Commercial Real Estate (CRE) – Risks and Effective Risk Management

July 21, 2016 New York Region Industry Teleconference
Nationwide, CRE Trends are Positive with Some Signs of Emerging Risk

- **CRE market conditions** continue to improve
- **CRE lending** has increased, but concentrations are below those of the bubble years
- The **multifamily market** has seen a lot of construction and some areas may be approaching oversupply
- **Loan underwriting standards** have relaxed, which may continue as competition increases

Note: Information and comments are the opinion of the author, not the FDIC. This presentation and comments are not for attribution, quotation, or distribution.
CRE Concentrations are High in Several Areas of the Country

Nation 176%

Source: FDIC.
Note: Data as of March 31, 2016.

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CRE Past-Due Rates are Higher Than the Nation in Many Eastern States

Median CRE Past Dues
- 0-0.5%
- .5 – 0.76%
- .76 – 1.5%
- > 1.5%

Nation 0.76%

Source: FDIC.
Note: Data as of March 31, 2016.
Strong Inflows from Abroad Continue

Foreign Capital Flows in U.S. CRE


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Valuation Pressures are Increasing

- Commercial property values have recently exceeded pre-crisis peaks
- Despite positive rent growth, net operating income has not kept pace with price appreciation, pushing capitalization rates below pre-crisis troughs

CRE Prices

Capitalization Rates

Source: CoStar Portfolio Strategies, data are as of First Quarter 2016.
Constant quality price index, 4Q08 = 100.

Source: CoStar Portfolio Strategies, data are as of First Quarter 2016.

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CRE Vacancy Rates are Improving but Multifamily May Face Some Weakness Ahead

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Price Appreciation is Expected to Ease

Note: Price growth is based on CoStar constant quality sales index.

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Who Holds Multifamily Loans?

Debt Outstanding by Holders of Credit Risk

<table>
<thead>
<tr>
<th>Holder of Credit Risk</th>
<th>Total $ in Billions</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Government Sponsored Enterprises (GSEs)</strong></td>
<td>$473</td>
</tr>
<tr>
<td></td>
<td>43%</td>
</tr>
<tr>
<td><strong>Banks and Thrifts</strong></td>
<td>$389</td>
</tr>
<tr>
<td></td>
<td>35%</td>
</tr>
<tr>
<td><strong>State and Local Credit Agencies</strong></td>
<td>$95</td>
</tr>
<tr>
<td><strong>Life Insurance Companies</strong></td>
<td>$63</td>
</tr>
<tr>
<td><strong>CMBS Issuers</strong></td>
<td>$57</td>
</tr>
<tr>
<td><strong>Other</strong></td>
<td>$37</td>
</tr>
</tbody>
</table>

Source: Federal Reserve Board, Flow of Funds Z.1, Table L219, June 9, 2016.
Note: Data as of March 31, 2016.
Multifamily Property Supply has been Expanding Rapidly

Four-Quarter Completions as a Share of Inventory (Percent)

- Retail
- Industrial
- Office
- Multifamily (Apartment)

Source: CoStar Portfolio Strategies. Note: Four-quarter completions are the sum of the most recent four quarters’ completions as a share of the inventory one year earlier.

Units Under Construction as a Share of Inventory (Percent)

- Multifamily (Apartment)
- Industrial
- Office
- Retail

Source: CoStar Portfolio Strategies. Note: Units under construction are those due to be completed within six quarters.

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New York Region Multifamily Supply is Also Increasing

Four-Quarter Completions as a Share of Inventory (Percent)

Source: CoStar Portfolio Strategies. Note: Four-quarter completions are the sum of the most recent four quarters’ completions as a share of the inventory one year earlier.

Units Under Construction as a Share of Inventory (Percent)

Source: CoStar Portfolio Strategies. Note: Units under construction are those due to be completed within six quarters.

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New Multifamily Units Underway Exceed Absorption

Source: CoStar Portfolio Strategies, first quarter 2016. Data represent the 54 largest markets nationwide.

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Additions to Existing Multifamily Stock are Very Large for Some Metro Areas

Multifamily Units Under Construction as a Share of Inventory, Percent

Burlington, NC
Provo, UT
Nashville, TN
Fort Myers, FL
McAllen, TX
Charlotte, NC
Corpus Christi, TX

Source: CoStar Portfolio Strategies. Data are as of first quarter 2016.

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Several Metro Areas in the New York Region are Also Adding Multifamily Stock

Units Under Construction as a Share of Inventory, Percent

Source: CoStar Portfolio Strategies. Data are as of first quarter, 2016.

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Increases in Multifamily Reflect a Decline in Homeownership Rates and Affordability

US Homeownership

Loan Growth By Type

Source: Census Bureau, National Association of Realtors, Haver Analytics.

Source: Federal Reserve Board, Haver Analytics.

