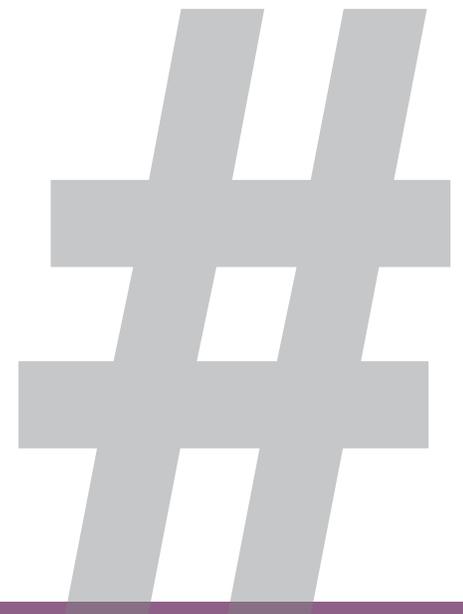


RISKS IN COMMERCIAL AND COMMERCIAL REAL ESTATE LENDING



The current economic recovery began in 2009 and is quickly becoming the longest recovery in history. Interest rates, until recently, and unemployment have been at historic lows. Capital and liquidity in the banking industry are near historic highs. Asset quality remains strong and overall underwriting is acceptable.

This provides the backdrop for a common question: “What stage are we in of this current economic cycle?” Although the answer is uncertain, it’s important to consider the emerging risks surrounding commercial and CRE lending.

THE ECONOMIC EPANSION CONTINUES?

There is an old adage that economic recoveries do not die of old age; there has to be a shock or imbalance in the economy to generate a downturn. It would appear that there have been several potential shocks and imbalances created within the economy.

- **Passage of Tax Reform in December 2017:** A potential shock to the economy was the substantial reduction of corporate tax rates beginning in 2018. With corporate liquidity already high, the lower tax rates will generate additional cash available for investment. While positive in the short term, the potential for overheating the economy in the medium term will be increasing.
- **Rising Interest Rates:** The time of low interest rates appears to be over. It is likely that the Fed will accelerate the number of rate hikes this year and into the future. As we underwrite loans in 2018, it will be critical to increase interest rate stress testing and consider interest rate protection as part of the structures. On commercial real estate, cap rates are likely to be impacted and values need to be stressed at higher levels.
- **Rising Labor Costs:** Unemployment is likely to fall into the 3% range in 2018. Immigration policy changes could also affect labor availability. Should economic activity accelerate, there will be more demands for labor with the relative imbalance resulting in increasing labor costs.

- **New Tariffs and Trade Deals:** New tariffs are being assessed on imported goods with some countries retaliating with tariffs on U.S. exports. Trade deals, in particular NAFTA, are in renegotiation potentially changing the business dynamic for commercial businesses.
- **Resulting Increasing Inflation:** The combination of the factors above could result in increasing inflation putting more pressure on economic activity.

In general, economists do not expect these factors to impact 2018, but there is growing conversation that these dynamics are creating an emerging risk to sustaining the recovery beyond this year.

NEED FOR LOAN GROWTH

Business loan growth fell to its lowest levels since the aftermath of the financial crisis in the final weeks of 2017. Commercial loan growth was an anemic 1.1% in 2017, the lowest level since 2011. Tax reform could make it better by increasing activity, or customers may choose to use the windfall to reduce debt. Regardless, loans are still the primary driver of profitability in banking and pressure for loan growth is increasing, resulting in these emerging risks.

- **Easing of Underwriting Standards:** With fewer deals, competitive pressure has been rising, which manifests itself in requests for easing of structure, more policy exceptions, and lower spreads.
- **Requests for Higher Hold Limits:** When there is a lack of new loan customers, banks increase exposure to existing customers. While this clearly results in putting more capital risk in a single deal, the potential cost of downgrading has also changed as the FDIC Insurance Assessment is now higher depending on an institution's criticized and classified assets level.
- **Managing Concentration Limits:** Overexposure to specific sectors was a critical issue in maintaining asset quality during the Great Recession. High exposure and rapid growth in the commercial real estate sector was particularly troublesome and demands for loan growth are generating calls for relief.
- **Launching New Products/Specialties:** The search for loan growth leads to the desire to expand into an area not previously offered. The challenge lies in whether the institution has the expertise to deliver effective risk management and customer satisfaction.

