Statement on Prudent Risk Management for Commercial Real Estate Lending

The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (the agencies) are jointly issuing this statement to remind financial institutions of existing regulatory guidance on prudent risk management practices for commercial real estate (CRE) lending activity through economic cycles.[1]

Recent Supervisory Findings

The agencies have observed that many CRE asset and lending markets are experiencing substantial growth, and that increased competitive pressures are contributing significantly to historically low capitalization rates and rising property values.[2] At the same time, other indicators of CRE market conditions (such as vacancy and absorption rates) and portfolio asset quality indicators (such as non-performing loan and charge-off rates) do not currently indicate weaknesses in the quality of CRE portfolios. Influenced in part by the continuing strong demand for such credit and the reassuring trends in asset-quality metrics, many institutions' CRE concentration levels have been rising.

The agencies' examination and industry outreach activities have revealed an easing of CRE underwriting standards, including less-restrictive loan covenants, extended maturities, longer interest-only payment periods, and limited guarantor requirements. The agencies also have observed certain risk management practices at some institutions that cause concern, including a greater number of underwriting policy exceptions and insufficient monitoring of market conditions to assess the risks associated with these concentrations.

[1] For purposes of this statement, a CRE loan refers to a loan where the use of funds is to acquire, develop, construct, improve, or refinance real property and where the primary source of repayment is the sale of the real property or the revenues from third-party rent or lease payments. CRE loans do not include ordinary business loans and lines of credit in which real estate is taken as collateral. Financial institutions with concentrations in owner-occupied CRE loans also should implement appropriate risk management processes.

[2] For example, between 2011 and 2015, multi-family loans at insured depository institutions increased 45 percent and comprised 17 percent of all CRE loans held by financial institutions, and prices for multi-family properties rose to record levels while capitalization rates fell to record lows. Sources: Consolidated Reports of Condition and Income, Costar Property Price Index, and CBRE.

Historical evidence[3] demonstrates that financial institutions with weak risk management and high CRE credit concentrations are exposed to a greater risk of loss and failure. In general, financial institutions that succeeded during difficult economic cycles took the following actions, which are consistent with supervisory expectations:

- established adequate and appropriate:
    - loan policies, underwriting standards, credit risk management practices, and concentration limits that were approved by the board or a designated committee;
    - lending strategies, such as plans to increase lending in a particular market or property type, limits for credit and other asset concentrations, and processes for assessing whether lending strategies and policies continued to be appropriate in light of changing market conditions; and
    - strategies to ensure capital adequacy and allowance for loan losses that supported an institution's lending strategy and were consistent with the level and nature of inherent risk in the CRE portfolio.
- conducted global cash flow analyses based on reasonable (not speculative) rental rates, sales projections, and operating expenses to ensure the borrower had sufficient repayment capacity to service all loan obligations.
- performed market and scenario analyses of their CRE loan portfolio to quantify the potential impact of changing economic conditions on asset quality, earnings, and capital.
- provided their boards and management with information to assess whether the lending strategy and policies continued to be appropriate in light of changes in market conditions.
- assessed the ongoing ability of the borrower and the project to service all debt as loans converted from interest-only to amortizing payments or during periods of rising interest rates.
- implemented procedures to monitor the potential volatility in the supply and demand for lots, retail and office space, and multi-family units during business cycles.
- maintained management information systems that provided the board and management with sufficient information to identify, measure, monitor, and manage concentration risk.
- implemented processes for reviewing appraisal reports for sufficient information to support an appropriate market value conclusion based on reasonable market rental rates, absorption periods, and expenses.

---

[3] Federal Deposit Insurance Corporation, Office of the Inspector General, *Study on the Impact of Failure of Insured Depository Institutions*, January 2013, Most Common Contributing Causes of Material Loss Failures, page 50, https://www.fdicig.gov/reports13/13-002EV.pdf. Keith Friend, Harry Glenos, and Joseph B. Nichols, *An Analysis of the Impact of the Commercial Real Estate Concentration Guidance*, April 2013, http://www.occ.gov/news-issuances/news-releases/2013/nr-occ-2013-59a.pdf.

Supervisory Expectations for Financial Institutions

In light of the developments mentioned above, financial institutions should review their policies and practices related to CRE lending and should maintain risk management practices and capital levels commensurate with the level and nature of their CRE concentration risk. In particular, financial institutions should maintain underwriting discipline and exercise prudent risk management practices that identify, measure, monitor, and manage the risks arising from their CRE lending activity. A list of existing regulations and guidance related to CRE lending is presented in the attachment. Financial institutions are especially encouraged to review the interagency "Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices" (Concentration Guidance), 71 *Fed. Reg.* 74580 issued in December 2006 for a discussion of the agencies' expectations for concentration risk management practices.

During 2016, supervisors from the banking agencies will continue to pay special attention to potential risks associated with CRE lending. When conducting examinations that include a review of CRE lending activities, the agencies will focus on financial institutions' implementation of the prudent principles in the Concentration Guidance as well as other applicable guidance relative to identifying, measuring, monitoring, and managing concentration risk in CRE lending activities. In particular, the agencies will focus on those financial institutions that have recently experienced, or whose lending strategy plans for, substantial growth in CRE lending activity, or that operate in markets or loan segments with increasing growth or risk fundamentals. The agencies may ask financial institutions found to have inadequate risk management practices and capital strategies to develop a plan to identify, measure, monitor, and manage CRE concentrations, to reduce risk tolerances in their underwriting standards, or to raise additional capital to mitigate the risk associated with their CRE strategies or exposures.

Attachment
Listing of Interagency Regulations and Guidance
Related to Commercial Real Estate Lending

Title	FRB	FDIC	OCC
Real Estate Lending Standards Regulations and Guidelines	12 CFR 208, subpart E	12 CFR 365	12 CFR 34, subpart D (national banks) and 12 CFR 160.101 (federal savings associations)
Appraisal Regulation	12 CFR 208, subpart E 12 CFR 225, subpart G	12 CFR 323	12 CFR 34, subpart C
Standards for Safety and Soundness	12 CFR 208	12 CFR 364 appendix A	12 CFR 30, appendix A
Interagency Supervisory Guidance Addressing Certain Issues Related to Troubled Debt Restructurings (October 24, 2013)	SR 13-17	FIL-50-2013	OCC Bulletin 2013-26
Interagency Appraisal and Evaluation Guidelines (December 2, 2010)	SR 10-16	FIL-82-2010	OCC Bulletin 2010-42
Prudent Commercial Real Estate Loan Workouts (October 30, 2009)	SR 09-7	FIL-61-2009	OCC Bulletin 2009-32
Interagency Guidance on Concentrations in Commercial Real Estate, 71 *Fed. Reg.* 74580 (December 12, 2006)	SR 07-1	FIL-104-2006	OCC Bulletin 2006-46
Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL) (December 13, 2006)	SR 06-17	FIL-105-2006	OCC Bulletin 2006-47
Interagency FAQs on Residential Tract Development Lending (September 8, 2005)	SR 05-14	FIL-90-2005	OCC Bulletin 2005-32
FFIEC Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions (July 2, 2001)	SR 01-17	FIL-63-2001	OCC Bulletin 2001-37
Interagency Supervisory Guidance on Stress Testing for Banking Organizations With More Than $10 Billion in Total Consolidated Assets (May 17, 2012)	SR 12-7	Press Release PR-53-2012	OCC Bulletin 2012-14
Interagency Statement to Clarify Supervisory Expectations for Stress Testing by Community Banks (May 14, 2012)	Federal Reserve Press Release 5/14/12	Press Release PR-54-2012	OCC News Release 2012-76