From the Examiner's Desk . . . Examiners Report on Commercial Real Estate Underwriting Practices

*This regular feature focuses on developments that affect the bank examination function. We welcome ideas for future columns. Readers are encouraged to e-mail suggestions to **SupervisoryJournal@fdic.gov.***

Much has been written about the increase in commercial real estate (CRE) lending. The FDIC has published numerous articles over the last few years reporting increased levels of CRE and construction and development (C&D) loans as a percentage of total capital.[1] The Federal banking regulators[2] have each alerted their supervised financial institutions to the risks associated with this rapid growth and the potential erosion of prudent underwriting practices in the effort to capture market share. In 2004, an article in this journal discussed a CRE lending review program conducted in the FDIC's Atlanta Region, where a relatively high number of banks reported significant levels of CRE exposure.[3]

In this article, we take a closer look at CRE underwriting and loan administration practices, present recurring examination findings, and discuss best practices for managing CRE portfolios in the current environment. This informal review suggests that examiners are observing weaknesses in CRE underwriting and loan administration fairly frequently. A strong economy has thus far helped protect insured banks against the risks associated with CRE. Nevertheless, the FDIC is concerned about trends in the underwriting and management of CRE risks. Examiners are considering these issues in their assessments of banks' risk management practices.

FDIC-Supervised Banks Are Becoming Increasingly Reliant on CRE Lending

The writers' field examination experience, as well as information from other examiners, indicates that many of the institutions experiencing moderate to rapid growth in CRE lending see such loans as their particular market niche. Larger financial institutions and other market participants have gained pricing advantages over community banks in other areas of lending, particularly traditional residential mortgages, home equity lines of credit, and other consumer financing. In addition, the use of predictive credit scoring models for small and medium-sized business loans continues to gain wider acceptance among larger lenders and leasing companies. Community banks can, however, compete for CRE loans because of their knowledge of local markets and borrowers. This characteristic has enabled community banks to expand their share of the CRE market nationwide. Growth in CRE concentrations among FDIC-supervised banks is detailed in Table 1.

Examiners Report on CRE Underwriting

In an effort to identify changes in underwriting practices for CRE concentrations, we requested information on examination findings from each of the

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[1] *FDIC Outlook,* Summer 2006; FDIC *Quarterly Banking Profile,* First Quarter 2006.

[2] Office of the Comptroller of the Currency; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; Office of Thrift Supervision.

[3] Assessing Commercial Real Estate Portfolio Risk, *Supervisory Insights,* Vol. 1, Issue 1, Summer 2004, https://www.fdic.gov/regulations/examinations/supervisory/insights/sisum04/sisummer04-article4.pdf.

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Table 1

Percentage of FDIC-Supervised Institutions with CRE Loans/Total Capital Ratios > 300% by FDIC Region

Region	June-00	June-01	June-02	June-03	June-04	June-05	June-06
San Francisco	42.0	46.8	51.8	54.1	55.2	60.0	59.8
Atlanta	21.9	28.6	35.7	40.4	44.1	47.6	50.9
Chicago	12.6	15.3	20.1	20.8	24.8	28.2	30.4
New York	10.5	12.1	17.7	19.2	21.7	24.8	27.6
Dallas	11.5	13.3	15.9	17.7	20.4	22.8	24.8
Kansas City	7.4	8.1	8.8	10.2	12.2	14.7	17.1

Note: Data from June 2000 through June 2006 Reports of Condition.

six FDIC Regional Offices. Examiners responded either with examples of individual institutions from recent examinations or with a synopsis of recurrent findings.

The most common deficiencies noted were of institutions failing to monitor their CRE portfolios properly and failing to comply with the requirements of Part 365 of the FDIC Rules and Regulations—Real Estate Lending Standards (see text box, Major Provisions of Part 365). Other areas of concern were the lack of effective oversight of construction projects, weak appraisal review programs, inadequate knowledge of lending markets, and poor loan structuring. While noting such deficiencies, examiners also reported many best practices that mitigate the risk.

