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## Understanding and Managing Commercial Real Estate Risk

**C**OMMERCIAL REAL ESTATE (CRE) IS AN IMPORTANT PART of many banks' loan portfolios. Depending on the markets they serve and the competition they face, banks can develop CRE concentrations that prove risky during downturns in the economy. If regulators determine that banks lack proper policies to manage their concentrations of risk—or even have high-growth areas that have not yet crossed one of the CRE thresholds—they might be forced to respond with severe penalties such as cease-and-desist orders for certain types of lending or, less severe, place a financial institution under a memorandum of understanding until concentrations have been addressed.

Understanding and managing CRE risk does not have to be difficult. It requires having a foundation of accurate data, conducting a thorough analysis to identify possible concentrations, and mitigating potential risks through appropriate planning and oversight. Such an approach can prove to be very effective even when local real estate markets are in turmoil.

On December 12, 2006, guidance from three federal regulatory agencies<sup>1</sup> went into effect. The document noted that “small to mid-size institutions

have shown the most significant increase in CRE concentrations over the last decade. CRE concentration levels at commercial and savings banks with assets between \$100 million and \$1 billion have doubled from approximately 156 percent of total risk-based capital in 1993 to 318 percent in third quarter 2006. This same trend has been observed at commercial and savings banks with assets of \$1 billion to \$10 billion with concentration levels rising from approximately 127 percent in 1993 to

approximately 300 percent in third quarter 2006.”<sup>2</sup>

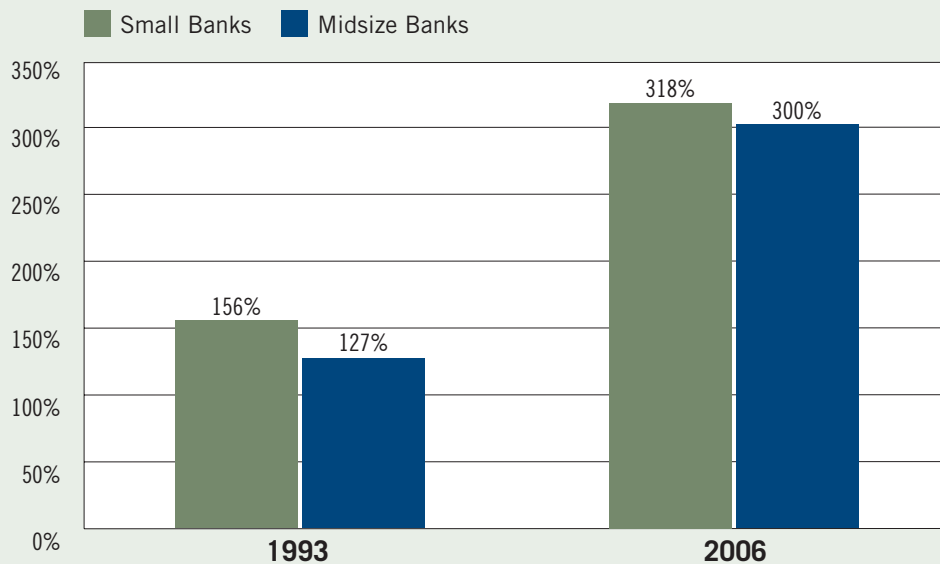
These CRE concentration levels involved three types of loans: real estate for construction, land development, and similar purposes; multifamily residential properties; and nonfarm nonresidential properties.

The interagency guidance applies to national and state-chartered banks. The Federal Reserve Board has said it believes the guidance is broadly applicable to bank holding companies as well. Significantly, the guidance does not establish bank lending limits but instead suggests that financial institutions employ enhanced risk-management techniques and capital levels as they approach either of two thresholds:

- Loans for construction, land development, and other land are 100 percent or more of total capital;
- Loans for construction, land development, and other land and loans secured by multifamily and

## CRE as a Percentage of Total Risk-based Capital

Source: Interagency Guidance on Concentrations in Commercial Real Estate Lending.



nonfarm nonresidential property (excluding loans secured by owner-occupied properties) are 300 percent or more of total capital.

### An Integrated Approach to Risk Management

For many banks, understanding and managing CRE risk can be viewed as a four-step process.

#### Step 1: Validate CRE Data

The quality of data in a management information system (MIS) is the foundation of all CRE concentration issues. Lest inaccuracies present a distorted picture of CRE concentrations, it's important for every bank to have a quality control process in place to verify that the correct codes are entered into the MIS. Someone familiar with the transactions should review the entries to ensure they make sense. In addition, banks should validate data by testing statistically accurate samples from their CRE records. As simple as it sounds, the step of validating CRE data is often overlooked.

#### Step 2: Analyze Concentration Risk

After databases have been scrubbed clean, a risk analysis of both portfolio and loan sensitivity is warranted.

