
**Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation**

**Concentrations in Commercial Real Estate Lending,
Sound Risk Management Practices**
(December 12, 2006)

PURPOSE

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively, the Agencies), are jointly issuing this Guidance to address institutions' increased concentrations of commercial real estate (CRE) loans. Concentrations of credit exposures add a dimension of risk that compounds the risk inherent in individual loans.

The Guidance reminds institutions that strong risk management practices and appropriate levels of capital are important elements of a sound CRE lending program, particularly when an institution has a concentration in CRE loans. The Guidance reinforces and enhances the Agencies' existing regulations and guidelines for real estate lending¹ and loan portfolio management in light of material changes in institutions' lending activities. The Guidance does not establish specific CRE lending limits; rather, it promotes sound risk management practices and appropriate levels of capital that will enable institutions to continue to pursue CRE lending in a safe and sound manner.

BACKGROUND

The Agencies recognize that regulated financial institutions play a vital role in providing credit for business and real estate development. However, concentrations in CRE lending coupled with weak loan underwriting and depressed CRE markets have contributed to significant credit losses in the past. While underwriting standards are generally stronger than during previous CRE cycles, the Agencies have observed an increasing trend in the number of institutions with concentrations in CRE loans. These concentrations may make such institutions more vulnerable to cyclical CRE markets. Moreover, the Agencies have observed that some institutions' risk management practices are not evolving with their increasing CRE concentrations. Therefore, institutions with concentrations in CRE loans are reminded that their risk management practices and capital levels should be commensurate with the level and nature of their CRE concentration risk.

¹ 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 part 365 and appendix A (FDIC). Refer to the *Interagency Guidelines Establishing Standards for Safety and Soundness*: 12 CFR part 30, appendix A (OCC); 12 CFR part 208, Appendix D-1 (FRB); and 12 CFR part 364, appendix A (FDIC).

SCOPE

In developing this guidance, the Agencies recognized that different types of CRE lending present different levels of risk, and that consideration should be given to the lower risk profiles and historically superior performance of certain types of CRE, such as well-structured multifamily housing finance, when compared to others, such as speculative office space construction. As discussed under “CRE Concentration Assessments,” institutions are encouraged to segment their CRE portfolios to acknowledge these distinctions for risk management purposes.

This Guidance focuses on those CRE loans for which the cash flow from the real estate is the primary source of repayment rather than loans to a borrower for which real estate collateral is taken as a secondary source of repayment or through an abundance of caution. Thus, for the purposes of this Guidance, CRE loans include those loans with risk profiles sensitive to the condition of the general CRE market (for example, market demand, changes in capitalization rates, vacancy rates, or rents). CRE loans are land development and construction loans (including 1- to 4-family residential and commercial construction loans) and other land loans. CRE loans also include loans secured by multifamily property, and nonfarm nonresidential property where the primary source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. Loans to real estate investment trusts (REITs) and unsecured loans to developers also should be considered CRE loans for purposes of this Guidance if their performance is closely linked to performance of the CRE markets. Excluded from the scope of this 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.

Although the Guidance does not define a CRE concentration, the “Supervisory Oversight” section describes the criteria that the Agencies will use as high-level indicators to identify institutions potentially exposed to CRE concentration risk.

CRE CONCENTRATION ASSESSMENTS

Institutions actively involved in CRE lending should perform ongoing risk assessments to identify CRE concentrations. The risk assessment should identify potential concentrations by stratifying the CRE portfolio into segments that have common risk characteristics or sensitivities to economic, financial or business developments. An institution’s CRE portfolio stratification should be reasonable and supportable. The CRE portfolio should not be divided into multiple segments simply to avoid the appearance of concentration risk.

The Agencies recognize that risk characteristics vary among CRE loans secured by different property types. A manageable level of CRE concentration risk will vary by institution depending on the portfolio risk characteristics, the quality of risk management processes, and capital levels. Therefore, the Guidance does not establish a CRE concentration limit that applies to all institutions. Rather, the Guidance encourages institutions to identify and monitor credit

concentrations, establish internal concentration limits, and report all concentrations to management and the board of directors on a periodic basis. Depending on the results of the risk assessment, the institution may need to enhance its risk management systems.

RISK MANAGEMENT

The sophistication of an institution's CRE risk management processes should be appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risk to the institution. Institutions should address the following key elements in establishing a risk management framework that effectively identifies, monitors, and controls CRE concentration risk:

- Board and management oversight
- Portfolio management
- Management information systems
- Market analysis
- Credit underwriting standards
- Portfolio stress testing and sensitivity analysis
- Credit risk review function

Board and Management Oversight

An institution's board of directors has ultimate responsibility for the level of risk assumed by the institution. If the institution has significant CRE concentration risk, its strategic plan should address the rationale for its CRE levels in relation to its overall growth objectives, financial targets, and capital plan. In addition, the Agencies' real estate lending regulations require that each institution adopt and maintain a written policy that establishes appropriate limits and standards for all extensions of credit that are secured by liens on or interests in real estate, including CRE loans. Therefore, the board of directors or a designated committee thereof should:

- Establish policy guidelines and approve an overall CRE lending strategy regarding the level and nature of CRE exposures acceptable to the institution, including any specific commitments to particular borrowers or property types, such as multifamily housing.
- Ensure that management implements procedures and controls to effectively adhere to and monitor compliance with the institution's lending policies and strategies.
- Review information that identifies and quantifies the nature and level of risk presented by CRE concentrations, including reports that describe changes in CRE market conditions in which the institution lends.
- Periodically review and approve CRE risk exposure limits and appropriate sublimits (for example, by nature of concentration) to conform to any changes in the institution's strategies and to respond to changes in market conditions.

