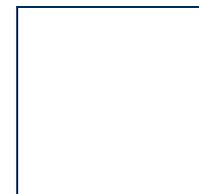


# Concentrations in Commercial Real Estate Lending



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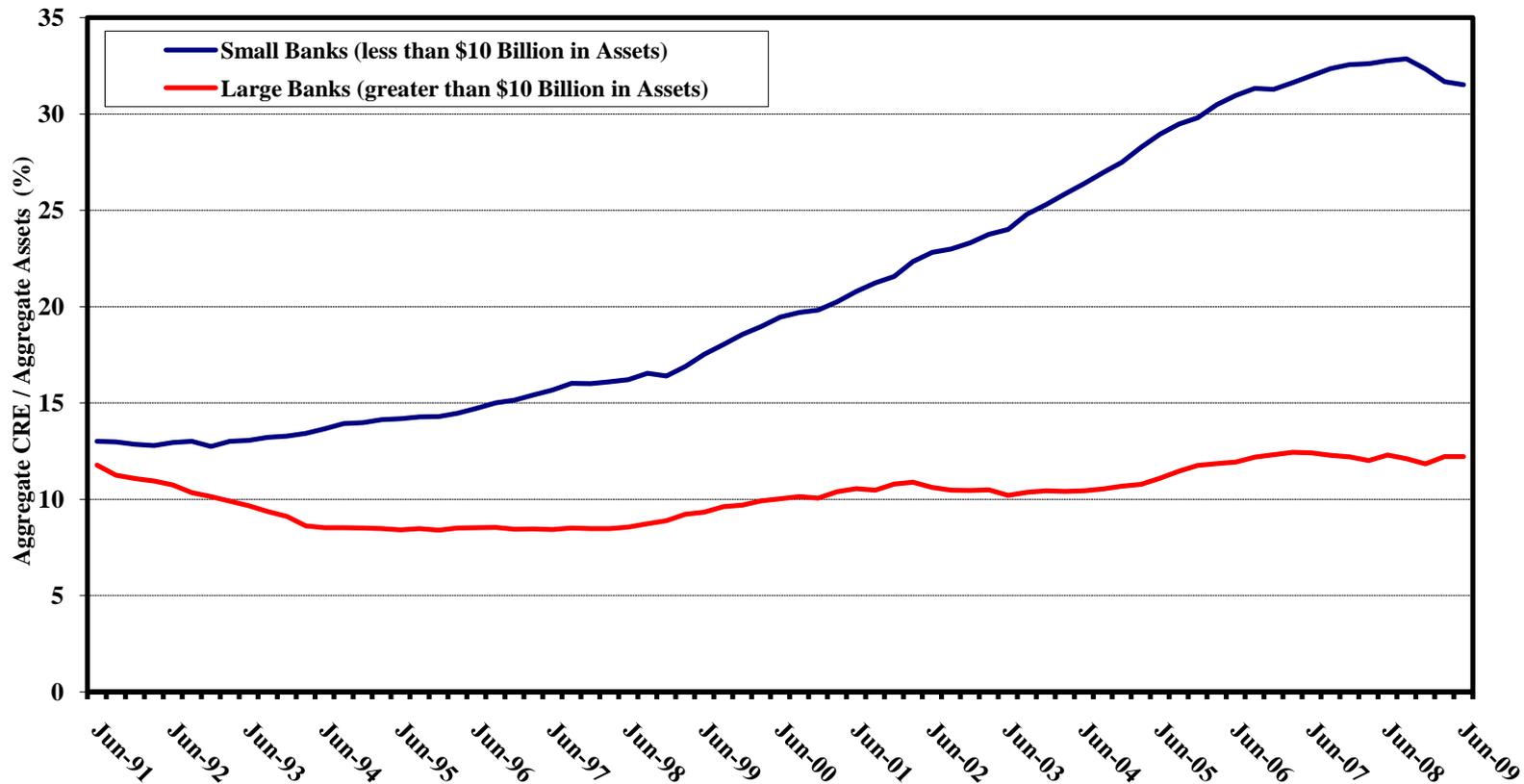
# CRE Trends

