

Introduction

The key to a successful commercial real estate (CRE) lending operation is the development of a robust risk management framework that includes strong underwriting standards and credit administration practices. The January 2013 Government Accountability Office (GAO) Study, *Financial Institutions Causes & Consequences of Recent Bank Failures*, found that most of the 414 financial institutions that failed between January 2008 and December 2011 pursued aggressive growth strategies, combined with weak underwriting standards, and weak credit administration practices. These bank failures were driven largely by CRE loan losses after the economic downturn that began in 2007.

This bulletin addresses the importance of sound risk management practices when credit risk is heightened by concentrations in CRE¹ credits. For purposes of this article, a CRE loan refers to a loan for which the cash flow from the sale or lease of the real estate is the principal source of repayment. These include loans to acquire, develop, construct, improve, or refinance a CRE property.

1 See SR Letter 15-17, "Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending," which is available at: <https://www.federalreserve.gov/supervisionreg/srletters/sr1517.htm>, and SR Letter 07-1, "Interagency Guidance on Concentrations in Commercial Real Estate," which is available at: <https://www.federalreserve.gov/boarddocs/srletters/2007/sr0701.htm>.

2 The supervisory criteria include:

- Rapid CRE growth;
- Significant CRE loan exposure in a specific sector;
- Total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total capital; or
- Total commercial real estate loans as defined in the interagency guidance represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's CRE loan portfolio has increased by 50 percent or more during the prior 36 months.

Supervisory Guidance Focus

Supervision and Regulation (SR) Letter 07-1, "Interagency Guidance on Concentrations in Commercial Real Estate"

Interagency guidance was issued in December 2006 under SR Letter 07-1, to address institutions' increased concentrations of CRE loans. The guidance emphasizes the importance of strong risk management practices and appropriate capital.

SR Letter 15-17, "Statement on Prudent Risk Management for Commercial Real Estate Lending"

Interagency guidance was issued in December 2015 under SR Letter 15-17, to reinforce the core principles in the Interagency Guidelines Establishing Standards for Safety and Soundness (12 CFR 208, appendix D-1). The federal banking agencies observed substantial growth in many CRE asset classes and lending markets; increased competitive pressures; rising CRE credit concentrations in banks; and an easing of CRE underwriting standards, including less restrictive loan covenants, extended maturities, longer interest-only payment periods, and limited guarantor requirements. Underwriting discipline and prudent risk management practices should be maintained in order to identify, monitor, manage, and control risks arising from CRE lending activity, and meet supervisory expectations for safe-and-sound lending.

The guidance provides supervisory criteria for CRE concentrations.² The criteria do not constitute limits or a "safe harbor" on an institution's lending activity, but rather serve as a starting point for examiners and bankers to discuss CRE concentration risk. For example, a bank should have heightened risk management practices if the bank has significant exposures to a single CRE sector (for example, multi-family properties in a single market). In addition, a bank with CRE exposure as its most significant credit risk, regardless of the level of exposure relative to capital, should have a framework in place to manage the risk. Above all, a bank's risk management practices should be commensurate with its risk profile and should be adjusted as the credit risk profile changes.

Key Risk Management Elements

An effective CRE risk management framework is integrated across seven key elements in the interagency guidance as shown in Figure 1. The components of a sound CRE risk management framework are dynamic and should be routinely reviewed and adjusted by management to account for changes in market conditions and the bank's overall risk profile.

Figure 1: Key Risk Elements



Consider the following example of how the risk elements should be employed at a bank pursuing a CRE growth strategy:

ABC Bank is located on the Gulf Coast in a high-income, high-net worth market where the economy is heavily reliant on the oil and gas industry. The bank has traditionally maintained a wealth management lending strategy focused on lending to individuals with substantial liquidity, net worth, and disposable income. Loans are typically well-secured by cash collateral. The bank has experienced nominal losses as a result of its lending strategy and, as a consequence, the allowance for loan and lease losses (ALLL) is relatively low when compared to peers of comparable asset size. Further, capital is sufficient for the bank's risk profile and the inherent risk in the loan portfolio. Bank management has noted an increase in CRE development in the market and an increase in construction and land development (CLD) lending by its competitors. In an effort to increase earnings and to meet its strategic growth objectives, bank management starts to engage in CRE lending, focusing on CLD loans. The lending staff has experience in wealth management and consumer lending, but limited CRE experience.

What steps should ABC Bank take prior to moving forward with a CRE growth strategy?

