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A Conversation on Commercial Real Estate (CRE) Loans with Elevated Risk

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Agenda for Today's Session

- CRE risks
- CRE lending cycle
- Current CRE risk environment
- Prudent CRE loan accommodations and workouts
- Supervisory risk ratings
- Valuation requirements for CRE loans
- Allowances for credit losses (ACL) considerations

CRE Risks

Why Is the Fed Focused on CRE Lending?

- CRE (concentrations and growth) has led to bank failures in past cycles.
- Multifamily (MF) lending volume has grown dramatically in recent years.
- There is a looming maturity wall, creating uncertainty as to whether loans can be refinanced at maturity given current valuations.
- CRE market factors and property fundamentals today are different than they were two to four years ago when today's CRE loans were underwritten.
- Timely and accurate risk ratings that reflect current conditions are key to bank business decisions and proactive risk and balance sheet management.
- Accurate risk ratings are critical to managing loan loss reserves and capital.

CRE Risk Drove Bank Problems in Past Cycles

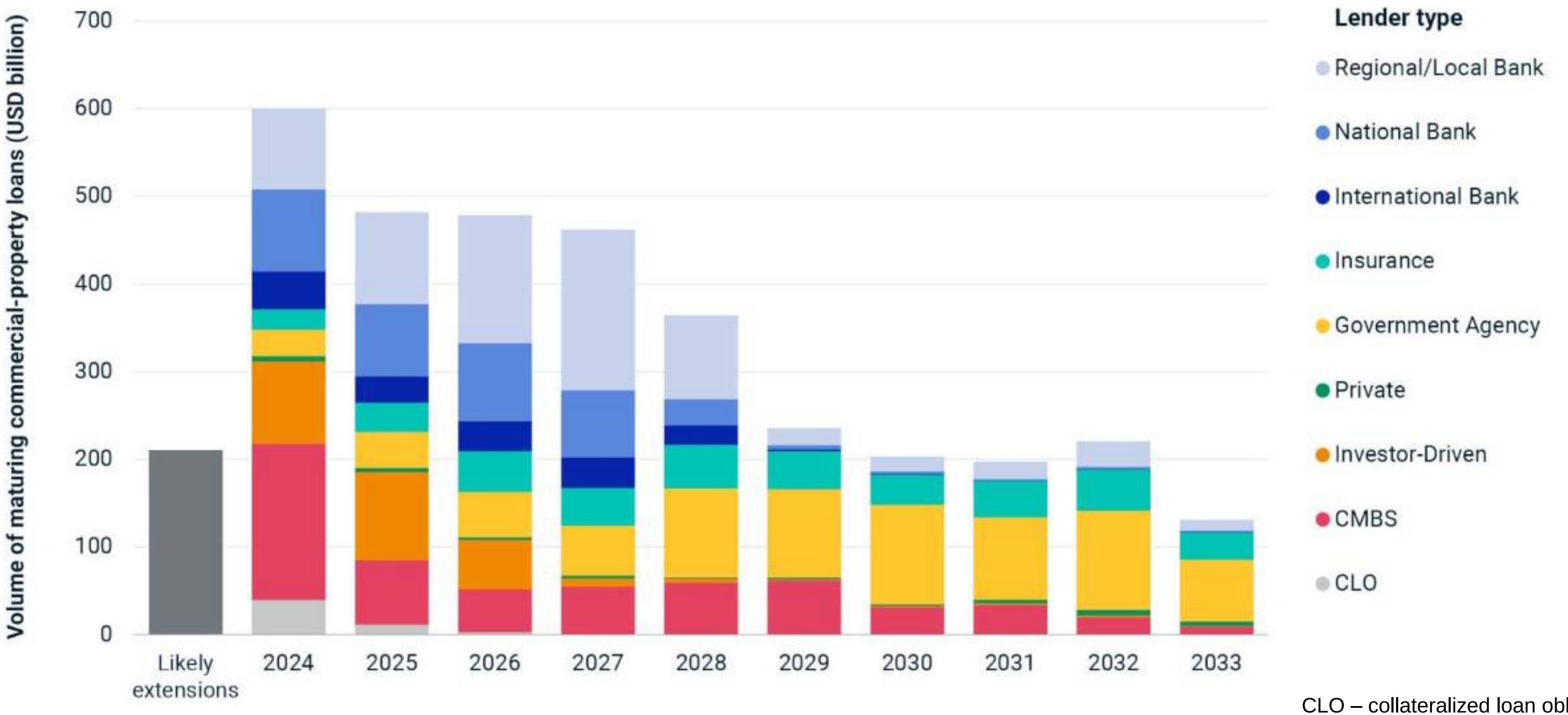
Key CRE lessons from history:

- **The Federal Deposit Insurance Corporation (FDIC) Office of Inspector General's *Comprehensive Study on the Impact of the Failure of Insured Depository Institutions* (January 2013) concluded the following:**
  - "The management strategy of **aggressive growth that concentrated assets in CRE and acquisition, development, and construction (ADC) loans**, coupled with inadequate risk management practices for loan underwriting, loan administration, and credit quality review, resulted in elevated net charge-off rates."
- **In the FDIC's *History of the Eighties: Lessons for the Future* (Volume 1: An Examination of the Banking Crises of the 1980s and Early 1990s, Chapter 9: Banking Problems in the Southwest), the following was noted:**
  - "The second wave of failures of many of the area's [Southwest] banks, in the middle to late 1980s, was caused primarily by the asset-quality problems connected with the expansion of commercial real estate lending, especially among Texas banks. Banks suffered as completion rates and office vacancy rates rose, leading to defaults on many real estate loans."

Shifts in CRE Market and Property Fundamentals

- **Market conditions today are markedly different than when loans were underwritten two to four years ago.**
  - Interest rates are higher.
  - Rents have declined.
  - Investor and lending appetite has cooled, leading to challenges with refinancings.
- **Property fundamentals are softening.**
  - Net operating income (NOI) has been adversely affected by increased costs, rising vacancies, and falling rents.
  - Increased volume of loan extensions aims to allow NOI stabilization. These extensions are meant to be temporary; permanent financing prospects have not improved for some loans.
  - CRE valuations are decreasing for select properties and markets.

