

## **Managing Commercial Real Estate Concentrations in a Challenging Economic Environment**

This advisory to insured state non-member banks and savings associations (FDIC-supervised institutions) reemphasizes the importance of strong capital, appropriate credit loss allowance levels, and robust credit risk-management practices when managing commercial real estate (CRE) concentrations. This advisory replaces an advisory issued in 2008<sup>1</sup> that emphasized these same points during a time when CRE market conditions had weakened, most notably in the construction and development (C&D) sector.

This advisory conveys several key risk management practices for FDIC-supervised institutions to consider in managing CRE loan concentrations in the current challenging economic environment. The advisory also continues to emphasize the importance of effectively managing liquidity and funding risks, which can compound lending risks, particularly for CRE-concentrated institutions. This advisory does not create new risk management principles; however, it does update and build upon previously issued guidance.

### **Previous Challenging Economic Environments**

The FDIC recognizes that financial institutions play a critical role in the economic vitality of the communities they serve by providing credit for businesses, often for CRE purposes, including real estate development. However, concentrations in CRE lending add dimensions of risk that warrant attention. CRE lending concentrations, combined with weak risk management practices, contributed significantly to past asset quality problems and bank failures.

One example is the banking and thrift crisis of the 1980s and early 1990s.<sup>2</sup> Bank decisions to loosen CRE lending standards during the 1980s were based primarily on the assumption that real estate values (collateral values) would continue to rise in the future as they had in the then recent past. Another example is the banking crisis of 2008-2013,<sup>3</sup> which impacted the many financial institutions that had greatly increased their holdings of, and concentrations in, in particular, loans to finance the development and construction of real estate (C&D loans) in the period leading up to the crisis. In these crises, when CRE markets deteriorated, poor management of CRE lending concentrations led to increased credit losses. Further, many CRE-concentrated institutions that failed also relied on funding sources other than stable deposits and had lower levels of capital.<sup>4</sup>

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<sup>1</sup> *Managing Commercial Real Estate Concentrations in a Challenging Environment*, March 17, 2008, <https://www.fdic.gov/news/financial-institution-letters/2008/fil08022.html>.

<sup>2</sup> *History of the Eighties*, December 1997, <https://www.fdic.gov/resources/publications/history-eighties/index.html>.

<sup>3</sup> *Crisis and Response: An FDIC History, 2008–2013*, <https://www.fdic.gov/resources/publications/crisis-response/index.html>.

<sup>4</sup> See FDIC Office of Inspector General, Eval-13-002, “Comprehensive Study on the Impact of the Failure of Insured Depository Institutions,” January 2013, <https://www.fdic.gov/sites/default/files/reports/2022-08/13-002EV.pdf>; Treasury Office of Inspector General, OIG-15-052, “Analysis of Bank Failures Reviewed by the Department of the Treasury Office of Inspector General,” August 15, 2016, [https://oig.treasury.gov/sites/oig/files/Audit\\_Reports\\_and\\_Testimonies/OIG16052.pdf](https://oig.treasury.gov/sites/oig/files/Audit_Reports_and_Testimonies/OIG16052.pdf); Board of Governors Office of Inspector General, “Summary Analysis of Failed Bank Reviews,” September, 2011, [https://oig.federalreserve.gov/reports/Cross\\_Cutting\\_Final\\_Report\\_9-30-11.pdf](https://oig.federalreserve.gov/reports/Cross_Cutting_Final_Report_9-30-11.pdf).

## **Current Challenging Economic Environment and Real Estate Conditions**

Recent weaknesses in the current economic environment and in fundamentals related to various CRE sectors have increased the FDIC's overall concern for state nonmember institutions with concentrations of CRE loans. CRE market and lending conditions have been significantly influenced by governmental and societal responses to the COVID-19 pandemic, rapidly rising interest rates, and the prolonged inverted yield curve. Also, CRE investment property capitalization rates have not kept pace with recent rapid increases in long-term interest rates, which leads to concerns about general over-valuation of underlying collateral.

CRE vacancy rates are rising, most notably in the office sector, but also in multi-family.<sup>5</sup> Office vacancy rates are affected by the demand for traditional office space, which has slowed due to the popularity of remote work. Office attendance is approximately 50 percent of its pre-pandemic level.<sup>6</sup> In addition to large amounts of available space, high levels of office loans and office leases are maturing or expiring in the next few years. The multi-family sector vacancy rate is also high in some markets, due in part to potential overbuilding. Rapid absorption of multi-family space experienced in 2021 has since slowed, while the pace of new construction remains brisk.

