ABA BANK DIRECTORS BRIEFING

MARCH 2008 WWW.BDBONLINE.BIZ

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THE DIRECTOR'S JOB

WHAT TO SAY WHEN FOLKS ASK YOU WHAT TO MAKE OF TROUBLING HEADLINES ABOUT THE BANK BUSINESS

One of the duties of a bank director or savings institution trustee is "good will ambassador." While some institutions emphasize director sales, as our recent series discussed, all board members are walking-talking representatives for the bank's image. And so, in days of grim headlines, you may be buttonholed not only about your own bank, but about the industry.

ABA recently published "talking points," abbreviated here, that you may find helpful.

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Banks are highly capitalized and prepared for economic fluctuations.

- Bank capital—buffer against losses—is at historic highs. At yearend 2007 the industry held $1.35 trillion in capital plus $102 billion in reserves, for a total buffer of $1.45 trillion.

Bank risk management methodology has improved dramatically.

- Banks have increasingly put enterprise-wide risk management processes in place; implemented strong checks and balances; and increased use of sophisticated risk-management tools.
- Advances in collecting data and benchmarking perf o rmance, identifying key risk indicators, and controlling operational risks have all contributed to sound banking.

Regulation and supervision of bank risk have also improved.

- Federal laws adopted since 1991 have significantly strengthened bank regulation.
- Auditing and internal control standards are tougher today.
- Regulators have beefed-up examination practices and use a "supervision-by-risk" approach to get bankers and examiners to focus on the quality of banks' risk management.

Banks have resources to lend.

- Banks have $8.4 trillion in deposits.
- Many have turned to local banks to refinance existing mortgages or consolidate debt.

DEAR DIRECTOR:

What Examiners Are Seeing In Commercial Real Estate Lending, And How Banks Can Respond

Ever see one of those big snakes at the zoo after feeding time? Such serpents can swallow a rat for dinner, whole, and you can see the rat in their body until the digestive process kicks in.

Why the zoology lesson? The rat analogy was used by two federal regulators speaking to bankers recently about the current state of commercial real estate and construction lending, with an emphasis on construction and development lending in residential real estate. In many sectors, it's the issue of the hour.

Examiners' eyes on problems

Some of the savings institutions that Thomas Constantine, Office of Thrift Supervision, has seen in his work were "all about production" during the industry's boom in commercial real estate. Constantine, an examiner in the agency's Santa Ana, Calif., office, says some *gung ho* lenders had no systems to warn them when it was time to throttle back.

"The production guys have been having their turn for years, and now it is the turn of the credit guys"

"So now," he told lenders at the recent ABA Real Estate Lending Conference, "they've got that rat passing through." Until that glut of credit has become more digested, they will have their work cut out for them, managing the risks they've taken on, and doing so to the satisfaction of regulators.

"The production guys have been having their way for years," said Constantine, "and now it is the turn of the credit guys."

Constantine's fellow panelist, Doreen R. Eberley, regional director of FDIC's New York Region, built on his rat analogy.

She had portrayed the last few years as a period where many lenders either built market share or struggled to maintain it, especially in the residential construction and development slice of the commercial real estate lending business.

Eberley spoke of the "good, the bad, and the ugly" among commercial real estate lenders.

The "good" maintained and lived by strong underwriting criteria, established portfolio limits, and kept up strict monitoring of exceptions to them. Furthermore, she said, their tracking and monitoring efforts were distilled for regular board review.

However, the "bad" failed to capture the data needed to produce meaningful staff and board reports, and thus had no way to track exceptions to policy nor to accurately monitor market shifts. Such institutions blindly went out buying more rats, she said, when they already had a big fat one stuck in their middles.

And what of the ugly? Some "ugly" lenders dipped down into second-tier borrowers' territory, to add more volume to their efforts among the best risks. Such lenders, she suggested, had doubts about the viability of these borrowers, but were counting on the "takeout"—the long-term lender or the sale of completed projects—to give them their profit and a way out before

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"A bank can't underwrite well enough to protect itself from an 80% drop in home prices"

things went bad.

