CONCENTRATIONS IN COMMERCIAL REAL ESTATE LENDING

Core Analysis Procedures

Examiners are to consider these procedures but are not expected to perform every procedure at every institution. Examiners should complete only the procedures relevant for the institution's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures not included below. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

References

- *Interagency Guidelines Establishing Standards for Safety and Soundness (FRB: 12 CFR 208, Appendix D-1; FDIC: 12 CFR 364, Appendix A)*
- *Interagency Guidelines for Real Estate Lending Policies (FRB: 12 CFR Part 208, Appendix C; FDIC: 12 CFR Part 365, Appendix A)*
- *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (FDIC: FIL-104-2006; FRB: SR 07-01)*
- *Statement on Prudent Risk Management for Commercial Real Estate Lending (FDIC: FIL-62-2015; FRB: SR 15-17)*
- *Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach (FDIC: FIL-31-2020; FRB: SR 20-8)*
- *Advisory: Managing Commercial Real Estate Concentrations in a Challenging Economic Environment (FDIC: FIL-64-2023)*

Considerations and Background

This module focuses on assessing Commercial Real Estate (CRE) portfolio risk, not individual CRE loans. This module should be used in conjunction with the Commercial Real Estate Lending loan reference module, which focuses on reviewing credits collateralized by income producing properties.

Findings and Conclusions

Document findings and conclusions here, and include a summary of these findings and conclusions in the Core Analysis Decision Factors in the appropriate Primary or Supplemental modules.

Preliminary Review

1. **Review documents that may identify issues relating to CRE concentrations, such as:**
   - **Prior examination reports and workpapers**
   - **Examination planning memoranda and file correspondence**
   - **Internal and external audit reports**
   - **Loan committee minutes**
   - **Documentation of action taken by management to correct prior deficiencies**

2. Review Call Report, Uniform Bank Performance Reports (UBPR), and internal management reports to determine the overall composition and performance of the CRE portfolio and to assess the level of CRE growth since the prior examination. Review UBPR concentration ratios for the CRE portfolio as a whole and by sectors in relation to the institution's capital base.[1]
3. Evaluate CRE risk management processes and internal assessments of CRE concentration exposures.
4. Determine whether internal assessments appropriately identify potential concentrations by stratifying the portfolio by common risk characteristics such as: • **Property type (e.g., raw land, developed lots, and residential or commercial construction)** • **Subcategories of property types (e.g., single family, 1-4 family, multi-family, office, warehouse, retail, industrial, hospitality, and special-purpose properties)** • **Loan purpose (construction, short-term, permanent) or structure (fixed or adjustable rate)** • **Speculative vs. non-speculative** • **Geographic market or out-of-territory loans** • **Purchased or participation loans** • **Industry/project type or developer/builder** • **Risk factors (e.g., debt service coverage (DSC), loan-to-value (LTV), and risk rating)**
5. Determine whether management actively mitigates concentration risks through portfolio diversification standards or other procedures designed to limit/control risks (e.g., by geographic dispersion, conservative underwriting standards, strict monitoring and reporting standards, increasing capital or allowance for credit losses (ACL) for loans and leases levels, or requiring "pre-sold" or other forms of take-out commitments).
6. Review board and committee minutes and internal management reports for evidence of CRE concentration concerns, ongoing monitoring/oversight, defined chains of accountability, market analysis, policy compliance, and stress testing.

[1] As detailed in the guidance on *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, the level and nature of an institution's CRE concentration risks may require further supervisory analysis if the institution appears exposed to significant CRE concentration risks.

7. Evaluate management's consideration of relevant economic and competitive conditions that may affect loan concentrations.[2]

8. Determine whether management securitizes and sells CRE loans into the secondary market or sells loan participations, and determine the volume of these activities.[3]

9. Determine whether interrelationships exist between concentrated asset and funding exposures. Consider whether the institution uses noncore-funding sources to fund CRE credit exposures. If material noncore funding sources are used, evaluate the risks associated with these sources.

