

**DEPARTMENT OF THE TREASURY**

**Office of the Comptroller of the Currency**

**[Docket No. 06-01]**

**BOARD OF GOVERNORS OF THE**

**FEDERAL RESERVE SYSTEM**

**[Docket No. OP-1248]**

**FEDERAL DEPOSIT INSURANCE CORPORATION**

**DEPARTMENT OF THE TREASURY**

**Office of Thrift Supervision**

**[No. 2006-01]**

**Concentrations in Commercial Real Estate Lending,**

**Sound Risk Management Practices**

**AGENCIES:** Office of the Comptroller of the Currency, Treasury (OCC); Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); and Office of Thrift Supervision, Treasury (OTS).

**ACTION:** Proposed guidance with request for comment.

**SUMMARY:** The OCC, Board, FDIC, and OTS (the Agencies), request comment on this proposed guidance entitled, Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (Guidance). The Agencies have observed that some institutions have high and increasing concentrations of commercial real estate loans on their balance sheets and are concerned that these concentrations may make the institutions more vulnerable to cyclical commercial real estate markets. This proposed Guidance helps identify institutions with commercial real estate loan concentrations that may be subject to greater supervisory scrutiny. As provided in the proposed Guidance, such institutions should have in place risk management practices and capital levels appropriate to the risk associated with these concentrations.

**DATES:** Comments must be submitted on or before [INSERT DATE 60 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER].

**ADDRESSES:** The Agencies will jointly review all of the comments submitted. Therefore, interested parties may send comments to any of the Agencies and need not send comments (or copies) to all of the Agencies. Please consider submitting your comments by e-mail or fax since paper mail in the Washington area and at the Agencies is subject to delay. Interested parties are invited to submit comments to:

**OCC:** You should include “OCC” and Docket Number 06-01 in your comment. You may submit your comment by any of the following methods:

- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.
- OCC Web Site: <http://www.occ.treas.gov>. Click on “Contact the OCC,” scroll down and click on “Comments on Proposed Regulations.”
- E-Mail Address: [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).
- Fax: (202) 874-4448.
- Mail: Office of the Comptroller of the Currency, 250 E Street, SW., Mail Stop 1-5, Washington, DC 20219.
- Hand Delivery/Courier: 250 E Street, SW., Attn: Public Information Room, Mail Stop 1-5, Washington, DC 20219.

**Instructions:** All submissions received must include the agency name (OCC) and docket number for this notice. In general, the OCC will enter all comments received into the docket without change, including any business or personal information that you provide. You may review comments and other related materials by any of the following methods:

- Viewing Comments in person: You may inspect and photocopy comments at the OCC's Public Information Room, 250 E Street, SW., Washington, DC. You can make an appointment to inspect comments by calling (202) 874-5043.
- Viewing Comments Electronically: You may request that we send you an electronic copy of comments via e-mail or mail you a CD-ROM containing electronic copies by contacting the OCC at [regs.comments@occ.treas.gov](mailto:regs.comments@occ.treas.gov).
- Docket Information: You may also request available background documents and project summaries using the methods described above.

**Board:** You may submit comments, identified by Docket No. OP-1248, by any of the following methods:

- Agency Web Site: <http://www.federalreserve.gov>. Follow the instructions for submitting comments at <http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm>.
- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.
- E-mail: [regs.comments@federalreserve.gov](mailto:regs.comments@federalreserve.gov). Include the docket number in the subject line of the message.
- FAX: 202/452-3819 or 202/452-3102.
- Mail: Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System, 20<sup>th</sup> Street and Constitution Avenue, NW., Washington, DC 20551.

All public comments are available from the Board's Web site at [www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm](http://www.federalreserve.gov/generalinfo/foia/ProposedRegs.cfm) as submitted, unless modified for technical reasons. Accordingly, your comments will not be edited to remove any identifying or contact information. Public comments may also be viewed in electronic or paper form in Room MP-500 of the Board's Martin Building (20th and C Streets, NW.) between 9 a.m. and 5 p.m. on weekdays.

