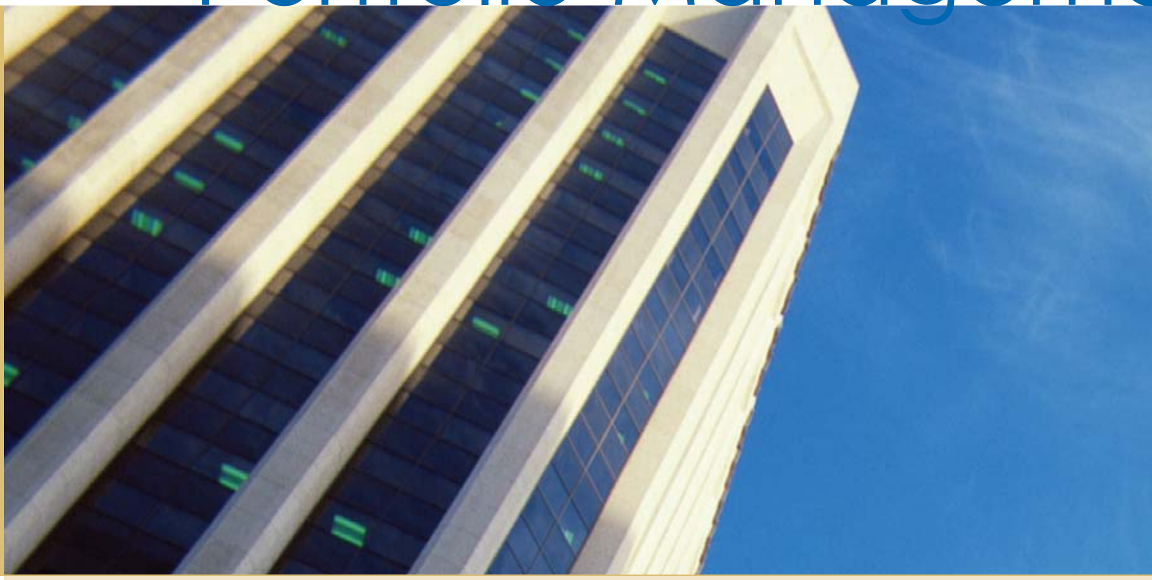
Best Practices in Commercial Real Estate Portfolio Management



The commercial real estate guidance released by the regulators in December was discussed during a recent RMA audioconference by a panel of senior bankers representing both large and small institutions.

by Kathleen M. Beans

Institutions are looking closely at their commercial real estate (CRE) portfolios as a result of the joint guidance on concentrations issued by the regulators in December. The issues addressed in the guidance—management oversight, portfolio management, management information systems, market analysis, credit underwriting standards, portfolio stress testing, sensitivity analysis, and credit risk review—were discussed during a recent RMA audioconference.

Portfolio Limit Setting

Ray Rusnak, group senior vice president and senior credit officer, LaSalle Bank Corp., said his $120 billion institution began using economic capital to determine limits about two years ago. "It's more dynamic than the traditional approach of setting an overall ratio of real estate loans to total loans and then setting sub-limits within that ratio for hotels, homebuilders, and REITs," said Rusnak, who has more than 40 years of commercial banking experience.

"In the past, lenders would argue for higher limits as the bank approached its limit on, say, hotels. But now we assign a total amount of economic capital to the real estate area. If homebuilder loans become more risky this year and credits are downgraded, it takes more capital to support those loans. The department has to decide whether it wants to make more

 Kathleen M. Beans is senior writer and public relations manager at RMA.

loans to homebuilders or make less risky loans that require less capital. The department has to manage its portfolio according to the overall limit it is assigned.

"When we first set those limits and allocated the economic capital, it adequately covered the real estate portfolio and gave it room to grow. We allowed the line department heads to determine if they wanted to put their economic capital behind a very risky area and, therefore, have less room to grow their loans, or whether they wanted to spread it out in various sub-industry segments. However, for the time being, we have maintained limits in sensitive areas such as hotels, although I suspect these limits also eventually will be removed."

As an institution that will opt-in to Basel II using the advanced approach, PNC also is moving to the economic capital model by the end of 2007. Kim McNeil, executive vice president and chief credit policy officer, PNC Real Estate Finance, said his $120 billion institution is currently testing its allocations before making its new model live. Previously, it used sub-limits for various product types: land, retail, apartments, office, warehouse, and hotels.

Mechanics Bank, a $2.6 billion institution based in Richmond, California, is not yet using economic capital to limit lending in its $1 billion CRE portfolio. Robert MacNaughton, senior vice president and senior real estate lender, said his institution's CRE portfolio has grown from about a quarter billion over the past 10 years. Noting that his bank's limits-setting policy has been driven by regulatory expectations, McNaughton said, "We've focused on keeping the ratio of commercial real estate to total loans in the 55% to 60% range. We didn't want any one category to be in excess of 30% of the total. We didn't want our land and construction to exceed 20% of total loans."

