Assessing Commercial Real Estate Portfolio Risk

Introduction

Insured financial institutions have increased their exposures to commercial real estate (CRE) lending at a time when CRE market fundamentals remain weak. To understand the potential portfolio risk, bank supervisors must "get behind the numbers" and review CRE lending practices to determine the nature and extent of the exposure. A horizontal review of selected community banks in the Atlanta metropolitan statistical area (MSA) shows that their CRE exposures are concentrated in residential construction and owner-occupied commercial real estate. CRE lending practices at the selected banks were stronger than those prevailing in the early 1990s.

The Atlanta CRE review was a pilot program the FDIC is replicating in other markets on the basis of perceived risks. For a relatively modest investment by the FDIC and the selected banks, the program provides a rapid assessment of issues that may need to be addressed in this traditionally higher-risk lending segment. The program also reinforces the need for banks to engage in sound CRE lending practices. This article identifies elements that are critical to a strong, well-managed lending program.

CRE Market Conditions

Following several quarters of deterioration nationwide, CRE conditions stabilized in late 2003, with vacancy rates peaking or retreating slightly in many metropolitan markets. Office markets weakened precipitously after 2000 owing to the loss of white-collar jobs during the economic downturn and subsequent weak recovery. Continued weak employment growth during the economic recovery has forestalled greater absorption of CRE space.

Tepid economic growth following the recession, combined with anxiety about travel following the 9/11 attacks, contributed to prolonged weakness in revenue per available room in several hotel markets. Retail markets have been comparatively resilient, as consumer spending remained remarkably robust in contrast to previous economic downturns. Industrial and warehouse market conditions have suffered from prolonged losses in manufacturing employment and a low inventory-to-sales ratio stemming from strong consumer sales. Multifamily housing has been hurt by an increase in the number of new homeowners, in part due to low interest rates. Although it appears that deterioration in CRE markets may have bottomed out, sustained economic growth and more rapid gains in employment and wages will be necessary to foster a recovery.

Key developments have changed the dynamics of the CRE sector. Public markets now play a much larger role in CRE financing. Greater public involvement began with the development of the commercial mortgage-backed securities (CMBS) market in the early 1990s. The success of the CMBS market then contributed to tremendous growth in the secondary market for distressed properties. The CMBS market has grown to more than $550 billion. In the mid-1990s, real estate investment trusts (REITs) also became a major force in financing CRE, with more than a sevenfold increase in market size in the past ten years. It also appears that the CMBS and REIT markets have taken on a larger share of the traditionally higher-risk types of loans.

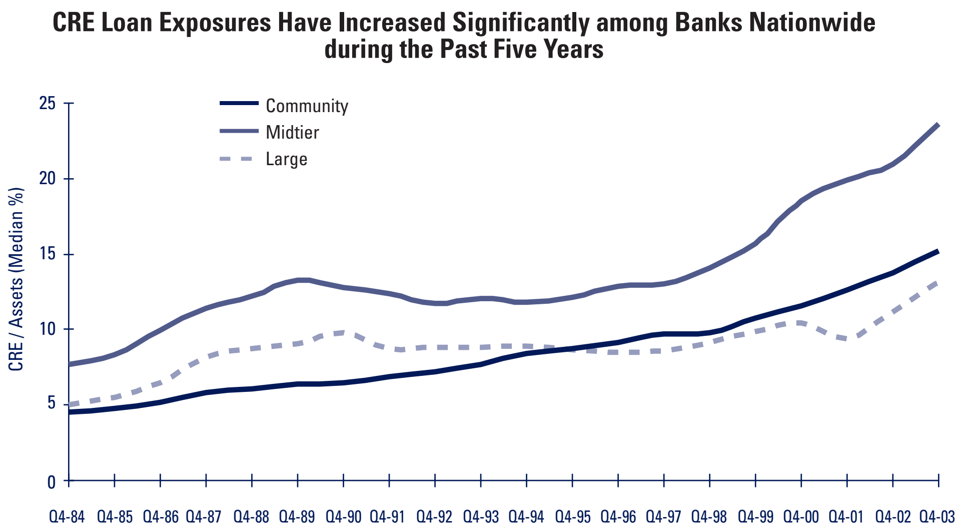
The quality, availability, and timeliness of market information and data have improved significantly. The CRE market also has benefited from the recent prolonged low interest rate environment. Cash-strapped property owners have been able to lower debt service burdens through refinancing or a contractual variable rate. The combination of these factors has constrained wide cyclical swings in the performance of the CRE sector.[1]

Trends in Bank CRE Portfolio Exposures

During the past 20 years, and more particularly during the past 5 years, insured institution CRE loan exposures have increased considerably. CRE lending growth has been greatest among midtier commercial banks.[2] The median exposure level of these institutions has consistently exceeded that of community and large-sized banks, with the difference among these groups widening during the past five years.[3] At year-end 2003, the median ratio of CRE loans to assets at midtier institutions was 24 percent, compared with 15 and 13 percent at community and large banks, respectively (see Chart 1).

