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# LOAN RISK MANAGEMENT DURING A DOWNTURN: A CALCULATED SCIENCE

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# PART I

Part of our job here at Extensia Financial—a very significant part—is to help our partners navigate the complex matter of risk management. This is one of the many functions a credit union service organization (CUSO) performs. In the midst of the current public health and economic crisis, we are fielding quite a few calls pertaining to the lack of property rental income. These calls are actually a good sign because both our Borrower and credit union customers are engaging in an early dialogue with us and keeping the lines of communication open. This is when we can help the most. When we look at data, trends, and options *together*, risk management can be much more proactive than reactive.

## History is on Our Side

It is not just the pre-funding loan aspect that the CUSO monitors for risk mitigation; Extensia also thoroughly reviews, assesses and mitigates post-funding risk whenever possible. Extensia has underwritten over $3.5 billion of commercial real estate loans spanning 42 states. Together, the executive staff at Extensia has approximately 150 years of experience helping Lenders manage and mitigate risk. Across our company, Extensia's typical staff member has about 8 years of tenure, and the vast majority of our team members came to us with prior real estate and/or lending experience.

Extensia is a full-service commercial real estate CUSO that originates, documents, underwrites, processes, and coordinates funding between Lenders and Borrowers. And once a loan has closed, we service the loan for its entire life, including special collections and foreclosure if necessary. Extensia has years of experience tracking the covenants that protect lenders, collecting loan payments, and working with Borrowers. Extensia provides local credit unions the ability to participate in larger commercial projects, often beyond the scope of their geographic area, field of membership, typical asset classes or loan size. Our relationships with our credit union partners allow us to source loan opportunities that best fit the credit union's lending strategy because we take the time to listen to each of our customers and work with them to understand the lending plan they want to put in place.

## What's Happening Today?

In the past few months, since the pandemic hit our shores, Extensia has received and processed a number of Borrower requests for payment forbearance due to the effects of COVID-19. While precautions vary from region to region and state to state, many commercial real estate properties not deemed "essential" have been required to temporarily close by public health mandate. Additionally, with the tremendous number of people that are unemployed, multi-family properties have also been, and continue to be, impacted. Suddenly, property cash flow and, in turn, loan payments are being affected, as are the lenders that financed these properties.

To offset the economic impact of the pandemic, the Federal Reserve has lowered its lending rate for banks to 0%. Many people mistakenly assume that the Fed's new, lower interest rate immediately translates to lower interest rates for the consumer; however, consumers typically will not see that interest-rate drop extend to main street in the near term.
Many commercial mortgage-backed security (CMBS) lenders have already paused issuing new commercial real estate loans until they determine the short and intermediate-term effects of COVID-19.

Fannie and Freddie have also temporarily pulled back from funding new multi-family loans. Simultaneously, multi-family and commercial lenders are inundated with requests for lower interest rate refinancing. Some banks have instituted false floors to prevent their interest rates from falling below a preset, profitable level.

## Operating Statements Are Essential

When assessing property operations and the financial health of the associated Borrower, it is essential to gather two to three years, or more if possible, of operating statements. Loan Servicers, such as Extensia Financial, are working to create for the Lender a clear picture of the property, Borrower and, if applicable, guarantor's trend line over the review period, as well as the prior two to three years. There are a number of questions we are looking to answer. Is the rental income showing an increasing trend, or has it remained relatively flat? Has the Borrower's liquidity and net worth continued to increase? Has there been a marked change in either dimension that cannot be easily explained, e.g. the purchase of a new real estate asset? The answers to these questions are incorporated into the loan review.

### ***Payment Performance***

As the loan servicer, Extensia verifies payment performance for regular, timely payments. The Borrower's payment history over both the short and long-term will typically provide a high-level indicator of the Borrower's financial health. Given the current world economy, this factor should be an area of focus for Lenders, if not already.

A loan payment history that contains late payments signals a Lender or Servicer that a more in-depth discussion or property inspection is warranted. It may indicate that a cash flow issue exists with the Borrower, which in turn can pose problems for the Lender. Because we are a CUSO servicing commercial real estate loans for the credit union industry, it is our responsibility under the National Credit Union Administration (NCUA) regulations to keep Lenders informed of their Borrowers' loan payment history.