SECTOR RISKS ON THE HORIZON

Not all business is created equal, and it is likely that certain sectors will see the impact of changing economic conditions more than others. Some sectors where emerging risk is growing:

- **Retail:** The conversion from brick and mortar sales to ecommerce is increasing. Retailers focused on goods rather than services are facing increased pressure from online sites that offer greater shopping convenience. Store closings and bankruptcies are on the rise, which also carries over to the CRE market.
- **Construction:** It is increasingly important to evaluate the need for projects. For example, multifamily has been particularly strong in certain markets potentially creating oversupply. The number of skilled nursing projects and assisted living facilities is increasing rapidly, possibly overbuilding despite the demographics.
- **Healthcare:** There remains potential for changes in the regulatory environment at the national level.
- **Commodities:** Prices continue to be volatile especially in the agricultural sector. Trade issues could have greater influence in the near future.

CYBER AND FRAUD RISK

As commercial clients transact more online, and for banks that offer commercial card programs, the risk of fraud has increased dramatically the last few years and will only intensify. Banks will need processes in place and systems that detect fraud in order to stem the losses that are occurring.

PREPARING THE TALENT

Perhaps not as obvious as economic and competitive risks is the emerging talent gap. Many bankers today do not have experience with a significant economic downturn. It is important to start assessing staff and structural readiness for the next downturn. Training opportunities and coaching mentors with experience need to be considered to help manage this increasing risk.

ABOUT RMA

The Risk Management Association (RMA) is a not-for-profit, member-driven professional association serving the financial services industry. Its sole purpose is to advance the use of sound risk principles in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, operational risk, securities lending, and regulatory issues.

Founded in 1914, RMA was originally called the Robert Morris Associates, named after American patriot Robert Morris, a signer of the Declaration of Independence. Morris, the principal financier of the Revolutionary War, helped establish our country's banking system.

Today, RMA has approximately 2,500 institutional members. These include banks of all sizes as well as nonbank financial institutions. RMA is proud of the leadership role its member institutions take in the financial services industry. Relationship managers, credit officers, risk managers, and other financial services professionals in these organizations with responsibilities related to the risk management function represent these institutions within RMA. Known as RMA Associates, these 18,000 individuals are located throughout North America and financial centers in Europe, Australia, and Asia.

No part of this publication may be reproduced, by any technique or process whatsoever, without the express written permission of the publisher.

Phone: 800-677-7621

Fax: 215-446-4101

Website: www.rmahq.org

RMA UNIVERSITY

In today's rapidly changing financial services industry, you need practical, day-to-day knowledge that will help you excel in your profession. RMA provides quality education to advance sound risk principles in the financial services industry. Traditional classroom training and online learning resources are available as open enrollments or in-bank training. Visit RMA's event calendar at <https://www.rmahq.org/eventcalendar.aspx> to find out what's available, or learn about RMA's online resources at <http://www.rmahq.org/rma-university-online/>.

ESTATEMENT STUDIES

RMA's eStatement StudiesSM is the only source of comparative data that comes directly from the financial statements of small and medium-size business customers of RMA's member institutions. Round-the-clock online access gives you the ease and flexibility to use this wealth of information at your convenience. Visit <http://www.rmahq.org/estatement-studies/> to learn more.

ARE YOU AN RMA MEMBER?

An RMA membership provides many benefits. In addition to a free subscription to *The RMA Journal*[®] and discounts on RMA events, products, services, and training, membership also provides countless networking opportunities and exposure to the industry's key decision makers and managers. RMA's local and national events keep you up to date on industry trends and issues while allowing you to meet new people and swap successes with peers. Visit <https://www.rmahq.org/membership-types/> to learn more about membership.