Effective Credit Risk Management
Commercial Real Estate (CRE) Risks / Transcription

Objective

- *CRE Valuation Risk* – Understanding the general risks of commercial real estate lending, and from a valuation (appraisal, evaluation, or validation) perspective

Expectations

- *CRE as a Source of Repayment Source* – Spend sufficient time and training into CRE lending risks, and view CRE collateral as a potential sole source of repayment during an economic downturn

CRE Collateral Risks – Appraisal Considerations

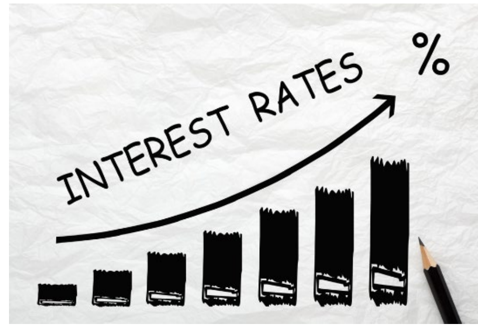
New Views on CRE Risks

- *Relevant Market Conditions / Impact on Borrower* – Analyze how market conditions during a downturn economic environment impact CRE borrowers: declining CRE valuations, inflation, increasing interest rates, employment rates, borrowing costs, increasing vacancy rates, decreased lease (rental) rates, increased operating expenses, decreased demand for CRE, lack of available financing, and less economic growth. Determine how these measures affect the borrower's ability to repay. Determine and document how these conditions are impacting the borrower

- *Extraordinary Assumptions* – Stakeholders, including the appraisal review function, analysts, underwriters, PROs, and CAs need to read and understand any noted extraordinary assumptions in a CRE appraisal report. These may include, for example, the following assumptions that the property is free of: zoning violations, structural defects, encroachments, easements, liens, title defects, flood risk, fire hazards, mold, termites, environmental contamination, hazardous materials, asbestos, radon, lead-based paint, sinkholes, soil contamination, water damage, foundation issues, roof leaks, etc.

- *Hypothetical Conditions* – Stakeholders, including the appraisal review function, analysts, underwriters, PROs, and CAs need to read and understand any noted hypothetical conditions in a CRE appraisal report. These may include, for example, the following conditions that the property may/may not be subject to: clear title, legal disputes, pending litigation, zoning changes, environmental conditions or regulations, building code violations, easements, liens, encroachments, leasehold interests, mortgage interests, restrictive covenants, adverse physical conditions, adverse economic conditions, adverse legal conditions, adverse market conditions, adverse political conditions, adverse social conditions, or any adverse technological conditions

- *Leases/Rental Rates, Vacancy, Operating Expenses* – Review current rental rates and compare them to market conditions (interest rates, tenant demands, zoning). Analyze vacancy trends over time and its impact on borrower income, and the root cause for higher vacancy: market conditions, tenant demand, economy, zoning; anticipate changes to vacancy rates. Observe material operating expense increases as a percentage of gross income, and determine the reason for the increase: improvement to the property and attract tenants, maintain, and prevent deterioration, reflect changes in the market, tenant demands, zoning regulations, etc. Project material changes with supported and documented analysis



- *CAP Rates (The ratio of a single-year of NOI to the property asset value)* – In an increasing interest rate environment as capitalization (CAP) rates increase, analyze the effect CAP rates are having on CRE valuations. In a down economy the CAP rate will increase as stakeholders become more risk-averse, thus making it more difficult to obtain financing, resulting in lower CRE values. Analyze and document how the bank's exposure on such CRE collateral needs to be handled. Consider additional risks to the bank and the borrower: market conditions, credit, liquidity, collateral valuation, environmental, legal, zoning, construction, tenant, management, hypothetical conditions and extraordinary assumptions in the appraisal report

- *Discount Rates (The investor's required rate of return, discounting future cash flows during the holding period back to the present to determine value)* – In a down economy the CAP and discount rates tend to increase, and both rates share these risks. Other risks include: default risk, foreclosure risk (the bank having to sell foreclosed properties in a down economy)

- *Absorption* – Understand the rate at which commercial space is being leased-up in the subject market. Review the original appraisal absorption assumption and compare that with the current demand for similar space today in a downturn market, as absorption rates will be lower, properties will take longer to sell, leased at lower prices, require more marketing or incentives such as rent concessions, tenant improvements to attract tenants or buyers. Per a physical inspection, identify any significant repairs

