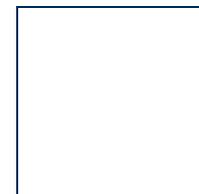


Concentrations in Commercial Real Estate Lending



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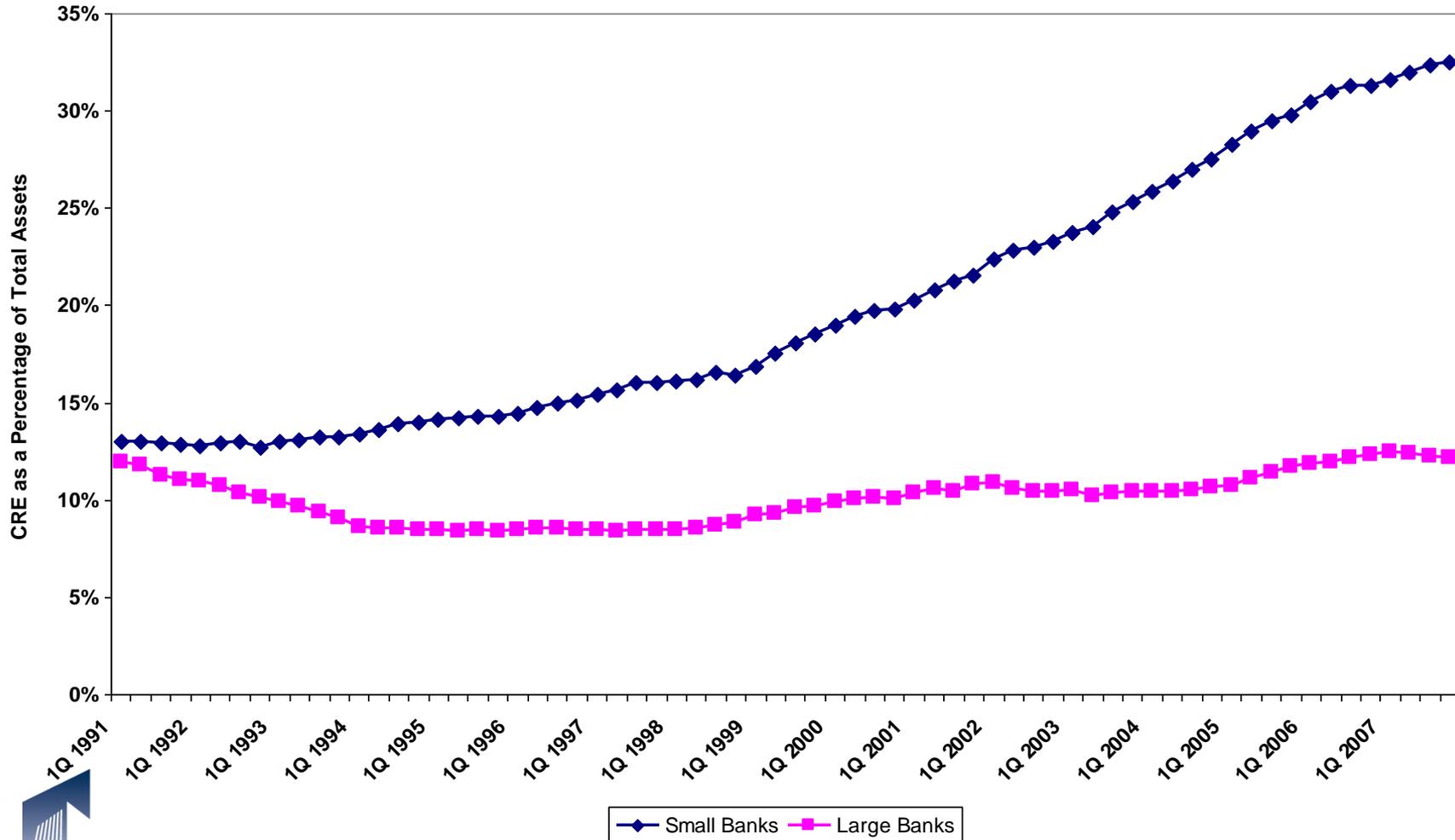


CRE Trends

- Commercial Real Estate lending (CRE) concentrations have risen significantly at community banks in recent years
- Small Banks versus Large Banks
 - 1991 CRE-to-assets below 15% for all banks
 - 2007 CRE-to-assets 33% for Small Banks, but almost unchanged from 1991 level for Large Banks



CRE Concentrations – Small Banks vs Large Banks 1991 to 2007





How Did This Happen?

