



**Regulatory Guidance on
Concentrations in Commercial Real Estate:
*Supervisory Expectations for
Sound Risk Management Practices***

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Agenda

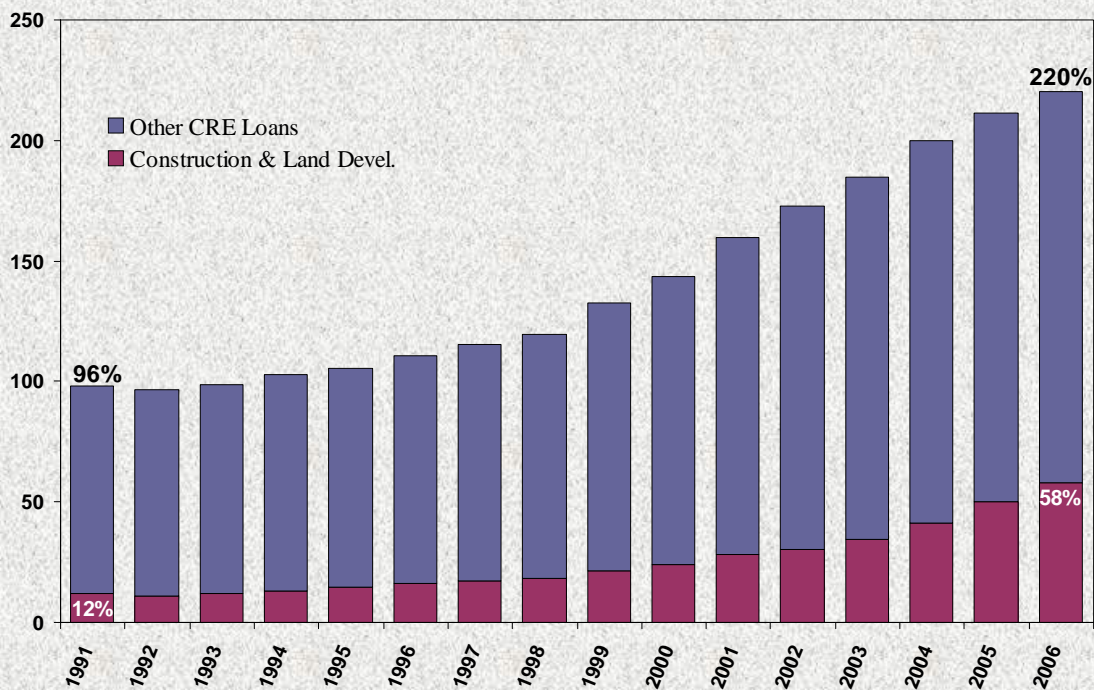
- I. Background, Purpose & Scope of the Guidance
- II. Key Elements of the CRE Guidance
- III. Risk Management Expectations & Range of Practices

The following presentation contains the views and opinions of the speaker and his interpretation of the regulatory guidance. It does not necessarily reflect the views of the management of the Federal Reserve Bank of San Francisco or of the Board of Governors of the Federal Reserve System.

Recap of Regulatory Concerns About Concentrations

- ❑ CRE concentration ratios are at record levels, with CRE lending a key business line
- ❑ Historically CRE has been highly cyclical and volatile, which led to big losses for highly concentrated banks
- ❑ CRE market fundamentals could change quickly and affect credit quality
- ❑ Risk management and strategic planning has not always kept pace with rapid growth in CRE lending