Refinancing office and multi-family loans could be challenging in an environment of pressured rent growth, higher interest rates, and lower property values, particularly for those institutions with CRE concentrations in areas with surplus office and multi-family space. The FDIC's concern also extends to the subset of banks with elevated C&D concentrations, which subset has risen in recent quarters, but remains well below the 2007 peak. Banks with significant exposure to C&D loans had substantial credit losses during the 2008-2013 banking crisis, and banks currently engaged in C&D lending could be affected by weaknesses in the current economic environment and real estate fundamentals.

The FDIC continues to be concerned that institutions with concentrated CRE exposures may be vulnerable to real estate downturns and is reminding such FDIC-supervised institutions of the importance of ensuring that credit risk management practices are strong, reliable funding sources are in place and liquidity contingency plans are robust, property valuation policies and procedures capture changes to property values, capital and allowance for credit losses (ACL) levels are appropriate, and workout processes are well-defined and ready to be deployed. It is strongly recommended that, as market conditions warrant, institutions with CRE concentrations (particularly in office lending) increase capital to provide ample protection from unexpected losses if market conditions deteriorate further.

## **Managing CRE Concentrations**

In December 2006, the FDIC and the other prudential regulators issued *Concentrations in*

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<sup>5</sup> National Association of Realtors, *Commercial Real Estate Market Insights Report*, July 2023, <https://www.nar.realtor/commercial-market-insights/july-2023-commercial-real-estate-market-insights>.

<sup>6</sup> Kastle Systems, "[Kastle Back to Work Barometer](#)," October 30, 2023.

*Commercial Real Estate Lending, Sound Risk Management Practices (CRE Guidance).*<sup>7</sup> Institutions with significant CRE concentrations<sup>8</sup> are reminded that strong risk management, governance, capital, and appropriate ACL levels are needed to help mitigate risks. Institutions with overall credit risk management processes that reflect consideration of the principles of the 2006 CRE Guidance are better positioned to manage through adverse economic environments. The principles in the 2006 CRE guidance remain relevant, particularly in challenging economic environments, and particularly for institutions engaged in significant CRE lending strategies to help them remain healthy and profitable while continuing to serve the credit needs of the community.

The FDIC has identified six key risk-management actions to help institutions with significant C&D and CRE concentrations<sup>9</sup> manage through changes in market conditions:

1. **Maintain Strong Capital Levels** – Capital provides institutions with protection against unexpected losses, particularly in stressed markets. Institutions with significant C&D and CRE exposures may require more capital because of uncertainty about market conditions causing an elevated risk of unexpected losses. As market conditions warrant, proactive directorates and management take steps to increase capital levels to support significant CRE concentrations and mitigate the impact of potential loss. Maintenance of an appropriate level of capital to protect an institution from unexpected losses related to C&D and CRE concentrations is an important consideration when contemplating cash dividends.
2. **Ensure that Credit Loss Allowances are Appropriate** – Institutions are expected to determine their ACLs in accordance with U.S. generally accepted accounting principles (GAAP) and regulatory reporting instructions, relevant supervisory guidance, their stated policies and procedures, and management’s best judgment. Prudent credit management includes periodic, at least quarterly, analysis of the collectability of CRE and all other exposures and maintenance of ACLs at a level that is appropriate to cover expected credit losses on individually evaluated loans, as well as expected credit losses in the remainder of the loan portfolio. In reviewing their ACL methodology, institutions with significant C&D and CRE concentrations are advised to consult recent supervisory

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<sup>7</sup> *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, December 6, 2006, <https://www.fdic.gov/news/financial-institution-letters/2006/fil06104.html>.

<sup>8</sup> As described in the CRE Guidance, the agencies will monitor and 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 land represent 100 percent or more of the institution’s Tier 1 Capital plus the ACL for loans; or (2) Total commercial real estate loans as defined in the CRE Guidance represent 300 percent or more of the institution’s Tier 1 Capital plus the ACL for loans, 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. Supervisory criteria do not constitute regulatory limits on CRE concentrations.

<sup>9</sup> For the purposes of this advisory, C&D and CRE concentrations are aligned with the definitions within the CRE Guidance.

guidance.<sup>10</sup> In accordance with GAAP, management should consider the effects of past events, current conditions, and reasonable and supportable forecasts on the collectability of the institution's loans. Specifically, GAAP requires management to use relevant forward-looking information and expectations drawn from reasonable and supportable forecasts when estimating expected credit losses. While historical loss information generally provides a basis for an institution's assessment of expected credit losses, management should consider whether further adjustments to historical loss information are needed to reflect the extent to which current conditions and reasonable and supportable forecasts differ from the conditions that existed during the historical loss period.

- 3. Manage C&D and CRE Loan Portfolios Closely** – Consistent with Parts 364 and 365 of the FDIC Rules and Regulations<sup>11</sup> and their appendices, institutions should maintain prudent lending standards and credit administration practices that consider the risks of material C&D and CRE concentrations. This includes management information systems that provide the board and management with relevant data on concentrations levels and related market conditions, including for concentration or market segments, as appropriate.

