HVCRE,
CRE Stress Testing, and
CECL Requirements

Robert D. McGibbon
Field Supervisor
Los Angeles Territory

Presentation Content

HVCRE
- Defining HVCRE
- Capital Impact and Reporting
- Proposed Regulatory Changes to HVCRE Rules

CRE Stress Testing
- CRE Stress Testing Requirements
- Types of Stress Testing

CECL
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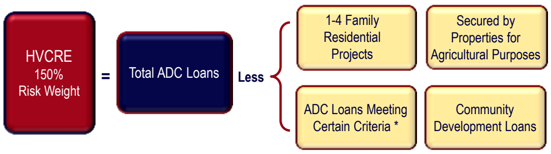
What is High Volatility Commercial Real Estate (HVCRE)?

Acquisition, Development, and Construction (ADC) Loans (with some exemptions)

- Effective January 1, 2015
- Requires 150% Risk Weighting

HVCRE Exemptions



* ADC loans meeting certain criteria are not HVCRE

HVCRE Exemptions (continued)

❑ Exclusion from HVCRE if:

- LTV is ≤ the applicable maximum supervisory LTV; **and**
- The borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid developmental expenses out-of-pocket) of at least 15% of the real estate's appraised as-completed value; **and**
- Capital must be contributed before bank advances funds, and capital contributed or generated by the project, is contractually required to remain in the project throughout the life of the project. The life of project concludes only when converted to permanent financing, sold, or paid in full.

Eligible Capital Contributions

- Land, purchased with cash, and contributed to the project prior to the advancement of funds. This includes, engineering or permitting expenses directly related to the project.
- Out-of-pocket development expenses paid by the borrower, including:
  - Brokerage fees
  - Marketing expenses
  - Cost feasibility studies
  - Soft costs

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<u>Ineligible</u> Capital Contributions

- Borrower-owned real estate from an unrelated project pledged to the subject project
- Buyer's deposits on units in a condominium project (that is not already exempt by virtue of its designation as a 1-4 family property)
- Financing from an external lienholder, such as a second mortgage or any other proceeds from a separate loan used to finance the project
- Assets contributed to the project **after** the advancement of funds
- Cash received in the form of grants, regardless whether the grant is received from nonprofit organizations, municipalities, or government agencies
- Any contribution that may be withdrawn by the borrower prior to obtaining permanent financing, selling the project, or paying the loan in full

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Reporting HVCRE

- Call Report Schedule RC-R, Part II, items 4.b and 5.b
- Risk Weight 150% for Risk-Based Capital

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Key Highlights of Proposed Regulatory Changes

- Replace HVCRE with HVADC
- Change Risk Weight to 130%
- Remove Restriction on Internally Generated Capital
- Grandfather Treatment of ADC Loans Originated Prior to Final Rule

Concentration

Generally a concentration is a significantly large volume of economically-related assets that an institution has advanced or committed to one person, entity, or affiliated group.

- Commercial Real Estate
- Geographic Location
- Single Borrower/Entity
- Industry
- Product Type
- Acquisition, Development, and Construction
- Agriculture
- Livestock

CRE Stress Testing

Institutions with CRE and subprime lending concentrations should perform portfolio-level stress tests or sensitivity analyses to quantify the *impact* of changing economic conditions on **asset quality, capital, and earnings**.

Supervisory Oversight

- ADC => 100% Total Capital

  or

- Non-owner-occupied CRE => 300% Total Capital **and** the CRE portfolio has increased by 50% or more during the prior 36 months

Definition of Stress Testing

Forward-looking quantitative evaluation of stress scenarios that could impact a banking institution’s financial condition and capital adequacy.

Stress Testing Models

The FDIC does not Endorse a Prescribed Method for Stress Testing.

- Does not have to be Complex
- Should be Tailored to the Institution
- Can be Performed Internally or by a Competent Third-Party
- Should be Performed Annually

Stress Testing Considerations

- Debt Coverage Ratio
- Loan to Value
- Cap Rate
- Vacancy/Occupancy
- Geographic Location

Stress Testing at Underwriting

- Interest Rate
- Vacancy/Occupancy
- Sales Volume
- Expenses

Current Expected Credit Loss (CECL) Model

- Issued on June 16, 2016
- Incurred Loss vs. Expected Loss
- Impact on FAS 5, FAS114, TDRs, Charge-off/Recoveries
- Applies to any Institution Issuing Credit

CECL Effective Dates

	US. GAAP Effective Date	Regulatory Reporting Effective Date*
Public business Entities (PBE) that are SEC filers (SEC filers)	Fiscal years beginning after December 15, 2019, including interim periods within 2020	March 31, 2020
Other PBEs (non-SEC filers)	Fiscal years beginning after December 15, 2020, including interim periods within 2021	March 31, 2021
Non-PBEs (private companies)	Fiscal years beginning after December 15, 2020, including interim periods beginning after December 15, 2021	December 31, 2021
Early application for all entities	Early application permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years	

*For institutions with calendar year ends

Today vs. Future

Annual — Current U.S. GAAP

[Unadjusted historical charge-off experience ± Qualitative adjustments] ✖ Loss emergence period ✖ Loan category balance =

ASC 450 (FAS 5) ALLL

Lifetime — CECL

[Unadjusted historical charge-off experience ± Qualitative adjustments] ✖ ~~en ce~~ ✖ Loan category balance =

CECL ACL (ASC 326)

Loss Rate Methods

- Snapshot/Open Pool Method
- Remaining Life Method
- Vintage Method

Common Challenges Requiring Adjustments

- Losses are Minimal
- No Predictive Pattern of Losses
- Lack of Sufficient Pool Data
- Lack of Historical Data
- Different Composition of Loans
- There are Changes in Economic Environment

Things to Consider

- Understand the Data
- Data Availability
- Utilize Relevant Data
- Systems/Operations and Third-Party Vendors

Most Importantly - Don’t Wait! Begin Now!

Resources

- *Community Bank Summary: Proposed Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996*
- *Conference of State Bank Supervisors: High Volatility Commercial Real Estate (HVCRE) Examiner Job Aid*
- *12-12-2006 FIL – Interagency guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*
- *The summer 2012 Supervisory Insights Journal article on Stress Testing Credit Risk at Community Banks*
- *Part 365 of the FDIC Rules and Regulations – Appendix A (Real Estate Lending Standards)*
- *12-18-15 FIL - Interagency statement on Prudent Risk Management for CRE Lending*
- *FDIC Examination Manual – Concentrations*

Resources

- *Joint Statement on the New Accounting Standard on Financial Instruments - Credit Losses*
- *Interagency Guidance – Frequently Asked Questions on the Current Expected Credit Losses Methodology (CECL)*
- *FASB CECL Standard (core guidance p. 101-123)*
- *Ask the Regulators: CECL Teleconference for Bankers: Practical Examples of How Smaller, Less Complex Community Banks can Implement CECL* *https://www.webcaster4.com/Webcast/Page/583/24368*


QUESTIONS