Looming Maturity Wall: Can Loans Refinance?



CLO – collateralized loan obligation
CMBS – commercial mortgage-backed security

Source: Morgan Stanley Capital International (MSCI); Banking Supervision and Regulation Risk Analysis Unit/Federal Reserve Bank of Atlanta

CRE Lending Cycle

CRE Lending Cycle

ADC Loan

Mini Perm Loan

Stabilization Phase

Permanent Financing

CRE Lending Cycle (cont.)

(1) ADC Phase:

- Interest-only (IO), often funded from an interest reserve
- Average ADC period is 18 to 24+ months

(2) Mini Perm/Stabilization Phase:

- IO for 12-month stabilization period
- Often combined with the original ADC loans
- Additional 12-month extension option

(3) Permanent Financing:

- Fixed-rate financing for stabilized properties
- Ten-year terms with amortization of 20 to 30 years
- Typically provided by pension funds, life insurance companies, or CMBS conduits
- Banks may participate but prefer not to in order to avoid interest rate risk

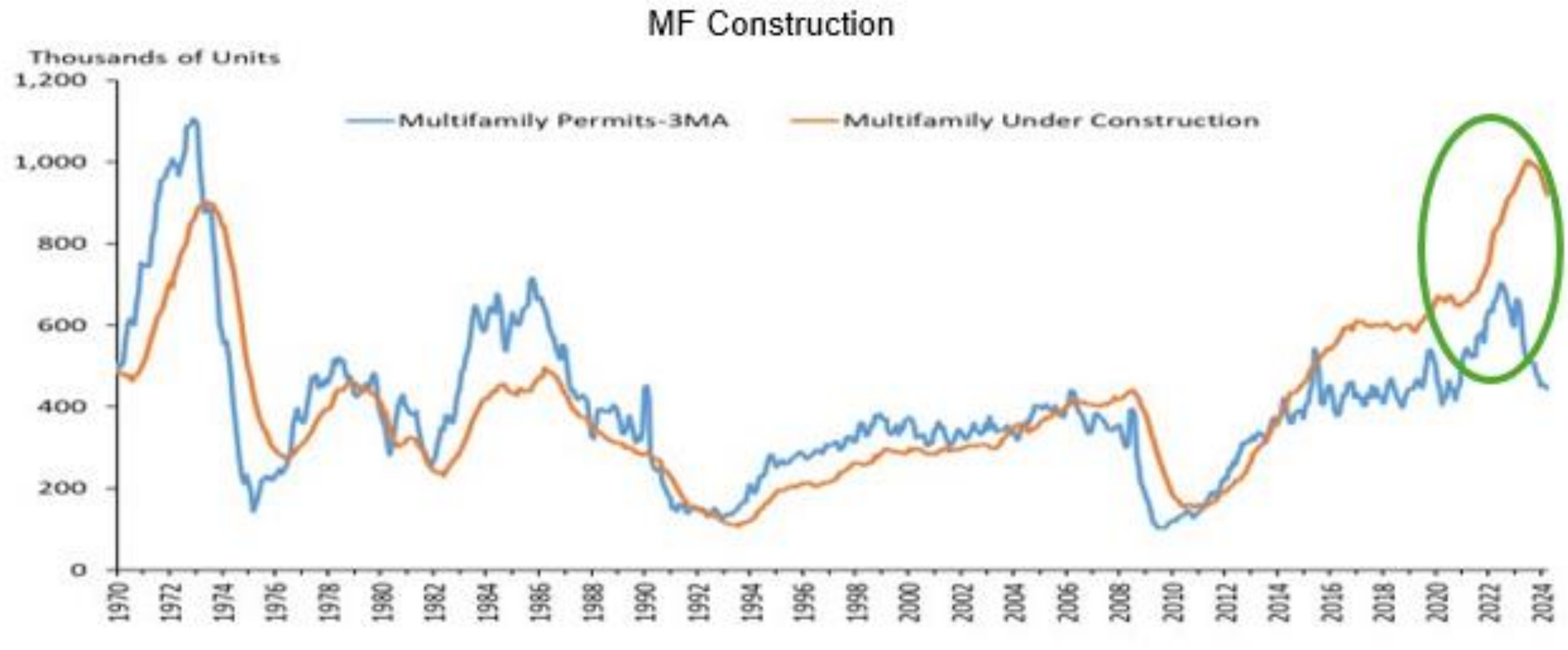
The Current CRE Risk Environment

Implications on MF Market

- Low interest rates in 2020 pushed home sales higher, increasing the rate of first-time home purchases.
- Falling home inventory from the 2020 high rate of purchases drove up home prices.
- Home affordability and first-time home purchases fell in 2021.
  - Renters remained underpinned by wage growth, driving demand and rent increases for high-end rental units.
  - MF developers jumped into the market in 2021.
  - The inflation spike in 2022 pushed up the costs to build and operate MF properties, driving rents even higher.