CRE Monitoring and Management Information Systems Can Mitigate Risk

Examiners indicated that many institutions have increased their exposure to CRE lending without a formal monitoring system or adequate consideration of concentration risk. Some institutions did not know what percentage of their CRE portfolio was concentrated in more risky speculative C&D loans. Common deficiencies include

- Failure to consider or establish limits of exposure by type (e.g., condominium conversion, multifamily) or geographic market;
- Preparing reports of activity for senior management and the board of directors that do not provide sufficient

Major Provisions of Part 365—Real Estate Lending Standards[a]

- Written lending policies must establish
  - Diversification standards
  - Prudent underwriting standards that include clear and measurable loan-to-value limits
  - Loan administration procedures
  - Guidelines for monitoring loan policy compliance
- Market conditions must be monitored.
- Real estate lending policies should reflect consideration of the Interagency Guidelines for Real Estate Lending Policies (Appendix A to Part 365).

[a] Part 365 of the FDIC Rules and Regulations prescribes real estate lending standards to be used in a state nonmember bank's lending policies. See 12 CFR 365.2.

information to enable management to make informed decisions;

- Inadequate or nonexistent interest rate stress testing; and
- Failure to prepare timely or consistent concentrations reports.

This lack of oversight often caused examiners to cite contraventions of FDIC Rules and Regulations, specifically Appendix A to Part 365—Interagency Guidelines for Real Estate Lending Policies[4] at safety and soundness examinations. Examiners provided examples of institutions failing to monitor the loan portfolio appropriately for loan-to-value exceptions (see text box, Supervisory Loan-to-Value Limits). The following were common deficiencies:

- Failure to track exceptions;
- Failure to track the aggregate amount of loans in excess of loan-to-value limits;
- Originating numerous loans in excess of loan-to-value limits without documentation of credit factors that support the underwriting decision;
- Failure to consider commitment amounts when computing loan-to-value limits;
- Underwriting raw land loans in excess of prescribed loan-to-value limits based on "As Complete" appraised values; and
- Failure to provide timely and sufficiently complete reports to the board of directors as required by Part 365.

There were numerous reports of institutions whose aggregate amount of all loans in excess of the supervisory loan-to-value limits routinely exceeded 100 percent of total capital, in contravention of Appendix A of Part 365.[5] Several examiners reported that banks were granting extensions of credit of up to 75 percent of value to acquire raw land although the borrowers had no plans to develop this property in the near term. Certain institutions in high-growth areas had concentrations in excess of 150 percent of total capital for land development loans, but for purposes of measuring risk, internal monitoring did not differentiate

Supervisory Loan-to-Value Limits[a]

Institutions should establish their own internal loan-to-value limits for real estate loans. These internal limits should not exceed the following supervisory limits:

Loan category	Loan-to-value limit (percent)
Raw land	65
Land development	75
Construction:	
Commercial, multifamily,[b] and other nonresidential	80
1- to 4-family residential	85
Improved property	85
Owner-occupied 1- to 4-family and home equity[c]	–

[a] Appendix A to Part 365 of FDIC Rules and Regulations, www.fdic.gov/regulations/laws/rules/2000-8700.html#2000appendixatopart365.

[b] Multifamily construction includes condominiums and cooperatives.

[c] A loan-to-value limit has not been established for permanent mortgage or home equity loans on owner-occupied 1- to 4-family residential property. However, for any such loan with a loan-to-value ratio that equals or exceeds 90 percent at origination, an institution should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

[4] Appendix A identifies prudent practices an institution should include in its policies in the areas of loan portfolio management, underwriting, and administration. In addition, the appendix provides supervisory loan-to-value limits. See www.fdic.gov/regulations/laws/rules/2000-8700.html#2000appendixatopart365.

[5] Appendix A to Part 365 requires that the aggregate amount of loans in excess of the supervisory loan-to-value limits should not exceed 100 percent of total capital. Within this aggregate limit, total loans for commercial, agricultural, multifamily, or other non-1–4 family residential properties should not exceed 30 percent of total capital. An institution that approaches or exceeds the aggregate limits is subject to increased supervisory scrutiny.

