DEPARTMENT OF THE TREASURY

Office of the Comptroller of the Currency

[Docket No. 06–14]

FEDERAL RESERVE SYSTEM

[Docket No. OP–1248]

FEDERAL DEPOSIT INSURANCE CORPORATION

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); and Federal Deposit Insurance Corporation (FDIC).

ACTION: Final guidance.

SUMMARY: The OCC, Board, and FDIC (the Agencies) are issuing final joint Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices (Guidance). This Guidance has been developed to reinforce sound risk management practices for institutions with high and increasing concentrations of commercial real estate loans on their balance sheets. This Guidance applies to national banks and state chartered banks (institutions). Further, the Board believes that the Guidance is broadly applicable to bank holding companies.

DATES: *Effective Date:* The final Guidance is effective December 12, 2006.

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SUPPLEMENTARY INFORMATION:

I. Background

The Agencies have observed that commercial real estate (CRE) concentrations have been rising over the past several years and have reached levels that could create safety and soundness concerns in the event of a significant economic downturn. To some extent, the level of CRE lending reflects changes in the demand for credit within certain geographic areas and the movement by many financial institutions to specialize in a lending sector that is perceived to offer enhanced earnings. In particular, small to mid-size institutions have shown the most significant increase in CRE concentrations over the last decade. CRE concentration levels [1] at commercial and savings banks with assets between $100 million and $1 billion have doubled from approximately 156 percent of total risk-based capital in 1993 to 318 percent in third quarter 2006. This same trend has been observed at commercial and savings banks with assets of $1 billion to $10 billion with concentration levels rising from approximately 127 percent in 1993 to approximately 300 percent in third quarter 2006.

While current CRE market fundamentals remain generally strong, and supply and demand are generally in balance, past history has demonstrated that commercial real estate markets can experience fairly rapid changes. For institutions with significant concentrations, the ability to withstand difficult market conditions will depend heavily on the adequacy of their risk management practices and capital levels. In recent examinations, the Agencies' examiners have observed that some institutions have relaxed their underwriting standards as a result of strong competition for business. Further, examiners also have identified a number of institutions with high CRE concentrations that lack appropriate policies and procedures to manage the associated risk arising from a CRE concentration. For these reasons, the Agencies are concerned with institutions' CRE concentrations and the risks arising from such concentrations.

To address these concerns, the Agencies published for comment proposed Interagency Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 FR 2302 (January 13,2006). The proposal set forth thresholds to identify institutions with CRE loan concentrations that would be subject to greater supervisory scrutiny. As provided in the proposal, an institution exceeding these thresholds would be deemed to have a CRE concentration and expected to have appropriate risk management practices as described in the proposed guidance.

After reviewing the public comment letters [2] on the proposal, the Agencies are now issuing final Guidance to remind institutions that there are substantial risks posed by CRE concentrations and that these risks should be recognized and appropriately addressed. The final Guidance describes sound risk management practices that are important for an institution that has strategically decided to concentrate in CRE lending. These risk management practices build upon existing real estate lending regulations and guidelines. The Agencies also have clarified that they are not establishing a limit on the amount of commercial real estate lending that an institution may conduct.

[1] CRE concentration levels for loans secured by real estate for (a) construction, land development, and other land loans; (b) multifamily residential properties; and (c) nonfarm nonresidential properties.

[2] The Agencies did receive a number of comment letters requesting a 30-day extension of the comment period, which the Agencies granted. *See* 71 FR 13215 (March 14, 2006).

In addition, the final Guidance includes supervisory criteria to help the Agencies' supervisory staff identify institutions that may have significant CRE concentration risk.

II. Proposed Guidance

The proposed guidance described the Agencies' expectations for heightened risk management practices for an institution with a concentration in CRE loans. Further, the proposal set forth two thresholds to identify institutions with CRE loan concentrations that would be subject to greater supervisory scrutiny. The proposal provided that such institutions should have in place the heightened risk management practices and capital levels set forth in the proposal.

The first proposed threshold stated that if loans for construction, land development, and other land were 100 percent or more of total capital, the institution would be considered to have a CRE concentration and should have heightened risk management practices. Secondly, if loans for construction, land development, and other land and loans secured by multifamily and nonfarm nonresidential property (excluding loans secured by owner-occupied properties) were 300 percent or more of total capital, the institution would also be considered to have a CRE concentration and should employ heightened risk management practices.

The proposal described the key risk management elements for an institution's CRE lending activity with an emphasis on those components of the risk management process that are particularly applicable to an institution with a CRE concentration, including: board and management oversight, strategic planning, underwriting, risk assessment and monitoring of CRE loans, portfolio risk management, management information systems, market analysis, and stress testing. The proposal also reminded institutions with CRE concentrations that they should hold capital exceeding regulatory minimums and commensurate with the level of risk in their CRE lending portfolios.