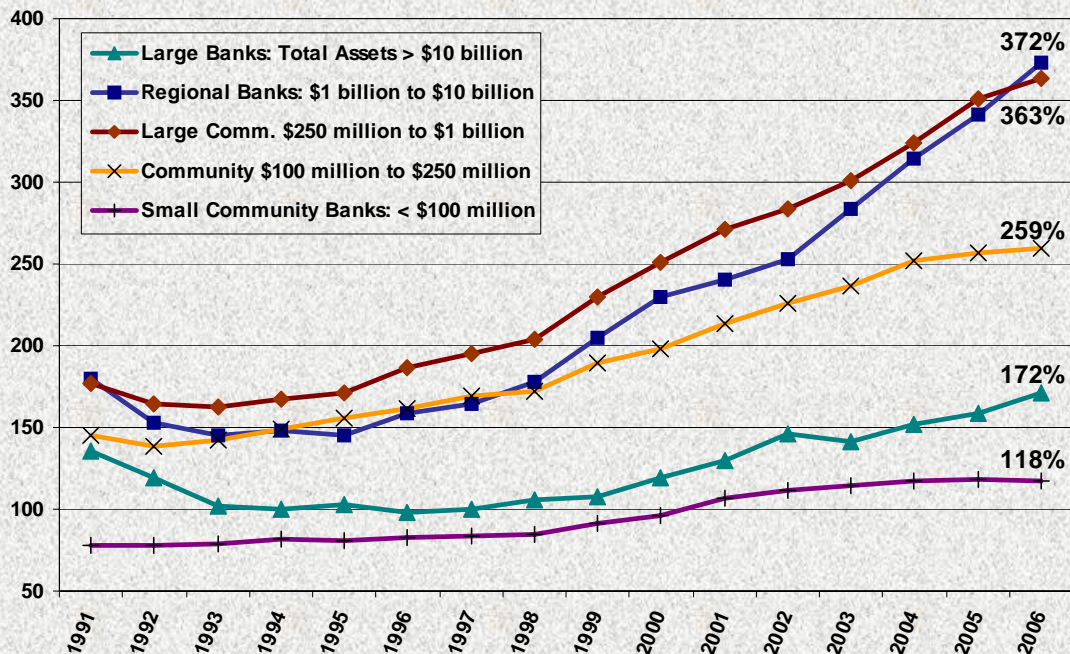
CRE Concentrations Have Increased Significantly



Source: Call Reports; Nationwide trimmed mean % of total risk-based capital (through 12/31/2006)

I. Interagency Guidance – Background, Purpose, Scope

Concentrations are Highest Among Regional and Larger Community Banks (\$250 million to \$10 billion)



Source: Call Reports; Nationwide trimmed mean % of total risk-based capital (through 12/31/2006)

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I. Interagency Guidance – Background, Purpose, Scope

Timeline

- ❑ Proposed interagency guidance issued for public comment January 2006
- ❑ Collectively, regulatory agencies received over 4,400 comment letters
- ❑ Regulatory agencies reviewed the public comments and revised the guidance
- ❑ Final guidance issued by the FDIC, OCC, and Federal Reserve, effective December 12, 2006

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Interagency Guidance – What it **IS**

- ❑ A pro-active “reminder” that banks with higher concentrations should have:
 - *Risk management practices commensurate with the size & complexity of the CRE portfolio*
 - *Clearly established strategy addressing CRE lending*
 - *Processes for monitoring market conditions & assessing the potential impact of changing conditions*
 - *Capital levels commensurate with the nature & extent of concentrations and other risks*
- ❑ A tool to reinforce and build upon interagency real estate lending standards developed in 1993
- ❑ A process for enhancing regulatory consistency

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Interagency Guidance – What it's **NOT**

- ❑ A plan to cap or restrict bank CRE lending
- ❑ A strategy to require all highly concentrated banks to raise more capital
- ❑ A tool to require complex stress test modeling for community banks
- ❑ A material change in regulatory expectations for managing CRE concentrations

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I. Interagency Guidance – Background, Purpose, Scope

Focus of the Guidance

- ❑ Focus on CRE concentrations that expose institutions to the cyclical conditions of the general real estate market, including
 - *Residential and commercial construction & land development loans (C&LD)*
 - *CRE loans where repayment is dependent on rental income or sale/refinancing of the RE collateral*
- ❑ Excludes “owner-occupied” RE loans where the primary repayment is from cash flow of a business
- ❑ Excludes RE taken as a secondary source of repayment or as an abundance of caution

