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Concentration Risk in Commercial Real Estate

As we mark the one year anniversary of the financial crisis, it is gratifying to see how much stability has returned to the global financial system. While some areas of the country are breathing a sigh of relief, out here the strongest banking organizations are rolling up their sleeves to meet the continuing challenges head-on. Community and regional banks in the west are facing unprecedented challenges from the ongoing fallout of the housing crisis as well as weakening fundamentals and declining values for income producing commercial real estate.

Recognizing that the vast majority of 12^{th} District banks have more than double the commercial real estate concentrations of banks nationally, I thought it might be helpful to revisit real estate conditions and some risk management fundamentals in this letter. Management and boards of directors need to understand these conditions and fundamentals in the face of these increasingly challenging developments.

The most recent issue of the FRBSF Real Estate Lending Risks Monitor discusses the continued decline in values of commercial properties of all kinds, and the potential increases in noncurrent rates for both income producing and construction & land development loans. Of particular concern is the expected rise in loss rates on CRE loans as they mature. For example, borrowers may not be in a position to increase equity to cover the decline in value of real estate collateral. In other cases, the borrower's ability to service their loan at market interest rates may be in jeopardy due to the declining cash flows from rising vacancies and/or declining rents.

These vulnerabilities point to the need for bankers to continue to work with their borrowers in ways that improve the ultimate collectability of loan principal and interest while extending credit under safe and sound banking principles. Reasonable borrower accommodations must receive proper accounting and regulatory classification treatment to ensure that there is appropriate transparency for the public and regulators regarding the degree of weak or problem credit exposures held by an institution.

In the face of these realities and expectations for a slow recovery over the next several quarters, it is useful to review the guidance that the federal banking agencies have provided to banks, and to highlight those areas of greatest regulatory concern given current conditions.

Interagency guidance for managing CRE risk is provided in SR 07-1 issued January 4, 2007. The CRE guidance identifies seven elements of a sound risk management framework: board and management oversight; portfolio management; management information systems; market analysis; credit underwriting standards; portfolio stress testing and sensitivity analysis; and credit risk review function. Policy guidelines set by a bank's board of directors and management's implementation of those guidelines through appropriate mechanisms and procedures form the foundation of CRE risk management. Although the SR Letter applies formally only to banks with CRE concentrations that exceed specified thresholds, institutions with concentrations below those thresholds would be well advised to follow its sound practices in light of ongoing weaknesses in CRE markets.

Two elements of managing CRE portfolio risk have, in particular, become the focus of regulatory concern with respect to managing commercial real estate portfolio risk at our state member banks:

Managing Risk—Management Information Systems

One of the key components of effective CRE portfolio risk management is a strong management information system (MIS). In the midst of declining fundamentals in real estate markets, examiners are increasingly concerned that existing MIS at many banks may be inadequate for the challenges ahead. The CRE guidance highlights the importance of stratifying the portfolio by key criteria such as property type, geographic market, individual and industry tenant concentrations, owner/developer concentrations and risk rating. Of course, in these difficult times further stratification by loan structure, loan purpose, debt service coverage, policy exceptions on newly underwritten credit facilities, affiliate loans, and loan-to-value are necessary to manage the portfolio's risk. To be clear, under the rapidly changing conditions of the current environment, any MIS is only as good as the timeliness and relevance of its data. Without updating key areas such as operating income, appraised value and risk rating, MIS output can become irrelevant at best, and misleading at worst.

From a very practical perspective, the importance of "Knowing Your Collateral" as a key element of a bank's MIS cannot be overstated. A sound appraisal and review process is essential. This will include more frequent visits to properties, examination of rent rolls, and more careful collection and monitoring of loan maturities on a portfolio basis.

With these sound practices in mind, the board and senior management of institutions should ask themselves whether their MIS is adequately capturing emerging weaknesses in their portfolios. In particular, they need to ask whether the information collected and analyzed is adequate to properly identify, measure, monitor, and manage the declining cash flows and market values of both construction and income-producing CRE properties. If it is not adequate, then immediate action should be taken to improve MIS and better understand the institution's unfolding risk.

Managing Risk—Stress Testing

The CRE guidance also emphasizes the importance of stress tests—anticipating a range of outcomes, including severe-case scenarios that reflect local economic conditions and a bank's particular risk profile. Effective MIS and market analysis will provide banks with much of the information needed for developing stress tests. CRE stress testing should be done on a portfolio basis, with the objective of understanding and quantifying the impact of adverse conditions on asset quality, earnings, and capital.

Of course, for stress testing to be valuable, it must be used by senior management and board of directors to inform and influence key decision-making in the areas of business strategy, concentration levels, risk limit setting, reserve methodologies, as well as dividend and capital planning. Examiners have been impressed with the ability and willingness of some community banks to develop scenarios that are both realistic, and indeed reflect severe-case assumptions. We will continue to be focused on steps organizations are taking to address the stress test process (assumptions, calculations, scope, etc.) as well as actions taken in response to those results.

The Objective: Capital Planning

While stress testing is emphasized in the CRE guidance, the Federal Reserve and other regulators are noting the importance those stress tests should have in developing forward-looking capital analyses and planning. As we have all seen in recent failures, even banks starting out well above minimum capital ratios can find that their concentrations quickly overwhelm their capital buffers. By taking a more forward looking view of the challenges ahead using stress testing and other tools as a guide, stronger institutions are making conservative adjustments to their dividend and capital planning policies that better prepare them to weather the storm.

Going Forward

As western banks meet the tough challenges ahead, they will need to continue a proactive stance toward working with their borrowers and identifying problems, while bolstering their liquidity and capital positions. Those institutions that work with their borrowers, their communities, and their supervisors are more likely to come through these troubled times stronger and more competitive than ever. You have my commitment, and that of my fellow supervisors at the Federal Reserve Bank of San Francisco, to work with you as you position your institution for success in these trying times.

Sincerely,

Steve

Resources and FRBSF Contacts for Current Industry Issues

Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, SR 07-1 of January 4, 2007.

FRBSF contact for CRE risk management: Wally Young, Senior Manager, Risk Monitoring & Analysis Group

Real Estate Lending Risks Monitor (August 2009). This two-page report examines western RE market conditions, bank lending concentrations and loan quality indicators.

The Outlook for CRE & Bank Performance. (April 21, 2009) ***Call the Fed*** program on challenges facing the commercial real estate market in the West.

FRBSF contact on CRE issues: Gary Palmer, Manager, Project Analysis & Coordination

First Glance 12L (August 2009) A look at financial performance of commercial banks in the West, through 2Q 2009.

12L Economic Trends (September 2009) Most recent performance indicators for the 12th Federal Reserve District economy.

Economic Trends and Conditions (September 2009) Monthly review & analysis of key trends in the 12th District economy.

FedViews. (September 2009) Monthly research reports on the current economy and the outlook.

Consumer Compliance Outlook (Third Quarter 2009) Federal Reserve System publication focused on consumer compliance issues.

Consumer Compliance Hot Topics (July 22, 2009) ***Call The Fed*** audio conference with senior Federal Reserve staff discussing consumer compliance issues in the context of the current environment.

Recent Speeches by Federal Reserve Bank of San Francisco President and CEO Janet L. Yellen:

September 14 on *The Outlook for Recovery in the US Economy*

July 28 on *The Outlook for US Recovery and Community Banks*