



FEDERAL RESERVE BANK OF SAN FRANCISCO
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COMMERCIAL REAL ESTATE HORIZONTAL REVIEW EXECUTIVE SUMMARY

Background

This document provides findings and recommendations of a recent commercial real estate (CRE) horizontal review conducted by the Federal Reserve Bank of San Francisco. We initiated this project in late 2002 given the concern associated with high and increasing levels of CRE loan concentrations at banks throughout the 12th Federal Reserve District. Twelve state member banks were included in the review and were selected based on their geographic location and level of CRE concentrations.

Additional details regarding the background, purpose and objectives of the project may be found in *Section I* of the attachment beginning page 4. The *six key findings* from the review are summarized below and discussed in more detail in *Section II* of the attachment on page 6. Our *recommendations* for best practices are summarized in *Section III* of the attachment beginning page 10. The *Appendices* (see separate document) contain additional information related to a number of our findings and recommendations and include several resources and sound practices that should prove to be valuable to banks in managing and controlling concentration risk.

Summary of Findings

Over the past several years many banks in the U.S., particularly those in the Federal Reserve's 12th District, have individually and collectively reported high and increasing levels of concentrations in loans secured by commercial real estate.¹ The median CRE concentration ratio for banks in our district jumped from 307 percent in December 2000 to 379 percent as of December 2003, which is significantly higher than the national median and illustrates that growth in CRE lending has far outpaced capital formation in recent years. The risk associated with increasing concentration levels is also compounded by the cyclical and potentially volatile nature of the CRE industry.² Furthermore, CRE risk has increased in many areas given the deterioration in a number of real estate markets in recent years, which has resulted in increased scrutiny by bank regulators throughout our district as well as other districts.

We conducted this multi-phase project over an eighteen month period to determine how community state member banks in our District evaluated, monitored, and managed their exposure to CRE concentration risk at the portfolio level. The on-site review portion of the project, which included the participation of several state agencies, was critical and was designed to evaluate the full (and true) nature of CRE-related exposure. These reviews also assessed CRE credit risk at the individual loan level and attempted to gain a better understanding of how market risk impacts those credits and portfolios.

¹ CRE loans include loans for the purpose of construction and land development, loans secured by nonfarm nonresidential properties, loans secured by multifamily residential properties, loans secured by farmland, and other loans to finance construction and land development.

² Real estate markets have historically been cyclical due to a variety of factors that cause an imbalance between the supply and demand of CRE projects. The collapse of real estate, coupled with weakened underwriting, contributed to heavy losses in the 1980's and 1990's.

Some of the questions we attempted to answer through our review included the following:

- *At what level are CRE concentrations considered too high?*
- *How should capital adequacy be evaluated for banks with significant CRE concentrations?*
- *How is the risk associated with increasing concentrations compounded by the CRE market risk?*
- *What should our expectations be for management and directors with respect to strategic planning?*
- *What “sound practices” are banks currently using with respect to concentration management?*

The review has allowed us to develop and pilot a work-program that helps our examiners focus on the questions noted above. In addition, it has identified several effective sound practice approaches to better manage concentration risk. We have also identified gaps in regulatory guidance and, as such, have developed broad guidelines to assist our examiners in assessing the effectiveness of how banks manage and control concentration risk.

As further detailed in Section II of the attachment, our review resulted in six key findings regarding how banks monitor and manage concentration risk:

1. ***Many banks remain vulnerable to CRE lending risk*** because of extremely high concentration levels and difficult market conditions. Still, the overall quality of CRE portfolios remains sound.
2. ***Management and directors generally did not formally acknowledge CRE lending and high CRE concentrations in their strategic plans.*** Most have not developed well-supported limits.
3. ***Few banks adequately manage portfolio-wide concentration risk.*** Most have not developed management reports that give them a portfolio-wide perspective of their aggregate concentration risk. Our project also noted that, while banks generally subject individual CRE loans to stress testing, most do not utilize portfolio-wide stress testing. Stress testing, as a risk management tool for managing concentration risk, is not part of the current community bank regulatory framework but we believe it to be a prudent approach for institutions where CRE lending is a primary business line.
4. ***Most banks did not consider concentration risk in their capital planning,*** despite the significant exposures.
5. ***Banks adequately managed credit risk at the individual loan or transaction level*** through solid underwriting and credit administration practices. Nonetheless, opportunities for improvement exist.
6. ***Many banks maintained loan grading systems that lacked granularity and did not adequately differentiate risk.*** In addition, pricing did not reflect the inherent risk associated with the credit.

