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A Guideline – But Not a Rule?

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Whether we like it or not, bank analysts everywhere are finally being confronted with an issue with which we have not had to contend in some time— that of credit quality metrics that might not be headed in the direction to which we have become accustomed. Whether it's delinquencies in credit cards (on the rise), deterioration in some lower tranches of auto paper (becoming more visible), or regulatory concerns about commercial lending, it seems that the moment is approaching for greater attention to be paid.

So it was interesting to us that a number of companies started putting forth guidance in their second quarter earnings conference calls concerning their exposures to commercial real estate lending, and how these exposures stacked up against their capital. These disclosures—which were still somewhat random and in most cases not terribly enlightening—were apparently engendered by the continued stream of warnings on the subject flowing from the Office of the Comptroller of the Currency, and OCC head Tom Curry has taken the opportunity on a number of occasions in recent months to express his concern over the hotly competitive environment and the loosening of credit standards in this sometimes troublesome credit segment.

Indeed, the OCC raised its regulatory stance on CRE lending from "ordinary monitoring" to "additional emphasis" after the issuance of its semiannual risk report in July, and the other banking regulatory bodies have followed suit. From our talks with CFOs across the industry, it is clear that this guidance has been explicit—in the form of email "reminder" messages to senior managers and in the form of targeted discussions during the examination process—and it's also very clear that the industry has received the message, thus the willingness to disclose and analyze exposures in a way that had been missing in previous discussions of quarterly results.

It also bears repeating that there is nothing new here. These guidelines were first promulgated by the FDIC in 2006—admittedly after the horse had fled the burning barn in the run-up to the real estate meltdown in 2007—and may be sourced at **https://www.fdic.gov/regulations/laws/federal/2006/06notice1212.html**. And for those who may have forgotten, the "guidelines" are that ADC (construction, land development and other land) may not exceed 100% or more of total capital and that total commercial real estate loans (as defined in regulatory

guidelines that exclude owner-occupied CRE) may not exceed 300% of total capital. In addition, there is another qualifier—and perhaps a more potentially troublesome one for the community banks—that the "outstanding balance" of a bank's CRE portfolio should not have grown more than 50% over the previous 36 months.

OK, first and foremost these are guidelines—not rules—and the difference can be an important one. We want to clarify our previous writings on the exposure of one bank—**State Bank Financial (STBZ)**—and use them to illustrate this point. We erroneously wrote in our 2Q16 **BSP***erspectives* piece that State Bank had exceeded these guidelines, with ADC equaling 150% of capital and total CRE exposure of 400%. Their actual exposure is 108% of the ADC guideline and total CRE exposure of 288%, and the higher percentages (150% and 400% respectively) represent the company's internal CRE risk policies, not an actual level of exposure. (Our apologies for the confusion.) CFO Sheila Ray pointed out that their regulators are aware of these internal guidelines and have not expressed any objections to them, due to their comfort level with the company's risk management systems and internal stress testing processes. We would also add that STBZ CEO Joe Evans is well known to the regulators as an experienced and respected acquirer and operator of failed banks, and that in spite of an active program of acquisitions, the bank has grown its CRE exposure only 42% over the last three years.

So what about that 50% growth qualifier? Is that a problem for the larger community banks, many of which have been active acquirers of smaller banks in the last 2-3 years? Indeed, in our covered companies of $1 billion-$10 billion in asset size, only three—**Capital Bank (CBF)**, **South State Bank (SSB)** and State Bank—have experienced growth less than that 50% guideline. But we would note a couple of circumstances that should mitigate the concern over these high growth rates for the other large community banks. For one thing, these consolidators have ample opportunities to assess the risks in acquired CRE portfolios and to take their credit marks accordingly. Secondly, each of these deals affords the regulators a new opportunity to look at the size and quality of these combined loan portfolios, and to mandate additional capital if required.

OK, then—when is a guideline not really a guideline, and conversely—when can a guideline then become a rule? It seems that the answer to both of those questions is in the eye of the beholder—with the beholder being the applicable banking regulator—and therein resides our concern for the future. Any observer of the Southeast banking scene (and the Atlanta banks, most pointedly) knows that regulatory "concern" can rapidly morph into regulatory "panic" in the event of a liquidity event in the markets or in the face of evidence of more rapid deterioration in the regional CRE segment.

One observer of the metro Atlanta banks in the 2006-2007 time period described the situation here at that time as one of "musical chairs" in which many banks carried total CRE exposures in excess of 500%-600% of total capital. Many of these banks continued to carry CAMELS 1 and CAMELS 2 ratings until the events of mid-2007 (the failure of subprime hedge funds at Bear Stearns and liquidity concerns at Countrywide Mortgage, most notably) led to a massive regulatory reassessment of these loans and to big regulatory downgrades of banks' capital and operational adequacy. CAMELS 2-rated banks became CAMELS 4-rated banks seemingly overnight, and the whole CRE situation spiraled downward as real estate developers suddenly found themselves and their uncompleted projects cut off from necessary funding.

Will it be different this time around? We'd like to think so. For one thing, 2007 was not that long ago and the lessons of regulatory laxity—and the examples of regulators and examiners who lost their jobs as a result—are very fresh for those who mind the banking industry nationally and especially in the Southeast. Secondly, the capital levels and the quality of capital is so much more robust than they were previously, and the willingness

of the regulators to exert oversight over potentially troublesome banks is much greater. But we continue to be nagged by that old saying—"a watched pot never boils"—and we keep asking ourselves: What are we missing?

Table 1: Commercial Real Estate Concentrations in the Southeast, By Asset Size

		Test 1		Test 2			
	No. of Companies	Median ADC Concentration (100% Guideline)	Companies Exceeding Test 1 Guideline	Median CRE Concentration (300% Guideline)	Median 3-Year CRE Growth (50% Guideline)	Companies Exceeding Test 2 Guidelines	Companies Exceeding Growth Guideline
Assets > $50B	7	17.6%	0	89.7%	40.7%	0	3
Assets $10B - $50B	12	44.6%	1	161.1%	55.5%	1	6
Assets $5B - $10B	21	75.3%	3	260.6%	101.7%	4	16
Assets $1B - $5B	104	57.0%	12	197.6%	50.0%	13	53
Assets $500mm - $1B	155	54.2%	20	186.0%	29.1%	8	49
Assets < $500mm	1,066	8.9%	81	42.6%	-9.4%	161	262

Companies with no lending in either category were excluded from the analysis to ensure medians reflect participants in these loan segments

Southeast defined as: AL, AR, FL, GA, KY, LA, MS, NC, SC, TN, VA and WV

Sources: SNL Financial, Call Reports

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