## To Their Credit

### ***Poor Credit Reports***

As most people know, Credit ratings play a significant role in the interest rates for which a Borrower will qualify. In fact, they determine a number of factors: the degree of risk (i.e., exposure to possible default), the amount of capital to be loaned/borrowed, the interest rate, and the term associated with the loan. While favorable credit reports typically translate into lower risk and, therefore, lower rates, weak credit reports usually translate into higher risk and higher rates.

### ***The Three C's of Credit – Character, Capital, and Capacity***

Credit scores are dynamic. They can change either positively or negatively depending on the amount of debt incurred and how timely bills are paid. Lenders look at a Borrower's *character* as indicated by how they have handled debt and payments in the past. By looking at a Borrower's credit history and personal background, Lenders can determine a Borrower's integrity and reliability, and, thus, their likelihood to pay their bills. *Capital* refers to current assets available to the Borrower, such as savings, investments, and real estate that could be used to repay debt, if necessary. *Capacity* addresses how much debt a

Borrower can comfortably handle. To determine capacity, income streams and borrowing obligations are assessed to determine the amount of liability that would be considered reasonable for the Borrower to take upon themselves.

A good loan Servicer recognizes that credit reports function not only as an early indicator of risk exposure at the origination of a loan but also as an on-going benchmark during the loan tenure. By keeping apprised of the Borrower's credit scores, the Servicer is often able to identify and address any concerning indicators before a greater problem comes to light. Extensia reviews each loan it services annually to determine the trend line of each loan. Our Asset Managers typically create a 3-year operating history comparison, if available, to determine whether a loan is holding steady, improving, or declining. We also review each entity's date-to-date operating results, liquidity and net worth. These data-points are incorporated into the analysis, along with credit scores, when creating a loan review. Equipped with the information gained from all the data compiled in the loan review, Extensia is able to tailor a plan for that specific loan.

## Steady Flow

### ***Global Cash Flow***

*Global Cash Flow* refers to the amount of income (or cash) that is generated across a Borrower's entire real estate portfolio. This calculation takes all properties with positive cash flow and subtracts any property's operating results that are simultaneously experiencing a negative cash flow to derive the positive or negative global cash flow of that Borrower. It is essential to assess how much cash is available, globally, to pay all obligations across the entire portfolio, as ancillary or contingent liabilities can potentially affect assets with positive cash flow by requiring the cash be drained in support of weaker properties. For this reason, Servicers and/or Lenders must always consider the possible impact of one asset's negative cash flow on the other assets within a real estate investor's portfolio. We want Lenders to understand that, depending on the ownership structure, a Borrower's portfolio very well may function as a whole.

Any operating statement anomalies must be vetted with the Borrower to determine if these items constitute one-time capital expenses that depreciate over time or if an underlying maintenance or management issue exists. These types of issues frequently arise in annual reviews. By assessing how global cash flow plays out across entire portfolios, we are able to work with Borrowers to mitigate risk for our credit union customers. Our objective is to keep the loan current and the risk rating as favorable as possible.

## It's All in the Math

### ***Loan to Value (LTV) Ratio***

Lenders and Servicers utilize indicators to ensure they are not lending more on a property than they reasonably should. To calculate an LTV ratio, the outstanding loan balance (LB) is divided by the present value (PV) of the property. LB/PV=LTV%.

Lenders often have differing minimum LTV requirements based on the specific type of asset or location of the property. This calculation helps the Lender and Servicer keep track of the equity in the property value to ensure that it is not eroding. If it is, then it becomes necessary for us to work with the Borrower to mitigate this erosion (risk).

### ***Debt Service Coverage (DSCR) Ratio***

Another number we look at is the Debt Service Coverage Ratio (DSCR), which measures the cash flow available to pay current debt service obligations after all property expenses are satisfied. A decrease in revenue causes a reduction in DSCR, so we keep our eye on this figure to identify trend lines, spikes, or repeating patterns. In this calculation, the higher the number, the more cash flow available to make mortgage payments. Again, as with LTV, the minimum DSCR that a Lender requires may vary depending on the asset class or property type.

All of these tools are utilized in concert to help Servicers and Lenders identify and mitigate on-going exposure to risk.

# PART II

As a credit union service organization (CUSO), Extensia helps credit unions navigate the intricacies of commercial real estate lending, and risk diversification is an important part of what we do. Examining the data, trends, and options make our risk management recommendations analytical, methodical and systematic.

