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Banking Agencies Issue Advisory on CRE Lending

December 28, 2015

Federal banking agencies have advised banks to review their policies related to commercial real estate ("CRE") lending in light of what the agencies believe to be an easing of CRE underwriting standards.

The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of the Comptroller of the Currency (collectively the "Agencies") jointly issued a statement reminding banks of existing regulatory guidance on prudent risk management practices for CRE lending. CRE loans, for the purpose of the Agencies' statement, refer to loans where the use of funds is to acquire, develop, construct, improve or refinance the real property and where the primary source of repayment is the sale of the real property or the revenues from third-party rent or lease payments.

The Agencies' examination and industry outreach activities have revealed an easing of CRE underwriting standards, including less-restrictive covenants, extended maturities, and limited guarantor requirements. In addition, the Agencies found some banks' risk management practices to be concerning, including a greater number of underwriting policy exceptions and insufficient monitoring of market conditions to assess the risks associated with the growing CRE concentration levels.

The Agencies have noted that banks with weak risk management and high CRE credit concentrations are exposed to a greater risk of loss and failure. The following supervisory expectations provided by the Agencies are in line with actions taken by financial institutions that succeeded during difficult economic cycles:

- Establish adequate and appropriate: (1) loan policies, underwriting standards, credit risk management practices and concentration limits approved by a board or designated committee, (2) lending strategies, such as plans to increase lending in a particular market or property type, and (3) strategies to ensure capital adequacy and allowance for loan losses that support the lending strategy and CRE portfolio.
- Conduct global cash flow analyses based on reasonable rental rates, sales projections, and operating expenses to ensure sufficient repayment of all loans.
- Perform market and scenario analyses of CRE portfolios to quantify the impact of changing economic conditions on asset quality, earnings, and capital.
- Provide the board and management information regarding whether lending strategies are appropriate in light of market conditions.
- Assess the ability of the borrower and the project to service all debt as loans convert from interest-only to amortizing payment or during periods of rising interest rates.

- Implement procedures to monitor the potential volatility in the supply and demand for lots, rental and office space and multi-family units during business cycles.
- Maintain management information systems that provide sufficient information to identify, measure, monitor and manage concentration risk.
- Implement processes for reviewing appraisal reports for information to support appropriate market value conclusions based on reasonable market rental rates, absorption periods and expenses.

During 2016, the Agencies will continue to pay special attention to risks associated with CRE lending and conduct examinations that may include a review of CRE lending activities and banks' implementation of the principles found in existing regulations and guidance. A list of existing regulations and guidance on CRE lending can be found on the exhibit of the Agencies' statement located here: http://www.occ.gov/news-issuances/news-releases/2015/nr-ia-2015-163a.pdf. The Agencies may ask financial institutions with inadequate risk management practices and capital strategies for CRE lending to reduce risk tolerance in their underwriting or raise capital to mitigate the risk with their CRE strategies.

Please note that Cullen and Dykman has extensive experience representing financial institutions in connection with CRE loans, including advising on regulatory issues, drafting loan documents, and closing such loans. If you have any questions regarding such transactions or the Agencies' joint statement, please feel free to contact Joseph D. Simon at 516-357-3710 or via email at jsimon@cullenanddykman.com, Kevin Patterson at 516-296-9196 or via email at kpatterson@cullenanddykman.com, or Diana Acosta at 516-357-3739 or via email at dacosta@cullenanddykman.com.

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Attorneys

- Kevin Patterson
- Joseph D. Simon