- CRE crisis of the late 1980's and early 1990's
- Prosperity
 - CRE and C&LD comeback in the mid-1990's
- Community (Small) Banks
 - Loss of Market Share - Residential mortgages, Credit cards, and Consumer loans
 - "Knowledge of Local Markets & Borrowers"
- Fifth District anomaly
 - SMBs have consistently held an above average percentage of C& LD loans



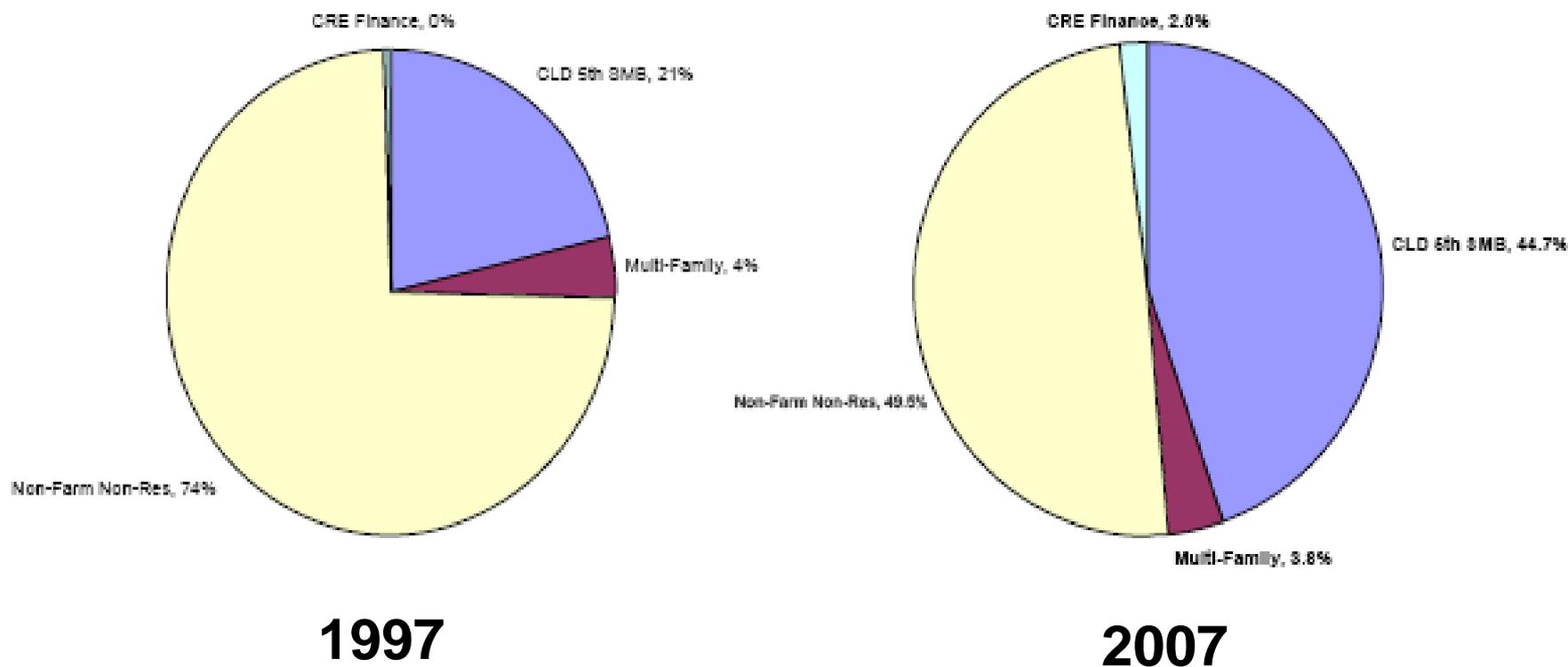


Not only has the collective level of CRE lending increased, but the composition of the CRE portfolio has changed dramatically as well.



