

Regulatory Guidance on Commercial Real Estate Risk

Mind the Gap for Great Guidance on Good Lending

This article describes the key elements of an interagency guidance issued in December 2006 regarding concentrations in commercial real estate lending and sound risk management practices. The guidance can be used to identify possible gaps in an institution's commercial real estate risk management policies and procedures, as well as practices and processes. The article concludes with some options and reference resources for plugging those gaps.



by Dev Strischek **T**he German philosopher Georg Wilhelm Hegel advised that order is the first requisite of liberty, and here in the land of liberty, we bankers enjoy considerable order. For the continuing good of the order, on December 12, 2006, the FDIC, OCC, and Federal Reserve published their final guidance on concentrations in commercial real estate. Absent the OTC¹, these agencies have observed that commercial real estate (CRE) concentrations² have been rising over the past several years and, in their collective opinion, “have reached levels that could create safety and soundness concerns in the event of a significant downturn.”³

Small to mid-size institutions have been especially attracted to the profit potential of CRE lending, yet past history has shown the CRE markets rapidly reverse their fortunes during economic downturns. A bank's ability to survive CRE recessions depends on the adequacy of its risk management practices and capital levels⁴, but the agencies are concerned that the typical bank with a high

CRE concentration may not have the policies and procedures to manage the risk. Consequently, the agencies have issued this latest guidance for helping banks manage their CRE risk.⁵

Concentration Growth and the Final Guidance: Up, Up, and Away

The agencies' concern about CRE concentration stems from exponential growth in CRE relative to risk-based capital among smaller banks in just under three years:

Bank size (\$millions)	December 31, 2003	September 30, 2006
100-1,000	156%	318%
1,000-10,000	127%	300%

At the same time, surveys of banker practices as well as examination results indicate that high-concentration institutions have relaxed their under-

writing standards in response to stiff competition, and many banks lack appropriate policies and procedures to manage the related CRE risk.⁶

CRE concentration criteria. The agencies will employ two ratios and a growth measure “as a screen for identifying institutions with potential CRE concentration risk...that, if breached by a bank, may invite greater regulatory scrutiny to ensure the bank has in place heightened risk management practices and capital levels.”⁷

- Total reported loans for construction, land development, and other land add up to 100% or more of total risk-based capital.
- Total commercial real estate loans meet or exceed 300% of capital.
- Outstanding CRE loans have grown 50% or more over the past three years.

The guidance is aimed at CRE loans for which the cash flow from the real estate is the primary source of repayment, not at loans for which real estate collateral is taken as a secondary source of repayment or through an abundance of caution. Their risk profiles are *sensitive to the condition of the market and its drivers*—capitalization rates, vacancy rates, rental rates, and so on. They derive 50% or more of their repayment source from third-party, nonaffiliated rental income or from the proceeds of the sale, refinancing, or permanent financing of the property. Therefore, the following loans fall within the parameters of the guidance:

- Land development and construction loans, including one- to four-family residential and commercial construction loans and other land loans.
- Loans secured by multifamily property and nonfarm, nonresidential property where the primary source of repayment is derived from rental income associated with the property.
- Also subject to the guidance are loans to real estate investment trusts (REITs) and unsecured loans to developers if repayment depends on the performance of the CRE market.

Excluded from the guidance are loans secured by nonfarm, nonresidential properties *where the primary source of repayment is the cash flow* from the ongoing operations and activities conducted by the party, or affiliate of the party, who owns the property. So, the guidance is aimed at 1) borrowing real

The guidance actually provides an opportunity for financial institutions to compare their individual CRE risk management practices with the final guidance, identify any gaps, and then try to plug them.

estate developers and investors (REDI borrowers) and 2) co-REDI borrowers (e.g., the doctor who decides to build, own, and operate a shopping center)—but not at owner-occupied borrowers.⁸

While these new measures have generated considerable debate between bankers and regulators, the guidance is now in place, so bankers must learn to live with it. In fact, the guidance actually provides an opportunity for financial institutions to compare their individual CRE risk management practices with the final guidance, identify any gaps, and then try to plug them.

Overview of the Guidance: The Magnificent Seven

The guidance looks at seven elements of CRE risk management that institutions should address in establishing and maintaining a risk management framework that effectively identifies, monitors, and controls CRE concentration risk:

1. Board and management oversight.
2. Portfolio management.
3. Management information systems.
4. Market analysis.
5. Credit underwriting standards.
6. Portfolio stress testing and sensitivity analysis.
7. Credit risk review.

Most bankers will discover that the guidance offered for each of these seven aspects is very sound; even better, most institutions already have sound practices in place. Let's see what is expected of an institution for each of these elements and what remedies might be available to meet regulatory expectations.