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II. Interagency Guidance – Key Elements

Key Sections of the Guidance

- ❑ CRE Concentration Assessment
- ❑ Risk Management Framework
- ❑ Supervisory Oversight

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CRE Concentration Assessment

- ❑ Institutions should perform ongoing risk assessments to identify potential concentrations
 - *Stratify portfolio into segments with common risk characteristics or sensitivities*

- ❑ Determine what level of CRE concentration risk is manageable and acceptable
 - *Portfolio risk characteristics*
 - *Quality of internal risk management processes*
 - *Level of capital*

- ❑ Identify & monitor concentrations and establish internal limits and reporting procedures

Risk Management Framework

- ❑ Board & Management Oversight

- ❑ Portfolio Management

- ❑ Management Information Systems

- ❑ Market Analysis

- ❑ Credit Underwriting Standards

- ❑ Portfolio Stress Testing & Sensitivity Analysis

- ❑ Credit Risk Review Function

Supervisory Oversight

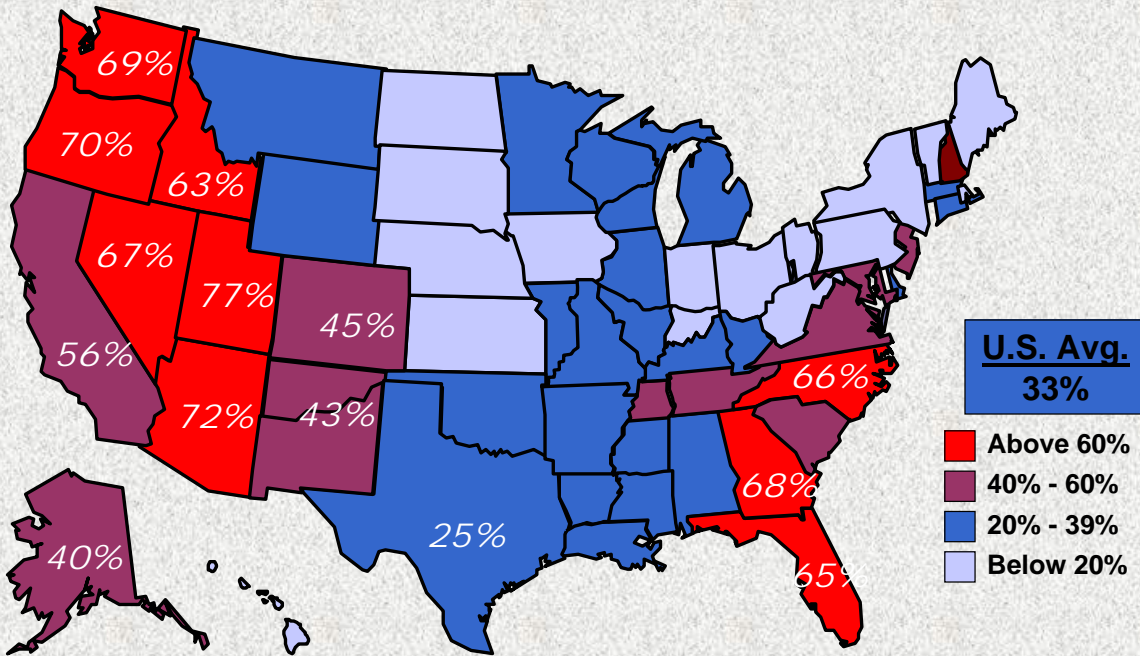
- ❑ Supervisory monitoring criteria
- ❑ Evaluation of concentrations & assessment of risk management practices
- ❑ Review of capital adequacy

Supervisory Monitoring Criteria **(NOT LIMITS)**

- ❑ Numerical criteria used as preliminary step to identify institutions with potential concentration risk
- ❑ Supervisors focus on rapid growth, large exposures to specific types, or concentrations that approach:
 - *Construction & land development concentrations 100% or more of total capital, or*
 - *Total CRE concentrations (not including owner-occupied), 300% or more of total capital, if CRE lending has increased 50% or more during the prior 36 months*
- ❑ Criteria do not constitute “safe harbor”
- ❑ Criteria are indicators of potential concentration risk and **do not constitute limits on CRE lending activity**