**FDIC:** You may submit comments by any of the following methods:

- Agency Web Site: <http://www.fdic.gov/regulations/laws/federal/propose.html>. Follow the instructions for submitting comments on the Agency Web site.
- E-Mail: [Comments@FDIC.gov](mailto:Comments@FDIC.gov).
- Mail: Robert E. Feldman, Executive Secretary, Attention: Comments, Federal Deposit Insurance Corporation, 550 17th Street, NW., Washington, DC 20429.
- Hand Delivery/Courier: Guard station at the rear of the 550 17th Street Building (located on F Street) on business days between 7 a.m. and 5 p.m.

*Instructions:* All submissions received must include the agency name. All comments received will be posted without change to <http://www.fdic.gov/regulations/laws/federal/propose.html> including any personal information provided.

- Public Inspection: Comments may be inspected and photocopied in the FDIC Public Information Center, Room 100, 801 17<sup>th</sup> Street, NW, Washington, DC, between 9:00 a.m. and 4:30 pm. on business days.

**OTS:** You may submit comments, identified by docket number 2006-01, by any of the following methods:

- Federal eRulemaking Portal: <http://www.regulations.gov>. Follow the instructions for submitting comments.
- E-mail address: [regs.comments@ots.treas.gov](mailto:regs.comments@ots.treas.gov). Please include docket number 2006-01 in the subject line of the message and include your name and telephone number in the message.
- Fax: (202) 906-6518.
- Mail: Regulation Comments, Chief Counsel's Office, Office of Thrift Supervision, 1700 G Street, NW., Washington, DC 20552, Attention: No. 2006-01.
- Hand Delivery/Courier: Guard's Desk, East Lobby Entrance, 1700 G Street, NW., from 9 a.m. to 4 p.m. on business days. Address envelope as follows: Attention: Regulation Comments, Chief Counsel's Office, Attention: No. 2006-01.

*Instructions:* All submissions received must include the agency name and docket number for this proposed Guidance. All comments received will be posted without change to the OTS Internet Site at <http://www.ots.treas.gov/pagehtml.cfm?catNumber=67&an=1>, including any personal information provided.

*Docket:* For access to the docket to read background documents or comments received, go to <http://www.ots.treas.gov/pagehtml.cfm?catNumber=67&an=1>. In addition, you may inspect comments at the OTS's Public Reading Room, 1700 G Street, NW., by appointment. To make an appointment for access, call (202) 906-5922, send an e-mail to [public.info@ots.treas.gov](mailto:public.info@ots.treas.gov), or send a facsimile transmission to (202) 906-7755. (Prior notice identifying the materials you will be requesting will assist us in serving you.) We schedule appointments on business days between 10 a.m. and 4 p.m. In most cases, appointments will be available the next business day following the date we receive a request.

**FOR FURTHER INFORMATION CONTACT:**

**OCC:** Daniel Bailey, National Bank Examiner, Credit Risk Division, (202) 874-5170, Office of the Comptroller of the Currency, 250 E Street, S.W., Washington, DC 20219.

**Board:** Denise Dittrich, Supervisory Financial Analyst, (202) 452-2783; or Virginia Gibbs, Senior Supervisory Financial Analyst, (202) 452-2521; or Sabeth I. Siddique, Assistant Director, (202) 452-3861, Division of Banking Supervision and Regulation; or Mark Van Der Weide, Senior Counsel, Legal Division, (202) 452-2263. For users of Telecommunications Device for the Deaf ("TDD") only, contact (202) 263-4869.

**FDIC:** James Leitner, Senior Examination Specialist, Division of Supervision and Consumer Protection, (202) 898-6790, or Benjamin W. McDonough, Attorney, Legal Division, (202) 898-7411.

**OTS:** William Magrini, Senior Project Manger, (202) 906-5744, or Karen Osterloh, Counsel, (202) 906-6639.

## **SUPPLEMENTARY INFORMATION:**

### **I. Background**

The Agencies have observed that some institutions have high and increasing concentrations of commercial real estate loans on their balance sheets and are concerned that these concentrations may make the institutions more vulnerable to cyclical commercial real estate markets. The Agencies have previously issued regulations and guidelines that outline supervisory expectations for a safe and sound commercial real estate lending program. This proposed statement is intended to reinforce that guidance as it relates to institutions with concentrations in commercial real estate loans.