Figure 1

LTV Exposure in Excess of FDICIA Guidelines

Loans Secured by Real Estate	FDICIA LTV	Aggregate \$ Over FDICIA LTV	Current Portfolio \$ Exposure	Portfolio Limit
A. Land carry loans, total			1,386	2,000
1. Commercial	65%	376	692	
2. Residential	65%	332	694	
B. Land developed loans, total			5,044	6,000
1. Commercial A&D loans	75%	512	1,370	
2. Residential A&D loans	75%	1,762	3,127	
3. Residential developed lots	75%	356	547	
C. Construction loans, total			11,508	12,000
1. Commercial construction	80%	731	3,987	
2. Residential construction	85%	990	7,521	
D. Improved property loans, total			14,962	18,000
1. Commercial O-O MP				
2. Commercial non-O-O MP	85%	1,362	8,479	
3. Mini-perm (MP):	85%	279	5,509	
a. Commercial				
b. Residential	85%	0	2	
4. Other:	85%	121	732	
a. Commercial				
b. Residential	85%	8	46	
c. Ag land	85%	0	0	
d. Misc	85%	16	191	
	85%	0	3	
E. One- to four-family mortgages, total			51,757	55,000
1. Residential O-O	90%	7,585	49,323	
2. Residential non-O-O	90%	119	2,434	
Total Aggregate RE, A through E		14,549	84,657	93,000
Total CRE, A1, B1, C1, D1, D3a, D4a, D4d		2,989		
Capital for current quarter			19,750	
1. Aggregate loans in excess of supervisory LTV/capital (100% max.)		73.67%		
2. Commercial loans in excess of supervisory LTV/capital (30% max.)		15.13%		

1. Board and management oversight. The board of directors is ultimately responsible for the level of risk assumed by the institution, so if the bank has taken on significant CRE concentration risk, then the bank's strategic plan should address the rationale for the CRE exposure in its overall growth objectives, financial targets, and capital plans. Moreover, real estate regulations dictate a written policy establishing limits and standards for credit extensions secured by real estate, whether REDI lending⁹ or owner-occupied (O-O) financing.

Specifically, the board or a board committee is to perform these tasks in order to demonstrate the bank's oversight:

- Establish CRE lending strategy and policy guidelines, including exposure limits¹⁰ for individual

borrowers and for property types. Periodically review them for possible adjustment to changes in market conditions or bank strategies.

- Ensure that management implements controls and procedures to comply with and monitor adherence to the bank's strategies and policies.
- Follow CRE market trends and conditions for properties where the bank is concentrated.
- Review portfolio risk reports¹¹ that identify and quantify CRE concentration risk.

So, the first step in our gap analysis begins with whether the board is approving your CRE strategy and policies, is receiving CRE portfolio reports that measure risk, evaluate concentration, and monitor policy exceptions, and is regularly informed on how the bank is responding to CRE markets and conditions. We can

dig a little deeper into the gap analysis by assessing what is expected of portfolio management next.

2. Portfolio management. Prudent underwriting of individual CRE loans does not necessarily result in low portfolio risk. What if all the CRE loans are made to the top three shopping center developers in the southwest Chicago suburbs? One step forward is to limit credit exposure to any one REDI borrower and to any one project. Other alternatives include hard-dollar limits or percentage of total CRE exposure limits by project types or for construction-permanent loan mix. Another option is to establish underwriting policies that make the loans salable in the secondary market, or actively pursue participations and whole loan sales.

Further, several regulatory measures now offer a framework for overall guidance of CRE exposure as a percentage of capital—the FDICIA LTV ratios and, of course, the new regulatory guidance ratios:

- Total commercial real estate loans secured by real estate with LTVs in excess of LTV guidelines should not exceed 30% of capital.
- Total commercial and residential real estate loans secured by real estate with LTVs in excess of FDICIA guidelines should not exceed 100% of capital.
- Total commercial real estate loans should not exceed 300% of capital.
- Total construction, land development, and other land loans should not exceed 100% of capital.

Quarterly board reporting of the FDICIA LTV results and the regulatory guidance keeps the organization focused on concentration measures that matter to examiners. Figure 1 illustrates a format for reporting FDICIA LTV exposure.

The guidance encourages institutions to stratify the CRE portfolio by property type, geographic market, tenant concentrations, tenant industries, developer concentrations, risk rating, loan structure (fixed rate versus adjustable rate), loan purpose (construction, short-term, or permanent), loan-to-value, debt service coverage, policy exceptions, and bank credit exposure to tenants. Of course, slicing and dicing the portfolio this much requires a very robust management information system.