- 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
  - 2009 CRE-to-assets 31.5% for Small Banks, but almost unchanged from 1991 level for Large Banks



# CRE Concentrations – Small Banks vs Large Banks 1991 to 2009

CRE Holdings- Small Banks vs. Large Banks  
1991:Q2 - 2009:Q2





# 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





# 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.**





# 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



# 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





# 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***



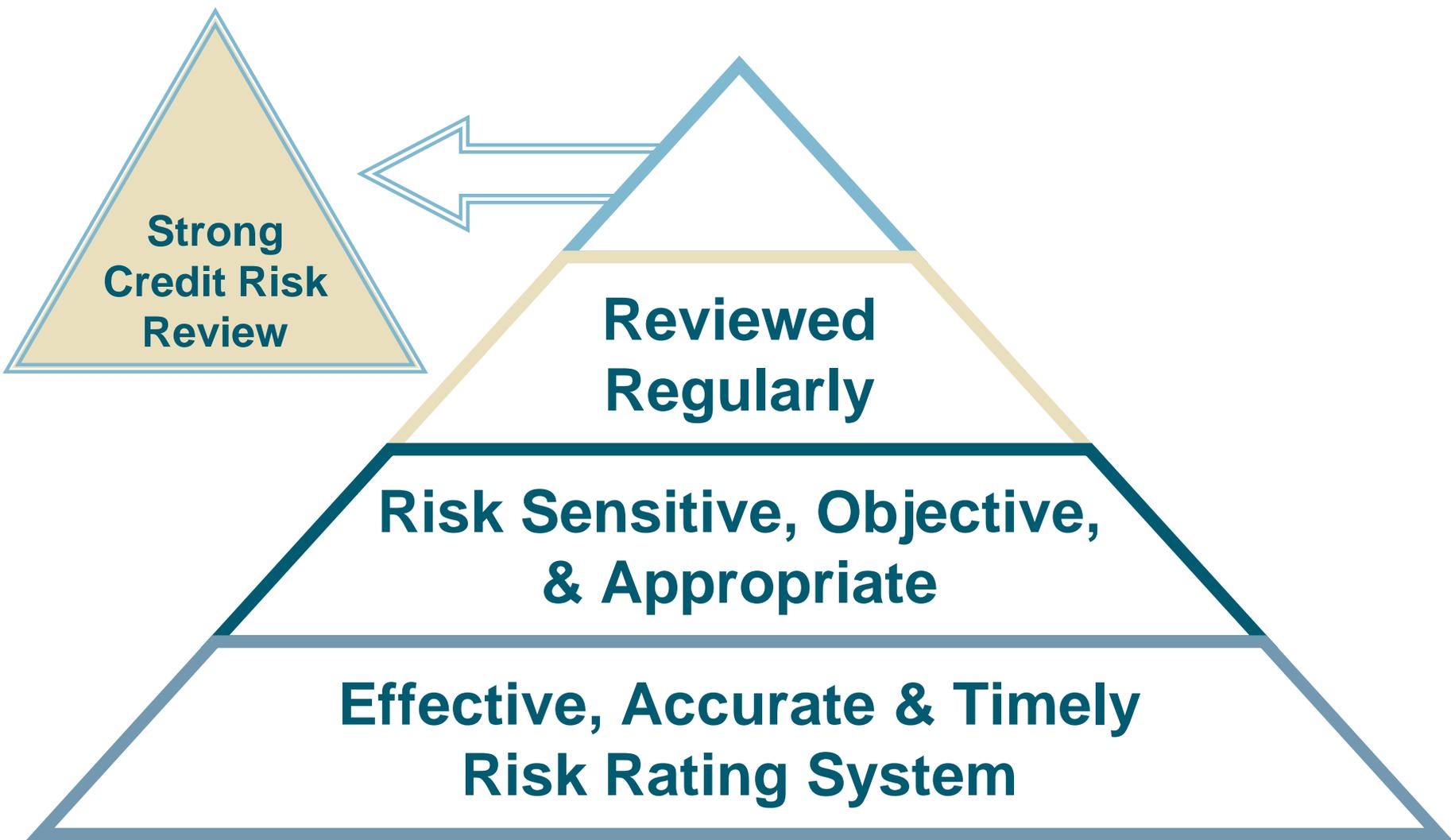


# Stress Testing

- Susceptibility to deteriorating economic, market, and business conditions
- Debt service coverage (DSC) and loan-to-value (LTV) ratios
- Conservative
- Ultra-sophistication not required
- “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.**