Policy Considerations

10. Review the institution's strategic plans regarding CRE lending and determine whether the plans:

- **Define appropriate risk tolerances pertaining to loan products, volumes, growth, diversification, geographic dispersion, markets served, and industry concentrations**
- **Set clear performance benchmarks (e.g., profitability goals and asset quality) for each segment of the portfolio and the portfolio as a whole**
- **Appropriately consider associated risks, such as credit, operating, liquidity, compliance, interest rate, and legal risks**
- **Appear reasonable (including the assumptions and projections used) and reflect current and anticipated changes in economic, market, and competitive conditions; management; technological and operational capacity; and capital support**
- **Assess projected concentration levels in relation to risk limits, current capital levels, and future capital needs**
- **Establish guidelines and goals (as needed) for securitizing and selling loans and ensuring that underwriting standards properly incorporate market criteria**

11. Determine whether policy guidelines address:

- **Periodic risk assessments that identify CRE concentrations**
- **Appropriate concentration limits**
- **Monitoring of identified CRE credit concentrations levels and related market conditions**
- **Regular reporting of concentration levels and risks to the board**

[2] Relevant economic conditions may include trends in local employment, wages, demographics, building permit applications, vacancy rates, significant land-use changes and zoning, and the overall level and changes in market interest rates. The effect of competitive conditions could result in weakened underwriting practices, lower interest rates, expensive marketing efforts, or other incentives.

[3] Refer to the Securitization ED module, as needed.

- **Periodic board reviews and approvals of CRE risk limits and exceptions to established limits**
- **Stress testing requirements for individual loans and loan portfolios, such as testing frequencies, validation processes, risk tolerances, and board reporting**
- **Contingency plans to reduce or mitigate concentration risks if concentration levels exceed established thresholds or market conditions begin to deteriorate**

12. Determine whether CRE underwriting guidelines consider concentration risks.

Board and Management Oversight

13. Assess the board's involvement in planning CRE strategies and goals. Consider whether the board established lending policies and processes that (as needed) address:

- **Plans to increase or decrease lending in particular products, markets, or property types**
- **Limits on credit and other asset concentrations**
- **Periodic assessments to determine whether lending strategies, goals, and policies are appropriate in light of current and projected market conditions**

14. Determine whether CRE product offerings and the CRE portfolio composition align with overall business strategies, stated risk tolerances, and approved policy guidelines.

15. Assess the reasonableness of CRE market analysis and concentration risk documentation in board and committee minutes.

16. Determine whether the board periodically considers how changing economic conditions affect CRE risks and, as needed, modifies strategic initiatives, policies, procedures, or underwriting standards.

17. Evaluate the effectiveness of committees that have oversight and control over CRE activities (e.g., lending, funding, operational, and marketing).

18. Determine whether management periodically compares the level of CRE risks to profitability and performance goals.

19. Determine whether management provides appropriate staffing and training to manage CRE portfolio volumes and complexity. This may include loan workout staff as well as increased managerial oversight. Consider market conditions, performance trends, and stress testing results. Assess management's plans to allocate appropriate managerial and financial resources at different points in the economic cycle.

20. Determine whether incentive compensation programs promote behaviors consistent with strategic portfolio objectives and risk tolerances, as well as with the Interagency Guidelines Establishing Safety and Soundness, which prohibits excessive compensation or compensation leading to material financial loss. Such programs may include deferred compensation, clawback provisions, and other incentives for loan producers dependent on portfolio performance.

Monitoring and Internal Controls

21. Evaluate controls to verify adherence to policies and procedures.

22. Determine whether internal and external audit programs are effective in assessing internal controls relating to CRE concentrations.