Portfolio Management

Institutions with CRE concentrations should manage not only the risk of individual loans but also portfolio risk. Even when individual CRE loans are prudently underwritten, concentrations of loans that are similarly affected by cyclical changes in the CRE market can expose an institution to an unacceptable level of risk if not properly managed. Management regularly should evaluate the degree of correlation between related real estate sectors and establish internal lending guidelines and concentration limits that control the institution's overall risk exposure.

Management should develop appropriate strategies for managing CRE concentration levels, including a contingency plan to reduce or mitigate concentrations in the event of adverse CRE market conditions. Loan participations, whole loan sales, and securitizations are a few examples of strategies for actively managing concentration levels without curtailing new originations. If the contingency plan includes selling or securitizing CRE loans, management should assess periodically the marketability of the portfolio. This should include an evaluation of the institution's ability to access the secondary market and a comparison of its underwriting standards with those that exist in the secondary market.

Management Information Systems

A strong management information system (MIS) is key to effective portfolio management. The sophistication of MIS will necessarily vary with the size and complexity of the CRE portfolio and level and nature of concentration risk. MIS should provide management with sufficient information to identify, measure, monitor, and manage CRE concentration risk. This includes meaningful information on CRE portfolio characteristics that is relevant to the institution's lending strategy, underwriting standards, and risk tolerances. An institution should assess periodically the adequacy of MIS in light of growth in CRE loans and changes in the CRE portfolio's size, risk profile, and complexity.

Institutions are encouraged to stratify the CRE portfolio by property type, geographic market, tenant concentrations, tenant industries, developer concentrations, and risk rating. Other useful stratifications may include loan structure (for example, fixed rate or adjustable), loan purpose (for example, construction, short-term, or permanent), loan-to-value limits, debt service coverage, policy exceptions on newly underwritten credit facilities, and affiliated loans (for example, loans to tenants). An institution should also be able to identify and aggregate exposures to a borrower, including its credit exposure relating to derivatives.

Management reporting should be timely and in a format that clearly indicates changes in the portfolio's risk profile, including risk-rating migrations. In addition, management reporting should include a well-defined process through which management reviews and evaluates concentration and risk management reports, as well as special ad hoc analyses in response to potential market events that could affect the CRE loan portfolio.

Market Analysis

Market analysis should provide the institution's management and board of directors with information to assess whether its CRE lending strategy and policies continue to be appropriate in light of changes in CRE market conditions. An institution should perform periodic market analyses for the various property types and geographic markets represented in its portfolio.

Market analysis is particularly important as an institution considers decisions about entering new markets, pursuing new lending activities, or expanding in existing markets. Market information also may be useful for developing sensitivity analysis or stress tests to assess portfolio risk.

Sources of market information may include published research data, real estate appraisers and agents, information maintained by the property taxing authority, local contractors, builders, investors, and community development groups. The sophistication of an institution's analysis will vary by its market share and exposure, as well as the availability of market data. While an institution operating in nonmetropolitan markets may have access to fewer sources of detailed market data than an institution operating in large, metropolitan markets, an institution should be able to demonstrate that it has an understanding of the economic and business factors influencing its lending markets.

Credit Underwriting Standards

An institution's lending policies should reflect the level of risk that is acceptable to its board of directors and should provide clear and measurable underwriting standards that enable the institution's lending staff to evaluate all relevant credit factors. When an institution has a CRE concentration, the establishment of sound lending policies becomes even more critical. In establishing its policies, an institution should consider both internal and external factors, such as its market position, historical experience, present and prospective trade area, probable future loan and funding trends, staff capabilities, and technology resources. Consistent with the Agencies' real estate lending guidelines, CRE lending policies should address the following underwriting standards:

- Maximum loan amount by type of property
- Loan terms
- Pricing structures
- Collateral valuation²
- Loan-to-Value (LTV) limits by property type
- Requirements for feasibility studies and sensitivity analysis or stress testing
- Minimum requirements for initial investment and maintenance of hard equity by the borrower
- Minimum standards for borrower net worth, property cash flow, and debt service coverage for the property

² Refer to the Agencies' appraisal regulations: 12 CFR part 34, subpart C (OCC); 12 CFR part 208 subpart E and 12 CFR part 225, subpart G (FRB); and 12 CFR part 323 (FDIC).

An institution's lending policies should permit exceptions to underwriting standards only on a limited basis. When an institution does permit an exception, it should document how the transaction does not conform to the institution's policy or underwriting standards, obtain appropriate management approvals, and provide reports to the board of directors or designated committee detailing the number, nature, justifications, and trends for exceptions. Exceptions to both the institution's internal lending standards and the Agencies' supervisory LTV limits³ should be monitored and reported on a regular basis. Further, institutions should analyze trends in exceptions to ensure that risk remains within the institution's established risk tolerance limits.