3. Management information systems (MIS). Even a robust MIS must have clean data to run properly, and sloppy booking is a serious problem in CRE

Real estate regulations dictate a written policy establishing limits and standards for credit extensions secured by real estate, whether REDI lending or O-O financing.



lending with its attendant heavy documentation requirements, complex valuation process, and heavily negotiated loan agreements. Regulations require satisfactory real estate valuations—ordered independent of the originating loan officer and adjusted as necessary by skilled valuation professionals—before a loan can be booked and funded. Nevertheless, in the rush to judgment, common omissions and errors include LTV, collateral codes, purpose codes, and facility codes. The loan preparation/documentation/closing/booking process is the Achilles' heel to MIS. Options to improve data integrity, stress testing, and sensitivity analysis include:

- Use of bank-approved CRE attorneys to prepare, close, and book CRE loans over some amount—say, \$1 million.
- Use of CRE-trained paralegals to prepare, close, and book CRE loans not handled by outside attorneys.
- Pre-closing and post-closing review of documents to identify missing documents critical to closing a legally, enforceable commitment compliant with bank policy:
 - Requiring higher approval levels of loans with policy exceptions.
 - Deferring booking and funding until critical documents are received by the closing unit.

Figure 2

Lending Authorities for a Bank with an 11-Point Risk-Rating System

Authorities		Total Borrower Exposure (\$M)		
Functional Title	Line of Business	Risk Rating (1-3)	Risk Rating (4-6)	Criticized and Classified ^B
Banking officer	Commercial & private banking	≤ 500	≤ 250	None
Banking officer	CRE ^C	≤ 500	≤ 250	None
Banking officer	SAD ^D	NA	NA	≤ 100
Managers	Commercial & private banking	≤ 1,000	≤ 500	None
Manager	CRE	≤ 1,000	≤ 500	None
Team leaders	SAD	NA	NA	≤ 1,000
Division heads	Commercial & private banking	≤ 2,000	≤ 1,000	None
Division heads	CRE ^C	≤ 2,000	≤ 1,000	None
Division heads	SAD	NA	NA	≤ 10,000
Senior lender	All LOBs	≤ 3,000	≤ 2,000	None
Credit officer	REFG ^C	≤ 10,000	≤ 5,000	≤ 1,000
Credit officer	Commercial & private banking	≤ 10,000	≤ 5,000	≤ 1,000
Chief credit officer	All LOBs	≤ 15,000	≤ 10,000	≤ 5,000
Bank president	All LOBs	≤ 15,000	≤ 10,000	≤ 5,000
Loan committee ^D	All LOBs	≥ 15,000	≤ 10,000	≥ 5,000

^ATransactions fully secured by properly margined securities and cash collateral may be approved under the authorities in this column regardless of risk rating.

^BThis column includes all criticized assets—special mention (7), substandard (8), non-accruals (9), doubtful (10), and loss (11).

^CREFG (Real Estate Finance Group) is the only LOB that may extend credit to REDl clients (real estate developers and investors).

^DThe Senior Loan Committee (SLC) is comprised of seven members, including the CCO (chief credit officer) or designee who chairs the committee. The other members include the bank president, the three division heads, and the two credit officers.

- Setting certain data fields as mandatory in booking a CRE loan:
 - Original appraised value.
 - Bank-adjusted appraised value.
 - Capitalization rate from appraisal.
 - LTV at inception.
- Requiring the following underwriting data be available in electronic medium so that it can be exported for sensitivity analysis:
 - Capitalization rate from appraisal.
 - Net operating income—
 - > Vacancy rates.
 - > Space rental rates.
 - Debt service coverage.
 - Interest rate spread, floor, and ceiling.
 - Annual principal and interest payments.

Of course, MIS reporting has to be timely as well as accurate and be flexible enough to permit ad hoc analyses in response to potential market events or

changing conditions. For example, what is the impact of a bankruptcy filing on the bank's local shopping center exposure if an anchor tenant such as a major supermarket chain files for bankruptcy?

4. Market analysis. Keeping up with market conditions and trends is necessary to tell whether the bank's CRE lending strategy and policies remain in sync. A number of vendors provide periodic market analyses for various property types and geographic markets, and market intelligence is especially critical if an institution is considering entry into new markets, new lending activities, or even an expanded presence in existing markets.