Despite increased exposure to CRE lending and weak market fundamentals, insured institutions have not reported any significant deterioration in credit quality. Although office vacancy rates have climbed to levels seen during the early 1990s, insured institutions are reporting lower delinquencies and

Chart 1



Source: Bank Call Reports, December 31.
Note: Includes all commercial banks nationwide and excludes de novos. Community bank assets: < $1 billion; midtier bank assets: $1 – $10 billion; large bank assets: $10 – $100 billion.

[1]For more detailed information on the CRE sector, see "The Changing Paradigm in Commercial Real Estate" (proceedings of a September 12, 2003, roundtable of industry experts convened by the FDIC), ***FYI,*** October 28, 2003 (http://www.fdic.gov/bank/analytical/fyi/2003/102803fyi.html), and Thomas Murray, "How Long Can Bank Portfolios Withstand Problems in Commercial Real Estate?" ***FYI,*** June 23, 2003 (http://www.fdic.gov/bank/analytical/fyi/2003/062303fyi.html). Analysis of the CRE sector in the FDIC's Atlanta Region was presented in "A Recovery in Some Commercial Real Estate Markets Remains Constrained by Weak Economic Growth," *Atlanta Regional Perspectives,* ***Regional Outlook,*** Fall 2003 (http://www.fdic.gov/bank/analytical/regional/ro20033q/na/index.html).

[2]Midtier commercial banks hold assets of $1 billion to $10 billion.

[3]Community banks hold assets of less than $1 billion, and large banks hold assets of at least $10 billion.

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charge-offs now than during that time (see Chart 2).

CRE loans are reported on Call Reports in broad categories and may be reported with limited descriptions in other publicly available financial reports. Off-site financial data are of little help in identifying the types of construction and CRE loans being financed (office, hotel, retail, industrial, residential construction), whether the project is speculative or under contract, or whether the property is owner occupied. Evaluating the risks inherent in CRE loan portfolios requires understanding portfolio composition, specific institution business strategies, and the types of risk management controls that are in place.

The Atlanta CRE Lending Pilot Program

Why the Atlanta Metro Area?

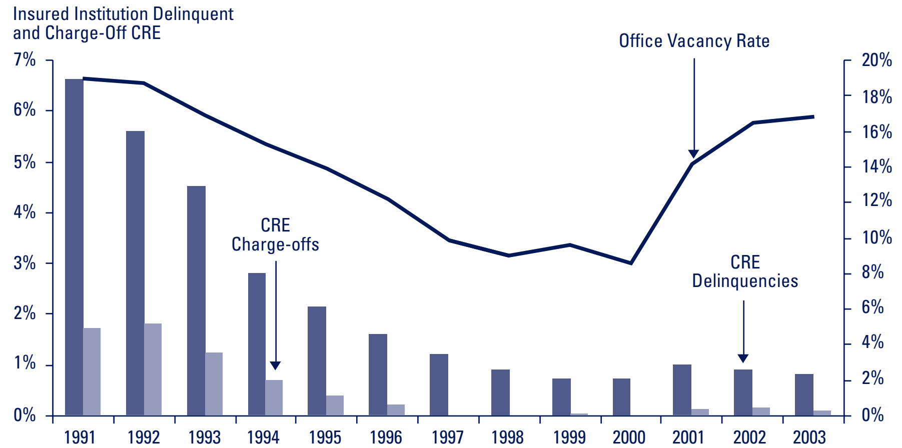
The decision to launch the CRE lending pilot program in Atlanta was driven by a consideration of the weak local market conditions in tandem with the fact that a relatively high number of banks based in this area were reporting significant levels of CRE exposures.

Nationally, the percentage of banks that report CRE loans exceeding 300 percent of Tier 1 capital (traditionally a threshold that represents a relatively high concentration of CRE loans) has more than doubled in the past six years—from 14 percent in 1997 to 31 percent at year-end 2003. More than half the institutions supervised by the FDIC's Atlanta Field Office report CRE exposures that exceed this threshold. Banks in this area have reported an increase in CRE loan exposures of roughly 197 percent since fourth quarter 1999, to 453 percent of Tier 1 capital at year-end 2003. This compares to a national median of approximately 188 percent.