The assessment should identify concentrations and diversification within categories of loans by stratifying the CRE portfolio into segments that have common risk characteristics or are sensitive to similar factors. Segments can include the following:

- loan types, such as residential development, industrial development, retail, residential rental, and non-owner-occupied manufacturing facilities;
- similar repayment sources;
- fixed rate or adjustable rate;
- geographic markets;
- common tenants;
- risk rating;
- loan purpose;
- loan-to-value ratios;
- debt service coverage.

Banks should also "stress test" their loan portfolios by looking at the effects of changes on earnings, capital, and criticized and classified levels of assets. Stress-testing the portfolio should be performed by analyzing a change in factors that may lead to loss, most notably the effect of increased default rates, a decrease in collateral values, and a scenario that takes into account both a decrease in collateral values and increased default rates.

In addition, banks should stress-test individual loans as part of the

underwriting process by examining and understanding the effect of key variables, such as lease rates, vacancy rates, capitalization rates, and other variables that affect the ability of borrowers to repay.

#### Step 3: Mitigate CRE Risk

Next, banks can start to mitigate their risk by addressing the following points.

#### Board and Management Oversight

The board of directors and senior management are responsible for protecting the bank against the risks associated with concentrations in CRE lending. Banks should have strategies—including overall growth objectives; CRE as it relates to overall growth of the portfolio, financial targets, and a capital plan—in place to understand, monitor, and mitigate this risk.

Written policies that establish limits and standards for CRE lending should:

- address overall CRE lending strategies for the level and nature of the CRE exposures that the bank finds acceptable;
- ensure that management has in place procedures and controls that enable it to follow and monitor compliance with its lending policies and strategies;
- review information that identifies and quantifies the nature and level of risk presented by CRE concentrations, including reports that describe changes in CRE market conditions;
- periodically review and approve CRE risk exposure limits to conform to changes in strategies and respond to fluctuations in market conditions.

#### Portfolio Management

Banks often focus on underwriting individual loans but pay less attention to their portfolios as a whole. To reduce CRE risk, banks should incorporate both the aforementioned stress-testing and portfolio management processes into their oversight processes.

Banks need to create policies they can adjust in response to changing market conditions. For example, it is important to establish limits for various types of real estate and types of lending in different markets if a financial institution lends in different markets. It also is important that policies have measurable limits that can be applied and modified if the institution's risk tolerance changes. These strategies may include loans sales, securitizations, or participations as ways to reduce outstanding loans when market conditions become adverse.

In addition, banks should perform certain monitoring of the level of risk in this portfolio. Stress-testing the effects of increased default rates and decreases in real estate values should be incorporated in the overall understanding of the risk in the portfolio.

### Market Analysis

Market data should provide management with information to support decision making involving current and future CRE loans.

One of the challenges banks, particularly those in small markets, can face during the analysis is finding market data to compare to their own internal loan data. Understanding the market is a key part of understanding the risks involved in lending. In fact, one of the biggest challenges is to understand the market and what effects its changes might have on the portfolio.

### Credit Underwriting Standards

Banks' policies must clearly articulate the underwriting standards for CRE

loans. These policies should represent banks' appetite for risk, be supported by loan monitoring processes, and ensure that exceptions are rare and made only under mitigating circumstances.

Banks should review their credit underwriting standards periodically and update them as necessary to help manage portfolio risk. Awareness of the policies by all individuals key to the underwriting process is important. According to the new CRE guidelines, credit underwriting standards should include the following:

- maximum loan amount by loan type;
- acceptable loan terms;
- pricing structure;
- collateral valuation;
- loan-to-value limits by property type;
- circumstance requiring feasibility or market studies;
- procedures for stress-testing loans;
- requirements for capital and "hard" equity by borrower;
- minimum standards for borrowers, such as net worth, property cash flow, debt service coverage, vacancy rates, and lease-up time frame.

Underwriting should also include an analysis of the project being financed as well as the strength of the borrower. Because many developers borrow from several institutions, an understanding of borrowers' other projects is essential to understanding their strength. Adherence to prudent appraisal guidelines, regular inspections, tracking of sold-to-unsold units, preleasing, tenant analysis, and proper draw procedures are among the other items necessary to provide a strong CRE lending function.

### Step 4: Report to Senior Management and the Board

The final step in the process of managing risk is providing senior management and the board of directors with periodic reports on CRE loan quality and mitigation efforts. In most financial institutions, weekly or bi-weekly reports to management and monthly reports to the board are sufficient. Banks with higher levels of CRE loan activity, however, may want to invest in dashboard reporting systems that can provide management with daily reports. **BC**

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#### Endnotes

<sup>1</sup>The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation, Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices.

<sup>2</sup><http://a257.g.akamaitech.net/7/257/2422/01jan20061800/edocket.access.gpo.gov/2006/pdf/06-9630.pdf>, Federal Register, Vol. 71, No. 238, Tuesday, December 12, 2006, p. 74580.