



Concentrations in
Commercial Real Estate and
Lending - Risk Management
Best Practices



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Michael Umscheid, President and CEO of ARCSys

With the concerns around commercial real estate (CRE) loans in 2023, it is important to remember the previous policy statements concerning sound risk management practices. For financial institutions, proper risk management of CRE concentrations is essential now more than ever. To ensure that institutions are taking the necessary steps to guard against potential risks, the Office of the Comptroller of the Currency (OCC), the Federal Reserve, and the Federal Deposit Insurance Corporation (FDIC) issued guidance on this topic in December 2006, which you can access [here](#). The FDIC released updated Supervisory Insights on this topic in July 2023, which you can access [here](#).

In this whitepaper, we'll take a look at the background and scope of CRE concentration risk management, the assessments that should be conducted, the risk management practices that should be implemented, and the supervisory oversight that should be in place. To ensure your financial institution is taking all the necessary steps to minimize the risks associated with concentrations in CRE loans, contact ARCSys today to get started!

For more information about commercial real estate changes, see ARCSys' whitepaper titled [Interagency Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workout](#)

Overview of CRE Lending Concentration Risks

Given the potential risks associated with commercial real estate lending concentrations, financial institutions must ensure that they maintain appropriate levels of capital and regularly monitor their CRE loan portfolios. The 2006 guidance from the OCC, Federal Reserve System, and FDIC provides a valuable framework to assess these risks and build an effective risk management



system. To remain in compliance with this guidance, it is important for institutions to have policies in place to identify, monitor, and manage CRE concentrations. By taking proactive steps such as these, financial institutions can protect themselves against losses due to excessive CRE lending concentration risk. Now more than ever, managing the CRE portfolio will require more preparation and analysis to be ready for future risks from changing economic and employment changes.

CRE Concentration Assessments

The assessment of concentration risk in commercial real estate (CRE) lending is a critical element for institutions. The 2006 joint guidance from the OCC, Federal Reserve System, and FDIC emphasizes the importance of strong risk management practices and appropriate levels of capital for institutions with concentrations in CRE loans. To ensure that an institution's CRE portfolio is properly managed, it is necessary to assess the level of concentration associated with each loan type, geographic area, property type, or borrower.

Stratifying a CRE portfolio into segments with common risk characteristics or sensitivities can help identify potential concentrations. For example, institutions may segment their portfolios by loan size or loan-to-value ratio to identify higher-risk loans. Additionally, assessing concentrations by geography or property type allows lenders to better understand where their greatest exposures lie and what action needs to be taken to mitigate them if necessary.

Institutions should also be aware of their overall CRE concentration levels relative to their capital base. This will help them make sure that they are adequately managing their risk and adhering to regulatory guidelines for mitigating concentration risk. It is important for institutions to have appropriate processes in place such as periodic reviews of credit profiles and stress tests that are tailored specifically for assessing CRE concentrations.

Recommendations From Regulators

Consider factors such as:

- Portfolio diversification across property types
- Geographic dispersion of CRE loans
- Underwriting standards



- Level of pre-sold units or other types of take-out commitments on construction loans
- Portfolio liquidity (ability to sell or securitize exposures on the secondary market)
- Concentration risks correlation assessments between identified pools

Lending Risk Management

Risk management is an essential part of regulating CRE loans. To ensure that risk management strategies are in place and correctly followed, boards of directors and senior management must remain involved. This involves setting restrictions for exposure to risk, diversifying the selection of investments, and monitoring the performance of the loan portfolio. Moreover, institutions should have enough capital reserves to back up their CRE loans concentrations and a reliable system for assessing concentration risk.

Institutions holding a significant amount of Commercial Real Estate (CRE) should not just focus on managing the risk associated with individual loans but also pay attention to the overall risk of their loan portfolio. Even when they've been cautious in their underwriting of individual CRE loans, having too many loans affected by the same ups and downs in the CRE market can pose a dangerous level of risk if not handled properly.

To address this, management should consistently assess how closely different real estate sectors are connected and create in-house lending rules and limits to ensure the institution's overall risk exposure is kept in check. As market conditions change over time, it is important that these lending rules and limits are reevaluated and adjusted as needed.