III. Overview of Public Comments

Collectively, the Agencies received over 4,400 comment letters on the proposed guidance. The OCC received approximately 1,700 comment letters, the Board had approximately 1,700 letters, and the FDIC had approximately 1,000 letters. The majority of comment letters were from regulated financial institutions and their trade groups.

Among the trade or other groups submitting comments were seven nationwide banking trade associations, 26 state banking trade associations, the Conference of State Bank Supervisors, three state financial institution regulatory agencies, the Appraisal Institute, the National Association of Home Builders, National Association of REITs, and Real Estate Roundtable. Additionally, during the comment period, the Agencies met with several industry groups.

The vast majority of commenters expressed strong opposition to the proposed guidance and believe that the Agencies should address the issue of CRE concentration risk on a case-by-case basis as part of the examination process. Many commenters contended that existing regulations and guidance are sufficient to address the Agencies' concerns regarding CRE concentration risk and the adequacy of an institution's risk management practices and capital.

Several commenters asserted that today's lending environment is significantly different than that of the late 1980s and early 1990s when regulated financial institutions suffered losses from their real estate lending activities due to weak underwriting standards and risk management practices. These commenters contended that regulated financial institutions learned their lessons from past economic cycles and that underwriting practices are now stronger.

Many community-based institutions, particularly Florida-based and Massachusetts-based institutions, opposed the proposed guidance and contended that the proposal would discourage community-based institutions from CRE lending and serving the needs of their communities. If community-based institutions were forced to reduce their CRE lending activity, these commenters asserted that there was the potential for a downturn in the economy, creating systemic problems beyond the risks in CRE loans.

While smaller institutions acknowledged that many community banks do concentrate in commercial real estate loans, they contended that there are few other lending opportunities in which community-based institutions can successfully compete against larger financial institutions. Community-based institutions commented that secured real estate lending has been their ''bread and butter'' business and, if required to reduce their commercial real estate lending activity, they would have to look to other types of lending, which have been historically more risky. Moreover, these commenters noted that community-based institutions are actively involved in their local communities and markets, which affords them a significant advantage when competing for CRE loan business. Community-based institutions also noted that their lending opportunities have dwindled as a result of competition from other types of financial institutions, such as finance companies, Farm Credit banks, and credit unions.

IV. Overview of Final Guidance

After carefully reviewing the comments on the proposed guidance, the Agencies have made significant changes to the proposal to clarify the purpose and scope of the Guidance. The Agencies continue to believe that it is important for institutions with CRE credit concentrations to assess the risk posed by the concentration and to maintain sound risk management practices and an adequate level of capital to address the risk. Therefore, while the final Guidance continues to emphasize these principles, the Agencies have revised the proposal to clarify that financial institutions play a vital role in providing credit for commercial real estate activity and to make clear that the Guidance does not establish a limit on an institution's CRE lending activity.

A discussion of the changes in the final Guidance from the proposal, major comments on the proposal, and the Agencies' responses follows.

A. Purpose

The final Guidance reminds institutions that sound risk management practices and appropriate capital levels are important when an institution has a CRE concentration. Like the proposal, the final Guidance reinforces and builds upon the Agencies' existing regulations and guidelines for real estate lending and loan portfolio management.

Commenters expressed concern that the proposal placed additional burden on institutions that already have sound practices in place to manage their CRE lending activity. Further, commenters contended that the Agencies have sufficient existing authority to address their concerns with an institution's CRE lending activity and that the Agencies' examination process affords the Agencies with ample opportunity to address weaknesses in an institution's lending practices.

The Agencies are issuing the final Guidance to remind institutions of the substantial potential risks posed by credit concentrations, especially in sectors such as CRE, which history has shown to have cycles that can, at much lower concentration levels, inflict large losses upon institutions. While most institutions are practicing sound credit risk management on a transaction basis, the Agencies believe this Guidance is necessary to emphasize the importance of portfolio risk management practices to address CRE concentration risk.

B. Scope

The final Guidance, like the proposal, focuses on CRE loans that have risk profiles sensitive to the condition of the general CRE market. This includes loans for land development and construction (including 1- to 4-family residential and commercial properties), other land loans, and loans secured by multifamily and nonfarm nonresidential properties (where the primary source of repayment is cash flows from the real estate collateral). Loans to REITs and unsecured loans to developers also are considered CRE loans for purposes of this Guidance if their performance is closely linked to the performance of the general CRE market.

Commenters noted that the identification of CRE loans in the current Consolidated Reports of Condition and Income (Call Report) did not correspond to the proposed guidance's CRE definition and did not constitute an accurate measurement of the volume of an institution's CRE loans that would be vulnerable to cyclical CRE markets. Commenters did acknowledge that the revisions to the Call Reports, effective in 2007, would address this inconsistency.

In response to these comments, the Agencies have clarified that the focus of the Guidance is on those CRE loans where the cash flow from the real estate collateral is the primary source of repayment rather than on loans to a borrower where real estate is a secondary source of repayment or is taken as collateral through an abundance of caution. This is consistent with the 2007 revisions to the Call Report.

