Southeast Bankers Outreach Forum

CRE Exposures and Sound Risk Management Practices

Date: September 28, 2017

Presented by: Trey Wheeler – Assistant Vice President
Office - 404.498.7152
trey.wheeler@atl.frb.org

This presentation and my comments represent my personal views and do not necessarily reflect the views of the Federal Reserve Bank of Atlanta or the Federal Reserve System.

FEDERAL RESERVE BANK *of* ATLANTA

Presentation Topics

- **Commercial Real Estate (CRE) Overview**
- **CRE Supervisory Guidance**
- **CRE Sound Risk Management Practices**
- **2016-2017 CRE Horizontal Review**
- **Interagency Activities and Key Areas of Focus**

Commercial Real Estate Exposures

- Commercial real estate (CRE) is a key risk for the southeast and the banking industry as a whole.
- Renewed focus on CRE exposures by supervisors given current market conditions and growing credit exposures.
- Two key segments of concern are construction and land development (CLD) and total non-owner occupied (NOO) CRE.
- Regulatory thresholds used to define concentrations include CLD exposure of 100 percent or total NOO CRE exposure of 300 percent measured as a percentage of total risk-based capital.

CRE Concentrations Supervisory Guidance

- **SR Letter 07-1, *Interagency Guidance on Concentrations in Commercial Real Estate and Sound Risk Management Practices (December 2006)***
  - **Board and management oversight**
  - **Portfolio management**
  - **Management information systems**
  - **Market analysis**
  - **Credit underwriting standards**
  - **Portfolio stress testing**
  - **Credit risk review**
- **SR Letter 15-17, *Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending (December 2015)***

Purpose of Interagency CRE Guidance

- Issued to remind institutions that <u>strong risk management</u> practices and appropriate levels of <u>capital</u> are important elements of a sound CRE lending program, especially when an institution has a CRE concentration or a CRE lending strategy leading to a concentration.
- Provides a principle-based discussion of supervisory expectations for strong risk management practices and evaluation of capital adequacy.
- Not intended to be implemented through a "one-size-fits-all" approach. Exercise judgment when evaluating risk management practices and capital levels relative to the size and complexity of an institution's CRE portfolio and level and nature of CRE concentration risk.

CBOs that Exceed SR Letter 07-1 Thresholds

SR 07-1 Outliers	4Q07	4Q15	1Q16	2Q16	3Q16	4Q16
CLD>100% of RBC	290	57	55	49	53	48
NOO>300%RBC	169	70	72	75	72	67
Double Outliers	147	18	19	19	22	16
Total SR 07-1 Institutions	312	109	108	105	103	99
Total FRB CBOs	857	818	813	806	797	803
SR 07-1 Institutions / Total Portfolio	36%	13%	13%	13%	13%	12%

CRE Lending Risk Assessment

- **Perform and document CRE risk assessment on at least an annual basis.**
- **Identify potential concentrations by stratifying the CRE portfolio into segments that have common risk characteristics or sensitivities to economic, financial, or business developments.**
- **Include overall CRE portfolio risk characteristics, the quality of risk management processes, and capital levels.**

Board and Management Oversight

- **Establish policy guidelines and approve an overall CRE lending strategy regarding the level and nature of CRE exposures acceptable to the institution.**
- **Ensure that management implements procedures and controls to effectively adhere to and monitor compliance with the institution's 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 in which the institution lends.**
- **Periodically review and approve CRE risk exposure limits and appropriate sub-limits to conform to any changes in the institution's strategies and to respond to changes in market conditions.**

Portfolio Management

- **Evaluate the degree of correlation between related real estate sectors and establish internal lending guidelines including concentration limits that control the institution's overall risk exposure.**
- **Develop appropriate strategies for managing CRE concentration levels, including a contingency plan to reduce or mitigate concentrations in the event of adverse CRE market conditions.**
- **Pipeline management, loan participations, whole loan sales, and securitizations are all appropriate options for actively managing concentration levels.**

Management Information Systems (MIS)

- **Should provide management with sufficient information to identify, measure, monitor, and manage CRE risk.**
- **Include meaningful information on CRE portfolio characteristics that is relevant to the institution's lending strategy, underwriting standards, and risk tolerances.**
- **Should stratify the CRE portfolio. For example, loan portfolio stratifications could include:**
  - **property type, geographic market, tenant concentrations, tenant industries, developer concentrations, risk rating, loan structure, loan purpose, LTV ratio, debt service coverage, and policy exceptions on newly underwritten credit facilities.**
- **Should be timely and in a format that clearly indicates changes in the portfolio's risk profile, including risk-rating migrations.**

