New Bank Supervisory Expectations for Commercial Real Estate Credit Concentration

by Francis X. Grady

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On January 10, 2006, the four federal bank and thrift regulatory agencies issued proposed guidance on commercial real estate ("CRE") lending credit concentration. Reinforcing existing guidelines for real estate lending safety and soundness, the proposed interagency guidance provides criteria for identifying institutions with CRE loan concentrations that may warrant greater supervisory scrutiny. The Federal Reserve, the OCC, the OTS and the FDIC observed that some institutions have high and increasing concentrations of CRE loans on their balance sheets that make these institutions more vulnerable to cyclical CRE markets. As reported in the *American Banker*, CRE concentrations are roughly double the level 15 years ago.[1]

The agencies offer guidelines concerning how a bank should determine if the institution's CRE concentration warrants the use of heightened risk management practices. As a preliminary step, the guidance suggests banks use call report data to determine whether the bank exceeds or is rapidly approaching the following thresholds:

> 1.) Total reported loans for construction, land development, and other land[2] represent 100% or more of the institution's total capital; or
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> 2.) Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land represent 300% or more of the institution's total capital.

Institutions exceeding the 100% of capital threshold for construction and land development lending would be deemed to have a concentration in construction and development loans and should have heightened risk management practices appropriate to the degree of concentration risk in their loan portfolios. If an institution exceeds the 300% of capital threshold for construction, land development, and other land secured by multifamily and nonfarm nonresidential properties, the bank should further analyze the loan portfolio and quantify the dollar amount of loans that meet the definition of a CRE loan. The agencies propose to exclude loans secured by owner-occupied, CRE properties from the CRE loan

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[1] "Retired OCC Exec Still Has Concerns", *American Banker Online*, March 2, 2006.

[2] For commercial banks, "construction, land development, and other land loans" are reported in the call report FFIEC 031 and 041 Schedule RC-C item 1.a. The relevant call report instructions provide that loans secured by real estate made to finance land development (*i.e.*, the process of improving land - laying sewers, water pipes, *etc.*) preparatory to erecting new structures or the on-site construction of industrial, commercial, residential, or farm buildings are reported in this item. For this item, "construction" includes not only construction of new structures, but also additions or alterations to existing structures and the demolition of existing structures to make way for new structures.

definition because the risk profiles of owner-occupied, CRE are less influenced by the condition of the general CRE market. Because current call report instructions are silent on the distinction between owner-occupied, CRE loans and nonowner-occupied CRE loans, management should identify CRE loans qualifying for the owner-occupied exclusion.

As reported in the *American Banker* on March 3, 2006[3], observers have stated that as many as one-third of all banks and thrifts would meet one of the two criteria and have to comply with new guidelines. But in an internal memo leaked to the *American Banker*, the FRB reported the actual number of banks exceeding the 300% of capital threshold would be much lower because the guidelines would exclude CRE loans involving owner-occupied properties.[4] Whether the internal prediction of Federal Reserve Board staff is correct or the more dire prediction reported by industry supervisors in the March 3, 2006 *American Banker* proves to be true, the vast majority of these at-risk banks have less than $1 billion of assets and are located in the nation's fastest growing regions (the West and Southeast), areas with booming CRE markets.

According to analysis of the median CRE loan concentration to Tier 1 capital ratios from the FDIC's third quarter 2005 State Profiles for Arizona, California, Idaho, Nevada, Oregon, and Washington, the average median CRE lending concentration to Tier 1 capital for those six western states was 438.4%. The FDIC's State Profiles reports that the CRE loan concentration measures the median ratio of CRE loans divided by Tier 1 capital as of the end of the period for FDIC-insured institutions headquartered in a state. CRE lending for purposes of the FDIC's State Profiles includes construction and development, multifamily, and nonresidential real estate lending. The FDIC's web page shows Arizona and Nevada with the first and second highest ratios in the country of CRE loans to Tier 1 capital. For example, Nevada banks have a median ratio of CRE loans to Tier 1 capital of 479.6%. Land development loans in the booming CRE markets of the West are a prominent contributor to loans that count toward the 300% of total capital threshold.

Banks should determine how much of the bank's CRE loan portfolio reported on Item 1.e of call report Schedule RC-C is owner-occupied CRE. If CRE loans (exclusive of owner-occupied CRE loans), combined with loans for construction, land development, and other land, are less than 300% of the bank's total capital reported on call report Schedule RC-R--Regulatory Capital, line 21, the bank would not be subject to heightened risk management practices as described in the January 10, 2006 proposed interagency CRE credit concentration guidance. Western community bank boards would be wise to document the institution's enhanced prudent risk management undertaken commensurate with the level of CRE lending and construction and land development lending the institution follows as a business strategy.

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[3] "Small Banks' Dim View of CRE Proposal", *American Banker Online*, March 3, 2006.

[4] "CRE Guidelines Would Affect Fewer Banks", *American Banker Online*, January 27, 2006