Given these findings, the Federal Reserve has articulated supervisory expectations for banks to enhance their overall management of CRE concentration risks. Briefly, banks with high CRE concentrations need to:

1. ***Have well defined strategies that explicitly acknowledge concentration risks and well-supported concentration limits in relation to the bank’s capital,*** including supporting the rationale for high concentration levels, contingency actions in the event that CRE lending targets are not met, and strategies for mitigating concentration risks;

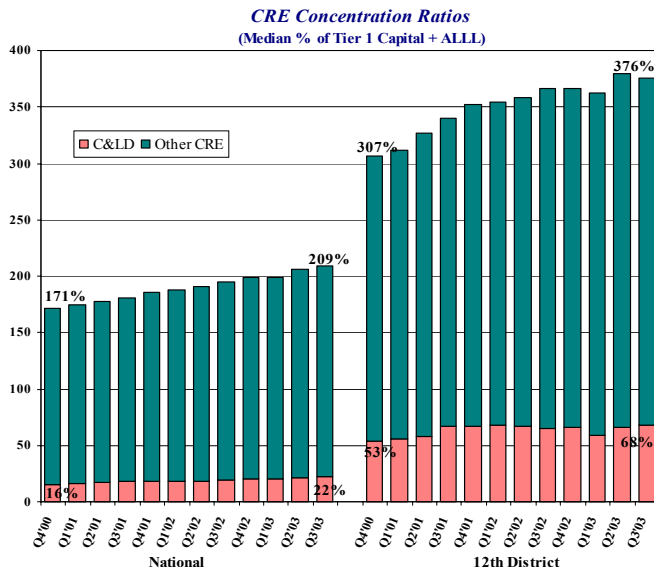
2. ***Implement portfolio-wide management techniques***, including enhanced systems for measuring and stratifying and MIS for reporting CRE concentrations across the portfolio, policies and procedures for conducting sensitivity analysis at both an individual loan level and on a portfolio-wide basis, and formal process for assessment real estate markets and including that assessment in the management of CRE concentrations;
3. ***Implement an enhanced capital planning process*** that includes an assessment and a quantification of capital in light of risks posed by the concentration in CRE loans and the incorporation of stress testing results;
4. ***Implement underwriting practices to ensure the quality of individual CRE loans***, including strong appraisal review procedures, analysis of borrowers' cash flow and debt service ability, and required periodic reviews of borrowers' financial condition (*e.g.*, operating statements, rent roll and the like); and
5. ***Implement enhanced loan risk ratings and pricing***, so that loan risk ratings provide a more accurate and meaningful distinction between loans that have different inherent risk and pricing decisions are explicitly linked to the inherent credit risk of a loan.

COMMERCIAL REAL ESTATE HORIZONTAL REVIEW

SECTION I: BACKGROUND, PURPOSE AND OBJECTIVES

Rationale for the CRE Project

As shown here, the median CRE concentration ratio for banks in our District rose significantly over the past three years to 379 percent as of December 2003. This level is significantly higher than the national median and illustrates that growth in CRE lending has far outpaced capital formation in recent years. Community banks continue to face challenges relating to CRE concentrations and remain vulnerable to CRE lending risks because of these very high concentration levels and difficult market conditions. Accordingly, these factors have heightened our supervisory concern and have resulted in increased regulatory scrutiny. Nonetheless, banks continue to increase their CRE concentrations for a number of reasons, including the following:



- Higher demographic and economic growth rates in the “sunbelt” and Western states, which resulted in increased supply and demand for CRE lending as well as increased bank competition.
- Community banks have lost market share through disintermediation of many loan types including residential mortgages, credit cards and consumer loans. Accordingly, many banks view CRE lending as one of the few remaining profitable business lines.
- In some markets, bankers are unwilling to invest heavily in traditional commercial and industrial (C&I) loans because they perceive a higher risk in these loans. This perception is based, in part, on (a) preference for real estate collateral to other collateral types, (b) historically higher charge off rates over the past 12 years for C&I loans, and (c) greater possibility of fraud and deception with accounts receivable and inventory lending compared with real property.
- Basel I capital guidelines provided a uniform risk weighting for both C&I and CRE loan types irrespective of loan quality. This leads banks to seek higher returns by going after riskier loans (“regulatory capital arbitrage”). Moreover, the guidelines weight C&I loans and CRE loans equally, i.e., both loans carry a uniform 100 percent risk weighting.
- Yields on C&I loans are becoming less advantageous compared with yields on other asset types, particularly real estate loans. This is particularly relevant in times of declining net interest margins.

While CRE lending continues to increase, CRE market conditions have declined in many areas over the past few years, as evidenced by high vacancy rates, depressed rents, and low absorption levels. Markets in the San Francisco Bay Area lead the nation in rent declines, with office rents down 53 percent from their 2001 peak. Fortunately, these weaknesses have not yet been reflected in the overall quality of CRE portfolios at most District banks. CRE delinquencies and charge-offs remain relatively low, especially when compared with the prior economic downturn. The current performance is attributed to a number of factors including lower interest rates, higher levels of CRE securitization and transparency along with greater degrees of regulatory oversight and stricter lending requirements.

Given the current strength of CRE portfolios, coupled with improving trends in regional and national economies, many would expect CRE loan quality to remain sound. However, several studies indicate that there is a natural lag between declining rents and declining cash flows on commercial properties which could ultimately impact the quality and performance of these portfolios. Because lease terms are often between three and five years, it may take several years before leases are renewed at the lower rates. This in turn leads to lower net operating income (NOI), which is expected to occur in many metropolitan areas. Consequently, a number of CRE properties could deteriorate to the point where NOI falls below the debt service coverage within the next two to three years. The likelihood of such an event increases for those loans with lower debt service coverage ratios, especially during periods of rising interest rates.

Project Overview

A critical part of our CRE project included on-site reviews at twelve of our state member banks. The reviews were performed by a team of senior examiners in two phases, from October 2002 through September 2003. Banks selected for the review were located in Arizona, California, Nevada, Utah, and Washington. The size of the institutions ranged from approximately \$70 million to nearly \$2 billion, with CRE concentration levels that ranged from 334 percent to 640 percent of tier 1 capital and reserves.

The reviews moved beyond the horizontal review that was conducted by this Reserve Bank in 2000, which consisted primarily of interviews and off-site evaluations. The on-site reviews of the 2003 project were designed to evaluate the full nature of CRE-related exposure and to develop a better understanding of how banks manage concentration risk. A guiding principle of the project was to review real estate lending practices in light of current economic conditions and to think more critically about our supervisory strategies for institutions with high levels of CRE concentration and related risk.

Project Objectives

The primary purpose of our review was to identify and evaluate how community banks in our District evaluated, monitored, and managed their exposure to CRE concentration risk at the portfolio level and CRE credit risk at the individual loan level. We also attempted to develop a more current perspective on the relationships between CRE concentration levels and the levels of capital and loan loss reserves. In summary, our key objectives included the following:

- ***Determine the level of CRE concentration risk and overall quality of CRE loans at each institution.*** Use internal reports and transaction testing to better understand portfolio composition and quality.
- ***Identify effective processes for managing portfolio-wide concentration risk.*** Expand our understanding of how banks identify and manage CRE exposures and evaluate different management systems in order to determine the most effective approaches.
- ***Identify effective processes for managing credit risk at the individual loan level.*** Use transaction testing to evaluate underwriting standards and monitoring procedures in a sample of credits.
- ***Ensure consistent regulatory treatment among banks in our District.*** Determine if existing guidelines are appropriate. Develop guidelines to ensure banks are treated consistently throughout the District in terms of the supervisory approach considering the relationship between CRE concentration levels, market risk, capital levels, and mitigating internal controls at each bank.