Implications on Multifamily: Construction Pipeline

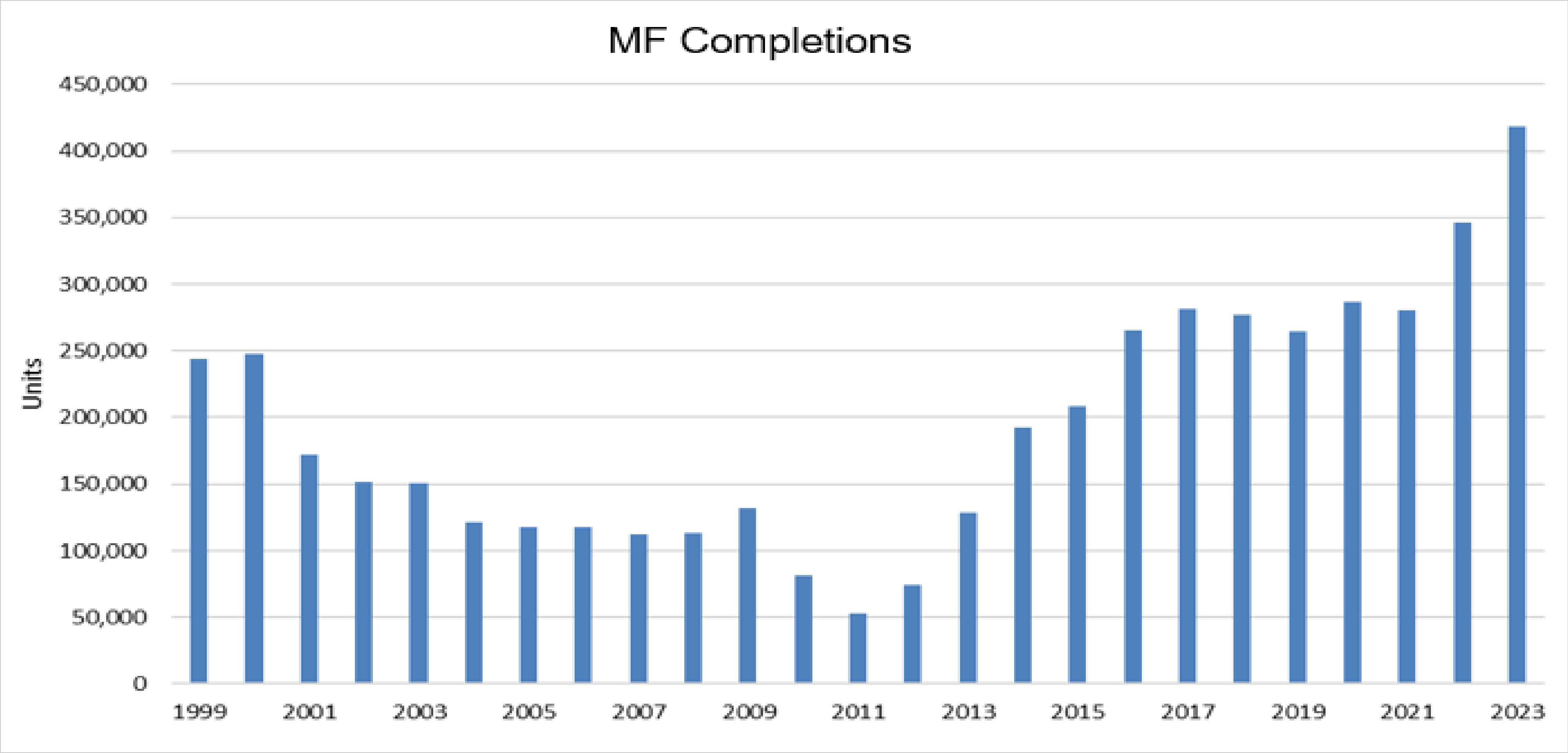
After holding back in 2020 and the first half of 2021, developers responded with a surge in MF construction.



3MA: Three-month average.