Indeed, Eberley showed a chart indicating that institutions with higher concentrations in construction and development lending have been exhibiting much higher past-due rates among those loans.

But as developers stopped work on projects for which demand fell through, the lenders got stuck. Often, developers had no resources to stick things out or saw the writing on the wall and stopped work. And some of the "ugly" got caught up in lending to projects that had hidden ties to a single lender, making their portfolio concentrations much higher than their investigations had indicated. Add in the uglies' tendency to not obtain current appraisals, as market values fell, and their rats are beginning to give them indigestion.

Steps banks can take

Commercial real estate and related credit has become part of the concern over the state of banking today, as recounted in the box on page three. So, this is both a financial challenge and an image challenge for banks. What can be done about such challenges on the financial side? Both the regulatory speakers, and members of a separate panel, at the ABA conference made suggestions that your management and board may find helpful.

Some the suggestions fall into the category of actions to take as soon as possible, if the company hasn't already taken them, to address problems already on the books—that "undigested rat" referred to earlier. Other suggestions deal with avoiding fresh trouble, while finding some opportunities amid the turmoil. And other suggestions address structural issues that bank managers and their boards can consider in order to improve all aspects of managing real estate lending risk.

"Digestive Aids": Steps to take now

There are many steps a bank can take. However, gravity can't be denied. Speaker W. Henry Claussen said no matter how well a bank underwrites credit, it can't underwrite well enough to protect itself from an 80% drop in home prices.

"I defy you to tell me that you do that," said Claussen. "It doesn't happen."

Claussen is vice-president at $1.9 billion-assets Bank of Stockton, Calif., one of the largest residential construction lenders in its county. The bank's primary market is one of the hardest-hit by the subprime lending crisis, and many value measures have gone off normal scales.

A key emphasis for all stages of the cleanup is the importance of meaningful management reports. FDIC's Doreen Eberley pointed out that the whole idea of having operational data is to enable the board, in the course of its oversight, and officers, in the course of managing the institution, to make adjustments.

Management reports are where many levels of behavior, loan by loan and lender by lender, come together into a—hopefully—coherent picture. One of the common observations among examiners, according to Eberley, is noncompliance. "The pattern we are seeing is that policies and required practices are not being followed," she said.

An area of special concern is the collateral-dependent loan. These are loans where the only reliable source for the lender's repayment is the value of the underlying collateral itself. It is important for a lender to identify such loans. If a borrower or sponsor of a deal is willing—and able—to assist with negative issues affecting a loan, then the regulators may not have to force the bank to establish a reserve against the credit. However, if a loan is clearly only going to be paid through eventual sale of the property, then appropriate treatment must be addressed. On such decisions hang differing accounting treatments for the loans, with various consequences.

Troubled debt restructurings will be evaluated by the regulators in light of many factors. A key factor, according to OTS' Constantine, is whether a deal, as restructured, could have been made as a new loan under the lender's existing policies and procedures. In such cases, while the loan has clearly been revised, it may not even be considered a troubled credit.

Constantine also urged boards and management to be realistic, going forward, concerning the labor needed to handle troubled loans

"If you're going to work a portfolio," said Constantine, "you've got to work it, and you've got to be staffed up to do that." Simply making sure that all modifications to existing contracts, and all related paperwork, has been handled, processed, and filed correctly takes a great deal of manpower.

"If you're going to work a portfolio, you've got to work it, and you've got to be staffed up to do it"

"If you think you are going to have a need, go out and hire it," Constantine, a former lender himself, urged.

At $3 billion-assets Wilmington Savings Fund Society, FSB, Del., many troubled real estate credits are transferred to an officer who has extensive workout experience. There are two chief reasons for this, according to Ann M. Rudolph, senior vice-president and head of commercial real estate and construction lending for the Wilmington, Del.-based savings institution. One is to

put this in the hands of experience. The other is to keep business development staff from getting distracted by labor-intensive workouts.

"We still want to grow," explained Rudolph.

Solutions to troubled credits frequently demand flexibility, and some innovation. Bank of Stockton's Henry Claussen gave several examples of deals his bank has made with residential construction borrowers.