- *Leasehold Interest* – Confirm the remaining length of the leasehold interest, rent escalations for reasonableness. Look for resizing requirements, additional collateral or guarantees if necessary; do it now before the leasehold interest buries the subject wasting asset altogether, if applicable

- *Tenant Improvements (TIs)* – Carefully analyze the TIs financed by the bank, whether they are cosmetic changes or major structural renovations. Get a resizing if necessary

- *Appraisal Recommendation (New appraisal, validation, or evaluation)* – Based on relevant/material changes in market conditions, project performance, geographic conditions, variances from original appraisal assumptions, change in project specs, loss of lease or takeout, high pre-lease fallout, or as borrower's financial condition deteriorates

CRE Lending Considerations

<u>Emerging CRE Risks</u>

- *Interest Rate Risk* – Higher interest rates result in likely higher borrowing costs, more difficulty for the borrower to repay or obtain replacement financing, and result in a higher likelihood of default and foreclosure. Possible mitigating strategies for managing interest rate risk is using interest rate swaps (exchanging a variable rate for a fixed rate). Interest rates can be capped to limit increases or maximize costs, or have floors that provide a minimum borrowing cost

- *Refinance Risk (Higher interest rates have a material impact on refinance risk)* – With the increased cost of borrowing, it becomes more difficult for borrowers to refinance, possibly leading to payment default and collateral liquidation. The property's value may become reduced and make it even more difficult to refinance. Banks should pay close to the earlier 'resizing opportunities' before refinance risk increases too far, including: closely monitoring interest rates and market conditions, borrower creditworthiness, upping guarantees, and taking additional collateral. Determine if outside financing is even possible, if the loan will need to be downgraded, extended with disclosable modification terms, or the collateral even be sold. The borrower may take measures to improve its creditworthiness and the property value, reduce debt levels, increase cash flow, obtain an additional interested guarantor, provide more collateral or guaranty percentage, or offer and negotiate a workout or loan modification

- *Resizing Opportunities* – As a commercial banker, you can determine if a CRE loan needs to be paid down or re-sized by considering various factors such as a higher interest rate environment, reduced net operating income due to decreased rents and higher operating expenses, declining economic market conditions, lower debt yield, weak forecast, poor liquidity, uncertain repayment ability, etc. Document the case for a resizing opportunity by using repayment tools like DSCR, LTV, DY, and stressed interest rate sensitivity, and propose and document a resizing paydown recommendation. Put the interests of the bank first, and the borrower second, even with a 'high deposit' borrower

- *Repricing Risk (The possibility a CRE loan may need to be refinanced at a higher interest rate upon maturity)* – Especially in an economic downturn and high interest rate environment, interest rates should cover cost of funds, loan servicing, probable loss, as well as a reasonable profit margin. Keep the following in mind when the borrower's creditworthiness, income, and the collateral property have declined: borrower's loss of a major client, supplier, employee, major contract, customer, or vendor

- *Physical Inspection* – Identify potential risks by conducting a thorough physical inspection of the CRE. Start with reviewing the loan documentation (title, survey, zoning) to learn of potential legal issues. The visual inspection should include the interior and exterior of the building and site, to document any potential physical or environmental issues to avoid potential liability. Review the borrower's balance sheet, income statement, and property lease agreements and note any other issues or questions for follow-up and discussion with the borrower. Conduct regular inspections. Remember to not ignore identified issues, get borrower authorization to conduct inspections, obtain necessary training, use proper safety precautions, and ensure proper supervision

- *Insurance Coverage (type; amount; timing; claims acceptance, doubt, or protracted resolution)* –

Hazard and fire insurance coverage should help protect damage from fires, natural disasters (property, general liability, business interruption, equipment breakdown). Review the adequacy of insurance coverage for loans secured by CRE, and determine how sufficient it will cover the cost of repairs or replacement in comparison to the actual outstanding loan balance. If the land value is excessive, the cost to replace the damage may be less than the loan balance. Ensure the policy is in force and has not lapsed. For claims, the insurance company will investigate the validity of the claim to confirm the destruction was caused by a covered event. Work with legal counsel if the claim is doubted, or if the claim resolution is expected to be protracted

- *Environmental Risk (Lender inspection, borrower questionnaire, base review, Phase 1 and 2 reviews)* – Ensure the bank conducts sufficient environmental risk due diligence, including an environmental lender inspection, borrower-completed questionnaire, and obtain Phase One environmental site assessments (ESA), or Phase Two ESA, if necessary. Review documentation to confirm the borrower’s responsibilities with respect to environmental compliance and remediation, considering the use of environmental indemnification agreements to shield the bank of potential environmental claims