Market information sources include published research data, real estate appraisers and agents, property tax statistics, local contractors, builders, investors, and community development groups.¹² Typical indicators include building permits, housing starts, new-

Figure 3

Commercial Real Estate Underwriting Standards by Project Type

Project Type for REDI and Owner-Occupied Borrowers	Bank Max. LTV	FDICIA Max. LTV	Max. LTC	Min. Equity	Min. DSC	Min. Pre-sales/ Pre-leasing	Max. Constructor Term	Max. Term	Max. Amortization
Apartments									
Shopping centers ¹									
Office buildings									
Industrial/warehouses									
Self-storage ²									
Hotels & motels ³									
Mobile-home parks									
Residential condos									
Golf course communities									
Commercial A&D									
Residential A&D									
Land									
Higher risk <ul style="list-style-type: none"> • A&D > 36 months • Unanchored shopping centers • Land loans > 12 months 									
Owner-occupied <ul style="list-style-type: none"> • Land • Agricultural land • Churches⁴ • Auto dealers 									
Other special purpose Owner-occupied <ul style="list-style-type: none"> • Retirement facilities • Auto care facilities • Cold storage • Gas stations • Convenience stores • Restaurants & bars • Marinas • Parking facilities • Amusement facilities • Recreational facilities • Health care facilities⁵ 									

¹ Kees, Amy, and Joe Heller, "Lending to Retail Landlords," *The RMA Journal*, November 2005, pp. 62-66.

² Sonne, Christian, "Lending to the Self-Storage Industry: Cinderella Has Her Day," *The RMA Journal*, June 2006, pp. 16-23.

³ Singh, A.J., Raymond S. Schmidgall, and Paul Beals, "A Survey of Community Banker Attitudes toward Hotel Feasibility Studies," *The RMA Journal*, April 2004, pp. 54-61.

⁴ McGovern, John, "Church Lending by the Numbers," *The RMA Journal*, June 2006, pp. 30-36.

⁵ Hutt, Paul, "Getting a Read on Lending to Surgery Centers," *The RMA Journal*, December 2002-January 2003, pp. 58-62.

Figure 4

Project Underwriting Guidelines

Guideline	Apartments ≥100 units	Unanchored Shopping Center	Multi-tenant Office Building
Max. LTV	80%	75%	75%
Max. FDICIA LTV	85%	85%	85%
Max. LTC	85%	80%	80%
Min. equity	15%	20%	20%
Min. DSC	1.30X	1.35X	1.25X
Min. pre-leasing/pre-sales	NA	0.70X	0.70X
Max. construction loan term	36 months	24 months	24 months
Max. loan term	5 years	5 years	5 years
Max amortization	30 years	20 years	20 years

home sales, used-home sales, vacancy rates, available commercial space, assessed tax valuations, sales tax revenues, inventory of commercial real estate product, and number of months to absorb the inventory. Rendering all this information into digestible facts is a matter of focus: What does the bank need to know as it steers a profitable and prudent real estate portfolio through this ocean of data?

5. Credit underwriting standards. First, a written commercial real estate policy is fundamental to compliance with guidance expectations *and* your bank's credit culture.¹³ Some basic components of a written CRE policy include:

- Portfolio limits.
- Lending authorities. CRE risk exposure needs to be evaluated, structured, decided, managed, and monitored by individuals skilled and experi-

enced in CRE lending. Banks typically restrict lending authorities to CRE-qualified lenders and credit approval officers, and the lending authority is generally apportioned according to rank, risk, and exposure. Figure 2 depicts an example of a bank with an 11-point risk-rating system.

- Risk ratings.
- Repayment analysis.¹⁴
- Underwriting guidelines. The meat of a CRE policy is its underwriting guidelines, and the exercise of establishing underwriting standards by type of project is where strategy meets the market. Filling in Figure 3's template is one way to establish underwriting standards for a wide range of CRE projects typical of REDI borrowers and for owner-occupied facilities representative of commercial borrowers. The list of projects is not all-inclusive, and project opportunities may vary from place to place. For example, underwriting standards for a ski resort are more appropriate for a Colorado bank than for a Florida bank. Further, even if a bank does not actively pursue hotel projects, the presence of underwriting may be preferable to the ambiguity of no criteria at all. By their nature, O-O properties are expected to be repaid from the cash flow of the borrowers and not from the liquidation of the real estate, especially since its liquidation might reduce the borrower's operating income. These properties are also typically special-purpose types with limited marketability.¹⁵ The O-O properties illustrated in Figure 3 cover a wide range of activities, but again, as with the REDI projects, location

Figure 5

Maximum LTV Differentiating Valuation Requirements: By Borrower, Transaction Size, and New/Renewed Loan

Valuation Guidelines	Business Purpose Loans (Owner-Occupied)		Investment Real Estate Loans (REDI/Co-REDI)	
	New Loan	Renewal ¹	New	Renewal ¹
Transaction amount				
If \$250,000 or less	Evaluation	Validation ² or Evaluation	Evaluation	Validation ² or Evaluation
If between \$250,001 and \$1,000,000	Evaluation	Validation ² or Evaluation	Appraisal	Validation ² or Evaluation
If over \$1,000,000	Appraisal	Validation ² or Evaluation	Appraisal	Validation ² or Evaluation

¹ A renewal with new money is a transaction that extends new funds over the original loan transaction amount in addition to reasonable closing costs.