## Got You Covered on Coverage Concerns

### ***Lapsed Insurance Policies***

*Lapsed Insurance Coverage* should not be overlooked when underwriting or reviewing a commercial real estate loan. The Lender, or their Servicer, must verify that the property that serves as security for the loan has adequate insurance coverage and that premiums are current. Insurance is an area that deserves renewed attention during the COVID-19 crisis. As owners face diminished rental income due to the economic impact of the pandemic, some Borrowers may have to begin making difficult decisions regarding which bills to pay with available cash flow. Some may opt to let insurance lapse, which places the Borrower and guarantor in an unfortunate position if a new tragedy, such as a natural disaster, should also hit the property and further strain liquidity. Reviewing the loan covenants to verify there are no loan defaults helps to ensure that unforeseen issues do not arise at a later date. When Lenders or Servicers make themselves aware of incongruencies, it becomes easier to anticipate potential problems and create a plan to mitigate further risk if necessary. Extensia proactively reviews insurance coverage, tax payments, cash flow, and credit reports, and determines if more frequent or off-cycle site inspections are warranted, so appropriate action can be taken.

### ***Delinquent Tax Payments***

*Delinquent Real Estate Tax Payments* to the city or state comptroller alert the Lender and Servicer to take a closer look at property operations and perhaps consider performing property inspection(s) more frequently than the typical annual basis. This closer look is warranted if a property tax installment is late or missed because penalties assessed on past due property tax bills are often quite high and will typically be avoided by Borrowers if at all possible. Additionally, property taxes, if not promptly and properly addressed, are one of a very few legal reasons for which a Lender's loan can be legally removed from a property. This is why it is so important that the Lender and Servicer be proactive in determining any underlying cause of a missed or late payment.

If a problem is discovered, this is not the time to presume or panic. Instead, it is a time for skillful investigation. Ask questions. Look at the property holistically. Consider the overall cash flow in the Borrower's portfolio and the depth of any potential impact. Delinquent tax payments can and should be interpreted as a red flag that warrants immediate attention.

## Inspection Anticipation

### ***Poor Site Inspection Results***

*Poor Site Inspection Results* provide the Lender and Servicer with another indicator that a commercial loan requires a more in-depth review. Lenders conduct a thorough preliminary inspection of commercial real estate before loan funding, but there is sometimes a temptation for some busy Lenders and Servicers to consider overlooking this tool when servicing the loan *after* funding. Yes, it can be time-consuming to perform site inspections with in-house staff and costly to have a vendor perform the inspection if the servicing portfolio is of significant size. There are also the issues associated with tracking the

inspections, reviewing them when they are complete, and following up if deferred maintenance issues arise during the inspection. However, a physical site inspection is an invaluable tool that has the ability to disclose otherwise unreported property conditions: resurfacing needs, interior water stains, obstructions to access and egress, lack of code compliance, etc.

For this reason, physical site reviews are essential in a Lender's regular reporting because risk invariably increases when assumptions are made and indicators willfully ignored. Site inspection results help answer the question, "What is *not* being taken care of as it should be?" Additionally, the physical inspection report, more often than not, affirms that competent property management professionals are taking care of the property per the loan covenants. However, should a conversation need to take place with a Borrower, it is important not to delay in reaching out to ask the important questions necessary to determine what is happening at the property and Borrower level.

The Lender and Servicer should expect transparency in communication with the Borrower. A case in point might be a high-net-worth Borrower residing in a different state than the subject property, who must rely on a local property manager. In situations such as this, the Borrower is usually grateful to be apprised of a potentially problematic situation at their property, so they can provide the property manager appropriate direction on how best to handle the asset on their behalf. After the issue is addressed, the Borrower will provide the Lender or Servicer with verification of completion of the repairs or maintenance. The conversation could also go in a completely different direction wherein the Borrower expresses their desire to refinance or sell the property. It's only possible to facilitate successful outcomes when the lines of communication are open, and the sooner the better.

## Keeping Covenants

A loan transaction documents a promise made between a Lender and a Borrower to abide by an agreed-upon set of conditions. In loan documents, these conditions are referred to as covenants.

### ***Loan Covenant Violations***

*Loan Covenant Violations* include any and every incident of *Late Payments, Delinquent Real Estate Property Tax Payments, Lapsed Insurance Coverage, Substandard Credit Scores,* and *Poor Site Inspection Results*. All of these violations should alert the Loan Servicer or Lender to take a closer look at both the Borrower and underlying property.

# PART III

Service organizations that work well in commercial lending utilize all tools available to mitigate risk, especially in preparation for any potential economic downturns. Extensia has this proficiency finely honed. We know how to mitigate risk, diversify portfolios, and analyze trends.