Prior to pursuing a CRE lending strategy, the board of directors and management of ABC Bank should ensure that its risk management framework can support such a strategy. Lending staff with CRE experience, bank capital levels, and policies and procedures should fully support the expected growth. The senior management of ABC Bank should review the interagency supervisory guidance detailed in SR Letter 07-1 to assess whether its risk management framework is sufficiently robust for the bank's CRE concentration risk and promotes safe and sound CRE lending. Senior management may also confer with the bank's primary supervisory contact to discuss whether the bank's risk management practices are appropriate for the lending strategy.

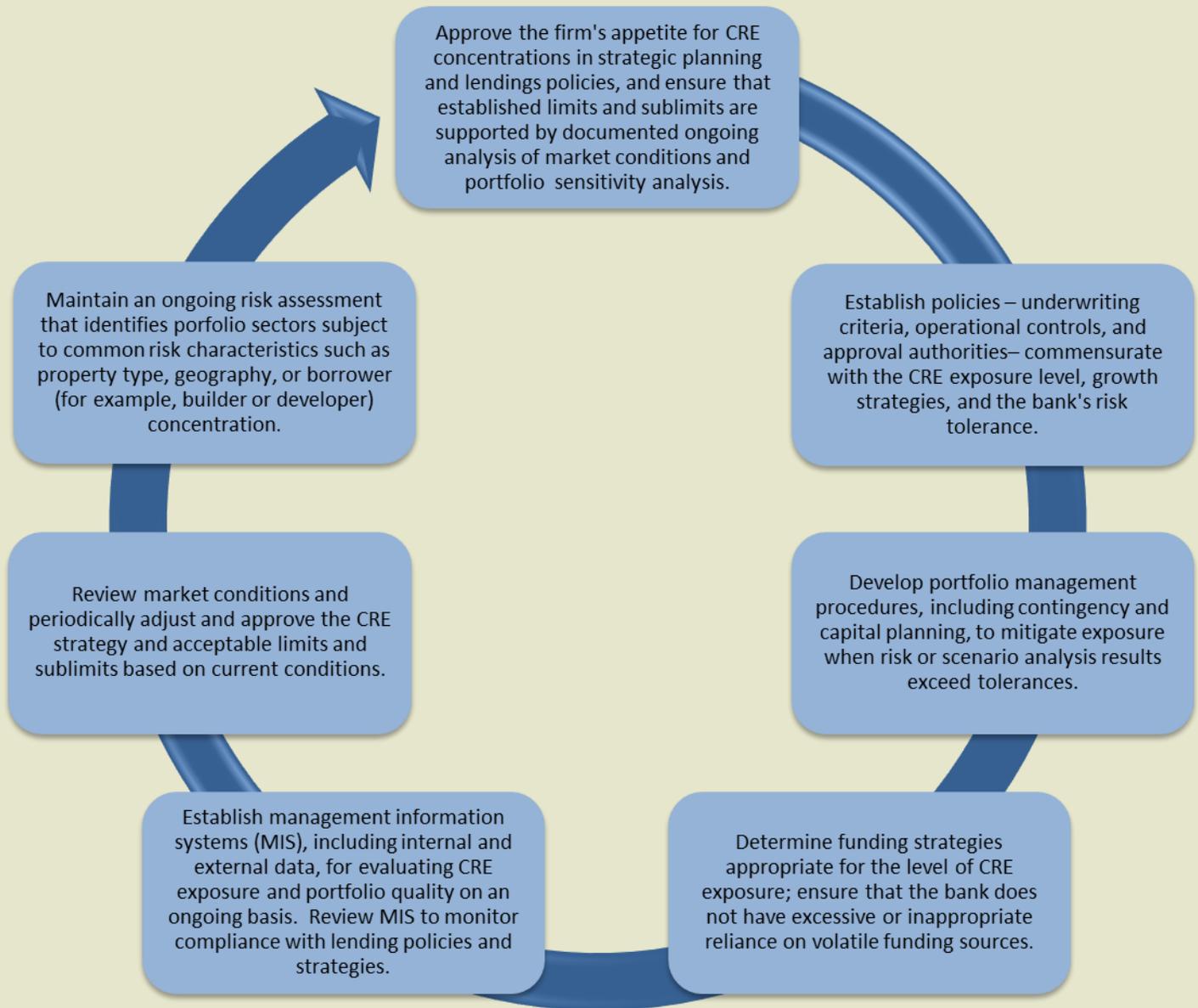
Risk Management Element: *Board of Directors and Management Oversight*

A bank's board of directors has ultimate responsibility for establishing the bank's lending strategy and CRE risk tolerance and ensuring that management is operating within internally approved risk tolerance. Board and senior management oversight of CRE concentrations can be viewed as a cyclical process as shown in Figure 2, on Page 3.