Changing Composition of CRE Portfolios

Construction & Land Development as a “Slice” of CRE





“Concentrations in CRE lending coupled with weak loan underwriting and depressed CRE markets have contributed to significant credit losses in the past.”

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Interagency Guidance on
Concentrations in
Commercial Real Estate



SR 07-1

Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices

- Purpose of Guidance
 - Ability to withstand market disruption will depend heavily on degree of management oversight and capital levels
- **Does NOT**
 - **Define CRE Concentration**
 - **Establish CRE lending limits**





SR 07-1

CRE Concentration

Assessments

Institutions actively involved in CRE lending should:

- Perform ongoing risk assessments

- Identify potential concentrations

- Establish concentration limits

- Report concentrations to board of directors





Supervisory Benchmarks

- Construction, Land Development, & Other Land > 100% of Total Capital
- Total Commercial Real Estate Loans > 300% of Total Capital and outstanding balance has increased by 50% or more during the prior 36 months
- Experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds limits outlined above





Focus on the Guidance is on those CRE loans where the cash flow from the real estate collateral is the primary source of repayment rather than on loans to a borrower where real estate is a secondary source of repayment or is taken as collateral through an abundance of caution.

Does not focus on owner occupied real estate loans, rather views these as risk mitigants to the regulatory benchmarks.



- Portfolio Risk versus Transaction Risk
 - Focus on Governance Practices
 - Not Individual Loan Review



Forest NOT the Trees



Risk Management

- Board and Senior Management Oversight
- Portfolio Management
- MIS
- Market Analysis
- Policy & Underwriting
- Stress Testing
- Credit Risk Review

Effective risk management processes cannot be implemented without prudent and robust CRE Concentration Assessments.





“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.”

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Board & Senior Management Oversight

- Director Involvement in CRE Strategic Process
- Establish Policy Guidelines in Support of Strategy
- Identifies and Quantifies Nature and Level of Risk Presented by CRE Concentrations
- Review and Approve CRE Risk Exposure Limits and Appropriate Sub-limits
 - Conform to Changes in Strategy
 - Respond to Changes in Market Conditions





Portfolio Management

- Prudent Underwriting of Individual Loans is NOT Enough
 - Cyclical Changes can Equal Unacceptable Risk
 - Establish Internal Lending Guidelines and Concentration Limits
 - Evaluate the Degree of Adherence to Internal Guidelines
- Develop Strategies for Managing CRE Concentrations
 - Contingency Plan – Participations, Sales, or Securitizations
 - Assess Marketability
 - Access to the Secondary Market
 - Comparison of Underwriting Standards





Management Information Systems

- Key to Effective Portfolio Management
- Ability to capture useful information that allows portfolio segmentation and stratification
- Information regarding changing market conditions and resulting market values
- Sufficient Borrower Information to Perform Stress Test Analysis
- Not Focused Solely on “Reports”, But On The Culture of Thought



MIS / Communications

- Timely
- Clear
 - Changes to risk profile
 - Risk-rating migrations
- Well-defined
 - Review and evaluates concentrations
 - Risk management reports
- Ad hoc analyses of events that could affect CRE portfolio



Portfolio Analytics

- Goes beyond Call Report codes
- Reasonable and supportable
- Common characteristics
- Encourages identification & monitoring

Robust *STRATIFICATION* provides the best opportunity for management to see the complete picture and assess inherent and enterprise wide credit exposures.





Management's Ability to Stratify

- “Slice & Dice”
 - Identify and aggregate exposures
 - Depth of information recorded
 - Knowledge of local economic conditions

- Identify & Monitor Concentrations
 - Do NOT segment just to avoid the appearance of a concentration.



CRE Portfolio Segmentation

- **Land – Raw or Pre-development**
 - Residential
 - Commercial
 - Not yet rezoned
- **Developed Lots**
 - Residential
 - Commercial
- **Residential Construction**
 - 1-4 family
 - Condo (include conversions)
- **Commercial construction (non owner)**
 - Office
 - Warehouse/industrial
 - Retail
 - Multifamily rental
 - Lodging
 - Other
- **Commercial income property completed but not yet stabilized**
 - Office
 - Warehouse/industrial
 - Retail Multifamily rental
 - Lodging
 - Other
- **Commercial income producing, permanent**
 - Office
 - Warehouse/industrial
 - Retail
 - Lodging
 - Other

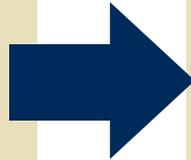




MIS - Stratification

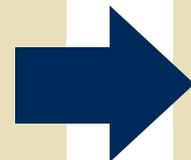
Multiple sorts have provide best picture

By NAICS



By Property Type

- Retail
- Apartment
- Office
- Warehouse / Industrial
- R&D Properties
- Hotels / motels
- Mobile home parks
- Housing projects
- C&D Loans



Other By...