II. Interagency Guidance – Key Elements

Higher % of Western Banks Exceed the Screens



Source: Call Report data as of 12/31/2006

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II. Interagency Guidance – Key Elements

Evaluation of CRE Concentrations

- Effectiveness of risk management practices a key component of the supervisory evaluation
- Institutions with recent, significant growth in CRE lending will receive closer reviews
- Regulators will consider the institution's own analysis, and will consider factors such as:
 - *Portfolio diversification across property types*
 - *Geographic dispersion of CRE loans*
 - *Underwriting standards*
 - *Level of pre-sold or other types of take-outs*
 - *Portfolio liquidity (ability to sell or securitize exposures)*

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II. Interagency Guidance – Key Elements

Assessment of Capital Adequacy

- ❑ Guidance does not imply that banks will necessarily need to increase capital because of concentrations
- ❑ Capital should be commensurate with the level and nature of overall risks, including CRE portfolios
- ❑ Existing regulatory procedures for reviewing capital take into consideration a number of factors:
 - *Level and nature of inherent portfolio risk*
 - *Strength of management & risk management practices*
 - *Underwriting standards*
 - *Historical performance*
 - *Market conditions*
 - *Loan loss reserves allocated for concentration risk*

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III. Interagency Guidance – Risk Management Expectations & Practices

Risk Management Expectations & Practices

- ❑ Board & Management Oversight
 - *CRE Limits & Sub-Limits*
- ❑ Portfolio Management & M I S
 - *Loan Segmentation & Stratification*
- ❑ Market Analysis
 - *Information Sources & Key Factors*
- ❑ Underwriting Standards & Credit Risk Review
- ❑ Portfolio Stress Testing & Sensitivity Analysis
 - *Stress Testing Factors*

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Board & Management Oversight

- ❑ Establish policy guidelines and approve overall CRE lending strategy
- ❑ Develop procedures to effectively adhere to and monitor compliance with policies & strategies
- ❑ Obtain information that identifies and quantifies nature & level of risk
- ❑ Review CRE exposure limits and sub-limits relative to changing strategies or market conditions

CRE Limits & Sub-limits

- ❑ Aggregate exposure to CRE (e.g. as a % of capital and/or loans) and sub-limits
- ❑ Limits on other segmentations relevant to the institution's lending strategy and risk tolerance
- ❑ Periodically review and approve CRE limits to reflect changes in strategy and market conditions
- ❑ Thought process behind the establishment of limits should be reasonable and documented
 - *overall risk appetite of the Board*
 - *quality of existing risk management*
 - *capital levels*
 - *risk mitigants*

CRE Limits & Sub-limits – Range of Practices

CRE Loan Limits		
	% of Banks	
Aggregate CRE Limit	92%	
Sub-limits (any form)	100%	(3 - 25 sub-categories)
Sub-limits (more granular)	62%	(6+ sub-categories)
Limits as % of Capital	92%	(Tier 1 + ALLL; Total RBC; Equity)
Limits as % of Loans	23%	(Total Loans or Loan Commitments)

Source: Sample of 12th District State Member Banks – Internal Management Reports

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Portfolio Management & Management Info Systems

- ❑ Institutions should measure and control CRE risk on a portfolio basis as well as on an individual loan basis
- ❑ Assess the degree of correlation between real estate sectors
- ❑ Develop strategies and contingency plans to reduce or mitigate risk in the event of adverse market conditions
- ❑ MIS should provide information to identify, measure, monitor, and manage concentration risk:
 - *Relevant portfolio stratification*
 - *Timely and accurate information*
 - *Information to evaluate portfolio trends*