Source: U.S. Census Bureau

Implications on MF Property: Deliveries

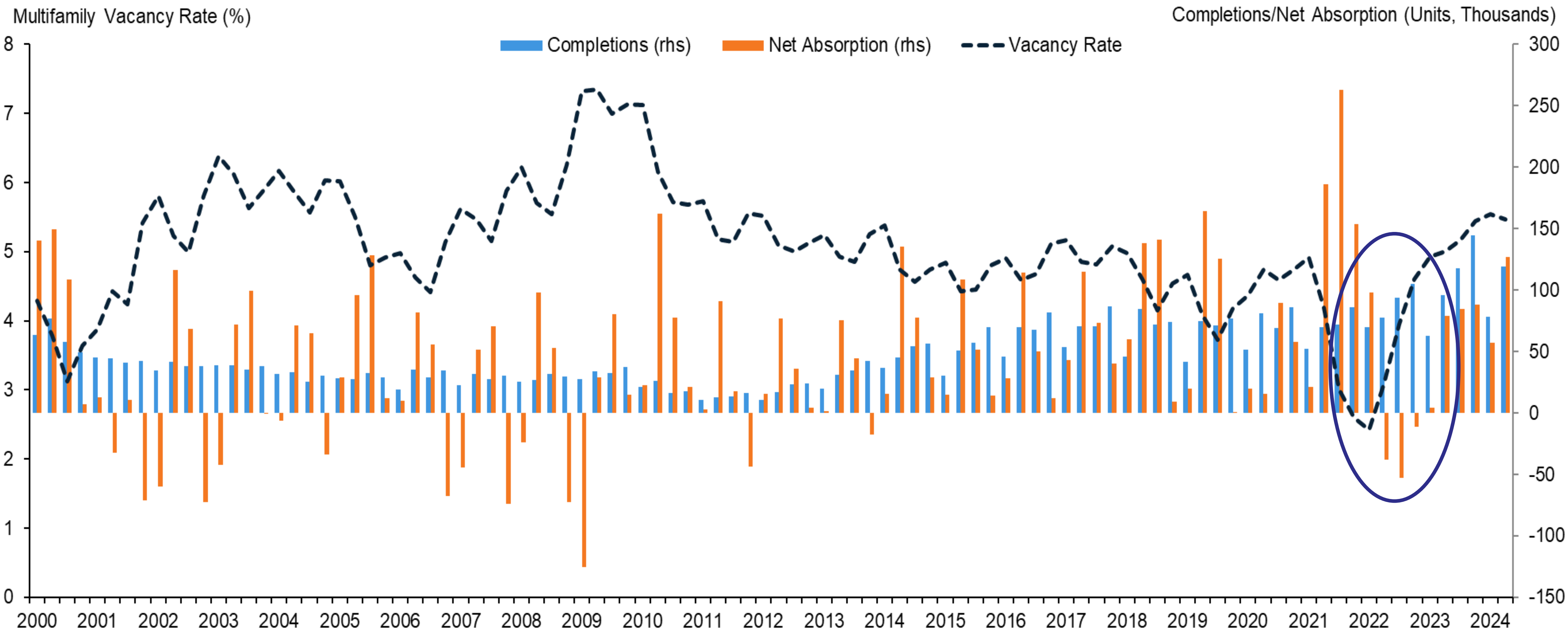


Source: CBRE

Implications on MF Loans

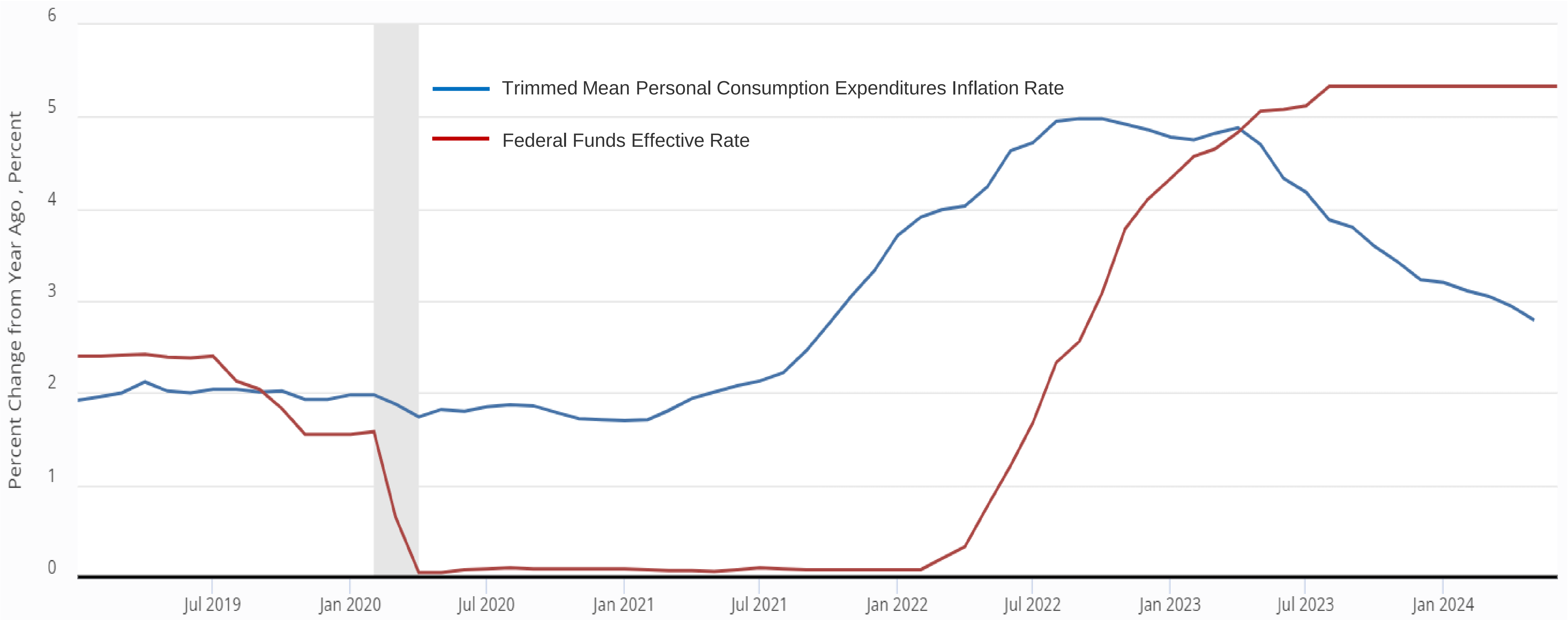
- ADC loans originated in 2021–2022 were underwritten based on comparable properties that stabilized under much stronger market conditions.
- Conditions prevailing at the time of the historic 2023 MF delivery period were much weaker.
- The occupancy, rent growth, operating expense, and NOI assumptions at origination may now be unrealistic.
- Interest rates increased markedly from January 2022 to July 2023.
- Combined with lower NOI prospects, collateral values may fall.