# 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.**



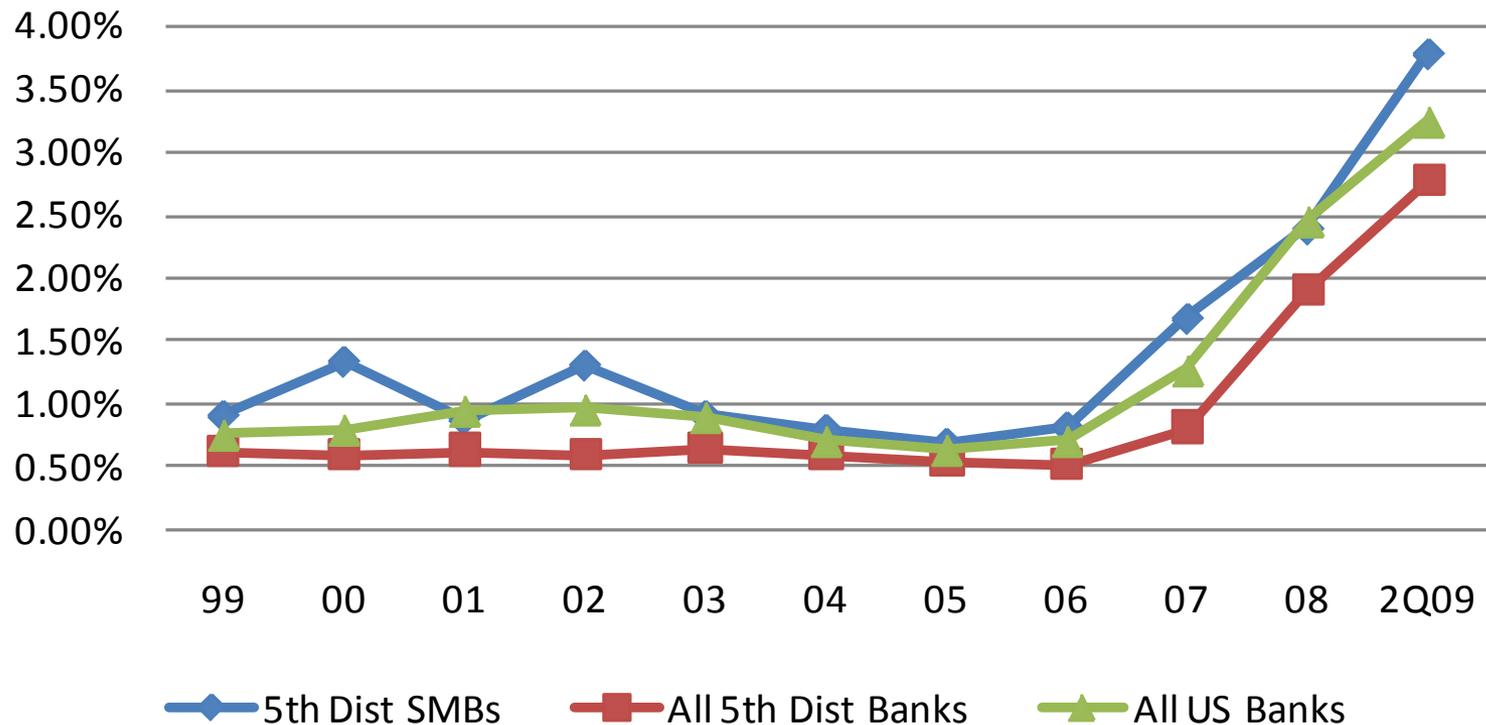


# What are examiners seeing in 5<sup>th</sup> District State Member Banks?



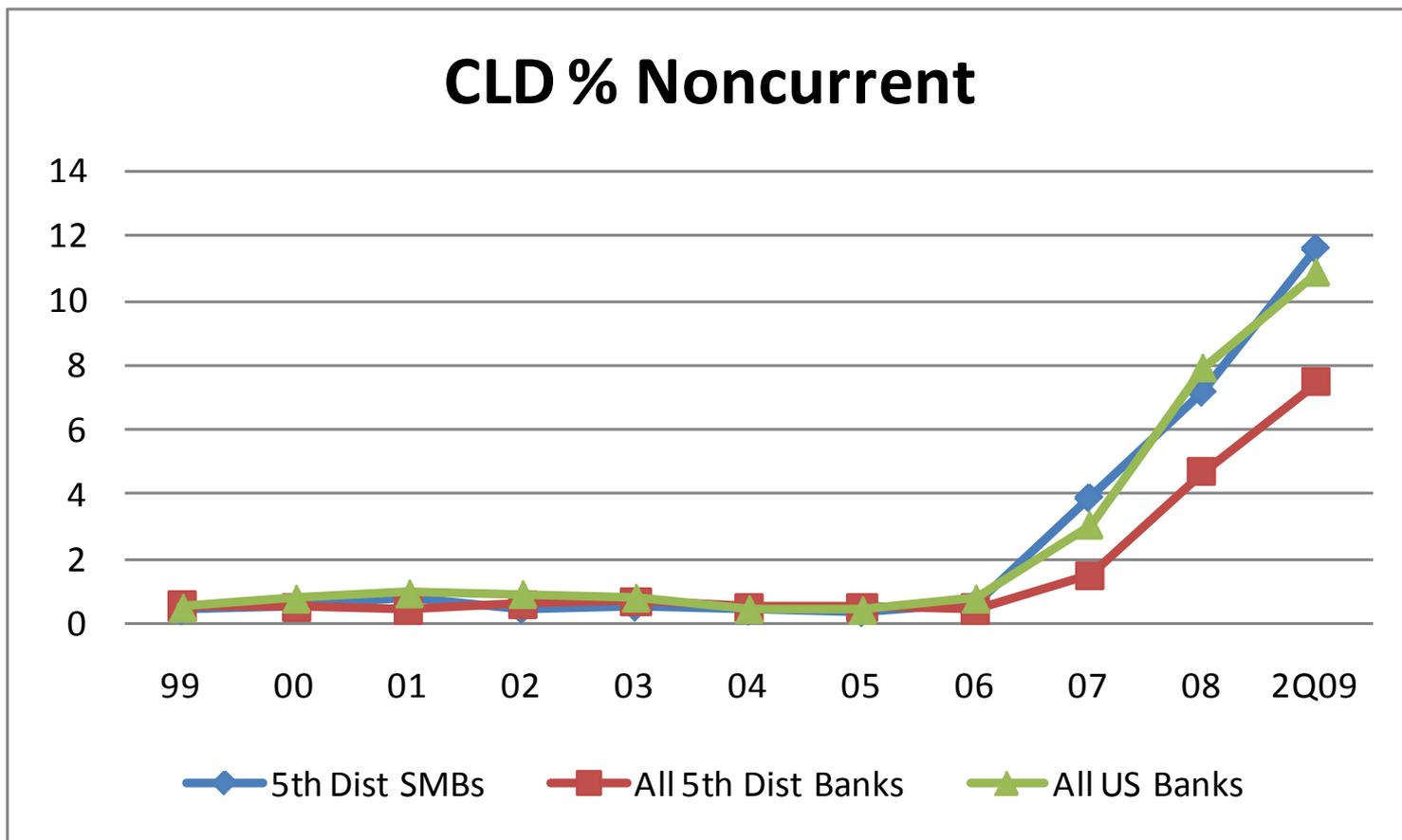


## Nonaccruals/Total Loans



**Nonaccrual loans have increased significantly over the past three years, and are at a ten year record high level. Average nonaccruals in 5<sup>th</sup> District State Member Banks exceed those of other 5<sup>th</sup> District banks and the national average.**