Many commenters found the proposal's definition of CRE loans overly broad and failed to recognize unique risks posed by loans with different risk characteristics. Further, commenters asked for clarification as to the types of properties included in the scope of the Guidance, such as loans secured by motels, hotels, mini-storage warehouse facilities, and apartment complexes where the primary source of repayment is rental or lease income. A number of commenters contended that loans on certain types of CRE properties should not be considered CRE loans, including: Presold 1- to 4-family residential construction loans, multifamily loans, and loans to REITs.

Commenters recommended that the proposal should not cover residential construction loans where a house has been sold to a qualified borrower prior to the start of the construction. These commenters argued that presold 1- to 4-family residential construction loans carry far less risk than speculative home construction loans because the future homeowners are known and contractually obligated to purchase the home, and have passed a credit review prior to the commencement of construction. Commenters noted that their rationale for excluding presold 1- to 4-family residential construction is consistent with the proposal's exclusion of CRE loans on owner-occupied properties.

Further, commenters recommended that multifamily construction loans with firm takeouts or loans on completed multifamily properties with established rent rolls be excluded from the scope of the guidance. Commenters contended that multifamily residential loans have much less risk than CRE loans that have no firm takeout or established cash flow history.[3] One commenter noted that over the last 20 years, institutions have incurred minimal losses on multifamily loans and attributed this performance to strong underwriting and stability in rental properties.

The Agencies note that because the Guidance does not impose lending limits, its scope is purposely broad so that it includes those CRE loans, including multifamily loans, with risk profiles sensitive to the condition of the general CRE markets, such as market demand, changes in capitalization rates, vacancy rates, and rents. However, the Agencies believe that institutions are in the best position to segment their CRE portfolios and group credit exposures by common risk characteristics or sensitivities to economic, financial, or business developments. As explained in the final Guidance, institutions should be able to identify potential concentrations in their CRE portfolios by common risk characteristics, which will differ by property type. The final Guidance notes that factors, such as portfolio diversification, geographic dispersion, levels of underwriting standards, level of presold buildings, and portfolio liquidity, would be considered in evaluating whether an institution has mitigated the risk posed by a concentration. Further, the Agencies acknowledge in the final guidance that consideration should be given to the lower risk profiles and historically superior performance of certain types of CRE such as well-structured multifamily housing loans, when compared to others, such as speculative office construction.

C. CRE Concentration Assessment

The final Guidance contains a new section referred to as ''CRE Concentration Assessment'' that provides that institutions should perform their own assessment of concentration risk in their CRE loan portfolios. While the final Guidance does not establish a CRE concentration limit, the Agencies have retained high-level indicators to assist examiners in identifying institutions potentially exposed to CRE concentration risk. These are described in section IV.E of this preamble.

Many commenters noted that the proposal did not recognize the different segments in an institution's CRE portfolio and treated all CRE loans as having equal risk. A commenter noted that a concentration test cannot reflect the distinct risk profile within an institution's loan portfolio and that the risk profile is a function of many factors, including the institution's risk tolerance, portfolio diversification, the prevalence of guarantees and secondary collateral, and the condition of the regional economy.

In response to such comments, the Agencies have added a section on CRE Concentration Assessments to the final Guidance. The Agencies recognize that risk characteristics vary by different property types of CRE loans and that institutions are in the best position to identify potential concentrations by stratifying their CRE portfolios into segments with common risk characteristics. The Agencies believe an institution's board of directors and management should identify and monitor credit concentrations and establish internal concentration limits. The final Guidance clarifies that an institution actively involved in CRE lending should be able to identify concentrations in its CRE portfolio and to monitor concentration risk on an ongoing basis.

Commenters raised concern that the proposed thresholds would be perceived by examiners as *de facto* limits on an institution's CRE lending activity. The Agencies believe that the

[3] Another commenter, representing REITs, sought clarification as to whether the proposed guidance would apply to both secured and unsecured loans to REITs. This commenter asserted that unsecured loans to REITs should not be considered a CRE loan for purposes of the proposed guidance as the commenter believes that the risk of an unsecured loan to a REIT is mitigated by well-diversified cash flow comprising the sources of repayment. The final Guidance, like the proposal, applies to both secured and unsecured loans to REITs where repayment capacity is sensitive to conditions of the general CRE market. The Agencies note that the structure of such loans would be considered a mitigating factor when an institution analyzes the risk posed by such a concentration.

final Guidance addresses the concerns of commenters by placing the emphasis on the institution's own assessment of its CRE concentration risk rather than on the proposed concentration thresholds. In the final Guidance, the Agencies have responded to these concerns by specifically stating that the Guidance does not establish any specific limits on institutions' CRE lending activity. Moreover, in implementing the Guidance, the Agencies will take the necessary steps to communicate the purpose of the Guidance to their supervisory staffs to prevent any unintended consequences.