### **II. Principal Elements of the Guidance**

For the purposes of the proposed Guidance, the Agencies are focusing on concentrations in those types of commercial real estate (CRE) loans that are particularly vulnerable to cyclical commercial real estate markets. These include CRE exposures where the source of repayment primarily depends upon rental income or the sale, refinancing, or permanent financing of the property. Loans to REITs and unsecured loans to developers that closely correlate to the inherent risk in CRE markets would also be considered CRE loans for purposes of the proposed Guidance.

The proposed Guidance sets forth thresholds for assessing whether an institution has a CRE concentration and should employ heightened risk management practices. This Guidance is based upon the principles contained in the Agencies' real estate lending standards regulations and guidelines.

The proposed Guidance also reminds institutions with CRE concentrations that they should hold capital higher than regulatory minimums and commensurate with the level of risk in their CRE lending portfolios. In assessing the adequacy of an institution's capital, the proposed Guidance states that the Agencies will take into account the level of inherent risk in its CRE portfolio and the quality of its risk management practices.

### **III. Request for Comment**

The Agencies are requesting public comment on all aspects of the proposed Guidance. In particular, the Agencies request comment on the scope of the definition of CRE and on the appropriateness of the thresholds for determining elevated concentration risk.

The text of the proposed Guidance entitled, Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices follows:

#### **Purpose**

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (the Agencies) are jointly issuing this Guidance to address the increasing concentrations of commercial real estate loans at many institutions. The Agencies are concerned that concentrations in commercial real estate loans where repayment is primarily dependent on rental income or from the proceeds of the sale, refinancing or permanent financing of the property may expose institutions to

unanticipated earnings and capital volatility due to adverse changes in the general commercial real estate market.

This Guidance reinforces the Agencies' existing guidelines for real estate lending and safety and soundness.<sup>1</sup> This Guidance also provides criteria for identifying institutions with commercial real estate loan concentrations that may be subject to greater supervisory scrutiny. As provided in the Guidance, such institutions should have in place risk management practices and capital levels appropriate to the risk associated with these concentrations.

For purposes of this Guidance, commercial real estate (CRE) loans are exposures secured by raw land, land development and construction (including 1-4 family residential construction), multi-family property, and non-farm nonresidential property where the primary or a significant source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third party, non-affiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. Loans to REITs and unsecured loans to developers that closely correlate to the inherent risk in CRE markets would also be considered CRE loans for purposes of this Guidance.

## **Background**

In the past, weak CRE loan underwriting and depressed CRE markets have contributed to significant bank failures and instability in the banking system. While underwriting standards are generally stronger than those during previous CRE cycles, the Agencies have observed high concentrations in CRE loans at some institutions. The Agencies are concerned that these concentrations may make the institutions more vulnerable to cyclical CRE markets. Accordingly, institutions with such CRE concentrations should have both heightened risk management practices and levels of capital that are higher than the regulatory minimums and appropriate to the risk in their CRE lending portfolios.

Recent examinations have indicated that the risk management practices and capital levels of some institutions are not keeping pace with their increasing CRE concentrations. In some cases, the Agencies have observed that institutions have rapidly expanded their CRE lending operations into new markets without establishing adequate control and reporting processes, including the preparation of market analyses. The Agencies are also concerned when institutions with high CRE concentrations maintain capital levels near regulatory minimums. Minimum levels of regulatory capital do not provide institutions with an adequate cushion to absorb unexpected losses arising from loan concentrations and are inconsistent with the Agencies' capital adequacy guidelines.

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<sup>1</sup> Refer to the Agencies' regulations on real estate lending standards and the *Interagency Guidelines for Real Estate Lending Policies*: 12 CFR part 34, subpart D and appendix A (OCC); 12 CFR part 208, subpart E and appendix C (FRB); 12 CFR part 365 and appendix A (FDIC); and 12 CFR 560.100-101 (OTS). Refer to the *Interagency Guidelines Establishing Standards for Safety and Soundness*: 12 CFR part 30, appendix A (OCC); 12 CFR part 208, Appendix D-1 (FRB); 12 CFR part 364, appendix A (FDIC); and 12 CFR part 570, appendix A (OTS).