Portfolio and loan level stress tests or sensitivity analysis can be an invaluable tool in identifying and quantifying the impact of changing economic conditions and changing loan level fundamentals on asset quality, earnings, and capital. Applying adverse scenarios while conducting stress tests or sensitivity analysis helps banks adjust risk management processes, capital planning, liquidity management, collateral valuation processes, and workout procedures to prepare for credit risk problems before they impact earnings and capital. Additionally, appropriate risk management practices include maintaining a strong credit review and risk rating system<sup>12</sup> that identifies deteriorating credit trends early. It is important for institutions to effectively manage interest reserves<sup>13</sup> and loan accommodations,<sup>14</sup> reflecting the borrower's condition accurately in loan ratings and documented reviews.

- 4. Maintain Updated Financial and Analytical Information** – Prudent institutions with

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<sup>10</sup> Refer to the *Interagency Policy Statement on Allowances for Credit Losses (Revised April 2023)*, April 21, 2023, <https://www.fdic.gov/news/financial-institution-letters/2023/fil23017.html>.

<sup>11</sup> See *Standards for Safety and Soundness*, Part 364 of FDIC Rules and Regulations, Appendix A, <https://www.ecfr.gov/current/title-12/chapter-III/subchapter-B/part-364>; and *Real Estate Lending Standards*, Part 365 and Subpart A to Part 365, <https://www.ecfr.gov/current/title-12/part-365/subpart-A>.

<sup>12</sup> *Interagency Guidance on Credit Risk Review Systems*, May 8, 2020, <https://www.fdic.gov/news/financial-institution-letters/2020/fil20055.html#>.

<sup>13</sup> Construction and development loans often are structured with an “interest reserve” as a portion of the initial loan commitment. During the construction phase, the lender typically recognizes interest income from the interest reserve and capitalizes the interest into the loan balance. If a development project stalls and management fails to evaluate the collectability of the loan, interest income could continue to be recognized from the interest reserve and capitalized into the loan balance, even though the project is not generating sufficient cash flows to repay the loan. In this case, the loan may be contractually current due to the payments being funded from the reserve, but future repayment of principal may be in jeopardy.

<sup>14</sup> Refer to the *Interagency Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts*, June 29, 2023, <https://www.fdic.gov/news/financial-institution-letters/2023/fil23034a.pdf>.

CRE and/or C&D concentrations maintain recent borrower financial statements, including property cash flow statements, rent rolls, guarantor personal statements, tax return data, and other income property performance information to better understand their borrowers' ability to repay and overall financial condition and enable timely identification of adverse trends. Such institutions emphasize global financial analysis of obligors, including in relation to pending loan maturities and lease expirations, as well as the concentration of individual property owners, builders, or developers in a loan portfolio. As real estate market and individual property conditions change, it is important for management to consider the continued relevance of appraisals and evaluations performed during prior economic or market and interest rate conditions, and update collateral valuation information as necessary.<sup>15</sup> Maintaining updated financial and analytical information provides key inputs to foster meaningful stress testing or scenario analysis described above.

5. **Bolster the Loan Workout Infrastructure** – Well prepared institutions ensure they have sufficient staff and appropriate skill sets to properly manage an increase in problem loans and workouts. Likewise, institutions that have a ready network of legal, appraisal, real estate brokerage, and property management professionals to handle additional prospective workouts are better situated for more positive outcomes.
6. **Maintain Adequate Liquidity and Diverse Funding Sources** – Since liquidity and funding risks may be compounded in challenging interest rate and economic environments, it is important for institutions to have a comprehensive management process for identifying, measuring, monitoring, and controlling liquidity and funding risks. Recent industry events have underscored risks related to relying on funding concentrations, such as high levels of uninsured deposits,<sup>16</sup> and the importance of robust liquidity risk management and contingency funding planning.<sup>17</sup> Institutions that have identified appropriate levels of cash and cash equivalents, that have identified and are able to use a stable and diverse range of funding mechanisms, and that have identified and tested sources of contingent liquidity, including establishing and testing access to the Federal Reserve Discount Window, are better positioned to profitably support CRE concentrations.

As with any asset exposure, significant CRE concentrations can lead to losses and capital deficiencies in a stressed environment. The FDIC's examiners recognize the challenges facing institutions in the current CRE environment, and will expect each board of directors and management team to strive for strong capital and appropriate ACL levels, and to implement

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<sup>15</sup> Refer to *Appraisals*, Part 323 of FDIC Rules and Regulations, <https://www.ecfr.gov/current/title-12/chapter-III/subchapter-B/part-323>; and to the *Interagency Appraisal and Evaluation Guidelines*, December 10, 2010, <https://www.fdic.gov/news/financial-institution-letters/2010/fil10082a.pdf>.

