March 3, 2009

Commercial Real Estate Lending

To the Chief Executive Officer of Each Tenth District State Member Bank:

The decline in our national and regional economy has created a challenging environment for district banking organizations. Credit risk is increasing for many institutions, and banks with concentrations in commercial real estate (CRE) lending have been hit especially hard. The purpose of this letter is to share our observations about bank's risk management practices, clarify our supervisory expectations and assist state member banks in strengthening CRE lending programs.

In the two years since the Federal Reserve issued SR 07-1 "Interagency Guidance on Concentrations in Commercial Real Estate," we have evaluated the CRE lending policies and risk management practices of all our state member banks. Many state member banks with large real estate loan portfolios employ a number of sound practices to manage this concentration risk. However, we have noted through our examinations that opportunities exist for enhancing CRE lending policies and risk management practices. The attachment to this letter summarizes several key supervisory issues identified in these examinations, and lists key reference material available through our website.

I encourage you to discuss these practices with your examination team or contact your local central point of contact for more information. You are also encouraged to attend one of our Regulatory Update seminars, which will also address issues and expectations regarding credit risk management. The schedule of seminars is available at www.KansasCityFed.org>>Banking Supervision>>Regulatory Update Seminars.

Sincerely,

Esther L. George
Executive Vice President

c: State Banking Commissioners

Attachment

Key Risk Management Issues for Commercial Real Estate Lending

- ***Problem loan identification weaknesses can result in under-funded loan loss reserves.*** The allowance for loan and lease loss (ALLL) methodologies must be documented, especially those reserve allocations and environmental adjustment factors used for Financial Accounting Standards (FAS) 5 pools of loans. In some cases, the FAS 5 loss histories have been based on a favorable loss history and have not appropriately considered current market conditions and potential losses given those conditions. Moreover, we have noted in some instances that classification and problem loan levels were often rising at a pace inconsistent with the allowance for loan and lease losses, resulting in lowered reserve coverage ratios.

- ***Global cash flow analysis for borrowers should be a standard underwriting practice.*** This analysis is a critical element in understanding a borrower's total cash flow requirements and in determining whether the borrower has the ability to repay debt. Examiners expect to see this review thoroughly documented in the credit files.

- ***Interest reserves should be supported by a reasonable and realistic assessment of the underlying project's continued feasibility, the timeframe for project completion, and the guarantor's capacity to service debt.*** Interest reserves should not be used to mask troubled or nonperforming credits, nor should lenders extend the term of loans or provide additional interest reserves to keep the credit facility current. Our expectations for lenders are to assess the continuing feasibility of the underlying project and the ability of the borrower to fulfill their obligations prior to funding an extension or an increase in a loan's interest reserve.

- ***Appraisals or collateral values should reflect current economic information.*** Banks are expected to maintain policies that address the monitoring and updating of collateral values to provide a realistic assessment of collateral protection. When updating collateral valuations, lenders must assess the reasonableness of key assumptions from the project's feasibility study, marketing plans, and the appraisal. They also must have a clear understanding of the impact that development delays may have on the project's cash flows and the borrower's ability to service debt. New appraisals should be obtained when necessary, or internal adjustments must be quantified to reach conclusions of value to determine risk to capital and appropriate reserve levels.

- ***Robust portfolio-level stress testing program is required.*** Banks are expected to stress test their high-risk portfolios to quantify the impact of changing economic conditions on asset quality, earnings, and capital. Information regarding risk exposure is expected to be captured in decisions made by bank management and directors regarding capital adequacy and planning, and in determining the loan loss reserve adequacy.

- ***Basic corporate governance practices, including a board-approved CRE policy and an effective management reporting system, are essential.*** The board of directors has the responsibility for the level of risk assumed by the banking organization. Therefore, our examiners have been encouraging banks to establish policy guidelines, as specified by SR 07-1, for the level and nature of CRE lending exposure that is acceptable for their institutions. The board of directors should also be supported by effective management reporting that provides for the periodic review of CRE concentrations, loans with interest reserves, market data and other information that assists the board in monitoring the overall level of risk that CRE lending poses to their institution.

- ***A bank's capital position should reflect the level and nature of inherent risk in its CRE portfolio***. Regulatory guidance provides that a bank must hold capital commensurate with its risk profile. Accordingly, banks that have significant CRE exposure, particularly those with high levels of construction and land development loans, should generally hold more capital. Other factors such as the quality of a bank's risk management practices, its reserve allocation for CRE concentrations, and current market conditions, should also be considered in capital planning.

References, available at www.KansasCityFed.org>>Banking Supervision>>References

SR 07-01	Interagency Guidance on Concentrations in CRE
SR 06-17	Interagency Policy Statement on the ALLL
SR 03-18	Independent Appraisal and Evaluation Functions
SR 01-17	Interagency Statement on ALLL Methodologies and Documentation