A renewal with no new money is a transaction that may extend funds up to the original loan transaction amount in addition to reasonable closing costs.

² Bank or any federally regulated financial institution or other financial services institution may be an acceptable form of valuation for a new transaction or for a renewal with or without new money.

Figure 6

Environmental Risk Assessment and Environmental Due Diligence

Environmental Risk Assessment Guidance		Environmental Due Diligence Requirements	
Transaction Type	Transaction Amount (\$000)	Normal Risk	High Risk ³
New loan or renewal with change in property usage	≤ \$500	Checklist ¹ ERF FCAO Review ¹	Checklist ² GRR ERF CLA Review
	\$501 to \$1,000	Checklist ² GRR ERF CLA review	Phase I ESA ERF CLA review
	> \$1,000	Phase I ESA ERF CLA review	Phase I ESA ERF CLA Review
Transaction Type	Transaction Amount (\$000)	Normal Risk	High Risk ³
Renewal (new money), no change in property usage ⁴	Regardless of dollar amount	Determined by FCAO	Determined by FCAO
Renewal (no new money), no change in property usage or other signs of environmental concerns ⁴	Regardless of dollar amount	No requirement	No requirement
Pre-foreclosure	Regardless of dollar amount	Phase I ESA ERF CLA review	Phase I ESA ERF CLA review
<p>¹ If there are any “Yes” responses on the Environmental Checklist, the FCAO (final credit approval officer) will determine either that no further environmental due diligence is required or that a GRR (government records review) or Phase I ESA (environmental site assessment) is needed.</p> <p>² If any “Yes” responses on the Checklist recommend consideration of a Phase I ESA, a Phase I ESA is required in place of a GRR.</p> <p>³ High risk is defined as business or property uses that have a higher potential for creating environmental contamination.</p> <p>⁴ The previously completed Checklist or Phase I ESA must be in the file.</p> <p>Legend: CLA = Construction Loan Administration Officer</p>			

may suggest others to be added or deleted. For example, a bank in an agricultural market may decide to set underwriting criteria for dairy barns, poultry sheds, or irrigation infrastructure. The result of the process should be a matrix of quantifiable measures for each project type that is simple to understand and easy to enforce. Figure 4 shows guidelines for a typical project underwriting.

- Monitoring of policy and documentation exceptions. If each of the underwriting criteria is afforded policy exception status, required to be documented as such, and mitigated in the approval document, the financial institution now has the ability to identify, evaluate, and decide on variances from policy. Assuming that both line producers and credit approvers concurred in setting underwriting criteria reflective of its CRE strategy and the bank’s overall risk appetite, the bank now has the ability to gauge

how closely it is adhering to its CRE strategy. The following list of common policy exceptions applies to both commercial and CRE lending:

- Risky borrower.
- Risky industry.
- Speculative, unethical, or illegal purpose.
- Unacceptable guarantee.
- Unacceptable collateral.
- Stale financial statements.
- Unacceptable appraisal.¹⁶
- Unacceptable environmental audit.
- Excessive LTV.¹⁷
- Excessive LTC.
- Insufficient DSC.
- Insufficient equity.
- Excessive term.
- Excessive amortization.
- Insufficient pre-leasing.
- Insufficient pre-sales.

A common technique for tightening underwriting

Figure 7

Stress Testing and Sensitivity Analysis for Mild, Moderate, and Severe Scenarios*

CRE Portfolio	NOI			Interest rates			Capitalization rates			LTV			DSC		
	Mild	Mod.	Severe	Mild	Mod.	Severe	Mild	Mod.	Severe	Mild	Mod.	Severe	Mild	Mod.	Severe
Residential construction															
Commercial construction															
Residential permanent															
Commercial permanent															
Land															
Total CRE															
Bank capital															
CRE/capital (%)															

*Mild, moderate, and severe scenarios for NOI (10%, 25%, and 50% increase), interest and cap rates (1%, 2%, and 3% increase). Changes in NOI would reflect adverse changes in vacancy rates, lease-rental rates, maintenance, etc.

criteria is to require one-up approval of a loan request with a policy exception. Remember, the guidance expects an institution to cite policy exceptions but to make them infrequently, say, 10% of monthly transactions. However, if LTV exceptions are occurring 50% of the time, either the standard is too tight relative to the market or the market has become extremely risky. The FDICIA LTV standards offer a useful ceiling on LTVs because they were set at levels the FDIC noted as symptomatic of the problem loans encountered in the recession of the early 1990s. FDICIA requires quarterly reporting of loans secured by real estate that exceed the various product LTVs—e.g., commercial properties with LTV in excess of 85%—to the bank’s board of directors; so treating the FDICIA LTV for a given product type as a policy exception ensures more accurate reporting of FDICIA LTV exposure for the board while serving as a ceiling LTV. Moreover, a bank’s own internal LTVs are typically 5-10% lower than FDICIA’s LTVs. In addition to underwriting standards, the bank is expected to have policies and procedures in place for real estate valuations¹⁸, environmental risk assessment¹⁹, and construction loan administration.