## Looking to the Future

Since each state's governor has been given latitude to reopen their state according to their own timetable, it remains unclear how much more time COVID-19 stay-at-home requirements in some states will remain in force or how long it will be before most people are back to work. Even the effectiveness of the bail-out bills, designed to ease the pandemic's economic impact, will not be apparent for another 6-12 months. But we do know, at least for now, it's *not* business as usual. Unemployment and other disruptions are being felt nationwide and are producing ripple effects throughout all areas of the economy.

Though there is no way we can be certain of the pandemic's impact on the overall economy, Borrower's responses to this year's events have been more immediate and proactive that responses during the 2008/2009 recession. Borrowers appear to see the downturn as (more) temporary. They are also responding more proactively in that they are willing to ask for assistance rather than wait for their situation to become even more critical. Given their willingness, it is essential to have candid conversations with Borrowers early on regarding any potential impact to rental income and not make the mistake of ignoring warning signs, as many did a decade ago.

When it comes to more sophisticated assessments of risk factors and potential risk factors affecting commercial real estate, it is clearly beneficial to work with a Servicer that is experienced in knowing the questions to ask and the analysis that must be performed to achieve the desired outcome. Servicing organizations such as Extensia are available to guide credit unions through these more advanced analyses and the difficult Borrower conversations that often ensue.

## Geographic & Risk Diversification

Credit unions are impactful both for and within the communities they serve. They specialize primarily in depository accounts, residential lending, auto loans, and credit card services. As not-for-profit financial institutions, credit unions can leverage their member's deposits to offer competitive lending rates. Though commercial lending is typically not a credit union's core business, those that expand into it will see commercial lending rates that are beneficially higher than auto or residential lending rates. Commercial loans can also help credit unions diversify their risk and increase their internal rate of return.

To assist our credit union partners, Extensia's proprietary participation lending website presents commercial real estate lending opportunities that credit unions may not otherwise be aware of or have the ability to take advantage of without the benefit of this platform. Additionally, Extensia provides the risk assessment and loss mitigation tools and experience that allows credit unions to participate in successful ventures without unnecessary exposure to risk. With its current loan portfolio spanning 42 states, Extensia can provide loan opportunities inside or outside the credit union's field of membership. This flexibility brings the advantage of diversifying risk geographically. Because commercial loans are

larger and more complex than residential loans, more than one Lender typically participates. This kind of collective participation helps the Lender limit their risk by investing in as many or as few property types as fit within their production goals and risk guidelines. Each credit union has the freedom to choose the degree to which they want to participate in a particular commercial loan being offered. Extensia then undertakes the servicing of the loan on behalf of the entire group of Lenders, collecting and remitting monthly mortgage and impound payments, if called for in the loan documents, and preparing monthly reporting packages that include collection, delinquency, tax, insurance, and risk rating reports. Additionally, Extensia conducts annual physical inspections and collects property operating reports and Borrower financial statements and tax returns as part of the loan review process. To ensure the information we provide is effectively summarized and useful to the credit union, Extensia compiles its analysis into a comprehensive five-page institutional-quality summary report with historical references, backed by a supporting-documentation package.

## Best Steps Forward

Benjamin Franklin had it right when he said, “An ounce of prevention is worth a pound of cure.” Lenders should never wait until a property has cash flow problems. They should always take the initiative to either use the available data to look for early indicators or have a loan Servicer, such as Extensia, perform this service. After years of identifying and responding to downward trends based on empirical data, we also have the experience to open positive and effective discussions with Borrowers on the Lender’s behalf.

## Mitigation Strategy

As credit unions asses the current downturn, Extensia wants them to understand that—although there are indeed inherent risks in commercial lending—there are real and practical ways to mitigate that risk. Our best advice for our partners, or any Lender, is to be proactive and, perhaps, associate yourself with a trusted commercial servicing organization that can help examine and respond to all the various loan indicators.

Commercial lending is still very much worth consideration for the credit union community. Additionally, for those organizations sitting on capital, commercial real estate investment provides an opportunity to distribute those funds back into the community.

Even if a credit union is new to commercial lending, Extensia has a thorough orientation and training process that will help that credit union understand the requirements and procedures. Extensia has been helping credit unions increase their production pipelines for over twenty years, and we would love the opportunity to help each and every credit union meet its own individual production goals. Our mission is to serve our customer-partners as the most trusted commercial real estate member business lending CUSO in the country.