The final Guidance does incorporate the proposed concentration thresholds as part of the Agencies' supervisory oversight criteria for examiners to use as a starting point for identifying institutions that are potentially exposed to significant CRE concentration risk. The Agencies believe that these numerical supervisory screens will serve to promote consistent application of this Guidance across the Agencies as well as within an agency. The supervisory oversight and evaluation of an institution's CRE concentration risk are discussed in more detail in section IV.E. of the preamble.

D. Risk Management

The final Guidance, like the proposal, builds upon the Agencies' existing regulations and guidance for real estate lending and loan portfolio management, emphasizing those risk management practices that will enable an institution to pursue CRE lending in a safe and sound manner.

Many commenters acknowledged that the risk management principles described in the proposal should be viewed as prudent industry standards for an institution engaged in CRE lending. However, some commenters alleged that the proposed guidance would create additional regulatory burden at a time when institutions are already faced with other compliance responsibilities. Further, commenters noted that the Agencies needed to consider an institution's size and complexity in assessing the adequacy of risk management practices. This particular concern was raised with regard to the expectations for management information systems and portfolio stress testing that commenters found to be burdensome for smaller institutions.

In response to these comments, the Agencies have revised the final Guidance's risk management section to make the discussion more principle-based and to focus on those aspects of existing regulations and guidelines that deserve greater attention when an institution has a CRE concentration or is pursuing a CRE lending strategy leading to a concentration. As a result, the risk management section in the final Guidance sets forth the key elements of an institution's risk management framework for managing concentration risk. Further, the final Guidance recognizes the sophistication of an institution's risk management processes will depend upon the size of the CRE portfolio and the level and nature of its CRE concentration risk.

The final Guidance describes the key elements that an institution should address in board and management oversight, portfolio management, management information systems, market analysis, credit underwriting standards, portfolio stress testing and sensitivity analysis, and credit risk review function. In general, an institution with a CRE concentration should manage not only the risk of the individual loans but also the portfolio risk. Recognizing that an institution's board of directors has ultimate responsibility for the level of risk assumed by the institution, the Agencies believe that appropriate board oversight should address the rationale for an institution's CRE lending levels in relation to its growth objectives, financial targets, and capital plan.

The Agencies believe that the final Guidance's discussion of management information systems (MIS), market analysis, and portfolio stress testing addresses the concerns of smaller institutions regarding regulatory burden. The Agencies recognize that the level of sophistication of an institution's MIS, market analysis and stress testing will depend upon the size and complexity of the institution. Therefore, the focus of the final Guidance is on the ability of the institution to provide its management and board of directors with the necessary information to assess its CRE lending strategy and policies in light of changes in CRE market conditions. Regardless of its size, an institution should be able to identify and monitor CRE concentrations and the potential effect that changes in market conditions may have on the institution.

Some commenters requested clarification on the Agencies' expectations for stress testing. These commenters expressed concern that, as a result of the proposal, management's time would be diverted to creating reports and statistics with not much value. These commenters represented that an institution's focus should be on a loan review program, portfolio monitoring procedures, and loan loss reserves.

The Agencies agree with these comments and have revised the discussion on market analysis and stress testing. The final Guidance acknowledges that an institution's market analysis will vary by its market share and exposure levels as well as the availability of market data. Further, the final Guidance notes that portfolio stress testing does not require the use of sophisticated portfolio models. Depending on the institution, stress testing may be as simple as analyzing the potential effect of stressed loss rates on the institution's CRE portfolio, capital, and earnings. The important objective is that an institution should have the information necessary to assess the potential effect of market changes on its CRE portfolio and lending strategy.

Commenters questioned the proposed guidance's suggestion that institutions should compare their underwriting standards to those of the secondary commercial mortgage market. Commenters noted that there is not a ready secondary market for CRE loans made by smaller institutions as the loans are smaller in dollar size and have characteristics that make them unsuitable for securitization.

The Agencies recognize that smaller institutions do not have ready access to the secondary market and had not intended that the proposal be viewed in this way. Therefore, in the final Guidance, the Agencies have clarified the situations when an institution should conduct secondary market comparisons. If an institution's portfolio management strategy includes selling or securitizing CRE loans as a contingency plan for managing concentration levels, an institution should evaluate its ability to do so and compare its underwriting standards to those of the secondary market.

E. Supervisory Oversight

In the final Guidance, the Agencies have retained the concept of concentration thresholds as a supervisory tool for examiners to screen institutions for potential CRE concentration risk. The intent of these indicators is to encourage a dialogue between the Agency supervisory staff and an institution's management about the level and nature of CRE concentration risk. While the final Guidance is effective immediately upon publication in the **Federal Register**, the Agencies will provide institutions with CRE concentrations a reasonable timeframe over which to demonstrate that their risk management practices are appropriate for the level and nature of the concentration risk.