Institutions with a concentration in CRE loans should ensure the maintenance of capital levels that are commensurate with the risk of such concentrations.

### **Identification of Institutions with CRE Concentrations**

Institutions with CRE concentrations should have in place risk management practices consistent with this Guidance to mitigate the increased risks associated with such concentrations. To determine whether it has a concentration in CRE lending that warrants the use of heightened risk management practices, an institution, as a preliminary step, should use regulatory reports to determine whether it exceeds or is rapidly approaching the following thresholds:

- (1) Total reported loans for construction, land development, and other land<sup>2</sup> represent one hundred percent (100%) or more of the institution's total capital;<sup>3</sup> or
- (2) Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land<sup>4</sup> represent three hundred percent (300%) or more of the institution's total capital.

Institutions exceeding threshold (1) would be deemed to have a concentration in CRE construction and development loans and should have heightened risk management practices appropriate to the degree of CRE concentration risk of these loans in their portfolios and consistent with the Guidance set forth below. If an institution exceeds threshold (2), the institution should further analyze its loans and quantify the dollar amount of those that meet the definition of a CRE loan contained in this Guidance. If the institution has a level of CRE loans meeting the CRE definition of 300 percent or more of total capital, it should have heightened risk management practices that are consistent with the Guidance set forth below. The Agencies have excluded loans secured by owner-occupied properties from the CRE definition because their risk profiles are less influenced by the condition of the general CRE market.

This Guidance may be applied on a case-by-case basis to any institution that has had a sharp increase in CRE lending over a short period of time or has a significant concentration in CRE loans secured by a particular property type.

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<sup>2</sup> For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC-C item 1a. For Savings associations as reported in the Thrift Financial Report, schedule SC lines SC230, SC235, SC240, and SC265.

<sup>3</sup> For purposes of this Guidance, the term "total capital" means the total risk-based capital as reported for commercial banks in the Call Report (FFIEC 031 and 041 schedule RC-R – Regulatory Capital, line 21). For savings associations as reported in the Thrift Financial Report, CCR, Line CCR39.

<sup>4</sup> For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC-C items 1a, 1d, and 1e. For savings associations as reported in the Thrift Financial Report Schedule SC lines SC230, SC235, SC240, SC256, SC260, and SC 265.

## **Risk Management Principles**

The Agencies have previously issued regulations and guidance that outline supervisory expectations for a safe and sound real estate lending program. This statement is intended to reinforce that guidance as it relates to institutions with concentrations in CRE loans. The risk management and capital adequacy principles contained in this guidance are broadly prudent for all institutions involved in CRE lending.

**Board and Management Oversight.** The board of directors has ultimate responsibility for the level of risk taken by its institution. Directors, or a committee thereof, should explicitly approve the overall CRE lending strategy and policies of the institution. They should receive reports on changes in CRE market conditions and the institution's CRE lending activity that identify the size, significance, and risks related to CRE concentrations. Directors should use this information to provide clear guidance to management regarding the level of CRE exposures acceptable to the institution. The board also has the responsibility to ensure that senior management implements the procedures and controls necessary to comply with adopted policies. The board should periodically review and approve CRE aggregate risk exposure limits and appropriate sublimits (for example, by property type and geographic area) to conform to any changes in the institution's strategies and to respond to changes in market conditions. Directors should also ensure that management compensation policies are compatible with the institution's strategy and do not create incentives to assume unintended risks.

Management is responsible for implementing the CRE strategy in a manner that is consistent with the institution's stated risk tolerance. Management should develop and implement policies, procedures, and limits that provide for adequate identification, measurement, monitoring, and control of the CRE risks. The Agencies' real estate lending regulations require that each institution adopt and maintain a written policy that establishes appropriate limits and standards for all extensions of credit that are secured by liens on or interests in real estate, including CRE loans. The Interagency Guidelines for Real Estate Lending Policies state that loans exceeding the interagency loan-to-value (LTV) guidelines should be recorded in the bank's records and the aggregate amount of loans exceeding the LTV guidelines reported to the board at least quarterly. Examiners will continue to review these reports to determine whether the institution's exceptions are adequately documented and are appropriate in view of all relevant credit considerations. Further, the Agencies' appraisal regulations and related guidance require that each institution have an effective real estate appraisal and evaluation program that adequately supports its CRE lending activity.<sup>5</sup>