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actual land development loans from raw land loans or speculative investment land loans.

Mitigation Practices. Despite these weaknesses, examiners cited a number of best practices focusing on effective internal controls and management information systems that monitor the activity and control the associated risk. Establishing policy limits appropriate to the bank's size, sophistication, and appetite for risk is fundamental to managing CRE concentration risk. The primary element of a useful monitoring process is the integration of quantitative and qualitative data that provide a summary of the overall activities in the CRE portfolio in order to measure risk across all dimensions of the portfolio. The size of the portfolio should not be the sole consideration. Factors such as geographic diversification, types of property held as collateral, and underwriting practices should be considered in the development of any risk management process.

Institutions with active and meaningful monitoring programs depended on a number of in-depth reports that were reviewed periodically either by committees of the board of directors or by the full board. In addition, some institutions included these reports as a regular agenda item at monthly board meetings. The most common quantitative reports included descriptions of CRE concentration by type and geographic diversification. Limits were established, and the reports provided a mechanism to review exposure and design risk mitigation strategies. Some of the qualitative reports included quarterly raw land, lot development, and construction loan reports with a detailed narrative summary of each project's current status, percentage of completion, expected completion date, and any completion or absorption issues. Repayment sources were described, as were other risk mitigation items of interest.

Market Analysis Is Often Overlooked

Examiners report that management could improve its practices of monitoring market conditions in its lending areas. There were numerous reports of institutions that either did not prepare a market analysis or prepared one that was incomplete or flawed.

Mitigation Practices. Some boards of directors, directors' committees, or loan committees mitigate this risk by maintaining contact with real estate brokers, developers, and builders and using the resulting information to establish maximum exposure limits.

Real estate markets and economic cycles are dynamic, and policy guidelines that were once adequate may, over time, become overly liberal. Management needs to monitor both local and regional economic trends, as well as any national trend that could impact the local economy, and adjust policy guidelines accordingly. Market analysis should include a review of concentrations by type of property compared to projects throughout the market, including completed, pipeline, and proposed developments.

Lenient Terms and Weak Loan Structuring Carry Risks

Examiners described a number of incidents in which institutions had relaxed underwriting standards for CRE loans. Conditions included

- Overreliance on collateral values instead of cash flow,
- Liberal use of interest reserves,
- Loans with one- to two-year balloon maturities secured by undeveloped land, and
- Unsecured loans and letters of credit granted for the purpose of investing in units of condominium projects (located primarily in the Southeastern United States).

Examiners also reported that many borrowers were not required or were unable to put equity into development projects, and material deposit relationships were either not required or unavailable.

Mitigation Practices. Repayment of any CRE loan is dependent upon the borrower's ability to produce cash flow from the project through either rental income or the sale of the property. Collateral value, while possibly providing certain protection, does not provide cash flow. Sound lending guidelines should help reduce exposure to borrowers with insufficient cash flow to meet the repayment terms. Along with good credit selection, an institution should develop strong policy guidelines with respect to loan-to-values, allowable exceptions, and reporting requirements. Slow or no principal reduction can erode the institution's collateral protection by allowing the loan-to-value to increase above prudent levels in depressed real estate markets. This is especially true of speculative construction lending, where slowing sales may prevent borrowers from carrying the debt for a period of time.

Oversight of the Appraisal Process May Be Weak

Examination findings indicated that oversight of the appraisal process was lacking in some institutions. Problems included

- Inadequate or missing internal reviews of appraisals,
- Violations of FDIC Rules and Regulations concerning appraisals (12 CFR 323—Appraisals[6]) for absent or inadequate appraisals,
- Funding loans prior to receipt of appraisals, and
- Including the proposed loan amounts on appraisal engagement letters.

In certain markets, banks had extended funds predicated on expected future gross sell-out values of condominium conversion and construction, as well as other development projects.

