: MIS

Management information systems should provide **sufficient information** to identify, measure, monitor, and control risk

- Adequacy of MIS should be **reassessed periodically** to address changes in the size, risk, and complexity of the portfolio
- Reporting should be **timely** and clearly **indicate changes in risk profile**, including risk rating migrations
- Control processes should **test the accuracy and reasonableness** of the CRE tracking systems

Risk Management Framework: Stratification Considerations

Stratification should be **sufficiently meaningful** to allow the institution to **monitor and react** to changes in aggregate risk profile

- Internal risk grade
- Property type
- Location
- Purpose (spec. or non-spec)
- DSCR and LTVs
- Loan structure (fixed, adjustable, term)
- Policy exceptions

Risk Management Framework: Market Analysis

Management should be **monitoring economic and competitive factors**

- **Regularly review market analyses** by property types and geographic markets
- **Monitor competition** to determine likely effects on the risk profiles of CRE portfolios
- Use analyses to ensure that stress tests consider **reasonably plausible stress scenarios**
- **Modify strategies** and policies in light of changes in CRE conditions

Risk Management Framework: Credit Underwriting Standards

Sound underwriting standards become more critical as CRE concentration risk grows

Lending policies and practices should:

- Consider both **internal and external** factors
- **Reflect the level of risk** that is acceptable to the board
- Address **minimum standards** of Part 365
- Provide **clear and measurable standards**
- **Limit, track, and analyze trends** in policy exceptions
- Be **regularly reviewed and revised** to respond to changes in conditions or strategy

Risk Management Framework: Stress Testing

CRE concentrated banks should determine the **impact of changing economic conditions** on the portfolio

- Perform portfolio-level stress tests or sensitivity analysis to **assess impact on asset quality, earnings, and capital**
- Consider the **sensitivity of portfolio segments** with common risk characteristics to potential market conditions
- Focus on the **more susceptible segments** of the CRE portfolio
- Ensure stress testing program is consistent with **size, complexity, and risk characteristics** of bank's exposures
  - Simple approaches can yield important information, as outlined in Summer 2012 Supervisory Insights Journal

Risk Management Framework: Credit Risk Review

*A strong credit risk review function is critical to management's ability to **identify emerging risks***

- Risk ratings should be sensitive, objective, and appropriate for the types of loans underwritten
- Periodic and timely reviews of ratings are necessary

Examination Procedures

Examiners will routinely assess the following:

- Adequacy of the internal risk assessment
- Level, trend, and growth in CRE (portfolio wide and within segments)
- Sufficiency of the risk management framework given the level, risk, and trends in CRE concentrations
- Consistency of growth and strategic objectives with capital and contingency plans
- Extent of board and senior management oversight in establishing risk appetite and risk mitigants
- Impact of economic and competitive environment
- Sufficiency of financial and managerial resources for current and stressed conditions

Next Bankers' Forum

- **Division of Depositor and Consumer Protection Bankers' Forum**
  - May 29, 2014: 1pm Pacific
  - Unfair or Deceptive Acts or Practices (UDAP)

Questions