- Valuation (appraisals). It’s key that all of these tasks be ordered and reviewed²⁰ independent of the loan production unit in order to be free of undue influence, be compliant with FIRREA requirements²¹, and minimize abuse of abundance of caution to skirt valuation requirements.²² The valuation policy ought to differentiate valuation requirements by borrow-

er, by transaction size, and for both new and renewed loans.²³ Figure 5 offers one way to accommodate these three factors.

- Environmental risk.²⁴ Environmental risk assessment lends itself to a similar approach—transaction size / borrower risk / new loan or renewal—as shown in Figure 6. Effective November 1, 2006, the steps that purchases must take to qualify for CERCLA²⁵ liability protection are now governed by Standards and Practices for All Appropriate Inquiries (AAI). This rule upgrades the professional qualifications for consultants who perform assessments, and a new assessment standard (ASTM E 1527-05) ensures liability protection.²⁶ Environmental policy should also address the following questions:

- Who should order the assessment, the borrower or the bank?
- Should the bank maintain a list of approved environmental consultants?

Whoever orders the assessment gets the liability protection, so the bank must consider whether the borrower or the bank needs the protection. As for approved lists of appraisers, attorneys, and other professionals, developing, maintaining, and monitoring such lists should be considered in terms of the bank’s available resources to keep them current.

- Construction administration.²⁷ Development and construction loan disbursements must be managed to ensure that the borrower continues to meet minimum equity requirements. Controls

Figure 8

CRE Guidance Gap Analysis

CRE Guidance's Seven Elements	Describe institution's current practice for each element	Identify gaps between current practice and guidance element	Set completion date deadline for filling gap and assign task to appropriate individual(s)	Monitor progress and provide comments if yellow or red status*
<p>1. Board & management oversight:</p> <ul style="list-style-type: none"> • Annual approval of CRE strategy and policies • Periodic review of compliance with strategies and policies • Periodic review of FDICIA ratios, guidance ratios, and other CRE concentration indicators • Periodic review of market conditions and trends reporting • Periodic review of CRE portfolio risk management performance 				
<p>2. Portfolio management:</p> <ul style="list-style-type: none"> • Strategies for managing CRE concentration levels, including contingency plans for reducing or mitigating concentration • Periodic assessment of portfolio's marketability • Periodic evaluation of bank's ability to access secondary market • Periodic reporting to board of CRE portfolio risk management, including <ul style="list-style-type: none"> • FDICIA LTV • Guidance ratios • Stress testing and sensitivity analysis 				
<p>3. Management information systems</p> <ul style="list-style-type: none"> • Ability to stratify CRE portfolio by: <ul style="list-style-type: none"> • Property type • Geographic market • Tenant concentrations • Tenant industries • Developer concentrations • Risk ratings • Loan structure • Loan purpose • LTV limits • DSC • Policy exceptions • Affiliated loans • TBE, including derivatives exposure • Timely, accurate, and readable management reporting of : <ul style="list-style-type: none"> • Risk profile changes • Risk rating migrations • MIS adequacy as CRE portfolio grows and changes • Concentration changes • Ad hoc reporting for CRE market events 				
<p>4. Market analysis:</p> <ul style="list-style-type: none"> • Periodic market conditions and trends reporting to evaluate appropriateness of CRE strategy & policies • Periodic market performance reporting of portfolio's property types and geographic markets 				
<p>5. Credit underwriting standards:</p> <ul style="list-style-type: none"> • Written CRE policy • Repayment analysis • Feasibility study • Sensitivity and stress testing • Project underwriting standards • Valuations and appraisals • Environmental risk assessments • Policy exceptions • Documentation exceptions • Construction loan administration 				
<p>6. Portfolio stress testing and sensitivity analysis:</p> <ul style="list-style-type: none"> • Interest rates • Capitalization rates • NOI • Rental rates • Vacancy rates • Maintenance • Other expenses • Effect on DSC • Effect on LTV 				
<p>7. Credit risk review function:</p> <ul style="list-style-type: none"> • Independent credit review • Risk-rating system 				

*Green = on schedule to meet deadline Yellow = currently behind schedule but will meet deadline Red = behind schedule and will not meet deadline

You are probably on the right track toward compliance, but keep moving. As Will Rogers used to say, “Even if you’re on the right track, you’ll still get run over if you just sit there.”

should include an inspection process, documentation of construction progress, tracking of pre-sold units, pre-leasing activity, and exceptions monitoring and reporting.²⁸ The overall goal of this element for credit underwriting standards is to make sure that the bank has a workable framework for evaluating and underwriting the CRE risk it chooses to assume. Of course, sometimes things just don’t go according to plan, but a bank needs to expect the unexpected by seeing how much adversity its CRE can take.