Risk Management Element: *Portfolio Management*

Credit risk should be managed at the individual loan level as well as at the portfolio level. Even when individual CRE loans are prudently underwritten, concentrations of loans that are similarly affected by changes in the CRE market may expose an institution to an unacceptable level of risk if not properly managed. The bank's board of directors and management should regularly evaluate the correlation between related real estate sectors, and establish internal lending guidelines, concentration limits, and contingency plans to control the overall risk exposure.

Figure 2: Board of Directors and Management Oversight



In the example, ABC Bank added CRE lending as a strategic initiative to remain competitive with its peers and meet market demands. What happens if there is a downturn in the energy market and local CRE development is curtailed? ABC Bank should establish contingency plans to reduce exposure when risk exceeds board approved tolerances.

Results from market analysis and sensitivity analysis can be triggers for invoking a contingency plan for managing concentration risk. Management may choose to implement one component of the contingency plan when a particular metric is triggered. For example, management may reduce the number of

construction projects outstanding with a single builder, based on market data related to property inventory, project permits or project starts in a particular geographic area. Contingency plans should be integrated into CRE lending policies and into capital and strategic planning. Examples of strategies to actively manage concentration risks include tightening underwriting standards, reducing exposure in specific sectors, participating or selling loans, and raising capital. If a bank relies on loan sales to reduce exposure or provide liquidity, the bank should test the marketability of its portfolio.

Risk Element: *Management Information Systems*

Robust MIS is key to a sound risk management framework and portfolio management. The sophistication and complexity of the MIS will vary based on the size and complexity of a bank's CRE portfolio and the level and nature of concentration risk. Reports to the bank's board of directors and senior management should be timely and accurate and contain sufficient information for bank leadership to identify adverse trends and risks. Further, analysis of CRE portfolio monitoring reports should be used to identify changes that indicate loosening or tightening of CRE underwriting standards and to track exceptions to internal underwriting standards.

Prior to embarking on the CRE growth initiative, ABC Bank should ensure that its MIS enables the board and senior management to monitor portfolio performance in relation to the board's risk tolerance and policy parameters. It is important to analyze the adequacy of the bank's MIS to provide information on current market conditions and portfolio composition, as delinquencies and loan losses are lagging indicators of portfolio deterioration. For instance, the MIS should provide the bank with the ability to identify increasing or excessive risks in the CRE portfolio that may indicate the need to further assess and mitigate risk in the portfolio, segments of the CRE portfolio, individual loans or borrowers, or projects. MIS should also track problem loans so the bank can assess the need for additional personnel with expertise in a particular segment of CRE lending or loan workouts.

Examples of CRE credit factors that may be monitored, though not all inclusive, include:

- Debt service coverage ratio trends;
- Loan-to-value (LTV) trends in relation to the bank's policy and supervisory LTV guidelines;³
- Length of amortization trends within portfolio sectors;
- Length of interest only periods, interest capitalization, payment extensions, or loan modifications or renewals since origination;
- Budget overages;
- Project status compared to projected schedule;
- Compliance with borrower loan covenants; and
- Trends in policy exceptions, exception type, business line, geographical region, and/or loan officer.

Risk Management Element: *Market Analysis*

In order to assess market conditions, banks should perform ongoing market analysis for markets in which it lends. Market analysis should also be performed prior to entering new markets, changing or expanding lending strategies, or expanding in existing markets.

ABC Bank plans to expand its CRE lending activity, specifically CLD lending. The decision to do so is based on observed growth in the market and anecdotal information. This approach does not provide the board of directors and senior management with sufficient information regarding the viability of a CRE growth strategy within its specific market and is not a supportable justification to enter into this line of lending. An effective approach to conducting market analysis should include data from published research, real estate appraisers and agents, property taxing authorities, local contractors, builders, investors, and/or community development groups. Examiners will review a bank's documentation of its market analysis and how the information is used to drive policies and strategies, including portfolio stratification; stress testing; and strategic, contingency, and capital planning.

Risk Management Element: *Credit Underwriting Standards*

CRE lending policies should indicate clear and measurable underwriting standards, reflecting the bank's risk tolerances. Policies should address items such as maximum loan amount by property type; loan terms; pricing structures; collateral valuation; LTV limits by property type; requirements for feasibility studies and sensitivity analysis; minimum requirements for initial investment and maintenance of hard equity by the borrower; and minimum standards for borrower net worth, property cash flow, and debt service coverage for the property. Exceptions to the bank's policy should be documented in the loan proposal, and the approval should include the rationale for the policy exception. Exceptions to the bank's internal lending standards should be monitored and reported to the board. Further, in accordance with the *Interagency Guidelines for Real Estate Lending Policies*, such loans should be identified in the institution's records as exceptions to the supervisory LTV limits and the aggregate amount of LTV exceptions reported at least quarterly to the institution's board of directors.