MF Vacancy Rate Increase Due to Excess Supply



Source: CBRE

High Inflation and High Rates Affect CRE

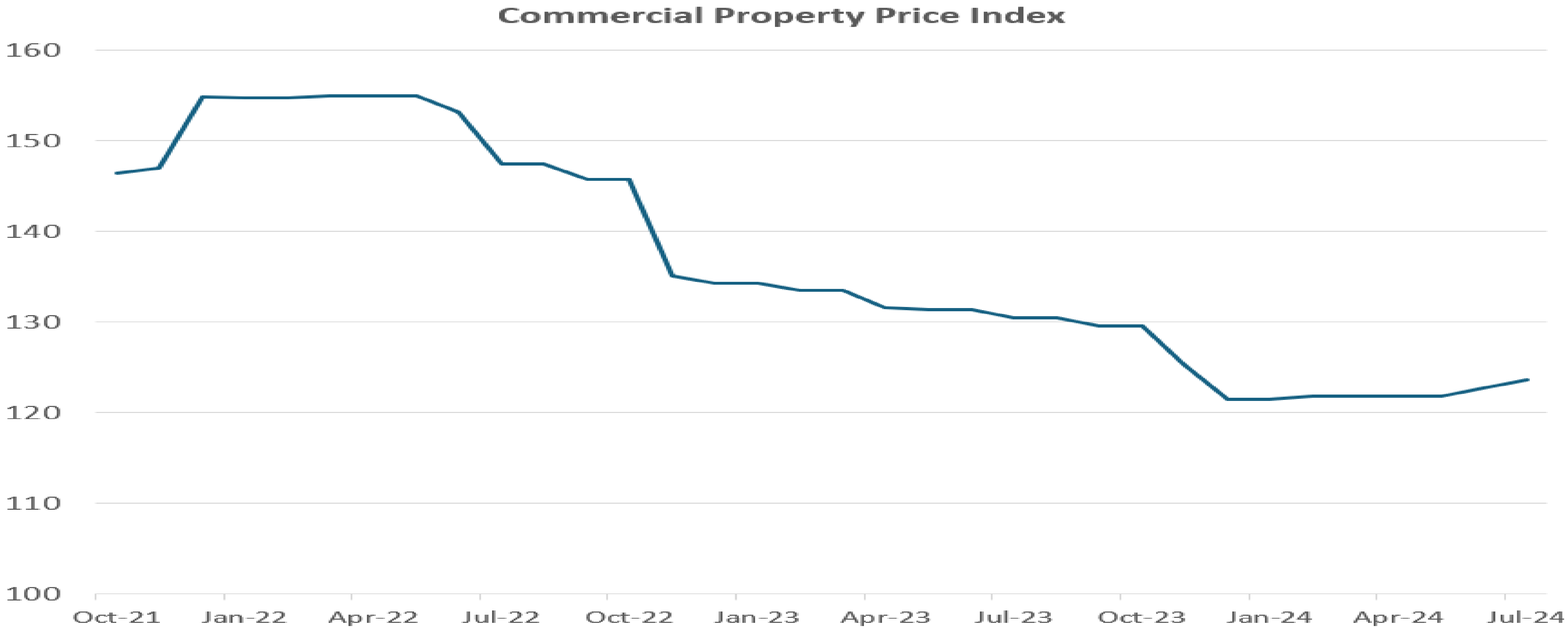


Source: Federal Reserve Economic Data (FRED) / Federal Reserve Bank of St. Louis

Implications on Office Properties

- Prior to the COVID-19 pandemic, office properties were oversupplied in many markets.
- A significant volume of office properties was in the CRE lending cycle when the pandemic period began.
- The shift to remote work arrangements extended into the post-pandemic period.
  - Pandemic-period "shadow vacancies" became permanent as office leases matured.
  - Stabilization prospects for "mini perm" office loans became weak.
  - Restabilization for permanently financed office properties was also under pressure.
- The 2022 and 2023 inflationary periods and higher interest rates added a layer of risk to collateral values.

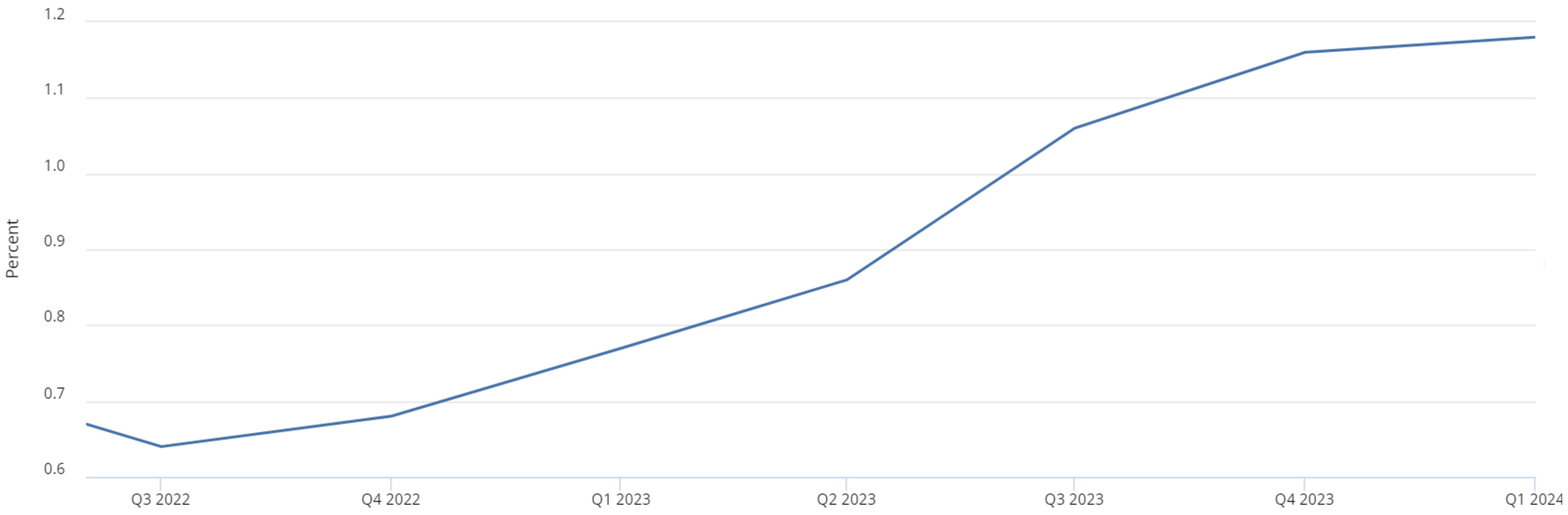
CRE Valuations Have Fallen Sharply in Past Two Years



Source: Green Street

Lower NOI and Higher Rates Push Delinquencies Up

Delinquency Rate on CRE Loans (Excluding Farmland), Booked in Domestic Offices (All Commercial Banks)



Source: FRED/Federal Reserve Bank of St. Louis

How Will the CRE Market Perform in the Future?

- Performance will vary property to property.
- Factors influencing performance may include:
  - Geography, property type, age, and amenities
  - Maturity date of loan(s)
  - Building and maintenance costs
  - Rent trends/concessions, vacancies, and competitive landscape
  - Equity
  - Other factors
- As such, bankers need to ensure each loan is rated according to its performance. The current NOI may be vastly different than projected NOI at origination.

Prudent CRE Loan Accommodations and Workouts

SR Letter 23-5: Key Concepts

- Examiners will not criticize a financial institution for engaging in loan workout arrangements, even though such loans may be adversely classified, provided that the loan has a well-conceived and prudent workout plan that supports the ultimate collection of principal and interest (P&I) and is based on key elements such as:
  - Updated and comprehensive financial information for the borrower, the project, and all guarantors and sponsors
  - Current valuations of the collateral supporting the loan and the workout plan
  - Appropriate loan structure (term and amortization), covenants, and requirements for re-margining
  - Appropriate legal analyses and agreements, including those for changes to original or subsequent loan terms

See SR Letter 23-5, "Prudent Commercial Real Estate Loan Accommodations and Workouts."

