Estimating Commercial Real Estate Losses

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Loss Estimation is key …

- To Stress Testing
- To Capital Adequacy analysis
- To Loan Provisioning analysis

- Key Principles:
  - Be careful of applying broad loss rates to individual portfolios.
  - Capital is for unexpected losses, not expected losses.
  - Concentration & correlation increase volatility.
  - Community banks can do a good job at this.

The SCAP Approach

- Constraints: limited by data, time and the need for consistent treatment across firms.
- Divided the portfolio into a series of subportfolios and separately estimated losses for each of them.
- Subportfolios include:
  - Construction (residential & commercial)
  - Owner Occupied CRE
  - Multi-family and non-farm, non-residential
  - Foreign and special portfolios
  - Term defaults and refinance defaults

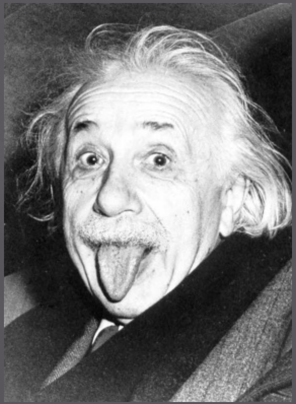
Cyclical Shifts vs. Regime Shifts

Case 1: Traditional			**Case 2: Bubble Period**			**Case 3: Post Bubble**		
SF		100,000	SF		100,000	SF		100,000
Rent PSF		$ 20	Rent PSF		$ 22	Rent PSF		$ 18
Gross Potential Rent		$ 2,000,000	Gross Potential Rent		$ 2,200,000	Gross Potential Rent		$ 1,800,000
Vacancy	15%	$ (300,000)	Vacancy	10%	$ (220,000)	Vacancy	20%	$ (360,000)
Net Rental Revenue		$ 1,700,000	Net Rental Revenue		$ 1,980,000	Net Rental Revenue		$ 1,440,000
Operating Expenses		$ 300,000	Operating Expenses		$ 300,000	Operating Expenses		$ 300,000
Net Operating Income		$ 1,400,000	Net Operating Income		$ 1,680,000	Net Operating Income		$ 1,140,000
Cap Rate	9%		Cap Rate	6%		Cap Rate	9%	
Value		$ 15,555,556	Value		$ 28,000,000	Value		$ 12,666,667
Max LTV	75%		Max LTV	80%		Current LTV	177%	
Loan Amount		$ 11,666,667	Loan Amount		$ 22,400,000	Loan Amount		$ 22,400,000
Debt Service	8%, 30 years		Debt Service	6%, Int Only		Debt Service	8%, 30 years	
$85,605.87		$ 1,027,270	$1,344,000		$ 1,344,000	$164,363.26		$ 1,972,359
DSCR		1.36	DSCR		1.25	DSCR		0.58

Changing the cap rate only accounts for 41% of the value change.
Changing the NOI only accounts for 59% of the value change.

CRE loss estimation for Community Banks

- SCAP used a series of national 2 year loss rates through 2010 that may not be appropriate for community banks.
- Historical data may not be helpful. We live in unprecedented times.
- Many banks are counting on a V-shaped recovery. What if it does not happen?
- "Imagination is more important than knowledge" – Albert Einstein



What level of analysis is appropriate for smaller banks?

- The level of analysis should be consistent with the size and complexity of the organization.
- If the bank has a concentration in CRE, then a higher level of analysis is expected.
- Banks should have sufficiently granular data to analyze loan level credit metrics, at least for the largest loans.
- Regional economic conditions will impact how CRE markets react to stress.

Construction Loans

- The hardest losses to quantify, but also the largest, especially for community banks.
- Additional problems:
  - Regime shift occurred in demand
  - No ongoing cash flow to structure around
  - Need to determine “highest and best” use
  - Single obligor concentrations
- The absorption time for these projects could be measured in years and not in months.
  - How much can a bank rely on recourse?

Prudent CRE Workout Guidance

- Having more foreclosures than necessary is in no one's best interest.
- A loan should not be adversely classified solely because the value has declined.
- As long as the property is producing cash flow a sustainable loan can be structured.
  - A / B Notes
  - Needs to include amortization and reasonable DSCR
  - TDR guidelines have not been changed
- Not "pretend & extend", but "prudent".