**Strategic Planning.** An institution's strategic plan should address the rationale for its CRE concentration levels relative to the institution's overall growth objectives and financial targets and capital levels. In developing its strategy as well as in continuous monitoring of CRE exposure, an institution should perform an analysis of the potential

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<sup>5</sup> Refer to the Agencies' appraisal regulations: 12 CFR part 34, subpart C (OCC); 12 CFR part 208, subpart E and 12 CFR part 225, subpart G (FRB); 12 CFR part 323 (FDIC); and 12 CFR part 564 (OTS).



effect of a downturn in real estate markets on both earnings and capital. The strategy should also include a contingency plan for responding to adverse market conditions. The contingency plan should address possible actions for mitigating CRE concentration risk and ensuring the adequacy of capital and reserves. If management believes the institution could reduce its CRE exposure by selling exposures, it should assess the marketability of the portfolio. This should include an evaluation of the institution's capabilities in accessing the secondary market and a comparison of its underwriting standards with those that exist in the secondary market.

**Underwriting.** An institution's lending policies should define the level of risk that is acceptable to its board of directors. Therefore, lending policies should provide clear and measurable underwriting standards and be consistent with the Agencies' real estate lending regulations and guidelines. Policy guidelines should be based on a careful review of internal and external factors that affect the institution, such as its market position, historical experience, present and prospective trade area, probable future loan and funding trends, staff capabilities, and technology.

Consistent with the Agencies' real estate lending standards, underwriting standards should include standards for:

- Maximum loan amount by type of property,
- Loan terms,
- Pricing structures,
- LTV limits by property type,
- Requirements for feasibility studies and sensitivity analysis or stress-testing,
- Minimum requirements for initial investment and maintenance of hard equity by the borrower, and
- Minimum standards for borrower net worth, property cash flow, and debt service coverage for the property.

Credit analysis should reflect both the borrower's overall creditworthiness and project-specific considerations.<sup>6</sup> Management should also compare the institution's underwriting standards for individual property types with those that exist in the secondary market. When an institution's standards are substantially more lenient, management should justify the reasons why the institution's risk criteria deviate from those of the secondary market and should document their long-term plans for these credits. Additionally, for development and construction loans, the institution should have sound policies and procedures governing loan disbursements to ensure that disbursements do not exceed actual development and construction costs. Prudent controls should include an inspection process, documentation on construction progress, tracking presales and preleasing, and exception reporting.

An institution's lending policies should permit exceptions to underwriting standards only on a limited basis. When an institution does permit an exception, it should document how the transaction does not conform to the institution's policy or underwriting standards, obtain appropriate management approvals, and provide reports to

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<sup>6</sup> Refer to the *Interagency Guidelines for Real Estate Lending Policies*: 12 CFR part 34, appendix A (OCC); 12 CFR part 208, appendix C (FRB); 12 CFR part 365, appendix A (FDIC); and 12 CFR 560.100-101 (OTS).

the board of directors detailing the number, nature, justifications, and trends for exceptions in a timely manner. Exceptions to both the institution's internal lending standards and the Agencies' supervisory LTV limits should be monitored and reported on a regular basis. Further, institutions should analyze trends in exceptions to ensure that risk remains within the institution's established risk tolerance limits.

**Risk Assessment and Monitoring of CRE Loans.** Institutions should establish and maintain thoroughly articulated policies that specify requirements and criteria for risk rating CRE exposures, ongoing account monitoring, identifying loan impairment, and recognizing losses. Risk ratings should be risk sensitive, objective, and tailored to the CRE exposure types underwritten by the institution. A strong risk rating system is important for maintaining the integrity of an institution's risk management system and in providing an early warning of emerging weaknesses. An institution's internal rating systems should consider an assessment of a borrower's creditworthiness and of an exposure's estimated loss severity to ensure that both the risk of the obligor and the transaction itself are clearly evaluated. When assigning risk ratings to CRE loans, an institution should consider the property's sensitivity to changes in macro and project-specific factors including variations in vacancy and rental rates, interest rates, and inflation rates.

