

APPENDIX A

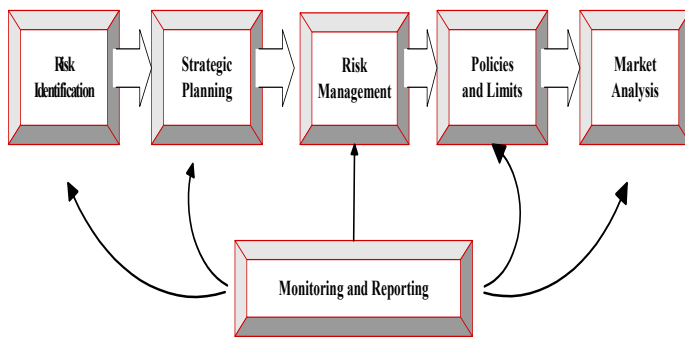
Portfolio-Wide Monitoring and Management Discussion (Suggested Best Practice Approach)

Community banks that accept above-average CRE concentration risk, as measured against capital, need to develop stronger and more sophisticated risk management processes. One component is a portfolio-wide approach to measuring, monitoring, controlling, and mitigating CRE risk.

The following six-step process offers a specific method for accomplishing the task of measuring, controlling, and ultimately mitigating CRE concentration risk.¹ The elements of this process are:

- ✓ Identify Risk
- ✓ Incorporate CRE Concentration Risk into the Strategic Planning Process
- ✓ Mitigate Risk
- ✓ Establish Policies and Limits
- ✓ Conduct Market Analysis
- ✓ Monitor and Report

The Proposed Best Practice Methodology, With Continual Monitoring And Reporting



1. Identify the Risk

Banks engaged in significant CRE lending need to apply the tenets of rigorous risk management to identify, measure, monitor, and control CRE risk. Management and boards of directors should use peer bank analysis to first determine, compare, and then monitor the level of their

CRE exposure relative to that of their peers (local, regional, and national). Above-average CRE concentrations suggest above-average risk. This inherent risk *cannot* be effectively managed without further analysis and documentation.

Bank management should then “drill-down” and determine the level of inherent risk within the broad CRE category. The analysis should not focus solely on the aggregate CRE concentration ratio. For example, a bank with a 300 percent CRE concentration may actually have more inherent risk than a bank with a 500 percent CRE concentration. This would occur if the former bank’s loan portfolio includes substantially more land development and/or construction loans (project gestation period increases time element uncertainty and level of risk); local market conditions are more volatile; or capital levels are outside certain median ratios.

Thus, a bank will need, at a minimum, to stratify the CRE portfolio using parameters including, but not limited to, loan type, geographic distribution, collateral, owner-occupied, pre-sold, residential construction versus commercial construction, loan-to-value, and risk grade. This stratification and analysis will identify those factors that either heighten or reduce the inherent risk. However, the analysis is not useful if it is not well-documented and preserved for future reference and follow-up (see *Report and Monitor*).

2. Incorporate CRE Concentration Risk into the Strategic Planning Process

A board’s strategic planning efforts should consider and address the bank’s significant business activities. If CRE lending is one of a bank’s most significant activities, then this should be incorporated into the strategic planning process.

¹ Although this suggested best practice is specific to CRE concentration risk, the approach outlined in this discussion could be used for other asset-based concentrations.

If management's CRE risk analysis process concludes that there is little risk from this activity, or the risk is well-within the board's tolerance, then the strategic planning process should, at the minimum, acknowledge this conclusion and ensure that any strategic goals do not lead to an undesirable increase in CRE risk exposure. For example, if one of the factors supporting a low-risk assessment was "a well-diversified portfolio", then management's growth strategies should be designed to ensure that growth does not adversely affect the portfolio's diversification. In other words, if management targets a specific market within its footprint for growth, absent all else, will this serve to increase or decrease portfolio diversification?

For those banks with elevated CRE concentration risk, incorporation of concentration risk mitigation into the strategic planning process needs to be more robust. In such a case, the strategic planning process would give specific consideration to controlling or reducing CRE concentration risk. These banks should not only acknowledge the risk, but their strategic objectives should include measurable goals for controlling the level of concentration risk or reducing it. Thus, if a bank desires to reduce its concentration risk, then the board could establish specific goals for increasing loan participation purchases or capital.

Other practices that would strengthen the strategic planning include:

- ✓ Incorporating areas within the strategic planning process that discuss and explain the rationale for high levels of CRE concentration risk and CRE lending, and overlaying these risks and overall growth objectives and targets with some kind of a risk/return analysis.
- ✓ Developing various measurement techniques that adjust for CRE concentration risk and/or RE credit risk, and create capital-at-risk targets that consider loss exposure characteristics. Results should be included in the strategic plan, which would assign capital targets beyond an undifferentiated regulatory basis perspective.

- ✓ Implementing capital planning techniques within the strategic planning process that correlate established capital limits to the bank's particular CRE concentration risk profile rather than merely relying on the PCA guidelines.
- ✓ Developing processes that require sensitivity and/or breakeven property analyses to assess the ability of an individual loan to withstand changing market conditions. Individual analyses should then be aggregated and used as a rudimentary form of portfolio stress-testing. While individual loan reviews may not occur at a single point in time, aggregating the information at periodic intervals and tracking aggregate trends over time can be a low cost, but effective, way for small banks to monitor their portfolio for changing real estate market conditions.
- ✓ Developing loan pricing practices that consider inherent risk and product differentiation instead of primarily market based pricing strategies.
- ✓ Exploring options for developing more robust portfolio-wide analyses to determine the sensitivity of portfolios to changing conditions.
- ✓ Incorporating contingency actions in the bank's strategic planning efforts in the event target objectives are not met (i.e., ROA, capital, ROE, asset growth, etc.).

3. **Mitigate the Risk**

Once the inherent CRE concentration risk has been quantified, management need to begin developing ways to reduce, control, and mitigate the bank's CRE exposure. SR 95-51 identifies four elements of a sound risk management system.

- ✓ Active board and senior management oversight;
- ✓ Adequate policies, procedures, and limits;
- ✓ Adequate risk measurement, monitoring, and management information systems;
- ✓ Comprehensive internal controls.

Management should evaluate and document the quality of these elements as they are (or are not) embedded in its practices as an organization and specific to its CRE lending activities. When evaluating each element, management should consider the level of inherent risk.

Also, management and the bank's board should evaluate alternatives to reducing its CRE concentration risk and increase contingency planning efforts. The Federal Reserve's Commercial Bank Examination Manual identifies several alternatives for institutions whose asset concentration risks are not likely to be reduced in the near term.² These alternatives include increasing bank capital, increasing the bank's allowance for loan and lease losses, pursuing loan participations, and participating in government guarantee programs.³

Something that is often overlooked or poorly documented while assessing risk and the adequacy of corresponding risk management practices is management expertise, depth, and succession. As bank management teams define their CRE risk exposure, they should also evaluate the quality of these management factors.

As an example, we would expect to see that a bank with significant construction lending has a seasoned lending staff with particular expertise in this area. Also, expertise should not be concentrated in one person. Such a situation could leave a bank exposed to higher risk if that person were to leave. Management should not forget to consider these factors in its analysis of CRE concentration risk. Correspondingly, examiners should not exclude these criteria when validating management's risk assessment.

² Section 2050.1

³ During this CRE Horizontal Review we observed that none of the banks had specifically retained additional capital to offset increased CRE concentration risk or attempted any other methods to review capital adequacy. Although some banks did include a CRE Concentration Risk Factor in their ALLL methodology, it was not always well-supported. Many banks gave no consideration at all to their CRE concentration in their ALLL analysis.

4. **Establish Policies and Limits**

Critical to any sound risk management system is the establishment of policies and risk limits that are designed to monitor and control a specific risk. SR 95-51 provides the following guidelines:

- ✓ An institution's policies, procedures, and limits should provide for adequate identification, measurement, monitoring, and control of the risks posed by its lending activities.
- ✓ The policies, procedures, and limits should be consistent with management's experience level, the institution's stated goals and objectives, and the overall financial strength of the organization.
- ✓ Policies should clearly delineate accountability and lines of authority across the institution's activities.

Loan policies should also provide specific guidelines for identifying and monitoring loan concentrations. For banks significantly engaged in CRE lending, these guidelines need to be more thorough and specific to controlling their CRE concentrations.

Depository institutions are currently required to establish and maintain comprehensive, written real estate lending policies that are consistent with safe and sound banking practices and appropriate to the size of the institution and the nature and scope of its operations⁴. SR 93-1 along with Federal Reserve Board's Regulation H, requires that lending policies establish:

- ✓ Loan portfolio diversification standards;
- ✓ Prudent underwriting standards, including LTV limits, that are clear and measurable;
- ✓ Loan administration procedures for the bank's real estate portfolio; and
- ✓ Documentation, approval, and reporting requirements to monitor compliance with the bank's real estate lending policies.

⁴ Interagency Guidelines for Real Estate Lending Policies, January 11, 1993

⁶ Bill Chalker and The Federal Reserve Bank of Atlanta, Market Analysis in Commercial Real Estate Lending - A Review of Practices at Selected State Member Banks, p.6

SR 93-1 also introduced supervisory LTV limits for each real estate category, and implemented limits for the aggregate volume of loans with LTVs in excess of the supervisory LTV limits. Therefore, the bank's policy guidance directed to CRE lending should address these limits and implement processes designed to measure compliance with them.

Moreover, SR 93-1 provides an extensive list of items that should be considered and addressed within an institution's lending policy, under the headings of *Loan Portfolio Management*, *Underwriting*, and *Loan Administration*.

One approach for establishing limits and enhancing portfolio analysis is to track loss rates by loan type over time. With the abundance of data from federal regulatory agencies, banks are now able to calculate loss rates on specific asset types in constructing their ALLL and in setting concentration limits.

Another approach for setting limits includes default probability measure analysis, which also estimates worst-case scenarios in setting benchmark limits. Banks can more effectively use limits for decision making and risk management in the following ways:

- ✓ By tying limits to economic capital and using capital more effectively;
- ✓ By setting risk appetite levels at the board level through enhanced strategic planning efforts;
- ✓ By creating sub-portfolio limits to cap exposure to a single segment taking into account lending, industry sector, region, and collateral; and
- ✓ By incorporating more portfolio theory and analysis in the limit setting process.

5. **Conduct Market Analysis**

In order to monitor adequately the loan portfolio and the CRE portfolio in particular, it is necessary to establish a formal process for providing regular review and analysis of market conditions within the bank's lending area. Regular review of real estate market conditions will allow bank management to be more responsive to changes in market conditions. SR 93-1 provides a list of specific factors that

should be considered when evaluating market conditions. They include:

- ✓ Demographic indicators, including population and employment trends;
- ✓ Zoning requirements;
- ✓ Current and projected vacancy, construction, and absorption rates;
- ✓ Current and projected lease terms, rental rates, and sales prices, including concessions;
- ✓ Current and projected operating expenses for different types of projects;
- ✓ Economic indicators, including trends and diversification of the lending area; and
- ✓ Valuation trends, including discount and direct capitalization rates.

Both the Atlanta and San Francisco CRE projects noted that banks are not properly analyzing and evaluating changing conditions, trends, and risks, in CRE markets. The Federal Reserve Bank of Atlanta commented that without an adequate review of CRE markets, "senior management is unable to evaluate the level of and trends in CRE market risk underlying the CRE portfolio knowledgeably and consistently." Also, "management cannot knowledgeably compare conditions across markets and determine when to exit or pull back from high risk markets."⁶

Understanding local real estate market conditions can also be a bottom-up function, whereby account officers (who are closest to the transactions) maximize their use of market information on a micro level, not only to underwrite loans, but to also enhance on-going monitoring of the condition of their CRE portfolio. This knowledge can then be disseminated upward through the organization and will ultimately provide senior management and the board with a macro view of market conditions.

6. **Monitor and Report**

The monitoring and reporting process is an important element of a strong portfolio-wide CRE risk management system. It is impossible to manage portfolio risk properly without the ability to provide meaningful reports that effectively measure and monitor inherent risk. In one sense, this can be viewed as the final stage in the

portfolio-wide risk management process outlined in this document. But the process is on-going, and this information should be incorporated into the ongoing risk identification, risk mitigation, and strategic planning processes.

Banks must have the ability to segment and stratify their CRE loan portfolio using a wide variety of criteria. Most banks have the ability to generate reports and monitor their CRE portfolio by sub-category (construction, multi-family, etc.) and location. Several banks included in our CRE Horizontal Review could segment the portfolio by additional factors such as risk grade, owner/non-owner occupied status, and LTV. Typically, reports were quantitative and not narrative or qualitative. While individual reports might add some value to the process, together they were disjointed and lacked a comprehensive viewpoint that could be easily interpreted by the boards of directors.

For this reason, the fundamental component of a quality reporting process is creating one document that summarizes the CRE portfolio and corresponding risk factors including the use of portfolio sensitivity analyses results in a concise and comprehensive manner. At a minimum, high concentration banks should demonstrate an ability to measure their CRE concentrations along many dimensions, such as by loan type, loan size, location, collateral type, collateral location, loan subtype, maturity date, industry code, and so on.

The Federal Reserve Bank of Atlanta noted that the most robust reporting packages included narrative trend information that demonstrated risk migration techniques in the CRE portfolio. Also, they identified several best practices for banks to follow when developing and using management reports that describe portfolio composition, portfolio risk characteristics, and portfolio changes by product type and market.

Accordingly, banks should develop portfolio reports that stratify the portfolio by geographic region (market, MSA, etc.), property type, and loan purpose. Stratification reports could highlight the volume of new loans, portfolio balances and changes, delinquencies, watch list loans, nonaccrual loans, and underwriting

exceptions. An expanded reporting package would add market grade or score, risk ratings, portfolio average debt coverage and LTV ratios, stress test results, large loan balances, and trend information provided in narrative and graphical format.⁷

⁷ Bill Chalker and The Federal Reserve Bank of Atlanta, Market Analysis in Commercial Real Estate Lending - A Review of Practices at Selected State Member Banks, p. 15

APPENDIX B

Appraisal Practices

Community banks need to enhance further existing appraisal practices including: ensuring an independent review appraisal function; expanding documentation of irregularities found in the appraisal; developing market parameters to prompt re-valuation/appraisals of existing RE secured loans; and maintaining a data base of appraisal information to better track market conditions. These findings and suggested best practices are discussed in more detail below.

- **Ensure an independent review appraiser function.** The CRE horizontal review revealed that only three of the twelve banks had an independent review function while all of the other institutions had the originating loan officer perform the appraisal review.

Best Practice: The appraisal review function needs to be independent of loan production. This can be achieved by either retaining an outside independent individual with appropriate credentials, or ensuring the appraisal review is conducted by a qualified individual independent of the transaction. In addition, this individual should not have approval authority on the specified transaction.

- **Expand documentation of appraisal deficiencies.** The review revealed six of the twelve banks did not have adequate documentation supporting appraisal irregularities. It was common practice to have a yes/no check list; however, at six banks (without an independent appraisal review function) examiners noted deficiencies in various appraisals that were not identified on the appraisal review check lists. Reasons why irregularities were not identified vary but primarily resulted from account officers' cursory review of the appraisal.

Best Practice: Appraisal reviews should be conducted in more depth with full documentation of appraisal weaknesses and mitigating factors. Additional appraisal review training may be warranted in certain cases. Proper documentation will ensure that the individual or committee approving the

loan transaction has accurate information on which to base a decision.

- **Develop market parameters to prompt re-valuation appraisals of existing RE secured loans.** Only one bank had procedures to prompt a re-valuation appraisal of existing CRE secured loans. Market factors are constantly changing, some of which may adversely affect the value of CRE collateral. As negative or positive trends emerge, management should be aware of the potential effects to RE collateral.

Best Practice: Procedures should be incorporated into appraisal policies that prompt re-valuation appraisals of existing RE collateral. Procedures may include monitoring market conditions, i.e., increased vacancy rates, lowered rents, and reduced sales of similar properties.

- **Maintain a database of appraisal information to better track market conditions.** None of the banks in the CRE review tracked appraisal information on a macro basis. However, one of the review banks is in the process of developing a data-base to track trends in vacancy, rents, cap rates and discount rates obtained from appraisals. This type of database will also be useful in comparing appraisals of similar type properties and assist in the ongoing monitoring of existing CRE loans.

Best Practice: Develop a data-base of appraisal information, such as vacancy rates, cap and discount rates, lease rates, and trends in volume of sales for similar types of properties. This will assist the bank in assessing the appropriateness of new appraisals and identify market trends.

Appraisal Review Best Practices for Examiners

Examiners are not expected to perform each one of the recommendations listed below when conducting reviews appraisals at high CRE concentration banks. However, based on findings during this CRE review and various articles comparing appraisal issues in the early 1990's to now, following are some best practices for examiners to consider when reviewing appraisals:

- ✓ Compare CAP and discount rates, vacancy rates, lease rates with other appraisals reviewed during the bank examination. Verify that management is also monitoring this information.
 - ✓ Appraisals are based on historical data. Ask the loan officer and/or internal appraisal reviewer about current market conditions.
 - ✓ Verify comparable sales are current. Stale comparables may be an indication of slower sales and softening of market.
 - ✓ Review for landlord concessions, which may also indicate a softening market.
 - ✓ Be aware of leases about to expire and/or above market leases. Compare to current market conditions.
 - ✓ Don't rely on appraiser to identify environmental issues.
 - ✓ Ensure appraiser appropriately discounts special use properties.
 - ✓ Determine whether appraisal included a discounted bulk value for certain types of construction projects.
 - ✓ Validate reason why an appraisal may exceed purchase price. Look for significant improvements.
 - ✓ Be skeptical of "as completed" appraisals. Construction delays and change of designs are common.
- ✓ Market rents should be applied to owner occupied properties.
 - ✓ Verify management's approved appraiser procedures comply with regulatory guidelines.
 - ✓ For term loans verify the loan officer is collecting rent rolls and performing a simple valuation using the previous CAP rate and current NOI.
 - ✓ Validate appropriateness of cost approach. Is price per square foot comparable to market?

APPENDIX C

Supervisory Regulations, SR Letters, and Resources

Listed below are several available reference sources for use during the normal course of performing CRE concentration related examination reviews:

SR 91-16	Supplementary Examination Guidelines on Real Estate Loans and Certain Reporting Issues Pertaining to Nonaccrual Loans
SR 91-24	Interagency Examination Guidance on Commercial Real Estate Loans – Policy statement on the review and classification of commercial real estate loans.
SR 91-25	Interagency Examination Guidance on Commercial Real Estate Loans – Joint interagency press release and joint staff memorandum.
SR 93-1	Real Estate Lending Standards (General risk management expected for comm. RE lending- documentation of strategy, policy limits, underwriting standards, etc.)
SR 93-11	Real Estate Lending Standards – LTV limits
SR 93-33	Clarification on Real Estate Lending Standards
SR 93-70	Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)
SR 94-55	Interagency Appraisal and Evaluation Guidelines
SR 95-27 (SUP)	Interagency Statement on Appraisals for Affordable Housing Loans
SR 99-18	Assessing Capital Adequacy in Relation to Risk
CBEM ¹ Section 2050	Concentrations of Credit
CBEM Section 2090	Real Estate Loans
CBEM Section 2100	Real Estate Construction Loans
CBEM Section 3020.1	Assessment of Capital Adequacy
ED Loan Reference	Construction and Land Development
ED Loan Reference	Commercial/Industrial Real Estate Loan Review
Regulation H	Subpart E, and Appendix C - <ul style="list-style-type: none">• Subpart E - Real Estate Lending and Appraisal Standards• Appendix C - Interagency Guidelines for Real Estate Lending Policies (includes LTV limits)
Web Sites	Internal 12 th District and BOG; external public site at www.bog.frb.fed.us/

¹ Commercial Bank Examination Manual

APPENDIX D

Underwriting Review Procedures

We considered the following factors when evaluating the banks' CRE underwriting standards and needs to be followed by examiners when examining high risk CRE concentration banks.

Management Philosophy and Credit Culture

Are policy guidelines and the adherence to policy guidelines acceptable? What is level of risk appetite demonstrated by established guidelines?

Debt Service Coverage Limits

Are they well-defined in the policy? How reasonable or aggressive are they?

Loan-to-Value Limits

What limits have been established for differing property types, how do these compare to other institutions and supervisory guidance and how is "value" defined?

Cash-In Requirements

Have the banks established minimum limits for cash-in (cash equity) from borrowers, and how is "cash" defined?

Take-Out Commitments

Are take-out financing requirements incorporated into policy and how frequently are they obtained?

Credit Analysis

What is the overall quality of credit presentations that are used to support the extensions of credit? Are extensions of credit well-supported? Is data accurate? Are policy exceptions well-documented, supported, and tracked?

Cash-Flow Analysis (i.e., property or project capacity)

Are repayment sources fully analyzed, or is excessive reliance placed on LTV? How thorough and reliable are cash-flow analyses?

Number of Credit Extensions

How frequently are banks granting loan extensions?

Pre-Sales or Pre-Leasing Requirements

Have banks established such requirements? What are they, and are they adhered to?

Interest Reserves

What policies have been established for interest reserves on construction loans?

Borrower and Guarantor Financial Strength (i.e., borrower capacity)

What is the quality of analysis, and how well are secondary sources of payment assessed? What is the strength of the typical borrower within the banks' portfolios? Are guarantees obtained?

Feasibility Studies

Are they required, obtained, utilized? Do banks overly rely on appraisals?