Market Analysis

- **Should provide management and board of directors with information to assess whether its CRE strategy and policies continue to be appropriate in light of changes in CRE market conditions.**
- **Particularly important as an institution considers decisions about entering new markets, pursuing new lending activities, or expanding in existing markets.**
- **Sources of market information may include published research data, real estate appraisers and agents, information maintained by the property taxing authority, local contractors, and builders.**
- **An institution should be able to demonstrate that it has a solid understanding of the economic and business factors influencing its lending markets.**

Credit Underwriting Standards

- **Lending policies should reflect the level of risk that is acceptable to its board of directors and should provide clear and measurable underwriting standards that enable the institution's lending staff to evaluate all relevant credit factors.**
- **An institution should consider both internal and external factors when establishing underwriting criteria, such as its market position, historical experience, present and future trade area, probable future loan and funding trends, staff capabilities, and technology resources.**
- **Institutions should monitor exceptions to lending policies and report to the board of directors or designated committee on a regular basis.**
- **Institutions should analyze trends in lending exceptions to ensure risk remains within the institution's risk tolerance limits.**

Portfolio Stress Testing and Sensitivity Analysis

- **Institutions with a CRE concentration should perform portfolio-level stress testing to quantify the impact of changing economic conditions on asset quality, earnings, and capital.**
- **Sophistication and frequency of stress testing practices should be consistent with the size, complexity, and risk characteristics of its CRE loan portfolio.**
- **Supervisory guidance emphasizes the importance of a forward looking strategic focus to identify potential weaknesses highlighted by current or planned concentrations.**
- **Institutions should adopt a stress testing method that fits their business strategy, size, products, sophistication, and overall risk profile.**

Credit Risk Review Function

- **A strong credit risk review function is critical for an institution's self-assessment of emerging risks.**
- **Risk ratings should be risk sensitive, objective and appropriate for the types of CRE loans underwritten by the institution.**
- **Risk ratings should be reviewed on a regular basis to ensure they are appropriate.**

CRE Horizontal Review

- **Conducted a horizontal review of banks deemed to have higher CRE concentration risk to assess overall compliance with existing CRE guidance (SR Letter 07-1) during 2016 and early 2017.**
- **Formed a project team with an experienced team of seven examiners to conduct all CRE reviews conducted during the exercise.**
- **Developed a formal framework with a consistent work program focused on the seven key elements outlined in SR Letter 07-1.**
- **Review was linked with existing exam events as much as possible to leverage exam loan review findings, including quality of underwriting.**
- **Formal messaging back to each bank including status of compliance with regulatory guidance and formal MRIAs and MRAs where necessary.**
- **Implemented a formal monitoring program with key credit metrics updated on a quarterly basis.**

CRE Horizontal Review Common Findings

- **Commonly identified areas of weakness:**
  - **Board and management oversight**
  - **Portfolio management**
  - **Market analysis**
  - **Contingency planning**
  - **Stress testing**
- **Few instances identified related to:**
  - **Credit underwriting practices**
  - **Loan review function**

Key Themes from Horizontal Review

- **CRE concentration risk management framework was fragmented and did not provide a holistic approach to managing CRE concentration risk.**
- **CRE risk assessment was not completed or updated at least annually.**
- **Rationale for CRE concentration not documented and incorporated into the bank's overall strategic plan.**
- **Formal CRE limits and sub-limits not granular enough or were unrealistic.**
- **Contingency planning not formally documented with viable options to reduce CRE exposures should a downturn in the CRE market occur.**
- **Stress testing processes were not severe enough and/or not linked to the capital planning process.**

Interagency CRE Workgroup (Fed, FDIC, OCC)

- **Collecting and aggregating findings at CRE concentrated banks across federal regulators.**
- **Key goal of the process is to establish risk management expectations and promote consistency in the exam process in line with the 2006 interagency guidance.**
- **Information collected is primarily qualitative and is aimed at addressing the seven elements in the interagency guidance (SR Letter 07-1).**
- **Collected for exams that started in April 2017 with data aggregated and shared quarterly.**

Forward Looking Key Areas of Focus

- **Stress testing and capital planning processes for banks with CRE concentrations.**
- **Underwriting standards may be loosening in some markets as a result of competition (extending tenor, absence of guarantor support, interest-only loans).**
- **Funding strategies for new loan growth.**
- **Changing market conditions and the potential impact on various CRE product types and exposures due to a changing interest rate environment.**
- **Cap rates and collateral valuations.**

Questions or Comments