<sup>16</sup> See for example, *FDIC's Supervision of Signature Bank*, April 28, 2023, <https://www.fdic.gov/news/press-releases/2023/pr23033a.pdf>; *Review of the Federal Reserve's Supervision and Regulation of Silicon Valley*, April 28, 2023, <https://www.federalreserve.gov/publications/files/svb-review-20230428.pdf>; and *FDIC's Supervision of First Republic Bank*, September 8, 2023, <https://www.fdic.gov/news/press-releases/2023/pr23073a.pdf>.

<sup>17</sup> *Updated Guidance: Interagency Policy Statement on Funding and Liquidity Risk Management on the Importance of Contingency Funding Plans*, July 28, 2023, <https://www.fdic.gov/news/financial-institution-letters/2023/fil23039.html>.

robust credit risk-management practices. Institutions are encouraged to continue making C&D and CRE credit available in their communities using prudent lending standards that rely on strong underwriting and loan administration practices. The Appendix includes selected FDIC regulations, supervisory guidance, and other relevant information for additional details about matters discussed in this advisory.

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## APPENDIX

Refer to the FDIC's regulations, supervisory guidance, and other information for additional details about matters discussed in this Advisory. Selected items appear below.

### Lending Standards

- *Standards for Safety and Soundness*, Part 364 of FDIC Rules and Regulations, Appendix A, <https://www.ecfr.gov/current/title-12/chapter-III/subchapter-B/part-364>.
- *Real Estate Lending Standards*, Part 365 and Subpart A to Part 365, <https://www.ecfr.gov/current/title-12/part-365/subpart-A>.

### CRE Concentrations

- *Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, December 6, 2006, <https://www.fdic.gov/news/financial-institution-letters/2006/fil06104.html>.
- *Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts*, June 29, 2023, <https://www.fdic.gov/news/financial-institution-letters/2023/fil23034a.pdf>.
- *Joint Statement on Prudent Risk Management for Commercial Real Estate Lending*, December 18, 2015, <https://archive.fdic.gov/view/fdic/284>.

### Credit Risk Management

- *Interagency Guidance on Credit Risk Review Systems*, May 8, 2020, <https://www.fdic.gov/news/financial-institution-letters/2020/fil20055.html#>.
- *Interagency Supervisory Guidance on Stress Testing for Banking Organizations with More than \$10 Billion in Total Consolidated Assets*, May 14, 2012, <https://archive.fdic.gov/view/fdic/4634>.
- *Interagency Statement to Clarify Supervisory Expectations for Stress Testing by Community Banks*, May 14, 2012, <https://archive.fdic.gov/view/fdic/4633>.

### Accounting

- *Interagency Policy Statement on Allowances for Credit Losses (Revised April 2023)*, April 21, 2023, <https://www.fdic.gov/news/financial-institution-letters/2023/fil23017.html>.

### Appraisals

- *Appraisals*, Part 323 of FDIC Rules and Regulations, <https://www.ecfr.gov/current/title-12/chapter-III/subchapter-B/part-323>.
- *Interagency Appraisal and Evaluation Guidelines*, December 10, 2010, <https://www.fdic.gov/news/financial-institution-letters/2010/fil10082a.pdf>.

- *Interagency Advisory on Use of Evaluations in Real Estate-Related Financial Transactions*, March 4, 2016, <https://www.fdic.gov/news/financial-institution-letters/2016/fil16016a.pdf>.
- *Advisory on the Availability of Appraisers*, May 31, 2017, <https://archive.fdic.gov/view/fdic/6464>.
- *Frequently Asked Questions on the Appraisal Regulations and the Interagency Appraisal and Evaluation Guidelines*, October 16, 2018, <https://www.fdic.gov/news/financial-institution-letters/2018/fil18062a.pdf>.

### **Liquidity and Funds Management**

- *Updated Guidance: Interagency Policy Statement on Funding and Liquidity Risk Management on the Importance of Contingency Funding Plans*, July 28, 2023, <https://www.fdic.gov/news/financial-institution-letters/2023/fil23039.html>.
- *Interagency Policy Statement on Funding and Liquidity Risk Management*, March 22, 2010, <https://www.govinfo.gov/content/pkg/FR-2010-03-22/pdf/2010-6137.pdf>.

### **Other Publications**

- *Commercial Real Estate: An Update on Bank Lending Amid the Evolving Pandemic Backdrop*, Supervisory Insights, Summer 2022, <https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum22/sisummer2022-article01.pdf>.
- *Stress Testing Credit Risk at Community Banks*, Supervisory Insights, Summer 2012, <https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum12/sisummer12-article2.pdf>.
- *Crisis and Response: An FDIC History, 2008–2013*, <https://www.fdic.gov/resources/publications/crisis-response/index.html>.