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Looking Ahead: CRE Issues to Watch

- Rising interest rates may put pressure on CRE debt service and capitalization rates
- Multifamily might be approaching the supply/demand equilibrium point in some areas – suggesting that prices may weaken and vacancy rates may rise
- Underwriting standards may continue to relax with increased competition

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CRE Risk Management Discussion Topics

- Overview of existing and recent applicable regulatory guidance
- Commonly identified risk management weaknesses
- Stress testing/Sensitivity analysis
Provides regulatory guidelines and expectations regarding:

- Lending Standards and Policies
- Risk Management
- Governance
- Maximum Loan-to-Values
- Internal Reporting
Real estate policies should include:
- Geographic areas in which the bank will lend
- Diversification standards and limits by type and geographic market
- Prudent underwriting standards and exception monitoring
- Regular portfolio monitoring and timely reports to the Board
- Consideration of the need to avoid undue concentrations of risk
- Regular monitoring of market conditions
Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices

Frequently Asked Questions for CRE Concentration Guidance

- Identifies concerns with rising CRE concentrations
- Provides an overview of regulatory expectations:
  - Ongoing risk assessments
  - Effective risk management framework
Effective Risk Management Framework

- Board and Management Oversight
- Portfolio Management
- Management Information Systems
- Market Analysis
- Credit Underwriting Standards
- Portfolio Stress Testing and Sensitivity Analysis
- Credit Review
Examples of Effective Risk Management

- Adopt adequate policies, underwriting standards, risk management practices, and concentration limits
- Develop appropriate lending, capital, and ALLL strategies
- Analyze global cash flows based on reasonable information
- Analyze markets and scenarios to quantify potential risk
- Implement management and Board reporting of strategies and policies
- Analyze repayment capacity over the life of the loan
- Monitor supply/demand
- Conduct sufficient ongoing reporting to identify, measure, monitor and manage concentration risk
- Perform appraisal reviews to ensure appropriate support
Statement on Prudent Risk Management for CRE Lending

• Concerns with weak risk management practices, high CRE exposures, and easing of underwriting standards

• Reinforces the need to maintain underwriting discipline and ensure prudent risk management practices to manage CRE lending risks

• Examiners will focus on the implementation of activities that identify, measure, monitor, and manage CRE concentration risks
“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.”

Institutions with inadequate risk management practices may be asked to:

- Develop improved practices,
- Reduce risk tolerances in underwriting standards, and/or
- Raise addition capital to mitigate CRE risks.
Most Commonly Identified CRE Risk Management Weaknesses

- Absence of or Inadequate/Excessive Limits
- Inadequate Underwriting Activities/Loan Policy Exception Programs
- Lack of or Insufficient Stress Testing
- Inadequate Concentration Reporting/Board Documentation
- Inadequate Independence/Expertise of Appraisal Review Programs
- Insufficient Internal Loan Review of CRE Activities
Most Commonly Identified CRE Risk Management Weaknesses (Continued)

- Inadequate Consideration of CRE or Lack of Appropriate Independence in ALLL analysis
- Outdated Market Analysis/Inconsistent with Strategic Plans
- Ineffective Construction Loan Oversight
- Lack of Appropriate CRE Contingency Plans
Key risk management elements include management information systems, market analysis, and stress testing.

The level of sophistication will depend upon the size and complexity of the institution.

Portfolio stress testing does not require the use of sophisticated portfolio models. Stress testing may be as simple as analyzing the potential effect of stressed loss rates on the bank’s CRE portfolio, capital, and earnings.
Stress Testing Steps Commonly Used By FDIC-Supervised Banks

- Portfolio Analysis/Segmenting
  - Property Type
  - Industry
  - Purpose
  - Ownership/Operation
  - Location
  - Repayment Sources
  - Internal Risk Ratings
  - Loan Structure
Market Analysis

- Published Research Data
- Real Estate Appraisers and Agents
- Property Taxing Authority
- Local Contractors/Builders/Investors
- Community Development Groups
Stress Testing Steps Commonly Used By FDIC-Supervised Banks (Continued)

- Select Most Appropriate Variable(s)
  - Sales Prices
  - Vacancy/Occupancy Rates
  - Interest Rates
  - Changes to Zoning/Regulatory/Consumer Preferences

- Determine Variable Change/Develop Scenario(s)

- Measure Impact of Variable Change(s), Report Results, Review Findings
Take Action(s), Such As:

- Continue As Is
- Reduce Exposure
- Enhance Monitoring and Reporting
- Revisit Current Risk Tolerances
- Increase ALLL, Capital, and Liquidity Levels
- Review CRE Contingency Plan, Strategic Plan, etc.
Stress Testing Steps – Example Overview

- Conduct Portfolio Analysis/Segmenting
  - Non-owner Occupied Commercial Office Buildings

- Perform Market Analysis
  - Market Rents Stable and Vacancy Rates Expected to Increase

- Select Most Appropriate Variable
  - Vacancy Rates

- Determine Variable Change/Scenario
  - Most Likely and Downside Scenarios

- Measure Impact, Report Results, Review Findings
  - Downside Scenario Revealed Significant Risks

- Take Action
  - Maintain Exposure, Revise Plans, and Revisit in 6 Months
Questions?
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- NY Region Regulatory Teleconferences
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- Event Web Link: