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MANAGING RISK IN CRE LOAN PORTFOLIOS: AVOIDING CRITICAL MISTAKES

On January 13, 2006, the Federal banking agencies issued Final Guidance on Concentrations in Commercial Real Estate Lending. The guidance reminds institutions that strong risk management practices and appropriate levels of capital are important elements of a sound lending program and reinforces and enhances existing regulations and guidelines for safe and sound real estate lending. In practice however, many institutions have not fully incorporated this guidance into their lending policies. Recognizing common weaknesses and adopting recognized 'best practices' can significantly reduce credit and regulatory risk for an institution.

CRE Monitoring and Management Information Systems Can Reduce Risk

Many institutions have increased their exposure to CRE lending without a formal monitoring system or adequate consideration of concentration risk. Common deficiencies include:

- Failure to consider or establish limits of exposure by type or geographic market;
- Insufficiently detailed portfolio activity reporting limiting management's ability to make informed decisions;
- Failure to prepare timely or consistent concentration reports;
- Failure to recognize the increased risk related to speculative construction and development loans; and
- Inadequate or nonexistent stress testing

This lack of oversight often causes examiners to cite contraventions of FDIC Rules and Regulations, specifically Appendix A to Part 365—Interagency Guidelines for Real Estate Lending Policies at safety and soundness examinations, particularly among those institutions failing to monitor the loan portfolio for loan-to-value exceptions. Common deficiencies include:

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

In many cases, institutions whose aggregate amount of all loans in excess of the supervisory loan to-value limits routinely exceed 100% of total capital, in contravention of Appendix A of Part 365. Banks have sometimes granted extensions of credit of up to 75% of value to acquire raw land although the borrowers have no plans to develop this property in the near term. Certain institutions in high-growth areas have concentrations in excess of 150% of total capital for land development loans, but for purposes of measuring risk, internal monitoring does not differentiate actual land development loans from raw land loans or speculative investment land loans.

Best Practices

Effective internal controls and management information systems that monitor loan activity should be implemented to control the risk associated with CRE lending. Establishing policy limits appropriate to the bank's size, sophistication, and appetite for risk is fundamental to managing CRE concentration risk.

The primary element of a useful monitoring process is the integration of quantitative and qualitative data that provides a summary of the overall activities in the CRE portfolio in order to measure risk across all dimensions of the portfolio. The size of the portfolio should not be the sole consideration. Factors such as geographic diversification, types of property held as collateral, and underwriting practices should be considered in the development of any risk management process.

Active and meaningful monitoring programs depend on in-depth reports that are reviewed periodically either by committees of the board of directors or by the full board as a regular agenda item at monthly board meetings. The most common quantitative reports include descriptions of CRE concentration by type and geographic diversification. Qualitative reports include quarterly raw land, lot development, and construction loan reports with a detailed narrative summary of each project's current status, percentage of completion, expected completion date, and any completion or absorption issues. Repayment sources should be described as well as any other factors potentially affecting repayment.

Market Analysis Is Often Overlooked

Monitoring market conditions in a bank's lending areas cannot be overlooked. Institutions that either do not prepare a market analysis or prepared one that is incomplete or flawed may fail to recognize fundamental shifts in supply and demand, pricing, and other changes in market condition that directly impact repayment.

Best Practices

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

Institutions should maintain contact with real estate brokers, appraisers, developers, and builders and use the resulting information, in combination with market and property type specific news services, to establish maximum exposure limits appropriate to the risk appetite of the bank.

Easy Terms and Weak Loan Structuring Carry Risks

In a fiercely competitive lending environment, many institutions have relaxed underwriting standards for CRE loans. Common loan structures have included:

- Over reliance on collateral values instead of cash flow (often on prospective or "as-complete" values rather than "as-is" values),
- Limited or no borrower equity in development projects and limited or no material deposit relationships,
- Liberal use of interest reserves,
- Loans with short term balloon maturities secured by undeveloped land, and
- Unsecured loans and letters of credit granted for the purpose of investing in units of condominium projects (located primarily in the Southeastern United States).

