

## What to expect in CRE exams

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In the latest "Pass the Aspirin" question, bankers relate recent experience with commercial real estate exams

A community banker in the Northeast writes: "My institution is about to have a targeted commercial real estate examination. If your bank has had one already, can you please tell me the following:

1. What did the exam team focus on?
2. Were they willing to discuss findings before they were cast in stone, or were they there to dictate?
3. What kinds of orders did the team leave you with?
4. Anything else you think I should know?"

Several prescribers answered this banker's call. Due to the sensitive nature of this topic, we are not identifying them other than by their region and their regulator. Certain other details have been rendered vague to avoid identification, as well. We welcome further submissions, which will be published on our website, [www.ababj.com](http://www.ababj.com), with the same protection.

### Remedy 1

Southern banker, examined by Comptroller of the Currency.

We had an OCC exam in late September through mid-October, 2008.

Please be aware that the senior members of the exam team, including the examiner-in-charge, have been examining our bank for more than a decade, so they know us and our management inside out. They did not come in with a dictatorial attitude. They focused very heavily on real estate-development loans and spec construction loans.

They also looked very, very closely at all appraisals. I would suggest that all appraisals on land development and spec construction loans be current within six months, and that they absolutely should have and specify absorption rates. The team was real big on current absorption rates.

They also asked us to get some guarantors to show them they could service debt, if needed. When we asked a couple of guarantors to come up, from their hip pockets, with a principal payment on a subdivision loan, and they did so, it calmed many of the examiner's apprehensions. They were willing to discuss findings and we only had one loan to be rated sub-standard that we had not already rated internally.

I would suggest that the CEO or Chief Credit Officer be proactive on real estate development loans and spec house construction loans. I sent out a memo to all of my loan officers and had them send me a list of all of their loans of the above types. I got date of loan, master-note amount, amount advanced, location of house or lots, and appraisal date and

amount. I then called our EIC about a month in advance and discussed my findings with him. I also sent him a summary of the information. It really worked well, as it showed him how much attention we were devoting to these areas.

Also, examiners want to make sure that banks have a good, centralized appraisal review process. Our team was very tough on the appraisal review process. We decided to discontinue internal valuation appraisals and worked out an arrangement with an outside appraiser to handle all appraisals under \$250,000 that do not require outside appraisals. We also named one officer who would be responsible for all appraisal reviews.

Finally the team looked closely at our cash flow analysis function. Global cash flow was a hot topic. The bottom line is that we had a very good exam in very tough times. I have to believe that our proactiveness in areas that we knew would be hot topics paid huge dividends.

## Remedy 2

Southwestern banker, reporting on a recent FDIC exam.

We found that examiners were extremely focused on any commercial real estate loan or C&I loans that have any payment restructuring, so they could classify them as TDRs (troubled debt restructurings). That's a very hot button these days. If you have not previously classified, they will. If collateral value is sufficient, no additional reserve is necessary. Loan can be reclassified back to 4 or 5 after a reasonable period of time (reasonable is six months).

Our team looked at mostly new CRE loans that were made in the last few years, and was not concerned with seasoned loans with good payment history. But, count on it, a team will look at every loan that has been delinquent or classified.

The team attempted to leave without providing a "preliminary findings report" on our CAMELS rating, but we would not allow them to do so. By regulation, a preliminary report to management, staff, and board, if requested, is mandatory, for any bank rated 3 and above.

As far as specific actions, most were recommendations. A hot one in our area is stress testing of the newer CRE loan portfolio. Stress testing is not as bad as it sounds, if you just do a spread sheet, with term, loan-to-value, duration, liquidation values, etc.

The exam team wanted to see on-balance-sheet liquidity, and also a strong and tested contingency liquidity plan. If your bank is tight on liquidity, I would purchase CDARS or other deposits which would reduce your liquidity ratio. This will cost the bank some money, but may be the only way to mitigate a downgrade.

## Remedy 3

Southern savings association, reporting on a recent Office of Thrift Supervision examination.

In my bank's examination, the commercial review targeted concentrations of loans. Then the team focused the exam on the higher concentration areas, primarily commercial real estate. Underwriting was a focus, with credit documentation, appraisals/and appraisal reviews, and current financial statements of primary concern. Classified assets,

and loans that were not in that classification and should have been, were noted. The Allowance for Loan Losses as it related to Classified assets was also a priority.

The examination was first to establish the creditability of the borrower&mdash;sources of repayment, subordinate debt of borrower, and cash flow of borrower.

Dates of financials, including financial statement, tax returns, etc., was important. Check your underwriting! Examiners spent a lot of time reviewing appraisals, concentrations in subdivisions on spec and land loans, and repayment abilities. The team did not seem to care much about over-collateralization if borrower didn't independently pass muster.

There was a willingness to listen to management, but the team still noted loans in examination report. Also, the team was interested in total loan classifications to total capital (CRE in excess of three times capital) and in loans classified as exceptions to policy.

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