Commenters encouraged the Agencies to evaluate institutions' CRE concentrations on a bank-by-bank basis and not to take a ''one-size-fits-all'' approach to evaluating concentrations. Commenters asserted that an assessment of concentration risk based on the Agencies' proposed thresholds did not consider the differing risk characteristics of the subcategories of CRE loans. Further, commenters noted that the proposed thresholds did not consider whether or not an institution had an established history of managing a high CRE concentration.

In the final Guidance, the Agencies addressed the commenters' concerns by stating that numeric indicators do not constitute limits; rather they will be used as a supervisory monitoring tool. These indicators will assist examiners in identifying institutions with CRE concentrations. These indicators will function similarly to other analytical screens that the Agencies use to evaluate an institution. By including these indicators in the final Guidance, institutions will have an understanding of the Agencies' supervisory monitoring criteria. The Agencies also have tried to strike a balanced tone in the final Guidance to promote an appropriate and consistent application of these indicators by their supervisory staffs.

As explained in the final Guidance, an institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk. The supervisory criteria are:

(1) Total reported loans for construction, land development, and other land [4] represent 100 percent or more of the institution's total capital; [5] or

(2) Total commercial real estate loans as defined in the Guidance [6] represent 300 percent or more of the institution's total capital and the outstanding balance of the institution's CRE loan portfolio has increased 50 percent or more during the prior 36 months.

While the criteria will serve as a screen for identifying institutions with potential CRE concentration risk, the final Guidance notes that institutions should not view the criteria as a ''safe harbor'' if other risk indicators are present, regardless of the measurements under criteria (1) and (2). Further, the final Guidance notes that institutions experiencing recent, significant growth in CRE lending will receive closer supervisory review than other institutions that have demonstrated a successful track record of managing the risks in CRE concentrations.

In response to comments that the proposal concentration thresholds did not consider an institution's track record for managing CRE concentrations, the Agencies have included an additional condition to the 300 percent screen. The Agencies also will consider whether the institution's CRE portfolio increased by 50 percent or more during the prior 36 months. This additional screen acknowledges that the Agencies will be focusing on those institutions that have recently experienced a significant growth in their CRE portfolio and may not have been subject to prior supervisory review.

While most commenters opposed the adoption of any concentration thresholds, several commenters did comment on the appropriateness of the proposed CRE concentration thresholds. These commenters asserted that the proposed 300 percent threshold was too low and suggested that a benchmark from 400 to 600 percent of capital would be more appropriate.

As previously discussed, the Agencies have retained the 300 percent screen with an additional screen (that is, an institution's CRE portfolio increased by 50 percent or more during the prior 36 months). In developing the supervisory criteria, the Agencies relied on historical trends in concentration levels over real estate cycles, the relationship of CRE concentration levels to bank failures, and supervisory experience. Further, the final Guidance clarifies that the Agencies' supervisory staffs will consider other factors, and not just these indicators, in evaluating the risk posed by an institution's CRE concentration.

F. Assessment of Capital Adequacy

In the final Guidance, the section on the ''Assessment of Capital Adequacy'' was significantly revised to address the commenters' concerns that the proposal was too restrictive and did not take into account the institution's lending and risk management practices. The proposal stated that institutions should hold capital commensurate with the level and nature of their CRE concentration risks and that an institution with high or inordinate levels of risk would be expected to operate well above minimum regulatory capital requirements. In the final Guidance, the discussion on the adequacy of an institution's capital has been incorporated into the Supervisory Oversight section to clarify that the assessment of an institution's capital will be performed in connection with the supervisory assessment of an institution's risk management.

Commenters asserted that many institutions already hold capital at levels above minimum standards and should not be required to raise additional capital simply because their CRE concentrations exceeded a threshold. There also was concern that the proposal would give examiners the ability to arbitrarily assess additional capital requirements solely due to a high concentration.

The Agencies agree with commenters that the majority of institutions with CRE concentrations presently have capital exceeding regulatory minimums and would generally not be expected to increase their capital levels. However, since an institution's capital serves as a buffer against unexpected losses from its CRE concentration, an institution with a CRE concentration and inadequate capital should develop a plan for reducing its concentration or maintaining capital appropriate for the level and nature of the concentration risk. To the extent an institution with a CRE concentration has effective risk management practices or is addressing the need for such practices, the Agencies' concerns regarding capital adequacy are reduced. However, an institution with a CRE concentration and with no prospects of enhancing its risk management practices should address the need for additional capital. Therefore, the final Guidance reminds institutions that they should hold capital commensurate with the level and nature of the risks to which they are exposed.

Commenters noted that the allowance for loan and lease losses (ALLL) is another means of protection for an institution and, therefore, should be considered in determining whether capital is adequate for the level and nature of concentration risk. The Agencies agree with this comment and have addressed ALLL within the context of the capital adequacy section.

V. Text of the Final Joint Guidance

The text of the final joint Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices follows:

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[4] For commercial banks, this total is reported in the Call Report FFIEC 031 and 041 schedule RC–C item 1a.

[5] 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.