In addition, the softness in the CRE market is more pronounced in the Atlanta MSA, where employment has declined and vacancy rates are high. The current vacancy rate of 22 percent for office space and 15.8 percent for industrial space significantly exceeds the national averages of 16.8 percent and 11.6 percent, respectively. High vacancy rates in the Atlanta MSA increase the vulnerability of insured institutions to a potential decline in CRE property values.

Chart 2

Insured Institution CRE Credit Quality Has Not Shown Effects of Weak Market Fundamentals



Sources: FDIC Research Information System data from bank and thrift Call Reports, Torto Wheaton Research—all insured institutions.

An Overview of the Pilot Program

Given increasing exposures, weak market fundamentals, and lack of detailed off-site financial data, in 2003 the FDIC developed and implemented a pilot program to better assess the risk in insured institution CRE loan portfolios and evaluate the adequacy of risk management practices and controls. Another goal of the program is to more thoroughly understand how banks with relatively high levels of CRE exposures identify concentrations and what techniques they use to monitor market conditions.

FDIC staff explained the pilot project to the sample banks and asked them to report detailed CRE data on a worksheet. The worksheet breaks down broad CRE loan categories into smaller, more specific loan types (e.g., existing retail, office development) and assigns them to risk groupings.

Site visits were conducted at 67 banks determined to have elevated levels of CRE exposures to verify data and review policies and practices. On the basis of the composition of the CRE loan portfolio and a review of lending practices and procedures, each bank in the sample was assigned a risk management profile of Strong, Satisfactory, Fair, or Unsatisfactory (see text box).

Risk Management Profiles

Strong

- Higher levels of owner-occupied CRE and residential construction under contract loans
- Strong underwriting and credit administration procedures
- Loan review and board reporting are usually thorough and timely
- Demonstrate the strongest identification, measuring, monitoring, and control of risks
- Low volume of past-due loans
- Exhibit the highest level of regulatory compliance

Satisfactory

- Higher percentage of development CRE loans and speculative residential construction loans
- Overall risk management is sound and risks are mitigated and controlled
- Satisfactory identification, measuring, monitoring, and control of risks
- Adequate board reporting

Fair

- Higher concentration of CRE development loans
- Loan policy risk limits and management's identification, measuring, monitoring, and control of risks warrant improvement
- Generally high volume of technical exceptions and past-due loans

Unsatisfactory

- Larger volume of higher-risk loan types
- Significant weaknesses in risk management
- May have high levels of adversely classified assets and past-due loans
- Banks are of significant regulatory concern

Results of the Pilot Program

Results show that area bankers are generally knowledgeable about CRE market conditions in the Atlanta MSA. In addition, insured institution risk controls and monitoring programs have improved significantly since the early 1990s. Overall, bank management has implemented more effective grading systems, improved control and approval limits, and adequate loan review procedures. Bankers understand current conditions and issues in submarkets and have access to a broader range of market information.

The pilot project showed that insured institution CRE exposures were centered in one- to four-family residential real estate development projects and owner-occupied commercial real estate—with limited involvement in speculative retail and office building construction loans. (See Chart 3 for an aggregate portfolio breakout.)

Banking necessarily involves the willingness to accept and manage risks, and this review provided insights into what CRE risks Atlanta community banks have accepted and how they are managing those risks. Active involvement in the financing of owner-occupied CRE involves a bet on the health of the local

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economy. The performance of exposures to residential construction depends on the financial health of local builders and developers, which in turn depends on Atlanta house price trends and indirectly on the behavior of interest rates. For both types of exposures, important risk mitigants include portfolio diversification and appropriate loan underwriting strategies. For the most part, the sampled banks appeared to be making effective use of such risk mitigants.

However, the pilot program also identified weaknesses in CRE lending programs among some insured institutions, including the following:

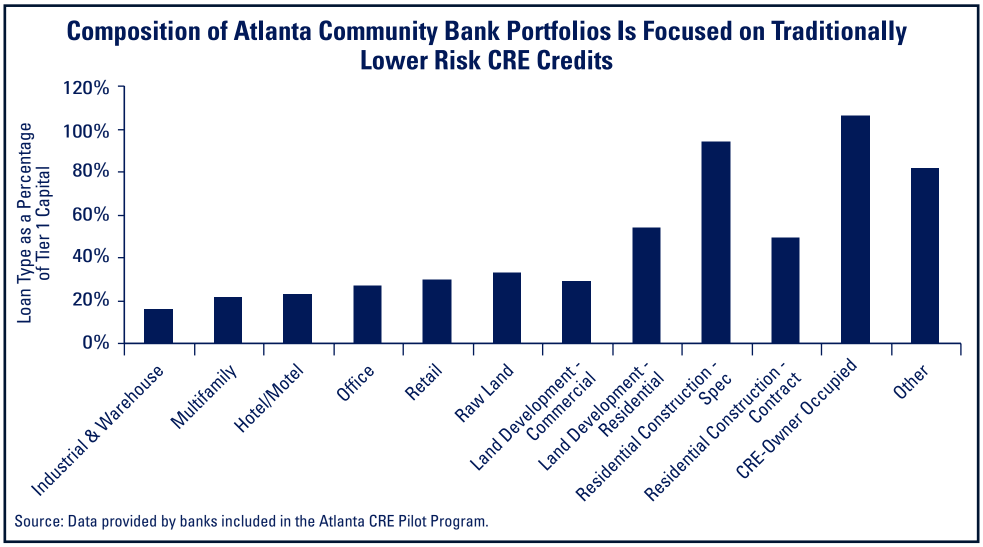
- Lack of adequate cash flow analysis
- Weak real estate appraisal review processes
- Inconsistent compliance with board reporting requirements and regulatory loan-to-value guidelines
- Inadequate management information systems regarding loan stratifications and risk designations
- Miscoded loan data and Call Report errors
- Limits for speculative loans that often were not established on an aggregate basis, but only by individual borrower

The results reinforced the need for enhanced identification of concentration risk and tools to monitor market conditions. The insights gained from the pilot program helped examiners allocate resources more efficiently in the risk-scoping and examination-scheduling processes. In addition, the program promoted communication between examiners and bankers about CRE market conditions and loan exposures, lending practices, and regulatory policies and priorities. Bankers were generally supportive of the project; some indicated that they intended to use the CRE worksheet for internal reporting and monitoring. The Atlanta Region is now planning to implement a similar review in selected markets, including parts of Florida and North Carolina, and the program also has been adopted in other Regions.

Results of the Pilot Program Reinforce the Importance of Sound CRE Lending Practices

The weaknesses identified through the pilot program confirm the need for bank management to develop and implement lending programs that incorporate certain key components. A sound CRE lending program begins with board of directors and senior management direction and

Chart 3



Source: Data provided by banks included in the Atlanta CRE Pilot Program.

oversight. Developing and adhering to a comprehensive loan policy that establishes clear and measurable standards for production, underwriting, diversification, risk review, reporting, and monitoring are critical. Within this context, certain elements are integral to strong, well-managed CRE lending programs:

Well-defined Underwriting Standards: Clear limits, expectations, and monitoring systems should be established.

Effective Due Diligence: Obtaining financial statements, market analysis, borrower background information, project schedules, and detailed property information is imperative.

Established Concentration Limits: Diversification standards by portfolio, property type, market area/submarkets, builder(s), and risk grades need to be established and enforced.

Strong Appraisal Review Process: An independent review that evaluates appraiser qualifications and the impact on assessed values under stressed scenarios is critical.

Formal Approval Process and Loan Administration Procedures: Comprehensive loan presentations that include the strengths and weaknesses of the credit should be submitted to the appropriate committees for approval. Insured institutions also should implement procedures to ensure adequate segregation of loan administration duties.

Comprehensive Risk Measurement and Monitoring: Segmenting CRE portfolios by product, geographic location, office, officer, and risk grade enhances the early identification of potential weaknesses and aids in the development of proactive risk mitigation strategies. More sophisticated CRE risk management programs include the ability to analyze the impact of changing interest rates or market fundamentals on debt service and collateral valuations at the portfolio level.

Conclusion

CRE lending programs consist of a broad array of products that present a range of risks. Although softness may exist in many CRE markets, financial reporting limitations may have contributed at times to overly negative assessments of the potential risks to insured financial institutions. The type of lending products insured institutions offer and their risk management practices may mitigate the potential risk. Most of the sampled banks appeared to be doing a good job of managing the risks associated with their most important exposure categories—residential construction and owner-occupied CRE.

Growth in CRE portfolios during a time of weak market fundamentals warrants a careful and complete risk assessment that reaches beyond financial statement presentations. The types of loans institutions make can vary widely from area to area and from bank to bank. Therefore, particularly in an environment of weak CRE fundamentals when interest rates could rise, supervisors must “get behind the numbers” to assess the extent of portfolio risk. The results of the Atlanta pilot program show that greater understanding of a bank’s CRE lending risk profile, as well as the controls and monitoring programs, can improve examiners’ ability to risk-focus examinations.

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