Information systems should be in place providing real-time updates on loan originations, maturities, balances owed etc., along with delinquency data associated with CRE concentrations. These systems should provide management with sufficient information to identify, measure, monitor, and manage CRE concentration risk.

Additionally, market analysis can offer insight into potential new risks arising due to changes in economic trends or other factors. The 2023 update recommends using heat maps to provide lenders with a quick reference tool detailing management's demand assessment for product types in each geographic market and guiding the level of aggressiveness in lending strategies, helping determine whether to grow, maintain, or reduce exposure for specific markets or product



types.

Lastly, credit underwriting standards need to be enforced to reflect the level of risk that is acceptable to the institution. Credit policies should include criteria for determining borrower credibility, as well as regulations regarding acceptable collateral types and loan-to-value ratios depending on the type of property being financed. These policies should be regularly checked and modified if necessary based on changing economic climates or market conditions.

Having a wait-and-see approach at maturity in higher risk times is not a good strategic plan. It is important to:

- Understand what loans are maturing within the portfolio over the next two years.
- Forecast expected risk based on annual updates or Automated Valuation Modeling (AVM).
- Develop internal loan review that collects relevant data such as DSCR, LTV and other metrics. These metrics must be stored in core systems to be usable.
- Reevaluate collateral values to be prepared for refinancing issues before they arise.

To evaluate how changes in economic conditions can affect an institution, stress testing and sensitivity analysis are instrumental. These tests should also consider how different parts of the portfolio, which share similar risk characteristics, respond to various market conditions. The complexity and thoroughness of these stress tests should match the institution's size, complexity, and the risks associated with its CRE loan portfolio.

Adopting effective risk management practices is paramount when it comes to managing CRE loan concentrations' risks adequately. Those looking for support can always reach out to ARCSys for assistance understanding regulatory guidelines and developing solutions concerning concentration risk management more effectively.

Supervisory Oversight

Regulatory agencies have established specific criteria to identify institutions that could be at risk due to significant concentrations in CRE. These criteria include institutions that have rapidly expanded their CRE lending, have substantial exposure to a particular type of CRE, or meet the following criteria:



1. Total reported loans for construction, land development, and other land represent 100 percent or more of the institution's total capital; or
2. Total commercial real estate loans represent 300 percent or more of the institution's total capital, and the outstanding balance of the institution's commercial real estate loan portfolio has increased by 50 percent or more during the prior 36 months.

These criteria are used as an initial step to identify institutions that may face CRE concentration risk. It's important to note that these criteria don't establish limits on an institution's lending activity but rather serve as general indicators to flag institutions that might be exposed to CRE concentration risk. They also don't provide immunity to institutions if other risk factors are present, regardless of whether they meet the criteria outlined in this section.

Conclusion: Managing CRE Lending Concentration Risks

Managing CRE lending concentration risks requires a comprehensive and thoughtful approach. Institutions must ensure they have effective policies and procedures in place to regularly review CRE concentrations and assess potential risks. This includes setting exposure restrictions, diversifying investments, monitoring portfolios, and having adequate capital reserves. Furthermore, it is essential for organizations to understand the full scope of a product or property type before investing in them.

Ultimately, an institution's ability to mitigate risk associated with CRE loans depends on their implementation of sound risk management practices that protect their bottom line while complying with regulatory guidance. It is advisable for institutions seeking additional guidance to contact ARCSys for assistance understanding requirements and developing solutions to reduce risk concentrations.

ARCSys Can Help!

ARCSys can help institutions before they decide on any strategies related to mitigating their CRE concentration risks, as well as setting up effective internal processes for assessments and monitoring. ARCSys can provide invaluable assistance when it comes to understanding regulatory requirements, developing customized solutions that meet those requirements, and building comprehensive systems for tracking compliance metrics over time.



- Data warehouse analysis of your institution's data
- Automated Valuation Modeling (AVM)
- Concentration modeling
- Risk analysis

Call ARCSys to Begin a Commercial Modeling Assessment Today!