But Mechanics Bank is now developing its own internal standards of percentages and testing them. "We are now looking at risk-based capital and running percentages, which are similar to those suggested in the regulatory guidelines. We see it as an excellent way to better understand our portfolio, but we continue to look at our total portfolio vis-à-vis the different product types."

Underwriting Loans

Cash flow drives underwriting at Mechanics Bank, said MacNaughton. "We determine the cash flow produced by our customers' properties. The debt service coverage ratio is our primary driver, and that, of course, is influenced by amortization and the interest rate. On fixed-rate loans, we underwrite to the fixed rate. To address the volatility of variable-rate loans, we add 50 to 100 basis points, depending on the market it's in or the type of property."

Mechanics Bank typically underwrites for 25 years. It uses a model for each discrete loan that breaks information down to the breakeven point and indicates the borrower's capacity as a function of the monthly rental rate, the square-foot-occupied vacancy rate, and interest rate.

When the bank performs that breakeven analysis, it then looks at the type of property and the markets and determines likelihood. It back-tests loans annually to make sure they stay in compliance.

PNC looks at underwriting two different ways. Similarly to Mechanics Bank, PNC looks for some cushion over the 10-year rate and then looks at spreads based on property type and what's going on in the market that day. "We also look at market underwriting, considering what the size would be if the product were to be delivered to the market that particular day," said McNeil. "We eliminate the cushion to get a second reference point."

Like Mechanics Bank, PNC does a breakeven analysis on occupancy and rental rates. "We watch spreads on a daily basis," he said. "The debt service coverage tests are regularly debated in terms of the influence of the conduit market and amortization, which now includes interest-only loans."

LaSalle Bank uses underwriting methodologies that are similar to those at PNC and Mechanics Bank, said Rusnak, adding that his institution also, depending on the project, looks at an "as is" as well as a "stabilized" appraisal. "In recognition of the development of the conduit market, we also analyze take-out not only on a conventional debt-service basis with interest rates grossed up for the length of the loan, but we do it on a conduit basis, making sure we add in the reserves that a conduit loan would have. In addition, we do the breakeven analysis on rental rates, vacancy rates, and interest rates."

Monitoring the Loan Portfolio

To monitor loans, PNC employs a team approach. It includes the relationship managers that originate the loan, the underwriting team that supports that line of business, and the credit team. The primary responsibility for the credit is always with the lenders, so they are responsible for knowing and updating their credits, using the resources of their underwriting teammates.

"PNC uses a periodic review procedure driven by the strength or weakness of the risk rating," said McNeil. "Weaker credits are reviewed quarterly, mid-range credits are reviewed semiannually, and stronger credits are reviewed annually."

LaSalle Bank and Mechanics Bank expect their relationship managers to be responsible for their loans from start to finish. They find the customer or prospect, underwrite the loan, and then perform ongoing monitoring.

"We have a small credit staff that reviews what the relationship manager is proposing, both initially and at least annually depending on the risk rating of the credit," Rusnak said.

MacNaughton said Mechanic Bank's member relations staff report problems to credit administration, indicating the status of those loans.

Portfolio Stress-Testing

Each panelist's institution handles stress testing differently. Mechanics Bank is not yet stress testing at the portfolio level, but expects to do so in 2007 and is looking outside the bank for help in doing that. "It's a matter of being able to gather the data effectively and then manipulate that data to make it useful for stress testing," said MacNaughton, who personally reviews every credit over $1 million. "We stress heavily individual loans, and we are just now learning what information our loan system can provide.

"The strength of our portfolio is that it's relatively small and it's not geographically diverse, and the weakness of our portfolio is that it's small and not geographically diverse. So we'll soon be able to get a good handle on a fairly sophisticated segmentation of our portfolio, and we will be able to stress test it much more effectively.

"The real question, though, is how you stress test the entire portfolio. It's easy academically to stress it on an individual basis, but what does it really mean? Are you getting good information and can you work with those results? Our initial attempts at segmenting this portfolio have opened a great deal of opportunity for us to do just that.

"Depending on the risk characteristics of the CRE portfolio, the guidance says stress testing may be as simple as analyzing the potential effect of stress loss rates on the CRE portfolio capital and earnings. It sounds simple, but when you try to implement it, it's not so simple."

Rusnak explained that LaSalle Bank has been experimenting by stressing the interest rates both on the whole portfolio and on a sub-portfolio basis. For example, LaSalle looked at its Florida condo exposure, stressing both interest rates and contract dropout rates. However, LaSalle found that "the real estate market's been so strong for the last 10 years that even under stress it looks pretty good," said Rusnak. "Our gut tells us that if a real period of stress came along, it wouldn't be as good as it's looked when we've done the analysis."

PNC's stress testing is driven by its risk-grading system. "We're on a 16-point probability of default scale and an eight-point loss given default scale, so those component parts will come up with an expected loss characteristic," explained McNeil. Like LaSalle Bank, PNC tests the entire portfolio and various pieces of it, moving credits down a grade or two to observe the impact on expected losses.

The impact of a two-point slide on the loss given default scale is dramatic, said McNeil, but on a sub-portfolio level it indicates some erosion in the portfolio.