6. Portfolio Stress Testing and Sensitivity Analysis.²⁹ Examiners expect a CRE-concentrated financial institution to stress test its CRE portfolio. The sensitivity analysis may be very simple for a bank with a well-margined and seasoned portfolio of multifamily housing. On the other hand, a bank engaged in A&D and construction lending is more vulnerable to cyclical downturns. What if interest rates rise, vacancies soar³⁰, capitalization rates increase, and market rental rates decline?

Therefore, common variables to test are usually rising interest rates, falling net operating income (NOI), and deteriorating values. How much can interest rates rise and NOI fall before a borrower’s DSC drops below 1.00X? How much can vacancy rates, tenant improvement concessions, and repair reserves increase and lease-rental rates drop before NOI turns negative? As interest rates rise, so do capitalization

rates, and higher cap rates relative to declining NOI lead to shrinking values and higher LTVs.

Given the interdependence of these variables, bankers like to focus their attention on three closely related indicators—interest rates, DSC, and LTV—especially in the context of how bad the market can deteriorate before CRE borrowers are unable to repay their loans and LTVs rise above 100% into partially unsecured territory. Figure 7 suggests that one way to think about the portfolio implications of interest rate changes and cap rate changes is to roll up loans into CRE portfolio segments.

7. Credit risk review function. An independent credit review function is critical to an institution’s self-assessment of risk. A good way to do this is by using an accurate, timely, and consistent risk-rating system. Further, the Basel Accord effort’s greatest contribution to the banking industry may be its call for credit risk to be assessed in two dimensions: the probability that an obligor will default and the loss given default.³¹ Now the borrower’s repayment ability and the transactional support—collateral, guarantees, etc.—can be quantified into an estimate of loss.

Gap Assessment: Mind the Gap

Now that you have reviewed the seven elements, use Figure 8 to 1) see how your institution measures up to the guidance, 2) set an appropriate deadline for filling the gaps, and 3) monitor the progress toward the deadline.

Summary and Closing: You’re Just Liable to Land on Your Assets

The allure of real estate loan profits has attracted so many banks that they have embraced film legend Mae West’s regulatory philosophy—“It ain’t no sin if you crack a few laws now and then, just so long as you don’t break any.” Unfortunately, the blockbuster expansion of CRE portfolios that outpaced the growth of bank capital to support it—along with regulatory concern about the industry’s capital adequacy to cushion CRE risk—led three of the four agencies to issue the December 2006 regulatory guidance.

The guidance offers us more than just a couple of capital adequacy ratios to measure our commercial real estate concentration. It provides an expedient template by which to measure the key elements of our CRE risk management.

Take the time to read the guidance and judge how well you comply with it, then take the appropriate steps to comply with it. Most of you will be pleasantly surprised that the gap between what you practice and what the guidance preaches is smaller than you think. You are probably on the right track toward compliance, but keep moving. As Will Rogers used to say, "Even if you're on the right track, you'll still get run over if you just sit there." □

Contact Dev Strischek by e-mail at dev.strischek@suntrust.com.

NOTES

1 The Office of Thrift Supervision (OTS) did not include the two capital ratios in its guidance for savings banks because, among other things, the ratios lump different project risks together, e.g., speculative office building versus fully occupied apartment building. The OTS guidance advises savings banks actively engaged in CRE lending to assess their concentration risk and establish internal thresholds for when they would increase their own monitoring.

2 CRE concentration levels for loans secured by real estate for: 1) construction, land development, and other land loans; 2) multifamily residential properties; and 3) nonfarm, nonresidential properties.

3 "Concentration in Commercial Real Estate Lending, Sound Risk Management Practices," *Federal Register*, vol. 71, no. 238, Tuesday, December 12, 2006, p. 74580. Go to <http://www.fdic.gov/news/news/financial/2006/fil06104.html> for a brief summary of the guidance and a link to a PDF containing the *Federal Register* publication.

4 See Robert L. Burns, "Economic Capital and the Assessment of Capital Adequacy," *The RMA Journal*, April 2005, pp. 54-62, on how capital adequacy and economic capital are linked.

5 "Concentration in Commercial Real Estate Lending, Sound Risk Management Practices," p. 74580.

6 *Ibid.*

7 *Ibid.*

8 *Ibid.*, p. 74585.

9 Cortez, Joseph M., "Understanding the Individual Real Estate Investor," *The RMA Journal*, April 2006, pp. 66-71.

10 See James V. Lentino, "Establishing Exposure Limits for a Credit Portfolio," *The RMA Journal*, July-August 2005, pp. 48-53, for guidance on how to set exposure limits based on economic capital.