SR Letter 23-5: Key Concepts (cont.)

- Analyze the borrower’s global debt service coverage (DSC), including realistic projections of the borrower’s cash flow, as well as the availability, continuity, and accessibility of repayment sources
- Analyze the available cash flow of guarantors
- Demonstrate willingness and ability to monitor the ongoing performance of the borrower and guarantor under the terms of the workout arrangement
- Maintain an internal risk rating or loan grading system that accurately and consistently reflects the risk in the workout arrangement
- Maintain an allowance methodology that calculates (or measures) an allowance in accordance with generally accepted accounting principles for loans that have undergone a workout arrangement and recognizes loan losses in a timely manner through provision expense and recording appropriate charge-offs

Assigning Supervisory Risk Ratings to CRE Loans

Risk Rating Considerations

Timely and accurate risk ratings are key to managing risk in the CRE portfolio. It is generally not necessary to classify extensions of credit that are adequately protected by the current sound worth and debt service capacity of the borrower, guarantor, or underlying collateral.

Key Considerations:

- The Special Mention rating is not justified if evidence of weakness cannot be identified.
- Documentation deficiencies alone don't warrant a Special Mention rating. However, when combined with other potential risks, they provide additional support to warrant a Special Mention or more adverse rating.
- Loans should not automatically be criticized, classified, or charged off solely because the value of the underlying collateral has declined.
- Some credits are originated based primarily upon the financial strength of the guarantor, who is, in substance, the primary source of repayment (PSOR). In such circumstances, examiners generally assess the collectability of the credit based upon the guarantor's ability to repay the credit.

Key Takeaway: Credit analysis should include a review of the borrower, guarantor, and/or sponsor (sponsor was not previously included in Workout Guidance). Collateral should also be considered, and a weakness must be identified prior to assigning a criticized or classified rating to a loan.

Evaluating Guarantor or Sponsor

Examiners will review the financial attributes of guarantees and sponsorships in considering the loan classification. Sponsors are similar to guarantors in that they may also possess the financial ability, the demonstrated willingness, and an incentive to provide support for the loan (SR Letter 23-5).

- **Capacity**
  - Assessment of capacity includes a current and robust analysis of the borrower's financial condition, including;
    - The borrower's global cash flow and adequacy of balance sheet liquidity
    - All contingent liabilities and all business and personal cash inflows and outflows
- **Willingness**
  - Determine the guarantor's or sponsor's economic incentive, and if timely repayment is reliant upon guarantor/sponsor support, they must have a track record of using other assets to pay P&I.
  - Troubled projects in which the guarantor/sponsor pays interest may merit continued accrual status, but this level of support does not mitigate the well-defined weaknesses of the credit.

Key Takeaway: If the PSOR fails, is there **CAPACITY and WILLINGNESS** to support the credit by the guarantor or sponsor? Credit analysis should focus on the ability to meet future debt service obligations.

Special Mention

A Special Mention asset has a potential weakness that deserves management's close attention. The Special Mention rating is used to identify a specific level of risk that raises potential concerns about asset quality/credit risk management.

Key Considerations:

- Revenues or rents that are currently sufficient to service debt but declining with reduced collateral margin and conditions signaling further deterioration
- Administrative weaknesses, like dated financial statements for borrower, guarantor, or sponsor; lack of current valuation; or no global financial analysis
- Reliance on secondary source of repayment to service debt
- IO payment plan due to borrower inability to service debt to include principal
- Borrower inability to obtain permanent financing due to financial weakness

Key Takeaway: A specific risk that exposes the institution to a potential weakness should be identified, as well as triggers for both a rating upgrade and downgrade.

Substandard

An asset classified Substandard is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged. The asset must have a well-defined weakness that jeopardizes the liquidation of the debt. The Substandard rating is characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

Key Considerations:

- Performance to plan lagging original underwriting, and PSOR cannot be relied on to repay the loan
- Borrower is experiencing difficulty making timely payments
- Administrative weaknesses, like lack of updated financial statements and appraisals/valuations
- Declining market conditions and/or borrower, guarantor, or sponsor financial deterioration
- Restructured, but not on reasonable repayment terms (i.e., IO at below-market rate)

Key Takeaway: A well-defined weakness must be identified, and potential loss should be quantified, if possible. Substandard loans may require nonaccrual treatment.

Determining Nonaccrual Status

Loans should be placed on nonaccrual status if (1) principal or interest has been in default for 90 days or more, unless the loan is <u>both well secured and in the process of collection</u>; (2) payment in full of principal or interest is not expected; or (3) the loan is maintained on a cash basis because the financial condition of the borrower has deteriorated.

Key Considerations:

- Borrower with limited ability or inability to service debt at below-market terms
- Loan restructuring at below market rates to allow the borrower to service loan
- Partial charge-off of loan amount

Key Takeaway: Nonaccrual status is considered in determining the ACL. Nonaccrual loans should be evaluated individually for expected credit losses (i.e., <u>impairment testing</u>). This will be further discussed in the ACL section of the presentation.

Doubtful

An asset classified Doubtful has <u>all the weaknesses inherent in one classified Substandard with the added characteristic that the weaknesses make collection or liquidation in full</u>, on the basis of currently existing facts, conditions, and values, <u>highly questionable</u> and improbable (i.e., interim measure until information becomes available to substantiate a more appropriate treatment).

Key Considerations:

- <u>Valuation not available</u>, cannot be determined, or in process
- Uncertain financial data that does not permit the accurate forecasting of future cash flows or estimating recovery value
- Legal proceedings, including bankruptcy, mechanics liens, or other litigation involving borrower, guarantor, or sponsor

Key Takeaway: Doubtful is a <u>temporary rating</u> for loans with a well-defined weakness (Substandard and nonaccrual) in which <u>value is difficult to determine</u> and there is low likelihood of repayment in full.