Best Practices

Repayment of any CRE loan is ultimately dependent upon the borrower's ability to produce cash flow from the project through either rental income or the sale of the property. Collateral value, while possibly providing certain protection, does not provide cash flow. Sound lending guidelines should help reduce exposure to borrowers with insufficient cash flow to meet the repayment terms.

Along with good credit selection, an institution should develop strong policy guidelines with respect to loan-to-values, allowable exceptions, and reporting requirements. Slow or no principal reduction can erode the institution's collateral protection by allowing the loan-to-value to increase above prudent levels in depressed real estate markets. This is especially true of speculative construction lending, where slowing sales may prevent borrowers from carrying the debt for a period of time.

Oversight of the Appraisal Process May Be Weak

Oversight of the appraisal process is frequently lacking in institutions. Common problems include:

- Inadequate or missing internal reviews of appraisals,
- Violations of FDIC Rules and Regulations concerning appraisals (12 CFR 323—Appraisals) for absent or inadequate appraisals,
- Funding loans prior to receipt of appraisals,

- Including the proposed loan amounts on appraisal engagement letters, and
- In certain markets, extending funds predicated on expected future gross sell-out values of condominium conversion and construction, as well as other development projects.

Best Practices

Institutions that avoid these problems generally have strong internal appraisal review programs that provide an independent analysis of appraisals or internal evaluations prior to funding. In addition, these institutions review the qualifications of their appraisers on an ongoing basis and removed those that do not consistently provide a product that conformed to the requirements outlined in 12 CFR 323—Appraisals.

Loan policies and practices should establish guidelines for the types of appraisals required on the basis of the type of project (speculative versus owner-occupied). These internal requirements should be consistent with the standards established by 12CFR 323 - or even more conservative.

Conclusions

Many institutions can benefit from enhancements to their existing monitoring systems. Softening of commercial real estate markets also implies that increased attention is warranted, given the risk exposure inherent in CRE lending. A robust program of measuring and monitoring CRE portfolios, with special attention to C&D exposure, is fundamental to effective risk mitigation.

A historically strong CRE market cloaked the potential ill effects of weakening lending standards over the past few years. As markets have unraveled, examiners have been aggressively making recommendations for corrective action. Many institutions have initiated their own corrective action
programs based upon those recommendations or upon the advice of internal and external auditors. In very few cases, informal and formal enforcement actions were necessary.

Best Practices for Commercial Real Estate Portfolio Oversight

- The board of directors should approve the scope of lending activities and the way real estate loans are made, serviced, and collected. Market conditions, concentrations, and lending activity should be monitored, and timely and adequate reports should be made to the board of directors.
- Internal and external factors should be considered in the formulation of loan policies and of a strategic plan considering the size and financial condition of the institution, the expertise and size of the lending staff, and market conditions.
- Prudent underwriting standards should be developed that consider relevant credit factors, including the capacity of the borrower, income from the underlying property to service the debt, the value of collateral, the creditworthiness of the borrower, the level of equity invested, and any secondary sources of repayment.
- Lending policies should reflect the level of risk that is acceptable to the board of directors and provide clear and measurable limits that include the maximum loan amount and maturities by type of property, amortization schedules, pricing structure for different types of real estate loans, loan-to-value limits by type of property, pre-leasing and pre-sale requirements, requirements for takeout commitments, and minimum covenants for loan agreements.
- Loan administration procedures should address the type and frequency of financial statements required, type and frequency of collateral evaluations, collateral administration, requirements for adequate construction inspections and loan disbursements, and collections and foreclosure.

For additional information, refer to Part 365 of the FDIC Rules and Regulations—Real Estate Lending Standards; Appendix A to Part 365—Interagency Guidelines for Real Estate Lending Policies or contact ENSO Advisors, LLC.