SECTION II: PROJECT FINDINGS

1. Banks Remain Vulnerable to CRE Concentration Risk

Many banks in our District remain vulnerable to the inherent risk associated with high levels of CRE concentrations. The historical volatility of real estate markets, coupled with the current economic environment and recent deterioration in local CRE markets, have exacerbated the banks' concentration risk. Furthermore, management supervision and board oversight of concentration risk have not kept pace with the increasing level of risk.

Over the past decade, the volume of CRE loans at many District banks increased rapidly, largely a reflection of their strategic focus. Commercial banks have originated and/or purchased a high volume of CRE loans, generally at the expense of C&I loans. As a result, the composition of bank balance sheets changed noticeably over the past ten years, with more assets invested in CRE and residential RE loans, and fewer invested in C&I and consumer loans. Furthermore, because CRE loan growth far exceeded capital formation at most banks, CRE concentration levels rose to unprecedented levels.

The inherent credit risk associated with high CRE concentrations is further compounded by the cyclical and potentially volatile nature of the CRE industry. Real estate markets have historically been cyclical due to a variety of factors that cause an imbalance between the supply and demand of CRE projects. The collapse of real estate markets, coupled with weakened underwriting standards, contributed to heavy losses and many bank failures in the late 1980's and early 1990's. Over the past several years, CRE risk has increased in many areas given the deterioration in a number of real estate markets throughout the District. These markets, which include the Bay Area and San Jose in particular and certain urban areas in the Northwest and Southwest, continue to report high vacancy rates and lower lease rates for commercial and industrial properties throughout 2003.

Market conditions for many areas in the District remain stressed and will not fully recover for some time. Consequently, banks may experience increased loan problems if CRE markets do not reverse their trends. Based on recent forecasts, improved demand for available space will be slow to materialize, particularly in the Office, Industrial and Hotel Sectors. Some analysts even predict it may take years for local CRE markets to recover. Given the tremendous economic growth in the late 1990's in the Bay Area, which was fueled by an extremely unusual spike in technology investment, a return to business activity compared with the late 1990's may be unlikely.

2. Banks Lacked Adequate CRE Strategic Plans and Limits

Most banks in our review neither formally acknowledged CRE lending and the high CRE concentrations in their strategic planning process, nor explicitly discussed CRE concentrations at their board meetings. None of the banks in our sample performed a risk/return analysis, and very few incorporated earnings performance measures for CRE lending.

Most senior bank officers exhibited little concern over their high concentration levels. Many were of the belief that if they were properly underwriting CRE loans at the transaction level, loan problems would not develop. Accordingly, they did not consider high concentrations to be a significant risk factor. However, this ignores the cyclical nature of real estate markets and the fact that a significant downturn or other market forces (such as rising interest rates) could erase any cushions provided by conservative loan-to-values or debt-service-ratios.

Several banks had no CRE concentration limits in place, while several other institutions had inadequate limits. Examples of inadequate limits include those that were not measured against capital, those that were considered too broad, those with insufficient sub-limits (product type, geographic location, collateral, etc.), or those that were not properly supported or documented. In general, we noted that when banks set CRE limits, including an aggregate limit, the limits were often exceedingly high and were rarely explicitly tied to the stated risk appetite of the bank.

In some instances, bank management merely increased concentration limits when those limits were approached or exceeded. Accordingly, the high concentration levels and correspondingly high and adjusting internal risk limits for these banks suggest that management and directors have a strong risk appetite for CRE concentrations that is not formally acknowledged or otherwise addressed in the strategic planning process.

3. Portfolio-Wide Concentration Risk Not Adequately Managed

A portfolio-based approach to managing CRE risk was not in place at most banks. Institutions generally focused on individual transactions without considering the market risk impact on the aggregate risk level. In addition, board and management reports generally did not provide a portfolio-wide perspective on CRE concentrations.