³ Refer to the Agencies' regulations on real estate lending standards and the *Interagency Guidelines for Real Estate Lending Policies*: 12 CFR part 34, subpart D and appendix A (OCC); 12 CFR part 208, subpart E and appendix C (FRB); and 12 CFR 365, appendix A (FDIC).

Prior to expanding CRE lending activity, ABC Bank should establish specific loan underwriting criteria for CRE loans and also establish MIS to monitor adherence to its internal policies and to supervisory real estate underwriting standards. MIS should enable management to assess compliance with policy and aggregate trends in underwriting policy exceptions. Furthermore, underwriting standards may need to be adjusted periodically to account for changing market conditions or in response to declining capital ratios resulting from growth.

Risk Management Element: *Portfolio Stress Testing and Sensitivity Analysis*

Sensitivity analysis should be consistent with the size, complexity, and risk characteristics of a bank's CRE portfolio. Examiners will analyze stress assumptions to determine whether the bank has sufficiently robust stress scenarios, which should be derived from market analysis and internal MIS, to analyze the impact of adverse conditions on the loan portfolio. The analysis should address the potential effect of stressed loss rates on the CRE portfolio, capital, and earnings.

ABC Bank should develop criteria for stress testing individual loans as well as for portfolio-wide analysis. The stressed loss assumptions of the CRE portfolio should differ significantly from ABC Bank's core wealth management loan portfolio. Assumptions should consider peak loss rates by property type under periods of economic duress. Acceptable ranges of results should be defined, and when test results are outside of risk tolerances, management should take action to mitigate the risk.

Risk Management Element: *Credit Risk Review Function and Risk Rating*

A strong credit risk review function is essential to validating the bank's self-assessment, timely identification of emerging risks, credit risk management framework, and credit administration practices. While the credit risk review function should be sufficiently independent of the lending function, it may be sourced internally or externally. The credit risk review scope should provide sufficient coverage of concentrated CRE sectors in order to assess credit risk and identify problem loans. ABC Bank should ensure that its credit risk review function provides a periodic assessment of internal risk ratings for the CRE portfolio. Risk ratings assigned at the time of underwriting and on an ongoing basis should be reviewed for accuracy. Effective review programs validate that loans are underwritten in accordance with policies and that exceptions are approved at loan inception and monitored on an ongoing basis.

Final Thoughts

Risk management practices play a critical role in mitigating and managing CRE concentration exposure, as we have learned during real estate market downturns. A bank actively engaged in CRE lending or contemplating a CRE strategy needs to have risk management practices that are commensurate with the risk assumed by the bank and a risk management framework that promotes safe and sound CRE lending. CRE credit risks should be appropriately identified, monitored, measured, and controlled, as examiners will consider the nature of inherent risk resulting from CRE growth and concentrations and evaluate the impact on asset quality, earnings, capital, and liquidity. Examiners will also evaluate the adequacy of the ALLL in relation to the CRE growth and concentrations levels. Finally, examiners may ask a bank that has inadequate risk management practices and capital strategies to develop a plan to better manage its CRE credit concentrations. Ultimately, the most effective CRE risk management frameworks address the multiple risk management factors described in this article.

Other Supervisory Resources

- SR Letter 15-17, "Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending," available at <http://www.federalreserve.gov/bankinforeg/srletters/sr1517.htm>
- SR Letter 07-1, "Interagency Guidance on Concentrations in Commercial Real Estate," available at <http://www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm>
- Board of Governors of the Federal Reserve System, *Commercial Bank Exam Manual*, section 2103.1, Concentrations in Commercial Real Estate Lending, Sound Risk-Management Practices, available at <https://www.federalreserve.gov/publications/files/cbem.pdf>
- Board of Governors of the Federal Reserve System, *Bank Holding Company Supervision Manual*, section 2010.2.5, Oversight of Concentrations in Commercial Real Estate Lending and Sound Risk-Management Lending, available at <https://www.federalreserve.gov/publications/files/bhc.pdf>
- Burns, Jennifer. (2017). Managing Risks of Commercial Real Estate Concentrations. *Community Banking Connections*, available at <https://communitybankingconnections.org/articles/2017/i2/managing-risks-of-commercial-real-estate-concentrations>

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