11 See John Barrickman and Gary D. Stein, "Getting the Most Out of Portfolio Reporting," *The RMA Journal*, July-August 2005, pp. 58-63, for useful portfolio report formats depicting composition, risk, profitability, and credit quality.

12 Hamm, Richard, "Commercial Construction Lending in 2006: Five Key Risk Areas," *The RMA Journal*, April 2006, pp. 42-47.

13 Strischek, Dev, "Credit Culture, Part 1," *The RMA Journal*, November 2002, pp. 52-55; Part 2, December 2002-January 2003, pp. 35-39, and Part 3, March 2003, pp. 38-43.

14 Lovelace, Tim, "A Loan Officer's Guide to Real Estate Investor Contingency Analysis," *The RMA Journal*, June 2004, pp. 38-44. See also the series on analyzing real estate developers written by Daniel Boykin and published in *The RMA Journal*:

- "New Perspectives in Analyzing Real Estate Developer Financial Statements, Part 1," May 2002, pp. 26-34.
- "New Perspectives, Part 2," June 2002, pp. 80-83.

- "New Perspectives, Part 3," July 2002-August 2003, pp. 22-26.
- "New Perspectives, Part 4," December 2003-January 2003, pp. 43-47.

15 Hamm, Richard, "The Monkey in the Middle: Mistakes with Owner-Occupied Commercial Real Estate Loans," *The RMA Journal*, November 2006, pp. 46-53.

16 Zoeller, Mark, "Appraisals and Valuations I Have Known," *The RMA Journal*, December 2004-January 2005, pp. 64-69. Zoeller details the key elements that differentiate a satisfactory real estate valuation from an unsatisfactory document.

17 Frachioni, Michael I., "Without a Net: LTV Ratios Offer Little Regulatory Leverage Against Risk of Real Estate Lending," *The RMA Journal*, June 2004, pp. 46-51.

18 Zoeller, Mark, "A Real Estate Appraisal Checklist," *The RMA Journal*, November 2006, pp. 63-68.

19 Ezovski, Derek, "As Environmental Rules Evolve, So Must Due Diligence," *The RMA Journal*, February 2006, pp. 97-100.

20 DiLorenzo, Frank, "Appraisal Review Tips for Bankers, Part 5: Absolute Value," *The RMA Journal*, December 2005-January 2006, p. 88. See also DiLorenzo's "Appraisal Review Tips for Bankers, Part 3: Now You See It, Now You Don't," *The RMA Journal*, September 2005, pp. 86-87 for evaluating vacancy, replacement reserves, and management fees.

21 Beans, Kathleen M., "How to Manage the Requirements of FIRREA in a Community Bank," *The RMA Journal*, April 2006, pp. 48-53.

22 Zoeller, Mark, "Appraisals and Valuations I Have Known: An Update," *The RMA Journal*, March 2005, pp. 74-75. In addition to a succinct description of abundance of caution, Zoeller also provides a summary of his "Selected Resources on Appraisals."

23 Luzod, Andrew M., and Armin R. Huff, "To Evaluate or Not to Evaluate," *The RMA Journal*, November 2005, pp. 54-57.

24 Luzkow, Steve, "Environmental Due Diligence for Lenders," *The RMA Journal*, November 2004, pp. 28-31. Luzkow provides some useful tips on the components of an environmental risk policy.

25 The comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) was enacted by Congress in 1980. More commonly known as Superfund, this law governs environmental risk. For more information, go to EPA's Web site, www.epa.gov/superfund/action/law/cercla.htm.

26 "Midway to 'All Appropriate Inquiries' Rule: Lenders Prepare for Change," *Environmental Risk Report*, vol. 3, no. 2, Spring 2006, pp. 1 and 3, Environmental Data Resources, Inc., www.edrnet.com.

27 DiLorenzo, Frank, "Draw Management: Construction Disbursement Caveats," *The RMA Journal*, June 2004, pp. 36-37.

28 Wedewer, Neil, "Best Practices in Lending to Homebuilders," *The RMA Journal*, November 2006, pp. 38-45. See also Tol Broome's "The Perfect Storm? How to Avoid A&D Lending Problems," *The RMA Journal*, December 2006-January 2007, pp. 70-77.

29 Newett, Mike, and Don Gilliam, "Commercial Real Estate Stress Testing," *The RMA Journal*, November 2006, pp. 24-37.

30 Rose, James R., Jr., "A Lender's Perspective on Residential Income-Producing Property Appraisals," *The RMA Journal*, March 2006, pp. 66-70.

31 Pappadopoulos, George, "Assessing PD and LGD of Construction Loans," *The RMA Journal*, November 2005, pp. 28-31.