[6] For commercial banks, this total is reported in the Call Report FFIEC 031 and 041 schedule RC–C items 1a, 1d, 1e, and Memorandum Item #3.

Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices

Purpose

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively, the Agencies), are jointly issuing this Guidance to address institutions' increased concentrations of commercial real estate (CRE) loans. Concentrations of credit exposures add a dimension of risk that compounds the risk inherent in individual loans.

The Guidance reminds institutions that strong risk management practices and appropriate levels of capital are important elements of a sound CRE lending program, particularly when an institution has a concentration in CRE loans. The Guidance reinforces and enhances the Agencies' existing regulations and guidelines for real estate lending [1] and loan portfolio management in light of material changes in institutions' lending activities. The Guidance does not establish specific CRE lending limits; rather, it promotes sound risk management practices and appropriate levels of capital that will enable institutions to continue to pursue CRE lending in a safe and sound manner.

Background

The Agencies recognize that regulated financial institutions play a vital role in providing credit for business and real estate development. However, concentrations in CRE lending coupled with weak loan underwriting and depressed CRE markets have contributed to significant credit losses in the past. While underwriting standards are generally stronger than during previous CRE cycles, the Agencies have observed an increasing trend in the number of institutions with concentrations in CRE loans. These concentrations may make such institutions more vulnerable to cyclical CRE markets. Moreover, the Agencies have observed that some institutions' risk management practices are not evolving with their increasing CRE concentrations. Therefore, institutions with concentrations in CRE loans are reminded that their risk management practices and capital levels should be commensurate with the level and nature of their CRE concentration risk.

Scope

In developing this guidance, the Agencies recognized that different types of CRE lending present different levels of risk, and that consideration should be given to the lower risk profiles and historically superior performance of certain types of CRE, such as well-structured multifamily housing finance, when compared to others, such as speculative office space construction. As discussed under ''CRE Concentration Assessments,'' institutions are encouraged to segment their CRE portfolios to acknowledge these distinctions for risk management purposes.

This Guidance focuses on those CRE loans for which the cash flow from the real estate is the primary source of repayment rather than loans to a borrower for which real estate collateral is taken as a secondary source of repayment or through an abundance of caution. Thus, for the purposes of this Guidance, CRE loans include those loans with risk profiles sensitive to the condition of the general CRE market (for example, market demand, changes in capitalization rates, vacancy rates, or rents). CRE loans are land development and construction loans (including 1 - to 4-family residential and commercial construction loans) and other land loans.

CRE loans also include loans secured by multifamily property, and nonfarm nonresidential property where the primary 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, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. Loans to real estate investment trusts (REITs) and unsecured loans to developers also should be considered CRE loans for purposes of this Guidance if their performance is closely linked to performance of the CRE markets. Excluded from the scope of this Guidance are loans secured by nonfarm nonresidential properties where the primary source of repayment is the cash flow from the ongoing operations and activities conducted by the party, or affiliate of the party, who owns the property.

Although the Guidance does not define a CRE concentration, the ''Supervisory Oversight'' section describes the criteria that the Agencies will use as high-level indicators to identify institutions potentially exposed to CRE concentration risk.

CRE Concentration Assessments

Institutions actively involved in CRE lending should perform ongoing risk assessments to identify CRE concentrations. The risk assessment should identify potential concentrations by stratifying the CRE portfolio into segments that have common risk characteristics or sensitivities to economic, financial or business developments. An institution's CRE portfolio stratification should be reasonable and supportable. The CRE portfolio should not be divided into multiple segments simply to avoid the appearance of concentration risk.

The Agencies recognize that risk characteristics vary among CRE loans secured by different property types. A manageable level of CRE concentration risk will vary by institution depending on the portfolio risk characteristics, the quality of risk management processes, and capital levels. Therefore, the Guidance does not establish a CRE concentration limit that applies to all institutions. Rather, the Guidance encourages institutions to identify and monitor credit concentrations, establish internal concentration limits, and report all concentrations to management and the board of directors on a periodic basis. Depending on the results of the risk assessment, the institution may need to enhance its risk management systems.

Risk Management

The sophistication of an institution's CRE risk management processes should be appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risk to the institution. Institutions should address the following key elements in establishing a risk management framework that effectively identifies, monitors, and controls CRE concentration risk:

- Board and management oversight.
- Portfolio management.
- Management information systems.
- Market analysis.
- Credit underwriting standards.
- Portfolio stress testing and sensitivity analysis.
- Credit risk review function.

Board and Management Oversight. An institution's board of directors has ultimate responsibility for the level of risk assumed by the institution. If the institution has significant CRE concentration risk, its strategic plan should address the rationale for its CRE levels in relation to its overall growth objectives, financial targets, and capital

[1] Refer to the Agencies' regualtions 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); and 12 CFR part 365 and appendix A (FDIC). 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); and 12 CFR part 364, appendix A (FDIC).

plan. In addition, 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. Therefore, the board of directors or a designated committee thereof should:

- Establish policy guidelines and approve an overall CRE lending strategy regarding the level and nature of CRE exposures acceptable to the institution, including any specific commitments to particular borrowers or property types, such as multifamily housing.
- 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 sublimits (for example, by nature of concentration) to conform to any changes in the institution's strategies and to respond to changes in market conditions.

