CRE GUIDANCE: EXAMINERS GAVE YOU A ROAD MAP

Yes, the CRE rules aren’t perfect. But they’re useful.

Nearly a month after the federal banking regulators issued their guidance of on prudent commercial real estate restructurings, a healthy level of uncertainty surrounds the likely outcome of this guidance. Many doubt that it will represent any regulatory “relief” for lenders.

Closer look at key concerns

The concerns fall into several categories and, to a degree, they are mutually exclusive:

1. “Cut us some slack.” Bankers with significant concentrations of commercial real estate and acquisition and development credit hope that examiners will create some slack in what previously has been characterized as very strict application of supervisory standards in the assessment of commercial real estate and acquisition and development credits.

2. “Who are you kidding?” Many observers feel that the supervisory relief, if it occurs at all, will give banks opportunities to understate credit weaknesses. These skeptics label the regulators’ move as “extend and pretend.”

3. “Making it up as you go along?” And there are many observers, including some bankers, who feel that the guidance is merely “eye wash” to create the impression that the supervisory agencies are not being arbitrary in the examination process. This should be understood in light of the letter by Rep. Barney Frank (D.—Mass., and chairman of the House Financial Services Committee) and Rep. Walt Minnick (D.-Idaho) to the heads of supervisory agencies requesting that they not be arbitrary in the application of examination standards.

O’Leary’s view

My own view on these viewpoints runs as follows.

First, there is little risk of the “extend and pretend” concerns that banks will use any supervisory relief to prolong the credit problems into future years. I seriously doubt that the examiners would permit that to occur. It would be politically hazardous for them to deliberately allow this.

Second, any significant “behavioral change” on the part of examiners is not very likely—certainly not in the context of concentrations of real estate credit and the extensive criticism of so much of the outstanding CRE credit.

My own view is that the examiners will do what they have to do. We only have opportunities to change their minds with strong and objective arguments that any specific credits are not subject to weakness sufficient to impair their ultimate collectibility of principal and interest.

Where optimism is warranted

Where there is some room for optimism—though a carefully qualified optimism—is what the examiners will do with those credits that appear to qualify under the “prudent restructuring” outlined in the FFIEC guidance.

The principal opportunity that I see, as a veteran of the banking crises in the mid-80s and again in the early 90s, is the opportunity to avoid a charge down of principal for a loan where its real estate collateral is underwater if the other aspects of the credit are sound.

This means a willing borrower with the demonstrable capacity to repay; reasonable (or at least stable) marketplace fundamentals; and an appropriate real estate appraisal process in place to assure integrity of the valuation process.

Each of these conditions has to be met and they are the burden of the lenders to prove, not the examiners.

Here are some issues to consider, along these lines:

• Has the repayment capacity of the borrower, including any guarantors, been analyzed thoroughly—with current market experience and expectations?

• Have the real estate fundamentals in the banks’ trade areas stabilized sufficiently to be reasonably predictable of values and trends for the foreseeable future?

• Are real estate appraisals carefully reviewed to conform to current banking law and regulation as well as the lenders’ experience with the appraisers and their track records?

A word about regulators’ scenarios

I found the scenarios offered as illustrations in the regulators’ guidance interesting. Where the hypothetical examiners disagreed with the existing internal calls of the hypothetical bankers, I had to side with the examiners.

Based on the information presented, the bankers failed to make a conservative case that the loan was fully collectible as to principal and interest in the current environment. This is one part of the process where the bankers have some control over the output.

When the examiners next visit to your bank, will each of you with portfolio responsibilities be able to put your best foot forward in terms of demonstrating that you understand your credits? Can you make an honest case for relief from the harshest views of these credits?

If not, you are missing an opportunity to showcase that you and your team know what you’re doing and are

sensible in assessing credit risk. Neither bankers nor examiners like unpleasant surprises. Are you doing your part to minimize the expectation of unpleasant surprises as these loans move toward ultimate repayment?

Getting back what you put in

Recently I spoke with a community banker recently whose institution had just experienced a scheduled FDIC safety and soundness examination.

He said that where the loan officers were fully conversant on their credits and the objective strengths and potential weakness of each, the examiners were in agreement with the classifications and no further adjustments or criticisms were experienced.

Where that level of persuasive certitude did not exist, the examiners burrowed in and the results were occasionally not happy ones for the lenders nor the institution.

Bankers have lost a great deal of credibility over recent months. The rapacious activities of some, combined with nearly reckless lending standards by some of the largest banks in our industry. have tainted most all of us. To the extent that we haven’t known our credits thoroughly inside and out, we have not fared so well.

We need to strengthen our internal controls over appraisal reviews and be sure that we have thoroughly and completely analyzed our borrowers’ ability to repay. Many community and regional banks have been doing this and they are likely to reap some tangible benefit from the new regulatory guidance.

A final warning

We are to some degree in control of our destinies for the final outcomes of examinations of our real estate loans.

To be anything less than fully prepared for coming discussions is to be utterly irresponsible.

We have enough to do in burnishing up our reputations for past lapses without permitting ourselves to sink deeper into the swamp due to ignorance or laziness.

The examiners are giving us the road map. We ignore it at great cost.

About Ed O'Leary:

Veteran lender and workout expert O'Leary spent more than 40 years in bank commercial credit and related functions,

working with both major banks as well as community banking institutions. He earned his workout spurs in the dark days of the 1980s and early 1990s in both oil patch and commercial real estate lending.

O'Leary began his banking career at The Bank of New York in 1964, and worked at banks in Florida, Texas, Oklahoma, and New Mexico. He served as a faculty member and thesis advisor at ABA's Stonier Graduate School of Banking for more than two decades, and served as long as a faculty member for ABA's undergraduate and graduate commercial lending schools.

Today he works as a consultant and expert witness, and serves as instructor for ABA e-learning courses and a frequent speaker in ABA's Bank Director Telephone Briefing series. You can hear interviews with Ed about workouts here. You can e-mail him at etoleary@att.net. O'Leary's website can be found at www.etoleary.com.

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