23. Assess any actions taken by management to correct audit and examination findings related to CRE concentrations.

Underwriting and Credit Administration

24. Assess CRE underwriting practices and the effect on concentration risks. Consider whether management:

- **Is easing or tightening pricing, loan covenants, maturities, interest-only payments, or guarantor requirements**
- **Conducts global cash flow analyses based on reasonable (not speculative) rental rates, sales projections, and operating expenses**
- **Assesses the ongoing ability of borrowers and projects to service all debt as loans convert from interest-only to amortizing payments or during periods of rising interest rates**

25. Determine whether management tracks policy exceptions by individual borrowers, as well as aggregate trends; verify that exceptions to policy are properly justified, supported, and documented; and assess the level and trend of policy exceptions.
Management Information Systems (MIS) / Communications
26. Determine whether management and board reports provide appropriate information on current conditions and anticipated changes in local CRE market conditions and market values.
27. Determine whether management and board reports provide information on individual customers (above select dollar thresholds) and the entire portfolio (e.g., industry, NAICS code, collateral type, and geographic location).
28. Determine who is responsible for reviewing key reports and assess their expertise and independence.
29. Assess the availability, accuracy, and effectiveness of MIS and portfolio management tools used to manage the CRE portfolio. Determine whether data integrity is regularly tested.
30. Determine whether management monitors and reports policy exceptions by individual borrowers and aggregate levels.
31. Determine whether management appropriately monitors performance within portfolio segments and revises lending and oversight standards when conditions warrant.
32. Assess the quality of market analysis reports and tools used. Consider the type of information provided, reports on specific market segments, the variety of sources used, and the timeliness of information.

33. Determine whether MIS captures sufficient data to facilitate appropriate stress testing and risk management.[4] Stress testing variables may include:

- **Stratified portfolios**
- **Recent interest and capitalization rates**
- **Net operating incomes (NOI)**
- **Average loan-to-value and debt-service ratios**
- **Current client/tenant operating incomes**

34. Assess the overall appropriateness, accuracy, and timeliness of reports provided to the board and management. Reports typically include or convey information in sufficient detail given the size, complexity, and risk of the organization's CRE activities and overall lending strategies and risk tolerances.

Stress Testing and Sensitivity Analysis

35. Determine whether management selects loan groups to stress test, focusing on vulnerable segments of the institution's CRE portfolio. Factors for selecting the pool of loans typically include:

- **Loans with similar characteristics, such as purpose, source of repayment, low DSC, high LTV, geographic location, property type, and industry type**
- **Loans that may be affected by negative trends in current or future market conditions**

36. Assess management's methodology and analysis for ensuring stress test samples appropriately reflect the loan pool's characteristics.

37. Review documentation and determine the appropriateness of any stress test or sensitivity analysis performed. Testing typically includes estimates of the portfolio's susceptibility to deteriorating economic, market, and business conditions. In addition, the resulting impact to DSC and LTV ratios are typically evaluated. Assumptions may be conservative and include *shock* testing of basic assumptions, such as:

- **Increases in interest rates**
- **Overall changes in property values**
- **Changes in property vacancy or absorption rates**
- **Declines in NOI**
- **Changes in capitalization or discount rates**

[4] Accurate, current loan information that appropriately reflects key portfolio characteristics supports meaningful stress testing.

38. Determine whether stress test results and sensitivity analyses are appropriately factored into items such as CRE strategies, policies, staffing/managerial needs, capital planning, funding requirements, underwriting criteria, loan pricing, and risk limits.
39. Determine whether the institution's stress test model or methodology is subject to a periodic comprehensive, independent validation process.
40. Determine whether the institution's stress test methodology considers the volatility in the supply and demand for lots, retail and office space, and multi-family units during varying business cycles.
Capital Adequacy
41. Assess capital planning relative to CRE concentration levels (and any CRE portfolio growth plans), and determine whether the planning process appears reasonable. Consider the factors management includes in capital plans and how stress test results, including anticipated charge-offs, are incorporated into capital planning.[5]
42. Determine whether management incorporates CRE concentration risks into its analysis of ACL for loans and leases, as applicable, and capital adequacy.
43. Consider whether capital levels are sufficient to support current and future CRE concentration risks. Determine whether the institution has adequate capital to buffer against unexpected losses from a CRE concentration. If not, discuss plans to reduce CRE concentrations or increase capital with management.
End of Core Analysis.

[5] **Coordinate activities with the examiner reviewing Capital Adequacy.**