In some cases, banks had developed management information systems (MIS) and internal reports to monitor CRE activity and concentration limits. However, those reports and systems generally did not provide a portfolio-wide perspective. In addition, most banks did not have an adequate system for monitoring, measuring or controlling unforeseen CRE risk during an economic downturn, including use of sensitivity analyses such as stress tests, portfolio analysis and economic capital valuation.

While stress tests were occasionally performed at the individual loan level, stress tests were rarely done on a portfolio-wide level. Also, most banks did not regularly utilize CRE market information in their management of CRE risk. None of the banks in our review had developed effective portfolio-wide MIS for managing their high levels of CRE concentrations. Consequently, management and the board could not fully assess the aggregate risk of their CRE activities.

Most banks did have the ability to generate management reports that segregated their CRE portfolios by various sub-categories, including loan type, collateral and location. Some also had the ability to segment their portfolios further by such factors as risk grade, owner-occupied status, loan-to-value, etc. However, these reports were generally quantitative in nature and rarely included any qualitative analysis or summary for the board of directors. Furthermore, it was not clear if bank management actively used these reports in portfolio monitoring or decision making.

Several banks in our review conducted occasional sensitivity analyses or stress tests of individual CRE loans. However, those reviews were somewhat simplistic and were not done on a consistent basis. For example, some banks would assess the impact of rising rates on the debt service coverage for a given loan. This type of stress test was generally performed only during the initial underwriting process and did not include other factors such as vacancy rates, capitalization rates, gross rents, net operating income, interest rates, etc. While some banks attempted to aggregate the results of the individual stress tests, none of the banks in our review conducted robust portfolio-wide analyses to determine the sensitivity of their portfolios to changing conditions.

Several banks did review regular economic reports and market data relative to their respective CRE markets. However, in most cases there was no formal indication or documentation that boards of directors acted on changing trends or developments in their markets. For example, as real estate conditions began to deteriorate in many 12th District markets, few if any banks formally acknowledged the downturn through such things as increased monitoring, revised policy limits or strategic planning changes. A more focused analysis of local markets would better enable management to identify trends and adjust strategies, if necessary.

4. Capital Planning and Analysis Did Not Include Concentration Risk

Management and boards of directors typically did not directly relate the risk profile of their institutions with their capital planning process. Moreover, banks in our review did not incorporate concentration risk into their capital planning processes, despite their significant concentration levels.

Banks relied solely on Prompt Corrective Action (PCA) guidelines in the establishment of their capital levels. Most institutions simply adopted the minimum capital ratios necessary to maintain the “well capitalized” PCA designation as their desired level of capital. These institutions performed little if any analysis to correlate their targeted capital levels with their overall risk profile. Consequently, using the basic PCA guidelines did not incorporate an estimate of the amount of “capital-at-risk” from the high levels of concentrations.

Management of most of the institutions in our review elected to maintain a small “cushion” in excess of the “well capitalized” benchmarks. However, there was little documentation and/or analysis to relate the size of the “cushion” relative to the bank’s risk profile.

Since most banks do not explicitly relate capital levels with the institution’s overall risk profile, we would generally expect banks with higher levels of concentrations to also have higher levels of capital to mitigate the additional risks associated with those concentrations. However, many banks with high CRE concentrations actually have capital levels below the District and National medians. These banks generally maintain relatively lower levels of tier 1 capital and reserves and higher levels of CRE loans as a percentage of risk weighted assets. In order to support the lower levels of capital, management and the board of these institutions should incorporate concentration analysis in their capital planning including sensitivity analysis models (stress tests) and should also have in place more robust portfolio-wide monitoring and management tools.

Our review also noted instances where banks were improperly reporting certain items on schedule RC-R of their quarterly Reports of Condition. These errors resulted in the overstatement of risk-based capital ratios by as much as 70 basis points and in one case nearly dropped the institution below its “well capitalized” designation. Most CRE loans fall within the 100 percent risk weight category, but in some instances, banks were improperly reporting portions of their portfolios in the 50 percent category, thereby understating the level of risk weighted assets. This error is exacerbated by the fact that management and boards of directors relied on the PCA guidelines to determine the adequacy of their capital and further illustrates why sole reliance on PCA is not appropriate.