Loss

An asset classified Loss is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted. This <u>classification does not mean that the asset has absolutely no recovery</u> or salvage value, but rather it is not practical or desirable to defer writing off this basically worthless asset, even though partial recovery may be affected in the future.

Key Considerations:

- Loan being 90 days or more past due
- <u>Borrower having limited ability to fully repay P&I</u>
- Borrower experiencing declining or declined cash flow, with reversal unlikely
- Property's value is difficult to determine with likelihood that value is below loan amount
- Guarantor or sponsor is unable or unwilling to provide support to a struggling borrower

Key Takeaway: A loan may be rated Loss if all or some portion of the loan is unlikely to be repaid. If only a portion of a loan is rated Loss, the portion of the loan that is likely to be repaid should be <u>analyzed for appropriate rating and accrual status</u>.

Office Loan Example

Origination: The lender originated a $15 million loan for the purchase of an office building, with monthly payments based on an amortization of 20 years and a balloon payment of $13.6 million at the end of year five. At origination, the loan had a 75 percent loan-to-value (LTV) based on an appraisal reflecting a $20 million market value on an “as stabilized” basis, a DSC ratio of 1.30×, and a market interest rate.

Current Expectations: The lender expected to renew the loan when the balloon payment became due at the end of year five. Due to technological advancements and a workplace culture change since the inception of the loan, many businesses switched to hybrid work-from-home arrangements to reduce longer-term costs and improve employee retention. As a result, the property’s cash flow declined, as the borrower has had to grant rental concessions to either retain its existing tenants or attract new tenants, since the demand for office space has decreased.

Office Loan Example (cont.)

	Origination	Case 1 Renewal	Case 2	Case 3
Loan Amount	$15 million	$13.6 million	$13.6 million	$13.6 million
Amortization	20 Years	15 Years	15 Years	N/A
Term	5 Years	1 Year	1 Year	1 Year
LTV	75%	102%	94%	94%
Value	$20 million	$13.3 million	$14.5 million	$14.5 million
Current Appraisal (Y/N)	Y	Y	N	Y
DSC Ratio	1.30×	1.12×	1.12×	1.10× on IO
Rate	Market	Market	Market	Below Market
Payment Type	P&I	P&I	P&I	IO
Market Trend		Weakening	Weakening	Weakening
Tenant Base		Stable	Weakening	Weakening
Payment History		Paid as Agreed	Paid as Agreed	Current (occasionally past due)
Current Financials (Y/N)		Y	N	N
Accrual Status		**Accrual**	**Accrual**	**Nonaccrual**
Rating		**Pass**	**Special Mention**	**Substandard**

Valuation Requirements for CRE Loans

Collateral Monitoring over the Life of the Credit

When to consider obtaining a new appraisal or an updated collateral valuation:

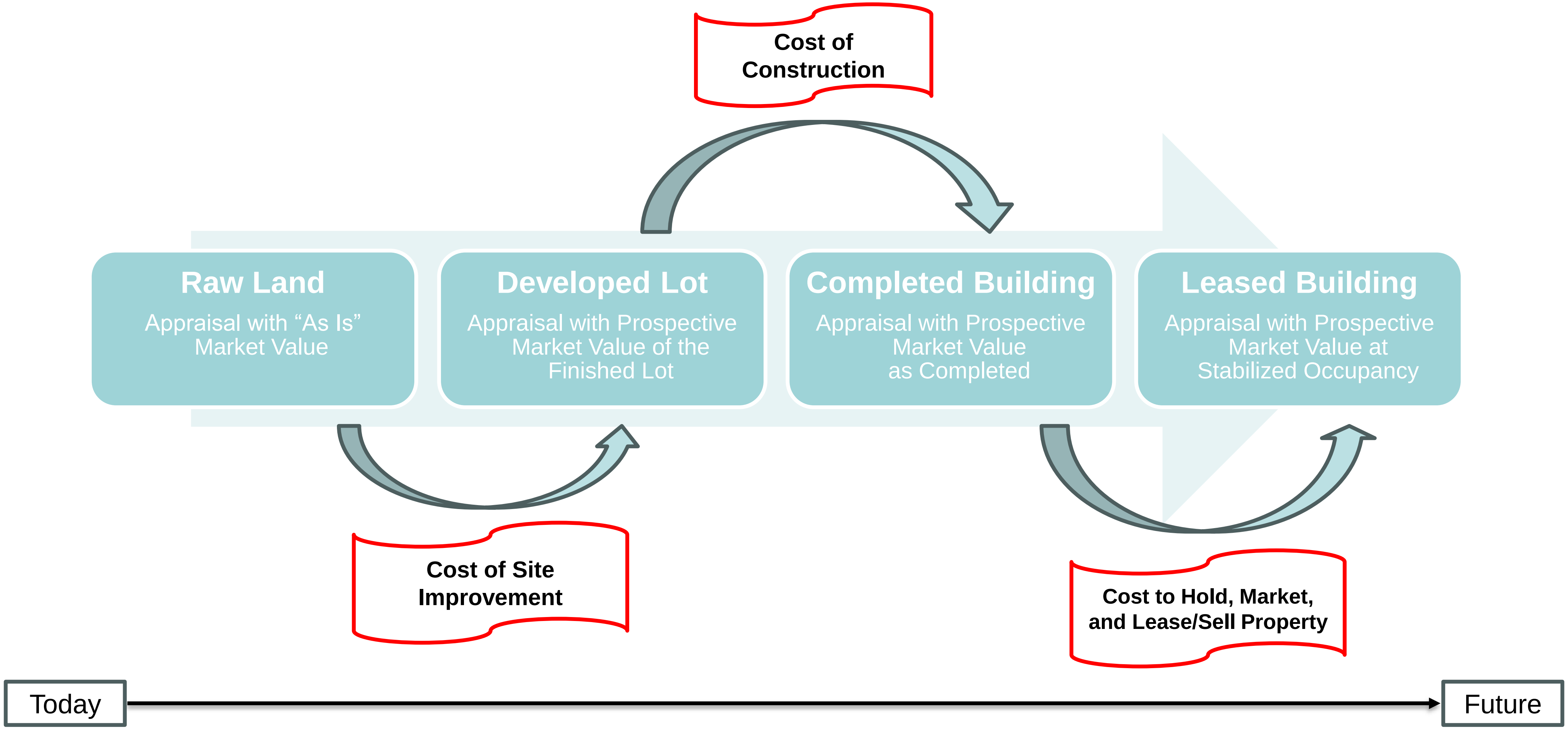
- ✓ Rating/grading a credit
- ✓ High-risk credit
- ✓ Assessment of impairment
- ✓ Loan workout or accommodation
- ✓ Assessment of risk in the loan portfolio