- Repayment source or borrower type
- Major / single industry
- Owner occupied vs. non-owner occupied
- Geographical area
- Zip code
- Average LTV
- Terms
- Tenant mix
- Risk Rating





“Management Information Systems should provide management with sufficient information to identify, measure, monitor, and manage CRE concentration risk.”

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Market Analysis

- Are CRE Lending Strategy and Policies Appropriate?
 - Changes in CRE Market Conditions
 - Property Types
 - Geographic Markets Represented
 - New Markets, New Lending Activities, Expanding Existing Markets
 - Sources of Information
 - Research Data, Appraisers, Local Authorities, Builders, Investors, Community Development Groups
 - Sophistication of Analysis Depends on Market Share and Exposure





Economic & Market Indicators

Economic

- Impact of national and regional factors on local market
- Economic growth trends
- Employment trends
- Population growth trends
- Demographic changes

Market

- Vacancy Rates
- Tenant Lease Incentives
- Absorption Rates
- Construction Permits
- Price of New Construction
- Real Estate Broker and Builder Feedback

Frequency of assessment? By whom?
Sufficient knowledge of market area?





Credit Analysis & Underwriting

- Maximum loan amount by type of property
- Loan terms
- Pricing structures
- Collateral valuation
- Loan-to-Value limits by property type
- Requirements for feasibility studies & sensitivity analysis & 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
- ***Exceptions – limited, approved, monitored, and reported***





Basic Documentation

- Recorded mortgage (or deed of trust)
- Recorded note
- Attorney's title opinion or title insurance
- Appraisal or collateral evaluation
- Evidence insurance (property, liability, flood)
- Assignments of leases
- Copies of leases

Minimum documentation expected in the loan file. All information should be complete and accurate.





Supporting Documentation

- Loan presentation or approval memorandum
- Commitment letter (final signed version)
- Settlement sheet
- Current operating statements of the project
- Bank prepared analysis
- Rent rolls
- Financial statement of other repayment sources
- Tax returns
- Loan officer's comment sheets
- Correspondence
- Guarantees



Credit Analysis Specifics for Development & Construction Loans

- Borrower's overall creditworthiness
- Project-specific considerations
- Prudent Controls
 - Minimum borrower equity requirements
 - Inspection process
 - Documentation on construction progress
 - Tracking pre-sold units
 - Pre-leasing activity
 - Exception monitoring & reporting





Stress Testing

- Susceptibility to deteriorating economic, market, and business conditions
- Debt service coverage (DSC) and loan-to-value (LTV) ratios
- Conservative
- “Shock” testing:
 - Increase in interest rates
 - Overall changes in property value
 - Changes in property vacancy rates
 - Declines in NOI
 - Changes in capitalization rates

**Focus
should be
vulnerable
segments of
the portfolio.**





MIS & Successful Stress Testing

- Data capture must be sufficiently robust to facilitate stress testing and might include:
 - Original appraised value
 - NOI used in the appraisal
 - Original loan to value
 - Original debt service coverage
 - Updated client / tenant operating income
 - Current interest rate data