5. Underwriting Practices Generally Sound, but Areas for Improvement Exist

Underwriting practices were generally sound at most of the banks in our review. Terms associated with CRE loans were more conservative than those granted during the late 1980’s and early 1990’s. Furthermore, we did not observe a significant number of loans with underwriting weaknesses or relaxed

terms. Appraised values were generally reliable, and banks were generally doing an adequate job of evaluating borrower capacity and sources of repayment. Nonetheless, several concerns were noted at some of the banks in our review.

For example, some banks exhibited appraisal deficiencies and/or weaknesses in their control processes. Specifically, some appraisals did not contain sufficient information or analysis to support the underlying assumptions and valuations. In addition, the in-house appraisal review process at several banks did not question the reasonableness of the assumptions and, in some cases, was not fully independent from the lending process.

Another concern noted at most of the banks in our review was the excessive reliance on loan-to-values in the underwriting process and inconsistent emphasis on financial and cash flow analysis. Also, other underwriting factors tended to be general in nature and/or not specifically addressed in bank policies or guidelines, such as minimum requirements for debt service coverage, pre-leasing, cash equity, and take-out commitments.

In practice, many banks applied minimum standards to these factors on a loan-by-loan basis, with little consistency between loan types and/or loan officers. Another concern noted at several banks was the number of exceptions to bank policies and guidelines. Many of these exceptions were poorly documented and not well supported. In addition, these banks did not have an effective way of aggregating and monitoring policy exceptions nor did they always report the exceptions to senior management and the board.

6. Internal Risk Ratings and Loan Pricing Did Not Adequately Differentiate Risk

Many community banks in the District, including those in our review, have internal loan grading systems that consist of eight to ten loan grades. During our review we noted that most banks graded nearly all CRE loans in only one or two of the higher “pass” grades, regardless of the type of credit or terms associated with the credit. For example, some banks graded raw land development loans the same as commercial property loans, despite the support afforded by income producing enterprises associated with the latter.

In several cases, 90 to 95 percent of all CRE loans fell into one or two risk grades, suggesting that those loans exhibited essentially the same risk characteristics. This lack of granularity masks the magnitude of risk within the portfolio, making it difficult for management to effectively manage portfolio risk. More differentiation would enable management to assess the overall quality of its portfolio and to monitor changes in portfolio quality through migration analysis. This in turn could provide management with an early warning system which would enable them to proactively manage their portfolios.

Loan officers generally did not price their loans to reflect the inherent risks associated with their credits. Those risks differ significantly, depending on the characteristics of a particular credit including loan type, location of the real estate, degree of collateral support, and other terms. Most of the banks in our review readily admitted that the pricing of CRE loans was driven primarily by competitive pressures.

In many of the banks, borrowers and the competition were dictating loan terms, particularly interest rates and fees. Consequently, pricing based primarily on competitive factors did not accurately consider the risk-return implications. Furthermore, loan pricing and ultimately loan profitability, was not linked to the internal loan grading system at most of the banks.

SECTION III: RECOMMENDATIONS

One of the key objectives of the CRE review was to identify gaps in current supervisory guidance and, where warranted, develop broad guidelines to help examiners assess the effectiveness of how banks manage and control concentration risk. The prior section summarized the key findings from our CRE review and this section outlines a number of recommendations to address those supervisory gaps and to ensure consistent regulatory treatment among the banks in our District. The following summarizes these recommendations which are meant to assist management of high CRE concentration risk banks in managing and controlling high levels of concentration risk.