Policies should address the ongoing monitoring of individual loans, including the frequency of account reviews, updating of borrower credit information, and status of leasing. Policies should require periodic comparisons of actual property performance information with projections at the time of original underwriting and the appraisal assumptions (for example, lease-up assumptions) to determine if any credit deterioration or value impairment has occurred. In addition, policies should specify the frequency with which transaction risk ratings should be reviewed to ensure they appropriately reflect the transaction's level of credit risk.

**Portfolio Risk Management.** Even when individual CRE loans are underwritten conservatively, large aggregate exposures to related sectors can expose an institution to an unacceptable level of risk. Therefore, an institution should measure and control CRE credit risk on a portfolio basis by identifying and managing concentrations, performing market analysis, and stress testing. A strong management information system is key to the successful implementation of a portfolio management system.

**Management Information System (MIS).** To accurately assess and manage portfolio concentration risk, the MIS should provide meaningful information on CRE portfolio characteristics that are relevant to the institution's lending strategy, underwriting standards, and risk tolerances. Institutions are encouraged, on either an automated or manual basis, to stratify the portfolio by property type, geographic area, tenant concentrations, tenant industries, developer concentrations, and risk rating. Institutions should be able to aggregate total exposure to a borrower including their credit exposure related to derivatives, such as interest rate swaps. MIS should maintain the appraised value at origination and subsequent valuations. Other useful stratifications include loan structure (for example, fixed rate or adjustable), loan type (for example, construction, mini perm, or permanent), loan-to-value limits, debt service coverage, policy exceptions

on newly underwritten credit facilities, and related loans (for example, loans to tenants). Management reporting should be timely and in a format that clearly shows changes in the portfolio's risk profile, including risk-rating migrations. In addition, the MIS should provide management with the ability to conduct stress test analysis of the CRE portfolio for varying scenarios. There should also be a well-defined, formal process through which management reviews and evaluates concentration and risk management reports, as well as special ad hoc analyses in response to market events.

Identifying and Managing Concentrations. Active oversight and monitoring by management is an important component of the management of CRE concentration risk. Management should continually evaluate the degree of potential correlation between related sectors and establish internal lending guidelines and limits that control the institution's overall risk exposure. An institution should combine and view as concentrations any groups or classes of CRE loans sharing significant common characteristics and similar sensitivity to adverse economic, financial, or business developments. Using established limits relevant to its lending strategy and portfolio characteristics, an institution should monitor and control its CRE concentrations.

Management should have strategies for managing concentration levels. The use of secondary market sales to institutional investors or securitizations is one example of a strategy for actively managing concentration levels without curtailing new originations. In addition, executing market sales provides corroboration that the institution's underwriting and pricing are consistent with market standards. Moreover, as firm take-out commitments have become rare, many institutions require that commercial construction loans be written to secondary market standards. Institutions with high levels of construction and development loans should closely monitor market conditions particularly when relying on permanent loan take-outs as a way of managing concentration levels.

In managing CRE concentration levels, institutions are also encouraged to consider other credit exposures correlated to the CRE market such as commercial mortgage-backed securities.

Market Analysis. Institutions should perform ongoing evaluations of the market conditions for the various property types and geographic areas or markets represented in their portfolio. Market analysis is particularly important as an institution expands its geographic scope of operations into new markets. In making decisions about new markets and new originations, market analysis should be an important evaluation criterion for individual credits as well as for the portfolio. Institutions should utilize multiple sources for obtaining market information such as published research data, monitoring new building permits, and maintaining contacts with local contractors, builders, real estate agents, and community development groups.

Management should ensure that the institution's CRE lending strategy and portfolio risk assessments integrate the findings of its market analysis and evaluation. Moreover, market information should provide management with sufficient information to determine whether revisions to its CRE lending strategy and policies are necessary to respond to identified market trends, and to form the basis for its stress testing.

Portfolio Stress Testing. Institutions should consider performing portfolio level stress tests of their CRE exposures to quantify the impact of changing economic scenarios on asset quality, earnings, and capital. The Agencies recognize that portfolio level stress testing is an evolving process and encourage institutions to consider its use as a risk management tool and to review periodically the adequacy of stress testing practices relative to their CRE exposures. The sophistication of stress testing practices should be consistent with the size and complexity of the institution's CRE loan portfolio.