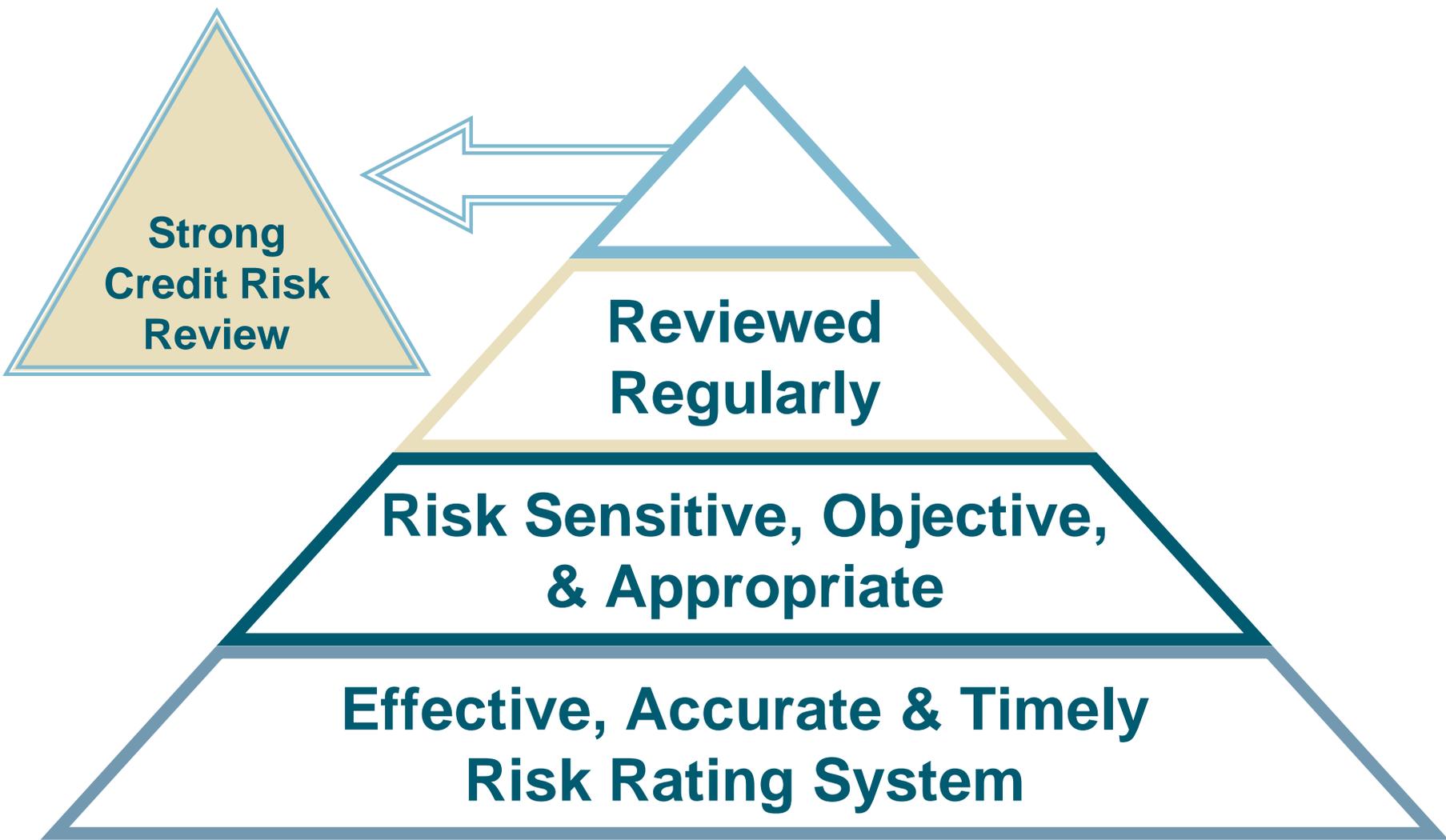




Ultra-sophistication Not Required

- Depends on risk characteristics
 - Potential effect of stressed loss rates on
 - CRE portfolio
 - Capital
 - Earnings
 - Prevailing market environment and institution's business strategy
- Stress Testing Results a part of:
 - CRE strategy and policies
 - Evaluation of capital adequacy and ALLL analysis
 - Periodic validation process.







Capital Adequacy

- Examiner should consider:
 - Inherent risk
 - Management expertise
 - Historical performance
 - Underwriting standards
 - Risk management practices
 - Market conditions
 - Loan loss reserves allocated for CRE concentration risk

Capital levels should be commensurate with the risk profile of the CRE portfolio.





Department of Supervision and Regulation

Ben Carter

804-697-4068

Keith Larkin

804-697-2731

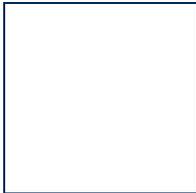
Steve Wilson

804-697-4045



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