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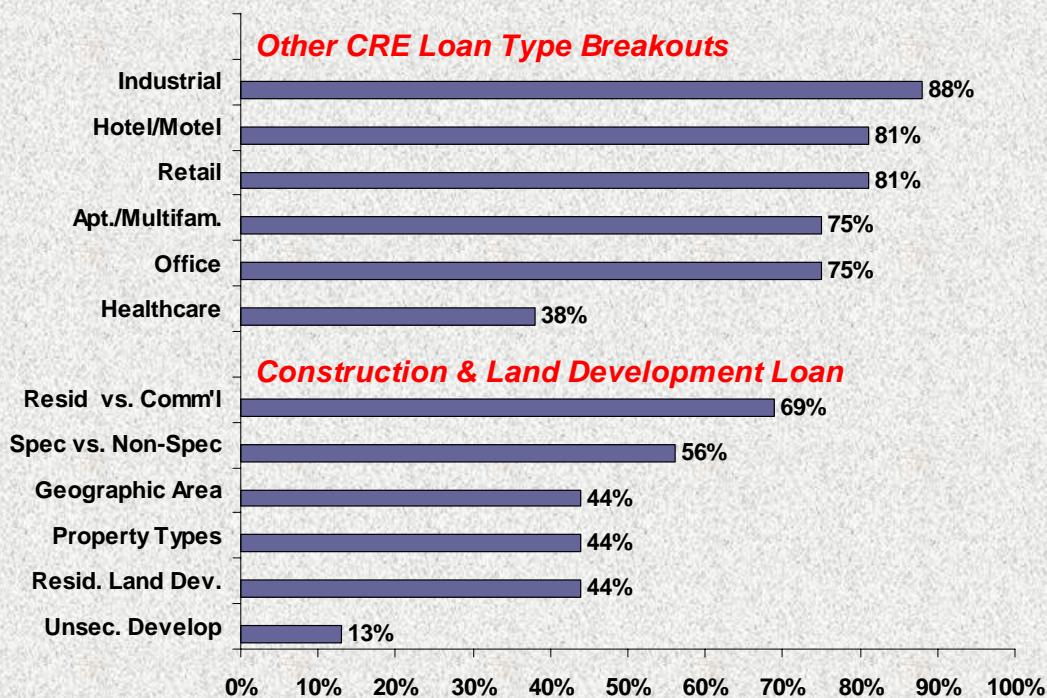
III. Interagency Guidance – Risk Management Expectations & Practices

Loan Segmentation - Current Range of Practices

- ❑ Loan Type (e.g. Resid. or Com'l; Construction or Term)
- ❑ Property Type (e.g. Industrial, Office, Multi-family, Retail) and Sub-Types (e.g. Hotel, Restaurant, Medical, etc.)
- ❑ Residential (e.g. Land Acquisition and/or Development, Single or Multi-Family Construction, Spec or Pre-Sold)
- ❑ Geographic (State, County, City, Zip Code)
- ❑ Loan Terms (\$ Size, Fixed or Adjustable, LTV, DSC)
- ❑ Internal Loan Grade (i.e. Grade 1, 2, 3, 4, etc.)