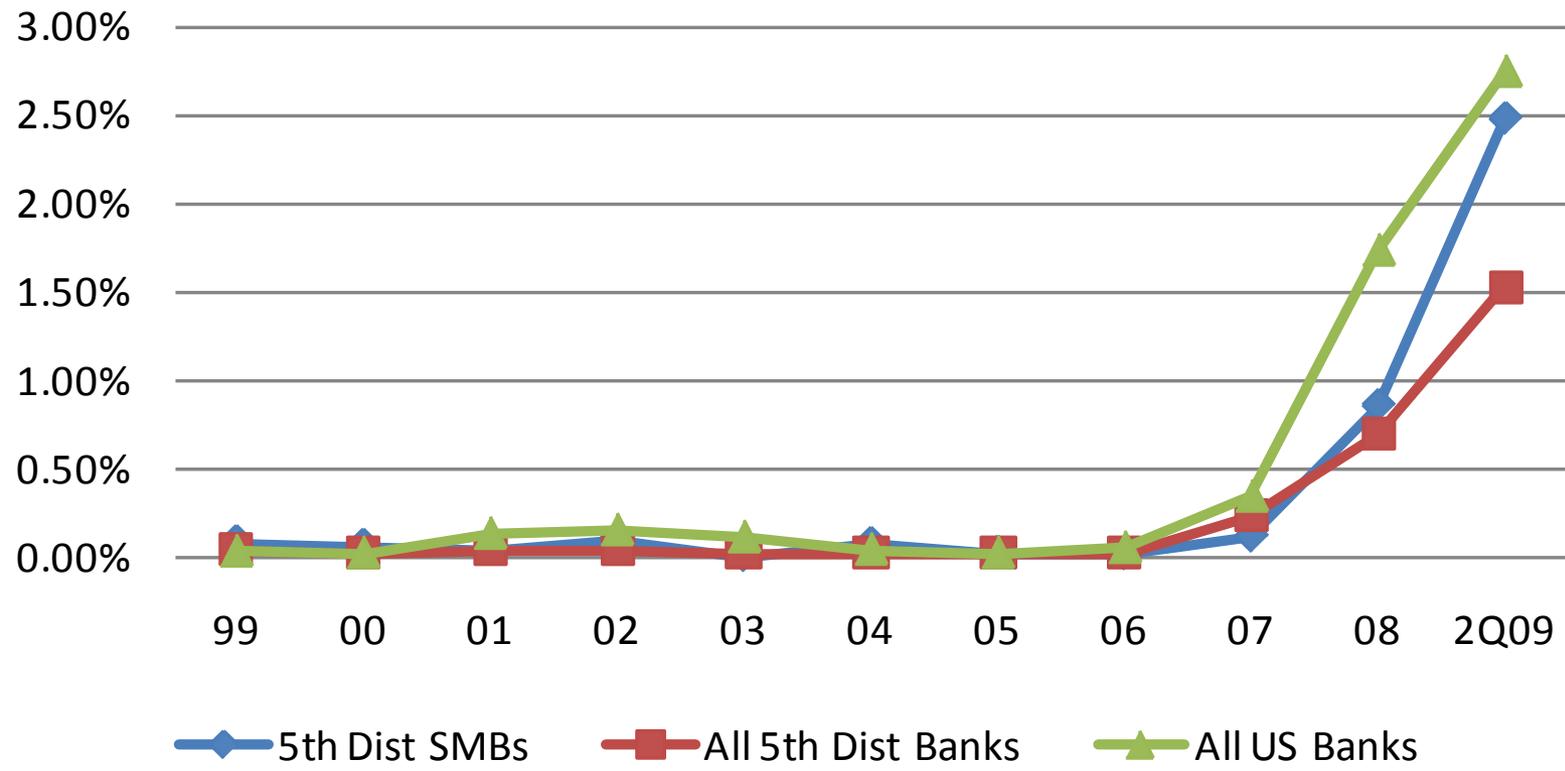


**Construction and Land Development loans have shown the sharpest increase, with an average of 11.6% reported as nonaccrual.**