Portfolio stress testing does not necessarily require the use of a sophisticated portfolio model. Depending on the risk characteristics of the CRE portfolio, it may be appropriate for a stress test to be as simple as an aggregation of the results of individual loan stress tests, testing the impact of ratings migration, or applying stressed historical loss rates to the portfolio. Stress tests should focus on the more vulnerable segments of an institution's CRE portfolio, given the prevailing market environment and the institution's business strategy.

Allowance for Loan Losses. Institutions also should consider CRE concentrations in their assessment of the adequacy of the allowance for loan and lease losses. *The Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions* provides guidance on criteria that institutions should consider when evaluating groups of loans with common risk characteristics.

### **Capital Adequacy**

The Agencies' capital adequacy guidelines note that institutions should hold capital commensurate with the level and nature of the risks to which they are exposed and that institutions with high or inordinate levels of risk are expected to operate well above minimum regulatory capital requirements. Minimum levels of regulatory capital<sup>7</sup> do not provide institutions with sufficient buffer to absorb unexpected losses arising from loan concentrations.<sup>8</sup> Failure to maintain an appropriate cushion for concentrations is inconsistent with the Agencies' capital adequacy guidelines. Moreover, an institution with a CRE concentration should recognize the need for additional capital support for CRE concentrations in its strategic, financial, and capital planning, including an assessment of the potential for future losses on CRE exposures.

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<sup>7</sup> Most CRE exposures are risk-weighted at 100 percent. By statute, however, certain loans made for the construction of single-family housing and certain multifamily housing loans are risk-weighted at 50 percent. See 12 U.S.C. § 1831n note (Risk-Weighting of Housing Loans for Purposes of Capital Requirements). The Agencies have codified these statutory risk-weighting requirements in their regulations at 12 CFR Part 3, Appendix A, Section 3 (OCC); 12 CFR Part 208, Appendix A, Section III. C. (FRB); 12 CFR Part 325, Appendix A, Section II.C. (FDIC); and 12 CFR 567.6(a)(1)(iii) (50% risk-weights for "qualifying multifamily mortgage loan" and "qualifying residential construction loan" as defined in 12 CFR 567.1) (OTS).

<sup>8</sup> Depending upon the level and nature of the CRE concentration, an institution may need to maintain capital at levels exceeding the "well capitalized" standard to ensure the overall sound financial condition of the institution.

In performing its internal capital analysis, an institution should make use of the results of any stress testing and other quantitative and qualitative analysis. The internal capital analysis should also reflect the possibility that any historical correlations used might not remain stable under stress conditions. For larger, more complex institutions that employ formal quantitative economic capital systems, the analysis of concentrations should provide for an adequate “cushion” above model outputs to compensate for potential uncertainties in risk measurement.

In assessing the adequacy of an institution’s capital, the Agencies will take into account analysis provided by the institution as well as an evaluation of the level of inherent risk in the CRE portfolio and the quality of risk management based on the sound practices set forth in this Guidance.

### **Supervisory Evaluation and Action**

The CRE sound practices set forth in this Guidance are effective methods for addressing the increased risks associated with CRE concentrations, and illustrate the types of practices that the Agencies consider important elements of sound risk management and adequate capital. An institution that is unable to adequately assess and meet its capital needs may be required to develop a plan for reducing its concentrations or for achieving higher capital ratios.

This concludes the text of the proposed Guidance entitled, Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices.

Dated: January 6, 2006.

John C. Dugan (signed)

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John C. Dugan,  
Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, January 10, 2006.

Jennifer J. Johnson (signed)

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Jennifer J. Johnson,  
Secretary of the Board.

Dated at Washington, D.C., this 9th day of January, 2006.

By order of the Federal Deposit Insurance Corporation.

Robert E. Feldman (signed)

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Robert E. Feldman,  
Executive Secretary.

Dated: January 9, 2006

By the Office of Thrift Supervision.

John M. Reich (signed)

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John M. Reich,  
Director.