One is to "term out" short-term debt as longer-term loans. One developer who borrows from Bank of Stockton took such a solution. To make it work, the developer brought additional cash into the revised deal, to bring about a loan-to-value ratio of 80%. This deal gave the developer time to begin leasing the homes he'd originally hoped to sell outright. The leases are bringing in some cash, and occupants get the opportunity to convert to a purchase.

"This has kept the developer on the books as an earning asset," said Claussen.

There are other options. But Claussen stresses that no workout should be decided by: "What would the regulators want me to do?"

"Don't ask that question," Claussen said. "The regulators' job is to protect the banking system. *Our* job is to get the money back and save the bank. And that helps them do *their* job."

"Better Seeds": Avoiding fresh trouble

In this arena, OTS examiner Tom Constantine says he has already seen some lenders taking remedial steps. This includes pulling their institutions out of certain geographic areas completely; insisting on tighter deal structures; reducing maximum permitted loan-to-value ratios; increasing documentation requirements; and insisting on higher equity infusions on construction projects, to produce lower loan-to-cost ratios.

Ann Rudolph of Wilmington Savings

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Real Estate Concentrations Views In D.C.

On March 4, banking and savings regulators testified on the health of the nation's banking system before the Senate Banking Committee, and commercial real estate and construction lending frequently came up.

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Commercial real estate loans at insured banks and savings institutions "are showing signs of deterioration at the same time that concentration levels are at or near record highs, particularly among small and mid-sized institutions," stated **FDIC Chairman Sheila Bair**. "Over half of institutions with assets between $1 billion and $10 billion have commercial real estate loan portfolios that exceed 300% of their capital, nearly double the share for institutions in this size range in 2000."

Bair added that among institutions with less than $1 billion in assets, the share with commercial real estate concentrations exceeding 300% has almost doubled since 2000, to over 32%, as of the end of 2007.

"Smaller banks that have exceptionally large concentrations in commercial real estate loans—and there are many of them—face real challenges in those parts of the country where real estate markets have slowed significantly," testified **Comptroller of the Currency John Dugan.** "Unlike the unprecedented market disruptions of the last six months, these more traditional credit problems are familiar territory to bankers and supervisors. The key to addressing them is for bankers to recognize problems early and manage through them, and that is exactly what our examiners are working with them to do."

Federal Reserve Board Vice-Chairman Donald Kohn testified: "The delinquency rate on commercial mortgages held by banking organizations almost doubled over the course of 2007 to over 2%. The loan performance problems were the most striking for construction and land development loans—especially for those that finance residential development—but some increase in delinquency rates was also apparent for loans backed by nonfarm, nonresidential properties, and multifamily properties."

Kohn noted that while many lenders have taken prudent steps to address heightened lending risks in these areas, others have not done so.

Special research by the Fed indicates that some banks "have not been as effective in their efforts and we have uncovered cases in which interest reserves and extensions of maturities were used to mask problem credits, appraisals have not been updated despite substantial recent changes in local real estate values, and analysis of guarantor support for real estate transactions was inadequate."

As a result, special targeted reviews are planned, to identify high-risk banks.

John Reich, director, Office of Thrift Supervision, testified that while real estate created serious challenges for savings institutions, the result has been an earnings problem, not a capital problem. "That's an important distinction," stated Reich. "Capital and loan loss reserves provide the foundation of support for financial institutions during times of challenge, and thrift institutions continue to maintain strong capital and continue to set aside significant loan loss reserves."

Survey finds rise in exam focus on commercial real estate

Commercial real estate and construction lending keeps looming larger and larger in regulators' sights these days. In the recently unveiled *2008 Community Bank Competitiveness Survey*, sponsored by ABA's America's Community Bankers Council and *ABA Banking Journal*, respondents reported that commercial real estate was the greatest focus by examiners. More than 38% of the sample mentioned this as top focus, up from 27%, and second-place-ranking, in the 2007 survey. You can find the report at *www.ababj.com*.

warned that, so long as the bank's loan limits and other key controls were considered current, they should be regarded as solid. Now, she said, is not the time to be showing a lot of exceptions in bank records.