Credit analysis should reflect both the borrower's overall creditworthiness and project-specific considerations as appropriate. In addition, for development and construction loans, the institution should have policies and procedures governing loan disbursements to ensure that the institution's minimum borrower equity requirements are maintained throughout the development and construction periods. Prudent controls should include an inspection process, documentation on construction progress, tracking pre-sold units, pre-leasing activity, and exception monitoring and reporting.

Portfolio Stress Testing and Sensitivity Analysis

An institution with CRE concentrations should perform portfolio-level stress tests or sensitivity analysis to quantify the impact of changing economic conditions on asset quality, earnings, and capital. Further, an institution should consider the sensitivity of portfolio segments with common risk characteristics to potential market conditions. The sophistication of stress testing practices and sensitivity analysis should be consistent with the size, complexity, and risk characteristics of its CRE loan portfolio. For example, well-margined and seasoned performing loans on multifamily housing normally would require significantly less robust stress testing than most acquisition, development, and construction loans.

Portfolio stress testing and sensitivity analysis may not necessarily require the use of a sophisticated portfolio model. Depending on the risk characteristics of the CRE portfolio, stress testing may be as simple as analyzing the potential effect of stressed loss rates on the CRE portfolio, capital, and earnings. The analysis should focus on the more vulnerable segments of an institution's CRE portfolio, taking into consideration the prevailing market environment and the institution's business strategy.

Credit Risk Review Function

A strong credit risk review function is critical for an institution's self-assessment of emerging risks. An effective, accurate, and timely risk-rating system provides a foundation for the institution's credit risk review function to assess credit quality and, ultimately, to identify problem loans. Risk ratings should be risk sensitive, objective, and appropriate for the types of

³ The Interagency Guidelines for Real Estate Lending state that loans exceeding the supervisory LTV guidelines should be recorded in the institution's records and reported to the board at least quarterly.

CRE loans underwritten by the institution. Further, risk ratings should be reviewed regularly for appropriateness.

SUPERVISORY OVERSIGHT

As part of their ongoing supervisory monitoring processes, the Agencies will use certain criteria to identify institutions that are potentially exposed to significant CRE concentration risk. An institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

- (1) Total reported loans for construction, land development, and other land⁴ represent 100 percent or more of the institution's total capital;⁵ or
- (2) Total commercial real estate loans as defined in this Guidance⁶ represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's commercial real estate loan portfolio has increased by 50 percent or more during the prior 36 months.

The Agencies will use the criteria as a preliminary step to identify institutions that may have CRE concentration risk. Because regulatory reports capture a broad range of CRE loans with varying risk characteristics, the supervisory monitoring criteria do not constitute limits on an institution's lending activity but rather serve as high-level indicators to identify institutions potentially exposed to CRE concentration risk. Nor do the criteria constitute a "safe harbor" for institutions if other risk indicators are present, regardless of their measurements under (1) and (2).

Evaluation of CRE Concentrations

The effectiveness of an institution's risk management practices will be a key component of the supervisory evaluation of the institution's CRE concentrations. Examiners will engage in a dialogue with the institution's management to assess CRE exposure levels and risk management practices. Institutions that have experienced recent, significant growth in CRE lending will receive closer supervisory review than those that have demonstrated a successful track record of managing the risks in CRE concentrations.

⁴ For commercial banks as reported in the Call Report FFIEC 031 and 041, schedule RC-C, item 1a.

⁵ For purposes of this Guidance, the term "total capital" means the total risk-based capital as reported for commercial banks in the Call Report FFIEC 031 and 041 schedule RC-R – Regulatory Capital, line 21.

⁶ For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC-C, items 1a, 1d, 1e, and Memorandum Item #3.

In evaluating CRE concentrations, the Agencies will consider the institution's own analysis of its CRE portfolio, including consideration of factors such as:

- Portfolio diversification across property types
- Geographic dispersion of CRE loans
- Underwriting standards
- Level of pre-sold units or other types of take-out commitments on construction loans
- Portfolio liquidity (ability to sell or securitize exposures on the secondary market)

While consideration of these factors should not change the method of identifying a credit concentration, these factors may mitigate the risk posed by the concentration.

Assessment of Capital Adequacy

The Agencies' existing capital adequacy guidelines note that an institution should hold capital commensurate with the level and nature of the risks to which it is exposed. Accordingly, institutions with CRE concentrations are reminded that their capital levels should be commensurate with the risk profile of their CRE portfolios. In assessing the adequacy of an institution's capital, the Agencies will consider the level and nature of inherent risk in the CRE portfolio as well as management expertise, historical performance, underwriting standards, risk management practices, market conditions, and any loan loss reserves allocated for CRE concentration risk. An institution with inadequate capital to serve as a buffer against unexpected losses from a CRE concentration should develop a plan for reducing its CRE concentrations or for maintaining capital appropriate to the level and nature of its CRE concentration risk.