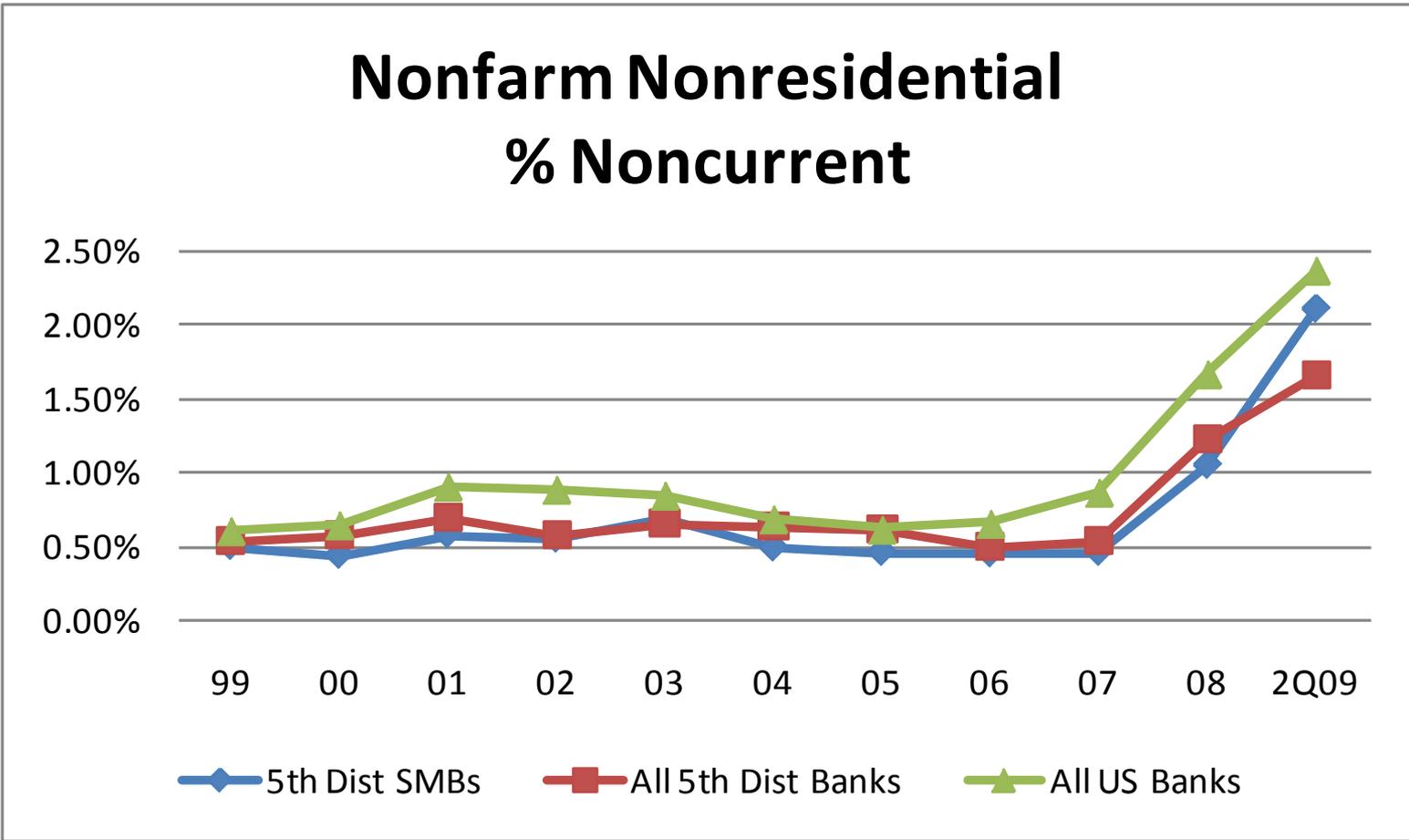




# CLD Net Chargeoffs/Total Loans



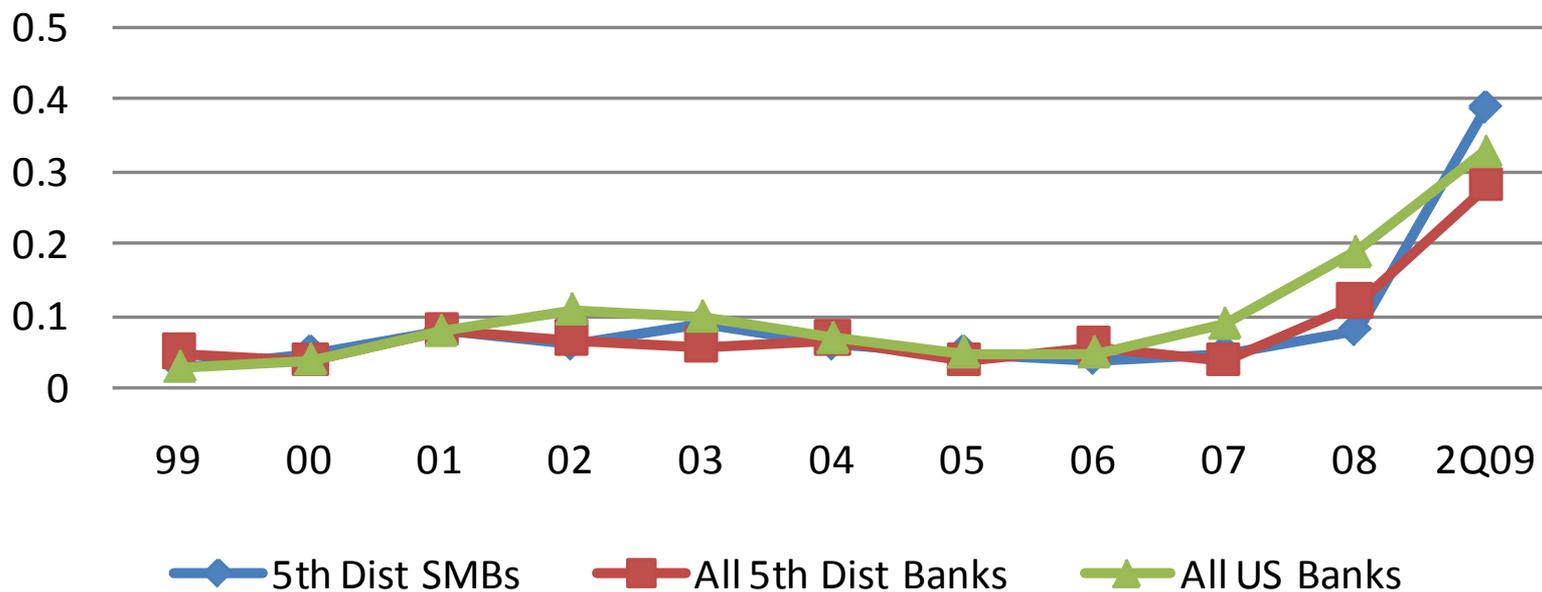
**Not only have noncurrent CLD loans increased, but so have net chargeoffs.**