One of the common failings among lenders is recordkeeping systems that don't break down credit into fine categories, enabling management reports to be sliced and diced for many different factors. Though the regulators' 2006 guidelines for lenders making commercial real estate and construction loans were quite specific about the types of monitoring that regulators hope to see, many institutions have yet to adopt such fine-detail coding, according to speaker Peter Cherpack, vice-president at Ardmore Banking Advisors, Inc. Indeed, he said research by his firm found that one in five banks were specifically instructed by examiners to enhance their commercial real estate portfolio management capabilities.

Indeed, a concern for regulators has been that many banks, attempting to quickly cobble together systems to adhere to the regulatory guidelines, have opted for building spreadsheets to track and report commercial real estate and related portfolio information.

The consultant said that the data going into such spreadsheets is often entered by hand, with the risk of transposed figures and other errors. He said this is a concern for some regulators and can be terribly time consuming. He also pointed out that manual spreadsheets can be an issue for Sarbanes-Oxley Act banks. The act frowns on manual reporting.

"Loan Improvement": Building better systems

Even if a bank thinks it has a pretty decent system in place, examiners may get pretty hard-nosed nowadays. Wilmington Savings Fund Society's Ann Rudolph said her institution had just had an OTS exam. "We were a little shocked at the negativity they came in with," the executive said. "We made it through, but we have a huge 'to-do' list of what we had thought we were doing pretty well."

Constantine urged boards and managers to supervise commercial real estate and related credit from a strategic planning perspective. He said a bank should be clear, up front, how much of its capital it wants to devote to any such area of risk. In a related vein, he said institutions have to balance the common interest to build market share with sound underwriting, such that quality isn't sacrificed to share.

This relates to OTS's attitude that internal self-assessment on concentrated exposures be a regular exercise. "We want you to know what your concentrations are," says Constantine. "We want you to know when you can push the envelope, and when you can't."

Among the areas speakers urged renewed attention to, and remedial effort in, when found to be lacking:

• *Underwriting guidelines*—These, and policies and procedures, should be very specific. They should detail such factors as maximum loan amounts by property type; loan-to-value limits, by property types; minimum requirements for initial investment by borrowers and sponsors; and minimum standards for borrower net worth, required cash flow from the property, and debt service coverage.

What's more, warned Constantine, every rule established should match the institution's business plan.

• *Loan terms and pricing structures*—Similarly, these should reflect the lender's goals and objectives.

• *Constant economic monitoring and evaluation*—Speakers stressed the importance of keeping tabs on the potential impact on earnings, asset quality, and capital of economic shifts. Similarly, individual projects and properties must be evaluated to make sure performance meets plan. Constantine warned that borrowers must be measured not only in exposures to the bank, but with an eye towards other obligations.

• *Frequent inspection and appraisal review*—Bank of Stockton's Henry Claussen noted that his bank has independent construction inspectors visit worksites every two weeks, to make sure borrower draws don't get ahead of project progress. Senior staff also gets into the field frequently. Further, in-house appraisal staff reviews values from existing appraisals every six months to see if they still appear to be current.

• *Board involvement*—Regular reporting to directors was stressed at several points. "Every month we give the board a report on every major subdivision that we have going," said Bank of Stockton's Henry Claussen. This has pleased examiners. At Wilmington Savings, there is a quarterly report and market update to the board, with accompanying discussion, for commercial real estate and development loans. Loans nearing maturity are reported to the board, with the status of each project and strategies for dealing with the loan summarized for the board's review.

Sincerely,

Steve Cocheo

for *ABA Banking Journal*

ABA Bank Directors Briefing (ISSN 15234134, USPS 017-217) is published monthly by Simmons Boardman Publishing Corp., 345 Hudson St., New York, N.Y. 10014-4502 in cooperation with the American Bankers Association. Periodical postage paid at New York, N.Y. and additional mailing offices. POSTMASTER: send address changes to *ABA Bank Directors Briefing* 1809 Capitol Ave. Omaha, NE 68102.

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