Market Analysis

The panelists said there is very little industry information available on a portfolio basis. "Call report data over the years is the only available information," said MacNaughton. "A number of models and vendors are working on various tools, but they're still in their formulative stages. Automated Financial Systems (AFS), an RMA partner, is soliciting actual commercial real estate portfolio data from a number of participants, and that will open some doors that have been closed for years."

Rusnak noted that there are few lenders working today who remember the last downturn in real estate. "On an individual loan basis, however, we use published data sources for market data and the rating agencies for tenant analysis, and we use feasibility studies by outside parties."

Rusnak said LaSalle Bank refers to market data in individual credit write-ups and compares the project to the market data to make sure that vacancy rates or the market's prospects are in line with the underwriting.

PNC has a market research team that is part of the real estate credit side of the organization. This team specializes in analysis of market data. "On the larger projects, they discuss the relative merits and the risks involved with a particular opportunity, using the available data," said McNeil.

MacNaughton noted, "There's an incredible amount of data out there. It's a matter of gathering it and manipulating it, understanding it, and bringing it together in a form that we can use.

"Global Real Analytics did a study that we found attractive for our market. Its metro market outlook reports, which are nationwide, judge the market on an attractiveness basis from an investment point of view. They use metrics to look at all the different elements that make up a marketplace and weight them. The study lets us review historical changes, which act as our driver.

"Other vendors provide a local outlook that lets the bank drill down to the street corner. Our real challenge is taking more of the macro information and putting it into a micro facility that we can use to consider the type of loan we would want to make in the future and also what types of loans we have on the books right now in our marketplace.

"There's an incredible amount of information, but the challenge is to turn it into a useful product. And Property & Portfolio Research is where we're looking right now, not only for taking that data but also looking at it to analyze our portfolio from a risk point of view."

Systems to Track Other Data

LaSalle Bank still uses Excel® to track other data. "We've tried several times to build or buy a stand-alone system that would hook into our loan system and collect the data, but it's either too expensive or too difficult to accomplish," said Rusnak. "So we have a fire drill every time there is a big event such as a major retailer going bankrupt, at which time we put an Excel spreadsheet together showing all our buildings where that retailer is a tenant and gauging our exposure in any sub-segment. We usually alert the field via e-mails and follow up with the spreadsheets. It's not ideal but it's the way we currently work."

PNC's construction loan portfolio is handled on an ACBS loan system with its standard reports. It does not provide real estate detail and specialization. The term loans are serviced by Midland Loan Services, Inc., a PNC subsidiary on its Enterprise! System. "It can pick out and report on the properties occupied by the large bankrupt retailers that Ray mentioned," said McNeil. "We are trying to develop the DealFlow model to cover construction loans as well as those term loans. DealFlow is an Internet-based system that simplifies and consolidates the information requirements of a commercial lending institution. DealFlow absorbs input and results from an entire lending organization's pipeline, contact, cash flow, underwriting, and asset management teams, and assimilates, stores, and reports this information in an efficient, consistent, consolidated manner."

Mechanics Bank inputs its data into an IT system. "We data dump into Excel and Access® depending on what our particular needs are," said MacNaughton. "I'm glad to know that a $120 billion bank manipulates its information the same way a little $2.6 billion bank does.

"Excel provides flexibility. Access is a good database for us and we can manipulate it. Our IT staff helps in designing reports to accept the data dump. It's a matter of getting that information into Information Technology, Inc. (ITI) and that's our challenge right now. We're learning the full capabilities of ITI flex fields.

"My goal is to drill down to the individual building tenants and use NAICS codes to determine not only the impact on the discrete building, but also changes in a particular segment of the business community that could impact the cash flow of the building."

Strengths and Weaknesses in Geographic Diversification

"Mechanics Bank's strength is that we're tight in our marketplace; our challenge is we need to get outside," said MacNaughton. "Most of our properties are on the Hayward Fault, so we have earthquake risk issues. It's critical that we disperse geographically, and we've begun opening loan centers in northern California. Part of the portfolio diversification comes through existing customers who are looking outside of California.

"With product types, we stay close to what we know best and avoid unfamiliar areas. If our marketing side decides to get into other areas, we're going to have to learn how to underwrite it or hire that capability. Our portfolio diversification is a function of our customers' needs. We track diversification so that if we find that we are getting a concentration in any particular area, we back off somewhat and perhaps do participations as a way to expand or control our portfolio, both buying loans and/or selling loans."

Rusnak said that LaSalle Bank opened loan production offices to go after that middle-market real estate credit over the past 10 years and get better geographic diversification. "We've also targeted large corporate and institutional real estate markets in a bigger way, which also increase geographic diversification."

McNeil said PNC has had a similar experience. "We've got a national platform, so we're constantly watching for and managing concentrations in products, geographic locations, and even in borrowers. We use the credit default swap market for some of the public companies for which we provide debt if we get outsized in a particular area. We also have a specialized real estate syndication group to help lay off exposure." ❒

Contact Kathleen M. Beans by e-mail at kbeans@rmahq.org.