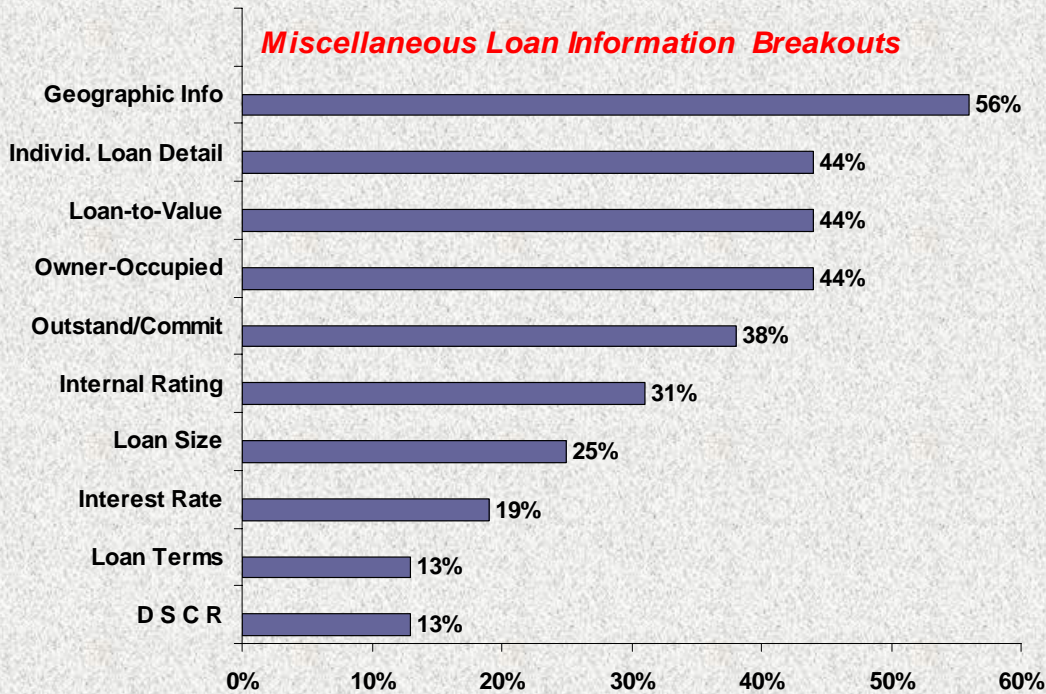
III. Interagency Guidance – Risk Management Expectations & Practices

Loan Segmentation - Current Range of Practices



III. Interagency Guidance – Risk Management Expectations & Practices

Loan Segmentation - Current Range of Practices



Source: Sample of 12th District State Member Banks – Internal Management Reports (% of banks stratifying) 25

III. Interagency Guidance – Risk Management Expectations & Practices

Loan Segmentation - Current Range of Practices

	Location A	Location B	Location C	Location D	Total	Product as % of Loan Type	Product as % of Total CRE
CRE Term Loan							
Industrial	12,345	67,890	9,876	54,321	144,432	11.9%	4.0%
Office	43,210	88,992	54,332	68,443	254,977	21.0%	7.1%
Retail	54,654	94,949	57,431	65,432	272,466	22.5%	7.6%
Hotel/Motel	14,032	23,391	11,921	8,122	57,466	4.7%	1.6%
A&D	12,345	67,890	9,876	54,321	144,432	11.9%	4.0%
Medical	43,210	8,992	54,332	22,443	128,977	10.6%	3.6%
Restaurant/Recreation	17,654	19,949	57,431	12,432	107,466	8.9%	3.0%
Multifamily	24,032	22,391	11,921	21,122	79,466	6.6%	2.2%
Other	9,876	7,654	4,321	1,248	23,099	1.9%	0.6%
Total Commercial Term	231,358	402,098	271,441	307,884	1,212,781	100.0%	33.6%
Location as % of Total CRE Term	19.1%	33.2%	22.4%	25.4%	100.0%		
Commercial Construction							
Industrial	44,032	58,391	11,921	81,122	195,466	8.2%	5.4%
Office	12,345	67,890	9,876	54,321	144,432	6.0%	4.0%
Retail	43,210	88,992	54,332	68,443	254,977	10.6%	7.1%
Hotel/Motel	12,345	67,890	9,876	55,921	146,032	6.1%	4.0%
A&D	43,210	22,992	54,332	68,443	188,977	7.9%	5.2%
Medical	17,654	19,949	57,431	65,432	160,466	6.7%	4.4%
Restaurant/Recreation	44,032	22,391	11,921	8,199	86,543	3.6%	2.4%
Multifamily	36,743	33,312	33,554	6,483	110,092	4.6%	3.1%
Other	2,121	44,324	3,321	5,432	55,198	2.3%	1.5%
Total Commercial Construction	255,692	426,131	246,564	413,796	1,342,183	56.0%	37.2%
Residential Construction							
Single-Family Housing	287,654	354,949	157,431	165,432	965,466	40.3%	26.8%
Land Acquisition & Development	44,032	23,391	11,921	8,199	87,543	3.7%	2.4%
Total Residential Construction	331,686	378,340	169,352	173,631	1,053,009	44.0%	29.2%
Total Construction	587,378	804,471	415,916	587,427	2,395,192	100.0%	66.4%
Location as % of Total Construction	24.5%	33.6%	17.4%	24.5%	100.0%		
TOTAL CRE	818,736	1,206,569	687,357	895,311	3,607,973		
Location as % of Total	22.7%	33.4%	19.1%	24.8%	100.0%		