Portfolio Management. Institutions with CRE concentrations should manage not only the risk of individual loans but also portfolio risk. Even when individual CRE loans are prudently underwritten, concentrations of loans that are similarly affected by cyclical changes in the CRE market can expose an institution to an unacceptable level of risk if not properly managed. Management regularly should evaluate the degree of correlation between related real estate sectors and establish internal lending guidelines and concentration limits that control the institution's overall risk exposure.

Management should 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. Loan participations, whole loan sales, and securitizations are a few examples of strategies for actively managing concentration levels without curtailing new originations. If the contingency plan includes selling or securitizing CRE loans, management should assess periodically the marketability of the portfolio. This should include an evaluation of the institution's ability to access the secondary market and a comparison of its underwriting standards with those that exist in the secondary market.

Management Information Systems. A strong management information system (MIS) is key to effective portfolio management. The sophistication of MIS will necessarily vary with the size and complexity of the CRE portfolio and level and nature of concentration risk. MIS should provide management with sufficient information to identify, measure, monitor, and manage CRE concentration risk. This includes meaningful information on CRE portfolio characteristics that is relevant to the institution's lending strategy, underwriting standards, and risk tolerances. An institution should assess periodically the adequacy of MIS in light of growth in CRE loans and changes in the CRE portfolio's size, risk profile, and complexity.

Institutions are encouraged to stratify the CRE portfolio by property type, geographic market, tenant concentrations, tenant industries, developer concentrations, and risk rating. Other useful stratifications may include loan structure (for example, fixed rate or adjustable), loan purpose (for example, construction, short-term, or permanent), loan-to-value limits, debt service coverage, policy exceptions on newly underwritten credit facilities, and affiliated loans (for example, loans to tenants). An institution should also be able to identify and aggregate exposures to a borrower, including its credit exposure relating to derivatives.

Management reporting should be timely and in a format that clearly indicates changes in the portfolio's risk profile, including risk-rating migrations. In addition, management reporting should include a well-defined process through which management reviews and evaluates concentration and risk management reports, as well as special ad hoc analyses in response to potential market events that could affect the CRE loan portfolio.

Market Analysis. Market analysis should provide the institution's management and board of directors with information to assess whether its CRE lending strategy and policies continue to be appropriate in light of changes in CRE market conditions. An institution should perform periodic market analyses for the various property types and geographic markets represented in its portfolio.

Market analysis is particularly important as an institution considers decisions about entering new markets, pursuing new lending activities, or expanding in existing markets. Market information also may be useful for developing sensitivity analysis or stress tests to assess portfolio risk.

Sources of market information may include published research data, real estate appraisers and agents, information maintained by the property taxing authority, local contractors, builders, investors, and community development groups. The sophistication of an institution's analysis will vary by its market share and exposure, as well as the availability of market data. While an institution operating in nonmetropolitan markets may have access to fewer sources of detailed market data than an institution operating in large, metropolitan markets, an institution should be able to demonstrate that it has an understanding of the economic and business factors influencing its lending markets.

Credit Underwriting Standards. An institution's 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. When an institution has a CRE concentration, the establishment of sound lending policies becomes even more critical. In establishing its policies, an institution should consider both internal and external factors, such as its market position, historical experience, present and prospective trade area, probable future loan and funding trends, staff capabilities, and technology resources. Consistent with the Agencies' real estate lending guidelines, CRE lending policies should address the following underwriting standards:

- Maximum loan amount by type of property.
- Loan terms.
- Pricing structures.
- Collateral valuation.[2]
- Loan-to-Value (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.
- Minimum standards for borrower net worth, property cash flow, and debt service coverage for the property.

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

[2] Refer to the Agencies' appraisal regualtins: 12 CFR part 34, subpart C (OCC); 12 CFR part 208 subpart E and 12 CFR part 225, subpart G (FRB); and 12 CFR part 323 (FDIC).

document how the transaction does not conform to the institution's policy or underwriting standards, obtain appropriate management approvals, and provide reports to the board of directors or designated committee detailing the number, nature, justifications, and trends for exceptions. Exceptions to both the institution's internal lending standards and the Agencies' supervisory LTV limits [3] 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.

Credit analysis should reflect both the borrower's overall creditworthiness and project-specific considerations as appropriate. In addition, for development and construction loans, the institution should have policies and procedures governing loan disbursements to ensure that the institution's minimum borrower equity requirements are maintained throughout the development and construction periods. Prudent controls should include an inspection process, documentation on construction progress, tracking pre-sold units, pre-leasing activity, and exception monitoring and reporting.