**Nonfarm/Nonresidential properties have experienced the same trends as those in the CLD portfolios.**

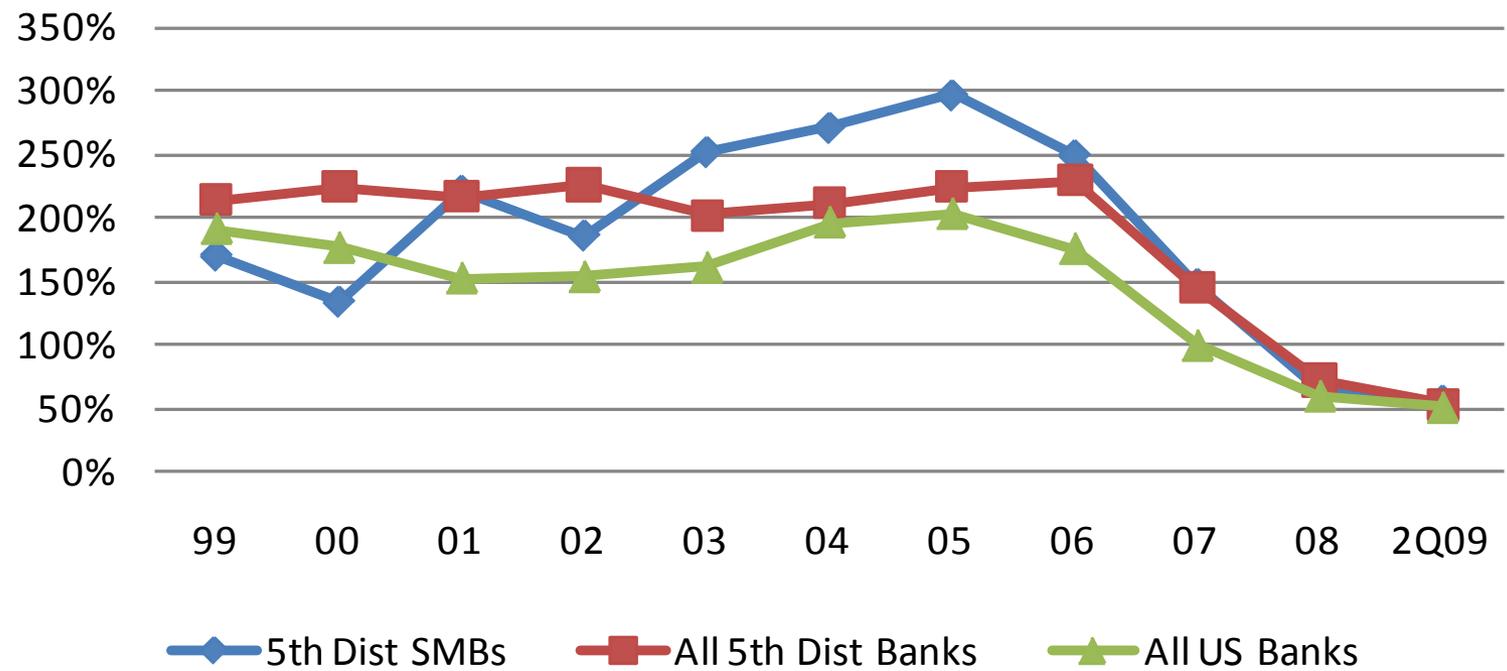


# Nonfarm-Nonresidential Net Chargeoffs (%)





## Reserves/Noncurrent Loans



**Despite sharp increases in nonaccrual and nonperforming loans, ALLL balances have not been directionally consistent.**

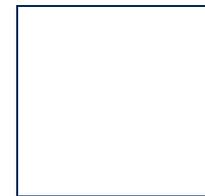
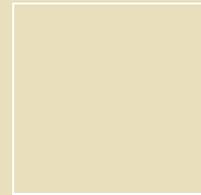




There appears to be a direct correlation in the quality of a bank's CRE portfolio and the conservativeness of underwriting standards and processes.



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