Strategic Planning and Limit Setting

We recommend that higher concentration risk banks need to have well defined strategies that explicitly acknowledge concentration risks in addition to well-supported concentration limits. Accordingly, these strategies would address the following:

- ***Rationale for the high levels of CRE concentrations*** along with a discussion of CRE risk relative to the bank's overall growth objectives and financial targets. The strategy should include some type of risk/return analysis.
- ***Meaningful concentration limits in relation to the bank's capital structure***, including documentation that supports the underlying rationale for the limits. Limits should reflect management's risk appetite, economic and market conditions and forecasts, and adequacy of internal controls and risk monitoring procedures.
- ***Other facets related to CRE lending*** including funding sources, the number of personnel involved with CRE activity, directors and their related interests tied to CRE lending, etc.
- ***Contingency actions*** in the event that CRE related target objectives are not met (i.e. ROA, ROE, capital, etc.).
- ***Strategies for mitigating high concentration risk***, including more active management oversight, additional capital and reserves, increased portfolio diversification, and loan sales.

Portfolio-Wide Management

High CRE concentration risk banks need to have stronger, more sophisticated risk management systems to identify, monitor, and manage their CRE concentrations. As such, we would expect that such banks develop:

- ***Enhanced systems for measuring CRE concentrations across the portfolio*** along a number of dimensions, such as loan type, purpose, size, collateral, industry, location, owner-occupied, maturity, internal risk grade, etc.
- ***Effective portfolio-wide MIS*** for managing high levels of CRE concentrations.
- ***Policies and procedures for conducting sensitivity analyses*** at the individual loan level. Banks should also begin investigating options for developing more robust portfolio-wide analyses to determine the sensitivity of their portfolios to changing conditions.
- ***Formal process for conducting more focused analyses of local markets*** in order to identify trends and adjust strategies, if necessary.
- ***Enhanced qualitative reports and analyses*** for management and the board.

Capital Planning

Banks with high CRE concentration risk must have adequate procedures in place for determining the adequacy of their capital structure. Accordingly, these banks would be directed to develop the following:

- ***Enhanced capital analyses for measuring the appropriateness of capital*** given the risk profile of the institution, the level of asset concentrations and the composition of those concentrations.
 1. CRE concentration risk should be directly incorporated by management into the capital planning process. Capital goals need to be expressed in a manner that goes beyond maintaining a well capitalized Prompt Corrective Action (PCA) designation and need to be explicitly associated with the bank's risk profile.
 2. Banks with high CRE concentrations need to begin investigating ways to **quantify** concentration risk exposure in its capital planning process and should consider additional factors including interest-rate exposure; liquidity, funding, and market risks; quality and level of earnings; other concentrations of credit; effectiveness of loan and investment policies; and management's overall ability to monitor and control financial and operating risks, including the risks presented by concentrations of credit and nontraditional activities.
- ***Enhanced capital planning process by incorporating stress tests*** that measure the potential impact to capital given various market scenarios.
- ***Improved procedures for preparing Reports of Condition*** to ensure Risk Based Capital calculations accurately reflect the risk weights of CRE loans.

Underwriting Practices

Banks with high CRE concentration risk must have strong underwriting procedures in place to ensure the quality of their CRE portfolios and to minimize the possibility that wide-spread asset quality problems could develop. Accordingly, these banks would be directed to develop the following:

- ***Enhanced appraisal review procedures*** that ensure assumptions and valuations are properly supported and documented.
- ***Formalized underwriting policies and practices that provide additional guidance to lending staff.*** The guidelines should outline a process for reviewing financial capacity that includes analysis of cash flow and debt service ability.
- ***Enhanced polices and procedures requiring periodic reviews of the borrowers,*** including credit reviews and analysis of operating statements, rent rolls, guarantor's financial statements, etc.

Internal Risk Ratings and Loan Pricing

Most banks in our review graded nearly all CRE loans in only one or two of the higher "pass" grades, regardless of the type of credit or terms associated with the credit. This lack of granularity masks the magnitude of risk within the portfolio, making it difficult for management to effectively manage portfolio risk. More differentiation would enable management to assess the overall quality of portfolios. Therefore, banks with high CRE concentration risk would be directed to develop the following:

- ***Enhanced internal loan grading systems*** that provide a more accurate and meaningful differentiation of the inherent risk associated with its credits.
- ***Procedures and guidelines that explicitly link pricing decisions with the inherent risk of a credit.*** Risk-pricing policy exceptions should be tracked by management and reported to the board on both a transaction and aggregate basis.