Mitigation Practices. Institutions that avoided these problems generally had strong internal appraisal review programs that provided an independent analysis of appraisals or internal evaluations prior to funding. In addition, these institutions reviewed the qualifications of their appraisers on an ongoing basis and removed those that did not consistently provide a product that conformed to the requirements outlined in 12 CFR 323—Appraisals. Loan policies and practices established guidelines for types of appraisals required on the basis of the type of project (speculative versus owner-occupied). These internal requirements were often more conservative than the standards established by 12 CFR 323.

Conclusions

Anecdotal information provided by the examiners suggests that many institutions would benefit from enhancements to their existing monitoring systems. The recently reported softening of real estate markets also implies that increased attention is warranted, given the risk exposure inherent in CRE lending. A robust program of measuring and monitoring CRE portfolios, with special attention to C&D exposure, is fundamental to effective risk mitigation.

While examiners have noted some degree of deterioration in underwriting practices, these practices have not adversely impacted the overall condition of most of the institutions. Capital levels are reported to be high, with over 99 percent of all insured institutions placing in the highest regulatory capital category at year-end 2005.[7] The levels of adversely

[6] See www.fdic.gov/regulations/laws/rules/2000-4300.html.

[7] *FDIC Quarterly Banking Profile,* Division of Insurance and Research, December 2005.

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classified assets and past-due loans are nominal, and earnings performance is strong, with net interest income providing most of the profit reported. A strong CRE market has also mitigated the potential ill effects of weakening lending standards over the past few years.

Where significant deficiencies were found, examiners made recommendations for corrective action. Many institutions initiated their own corrective action programs based upon those recommendations or upon the advice of internal and external auditors. In very few cases, informal and formal enforcement actions were necessary. On December 6, 2006, after careful consideration of comments received on proposed guidance on commercial real estate lending issued on January 13, 2006,[8] the Federal banking agencies issued Final Guidance on Concentrations in Commercial Real Estate Lending.[9] The guidance reminds institutions that strong risk management practices and appropriate levels of capital are important elements of a sound lending progrm and reinforces and enhances existing regulations and guidelines for safe and sound sound real estate lending. Many of the best practices identified in this article reflect long-standing supervisory expectations presented in Table 2.

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Table 2

Sound Practices for Commercial Real Estate Portfolio Oversight

The board of directors should approve the scope of lending activities and the way real estate loans are made, serviced, and collected. Market conditions, concentrations, and lending activity should be monitored, and timely and adequate reports should be made to the board of directors.

Internal and external factors should be considered in the formulation of loan policies and of a strategic plan considering the size and financial condition of the institution, the expertise and size of the lending staff, and market conditions.

Prudent underwriting standards should be developed that consider relevant credit factors, including the capacity of the borrower, income from the underlying property to service the debt, the value of collateral, the creditworthiness of the borrower, the level of equity invested, and any secondary sources of repayment.

Lending policies should reflect the level of risk that is acceptable to the board of directors and provide clear and measurable limits that include the maximum loan amount and maturities by type of property, amortization schedules, pricing structure for different types of real estate loans, loan-to-value limits by type of property, pre-leasing and pre-sale requirements, requirements for takeout commitments, and minimum covenants for loan agreements.

Loan administration procedures should address the type and frequency of financial statements required, type and frequency of collateral evaluations, collateral administration, requirements for adequate construction inspections and loan disbursements, and collections and foreclosure.

Refer to *Part 365 of the FDIC Rules and Regulations*—***Real Estate Lending Standards; Appendix A to Part 365—Interagency Guidelines for Real Estate Lending Policies.***

[8] FIL-4-2005, *Commercial Real Estate Lending Proposed Interagency Guidance,* January 13, 2006, www.fdic.gov/news/news/financial/2006/fil06004.html.

[9] PR-114-2006, *Joint Release/Federal Banking Agencies Issue Final Guidance on Concentrations in Commercial Real Estate Lending,* December 6, 2006, www.fdic.gov/news/news/press/2006/pr06114.html.