Portfolio Stress Testing and Sensitivity Analysis. An institution with CRE concentrations should perform portfolio-level stress tests or sensitivity analysis to quantify the impact of changing economic conditions on asset quality, earnings, and capital. Further, an institution should consider the sensitivity of portfolio segments with common risk characteristics to potential market conditions. The sophistication of stress testing practices and sensitivity analysis should be consistent with the size, complexity, and risk characteristics of its CRE loan portfolio. For example, well-margined and seasoned performing loans on multifamily housing normally would require significantly less robust stress testing than most acquisition, development, and construction loans.

Portfolio stress testing and sensitivity analysis may not necessarily require the use of a sophisticated portfolio model. Depending on the risk characteristics of the CRE portfolio, stress testing may be as simple as analyzing the potential effect of stressed loss rates on the CRE portfolio, capital, and earnings. The analysis should focus on the more vulnerable segments of an institution's CRE portfolio, taking into consideration the prevailing market environment and the institution's business strategy.

Credit Risk Review Function. A strong credit risk review function is critical for an institution's self-assessment of emerging risks. An effective, accurate, and timely risk-rating system provides a foundation for the institution's credit risk review function to assess credit quality and, ultimately, to identify problem loans. Risk ratings should be risk sensitive, objective, and appropriate for the types of CRE loans underwritten by the institution. Further, risk ratings should be reviewed regularly for appropriateness.

Supervisory Oversight

As part of their ongoing supervisory monitoring processes, the Agencies will use certain criteria to identify institutions that are potentially exposed to significant CRE concentration risk. An institution that has experienced rapid growth in CRE lending, has notable exposure to a specific type of CRE, or is approaching or exceeds the following supervisory criteria may be identified for further supervisory analysis of the level and nature of its CRE concentration risk:

(1) Total reported loans for construction, land development, and other land [4] represent 100 percent or more of the institution's total capital;[5] or

(2) Total commercial real estate loans as defined in this Guidance [6] represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's commercial real estate loan portfolio has increased by 50 percent or more during the prior 36 months.

The Agencies will use the criteria as a preliminary step to identify institutions that may have CRE concentration risk. Because regulatory reports capture a broad range of CRE loans with varying risk characteristics, the supervisory monitoring criteria do not constitute limits on an institution's lending activity but rather serve as high-level indicators to identify institutions potentially exposed to CRE concentration risk. Nor do the criteria constitute a ''safe harbor'' for institutions if other risk indicators are present, regardless of their measurements under (1) and (2).

Evaluation of CRE Concentrations. The effectiveness of an institution's risk management practices will be a key component of the supervisory evaluation of the institution's CRE concentrations. Examiners will engage in a dialogue with the institution's management to assess CRE exposure levels and risk management practices. Institutions that have experienced recent, significant growth in CRE lending will receive closer supervisory review than those that have demonstrated a successful track record of managing the risks in CRE concentrations.

In evaluating CRE concentrations, the Agencies will consider the institution's own analysis of its CRE portfolio, including consideration of factors such as:

- Portfolio diversification across property types.
- Geographic dispersion of CRE loans.
- Underwriting standards.
- Level of pre-sold units or other types of take-out commitments on construction loans.
- Portfolio liquidity (ability to sell or securitize exposures on the secondary market).

While consideration of these factors should not change the method of identifying a credit concentration, these factors may mitigate the risk posed by the concentration.

Assessment of Capital Adequacy. The Agencies' existing capital adequacy guidelines note that an institution should hold capital commensurate with the level and nature of the risks to which it is exposed. Accordingly, institutions with CRE concentrations are reminded that their capital levels should be commensurate with the risk profile of their CRE portfolios. In assessing the adequacy of an institution's capital, the Agencies will consider the level and nature of inherent risk in the CRE portfolio as well as management expertise, historical performance, underwriting standards, risk management practices, market conditions, and any loan loss reserves allocated for CRE concentration risk. An institution with inadequate capital to serve as a buffer against unexpected losses from a CRE concentration should develop a plan for reducing its CRE concentrations or for maintaining capital appropriate to the level and nature of its CRE concentration risk.

[3] The Interagency Guidelines for Real Estate Lending state that loans exceeding the supervisory LTV guidelines should be recorded in the institution's records and reported to the board at least quarterly.

[4] For commercial banks as reported in the Call Report FFIEC 031 and 041, schdule RC–C, item la.

[5] For purposes of this Guidance, the term ''total capital'' means the total risk-based capital as reported fro commercial banks in the Call Report FFIEC 031 and 041 schedule RC–R—Regulatory Capital, line 21.

[6] For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC–C, items 1a, 1d, 1e, and Memorandum Item #3.

Dated: December 5, 2006.

John C. Dugan,

Comptroller of the Currency.

By order of the Board of Governors of the Federal Reserve System, December 6, 2006.

Jennifer J. Johnson,

Secretary of the Board.

Dated at Washington, DC, this 6th day of December 2006.

By order of the Federal Deposit Insurance Corporation.

Robert E. Feldman,

Executive Secretary.

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