Source: Sample of 12th District State Member Banks – Example of Internal Management Report

III. Interagency Guidance – Risk Management Expectations & Practices

Market Information & Analysis

- ❑ Market analysis should incorporate multiple data sources and anecdotal information
- ❑ Analysis should be more than a compilation of data and should include management’s assessment of how conditions impact the bank
- ❑ Results should be integrated into strategy development and risk management
- ❑ Data sources and frequency of updates will depend on size and complexity of CRE portfolio and stability of market conditions

III. Interagency Guidance – Risk Management Expectations & Practices

Market Information – Range of Sources and Factors

Information Sources		Key Factors
National Publications		Employment & Population Growth Regional Employment & Population Rents Property Values Vacancies Home Sales Appraisal Trends Foreclosures Capitalization Rates Transaction Data Absorption Rates Construction Projects Equity Markets & Commodity Prices Residential Market Fundamentals Consumer Confidence/Sentiment Interest Rates Banking Conditions Credit Quality Trends Economic Conditions Housing Markets RMBS & ABS Loan Data Whole Loan Data
CoStar	Property & Portfolio Management (PPR)	
Credit Risk Solutions	Real Capital Analytics	
DataQuick	Realpoint	
DebtX	REIS	
Economy.Com	SNL Financial	
National Association of Realtors	Torto Wheaton Research	
National Real Estate Index	TWR Dodge Pipeline	
OFHEO	UBS Mortgage Strategist	
Local Market Reports; Trade Journals; Newspapers; Other Periodicals		
CB Richard Ellis	Marcus & Millichap	
Carpenter Group	MetroStudy	
Capital Company of the West	NAI Direct	
Central Valley Economic Outlook	Oncor International	
Collier's International	Smith Travel Research	
Cushman and Wakefield	State Realtor Associations	
Grubb & Ellis	UCLA Anderson California Forecast	
Integra Realty Resources		
Regulatory Publications		
Federal Reserve Banks	OCC	
FDIC	OTS	
Anecdotal Information		
Directors	Real Estate Brokers	
Developers	Appraisers	

Market Analysis Should Be Integrated Into:



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Underwriting Standards & Credit Risk Review

- Establish clear and measurable underwriting standards
 - *Maximum loan amount by property type*
 - *Loan terms*
 - *Pricing structures*
 - *Collateral valuation*
 - *LTV limits by property type*
 - *Feasibility studies and sensitivity analyses or stress testing*
 - *Initial borrower equity investments*
 - *Borrower net worth, cash flow, debt service coverage*
- Tightly control policy exceptions, including exceptions to supervisory LTV limits
- Credit review function that ensures effective, accurate, timely risk-ratings

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Portfolio Stress Testing & Sensitivity Analysis

- ❑ Stress tests should quantify the impact of changing economic or financial conditions on asset quality, earnings, and capital
- ❑ Assists management in understanding which portfolio segments are most vulnerable to changing conditions
- ❑ Range of practices and level of sophistication will vary with size and complexity of the portfolio
- ❑ Findings should be integrated & linked to the lending strategy, portfolio analysis, and risk management
- ❑ Periodic updates to management and the Board

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CRE Stress Testing - Current Range of Practices

CRE Portfolio Stress Testing	
	% of Banks
Moderate Level Stress Testing	31%
Advanced Stress Testing (including vendor models)	23%
Not Currently Stress Testing	23%
Basic Level Stress Testing	15%
In Process of Development	8%

Key Information for Stress Testing
Loan Origination Date
Original Loan Balance
Current Loan Balance
Original Appraisal Amount
Original Appraisal Date
Capitalization Rate
Interest Rate - Fixed %
Int. Rate Indx & Sprd - Float.
Int. Rate Floors/Caps
Annual Debt Service (P & I)
Net Operating Income
Debt Service Coverage Ratio

Source: Sample of 12th District State Member Banks – Internal Management Reports

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CRE Stress Testing - Current Range of Practices

CRE Stress Testing Factors

Change in Interest Rates & Net Operating Income

200 basis point increase in interest rates; 10% & 15% decline in NOI; Combination of both.
Impact on average weighted DSCR for each key collateral type

Capital Adequacy Model

Ability to maintain 8% capital under eight different economic scenarios, including higher interest rates, rising cap rates, higher vacancy rates, lower absorption rates

Sensitivity Analysis by Property Type

How much can rates rise before a given property type falls below 1.0 DSC ratio?

CRE Equity Shock Test

Property values decline 20%, 30%, 40% and potential loss or exposures in the event the borrower defaults

CRE Loan Portfolio Charge-Offs

Construction & Land Development	4%	Peak during 1991 - 1993
Non Farm, Nonresidential	1%	Peak during 1991 - 1993
Multi-family	1%	Peak during 1991 - 1993

Source: Sample of 12th District State Member Banks – Internal Management Reports

CRE Stress Testing - Current Range of Practices

CRE Sensitivity Analysis - Impact of Changes in Loan Balances, L T V, and Default Rates

Scenario	\$ - Capital at Risk (000)				\$ Earnings at Risk (000)			
	12/31/2006	9/30/2006	6/30/2006	3/31/2006	12/31/2006	9/30/2006	6/30/2006	3/31/2006
Base Case	1,849	1,725	1,580	1,416	925	863	790	708
10% Increase in CRE Loans	2,034	1,898	1,738	1,557	1,017	949	869	779
10% Deterioration in L T V	3,288	3,070	2,830	2,530	1,644	1,535	1,415	1,265
5% Increase in Default Rate	2,420	2,258	2,067	1,853	1,210	1,129	1,034	927
Combined Sensitivity	4,733	4,420	4,075	3,643	2,367	2,210	2,038	1,822

Scenario	% Total Risk Based Capital at Risk				% of Earnings at Risk			
	12/31/2006	9/30/2006	6/30/2006	3/31/2006	12/31/2006	9/30/2006	6/30/2006	3/31/2006
Base Case	5.1%	5.0%	4.8%	4.5%	21.8%	20.0%	18.3%	16.2%
10% Increase in CRE Loans	5.6%	5.5%	5.2%	4.9%	23.9%	22.0%	20.1%	18.7%
10% Deterioration in L T V	9.0%	8.8%	8.5%	8.0%	21.8%	20.0%	18.3%	16.2%
5% Increase in Default Rate	6.7%	6.5%	6.2%	5.9%	28.5%	26.1%	23.9%	21.2%
Combined Sensitivity	13.0%	12.7%	12.3%	11.5%	31.3%	28.7%	26.3%	23.3%

Source: Sample of 12th District State Member Banks – Example of Internal Management Report

Sensitivity Analysis Should Be Integrated Into:



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Summary – Interagency CRE Guidance

- ❑ Reminds banks that strong risk management practices and appropriate capital levels are important elements of a sound CRE lending program.
- ❑ Does not restrict or cap CRE lending, nor does it automatically require higher capital levels.
- ❑ Principle-based discussion of supervisory expectations for sound risk management and evaluation of capital, rather than a prescriptive, “one-size-fits-all” approach.
- ❑ Emphasizes that the risk management framework and capital structure should be commensurate with the size and complexity of the CRE portfolio and nature of risk.

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QUESTIONS?

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www.frbsf.org/banking/bsr/