Factors to consider:

- ✓ Changes in market conditions
- ✓ Deterioration in the credit
- ✓ Age of appraisal in loan file
- ✓ Delays in construction
- ✓ Change in use of the property
- ✓ Loan concentration

See SR Letter 10-16, "Interagency Appraisal and Evaluation Guidelines."

Market Value Matches the Purpose of the Loan



Supervisory Assessment of Collateral Values

- Per the appraisal regulation, examiners can direct banks to obtain a new valuation:
  - If weaknesses exist in the financial institution’s supporting loan documentation or appraisal or evaluation review process.
- Examiners can adjust collateral values and LTVs for classification purposes:
  - If the underlying facts or assumptions presented by the financial institution are irrelevant or inappropriate or can support alternative assumptions based on available information.
- Examiners should not reappraise property but should:
  - Assess the major facts, assumptions, and valuation approaches in the collateral valuation process and their influence on the financial institution’s credit and allowance analyses.

See 12 CFR 225, subpart G, and 12 CFR 208, subpart E.
See SR Letter 23-5.

Appraisal Regulatory Requirements for Subsequent Transactions

- Renewals, refinancings, and other subsequent transactions may be supported by evaluations rather than appraisals. The appraisal regulation permits an evaluation when either:
  - There has been no obvious and material change in market conditions or physical aspects of the property that threatens the adequacy of the bank's real estate collateral protection after the transaction, even with the advancement of new monies; **or**
  - There is no advancement of new monies other than funds necessary to cover reasonable closing costs.

See 12 CFR 225, subpart G, and 12 CFR 208, subpart E.
See SR Letter 16-5, "Interagency Advisory on the Use of Evaluations in Real Estate-Related Financial Transactions," and SR Letter 10-16.

Is a Loan Modification or Workout a Subsequent Transaction?

- A loan modification that entails a decrease in the interest rate or a single extension of a limited or short-term nature would not be viewed as a subsequent transaction.
- Examples:
  - An extension arising from a short-term delay in the full repayment of the loan when there is documented evidence that payment from the borrower is forthcoming
  - A brief delay in the scheduled closing on the sale of a property when there is evidence that the closing will be completed in the near term

See SR Letter 10-16.

ACL: Considerations for CRE Credits

ACL Overview

- Banks should consider *past events*, *current conditions*, and reasonable and supportable *forecasts* when estimating expected credit losses.
- The Financial Accounting Standards Board (FASB) requires estimating credit losses over the *contractual term* of the loans, considering expected prepayments. Renewals, extensions, and modifications are *excluded* from the contractual term.
- Expected credit losses should be evaluated on a *collective*, or *pooled*, *basis* when loans share similar risk characteristics.
- If a CRE loan does not share similar risk characteristics with other pooled loans, expected credit losses on the loan should be measured *individually*.

Pooled CRE Loans

- CRE loans should be segmented by considering relevant risk characteristics such as *property type* (e.g., office, hotel, warehouse) as historical data are available.
- *Historical losses* are the basis for loss rates applied to segments or loan pools. Examiners should ensure a *full credit cycle's* worth of loss rates is used.
- Management is required to consider forward-looking information, or *forecasts*, when estimating expected credit losses.
- Qualitative factor adjustments should be made to the ACL to ensure *all significant relevant factors* that affect loan collectability are considered.

Individually Evaluated CRE Loans

- Individually evaluated CRE loans are typically composed of *large, Substandard nonaccrual* loans.
- Failure to appropriately identify loans that should be on *nonaccrual* will result in an understated ACL if the loss rate applied to the pool of CRE loans is lower than the expected credit loss calculated using the *collateral method*.
- For regulatory reporting purposes, expected credit losses for *collateral-dependent loans** is measured using the fair value of collateral method, regardless of whether foreclosure is probable.

*****FASB ASC Topic 326 describes ***collateral-dependent assets*** as financial assets for which the repayment is expected to be provided ***substantially*** through the ***operation or sale of the collateral*** when the borrower, based on management's assessment, is experiencing financial difficulty as of the reporting date.

ACL Example: Accrual versus Nonaccrual Loan

- CRE office loan: Substandard, **accruing** loan
  - Loan balance is $10.0 million.
  - Collateral value is $9.5 million.
  - Loan is **pooled** with other CRE office loans.
  - Pooled CRE office loans have an average loss rate of 1.5 percent.
  - ACL allocation for loan is **$150,000** ($10.0 million times 0.015).

- CRE office loan: Substandard, **nonaccrual** loan
  - Loan balance is $10.0 million.
  - Collateral value is $9.5 million.
  - Loan is **individually evaluated**.
  - Foreclosure is probable; costs to sell are 5 percent.
  - ACL allocation for loan is **$1,000,000** ($10.0 million minus $9.5 million plus $0.5 million).

Key Takeaway: Not properly designating loans as ***nonaccrual*** can create an ACL that is understated.

ACL Example: Pass-Watch Loan

- CRE office loan graded **“Pass-Watch”**
  - Loan balance is $10.0 million.
  - Collateral value is $10.5 million.
  - The bank has a policy of measuring loans graded **“*Pass-Watch*”** or worse individually.
  - Pooled CRE office loans have an average loss rate of 1.5 percent.
  - There is **no ACL allocation** for this loan because the collateral value of $10.5 million exceeds the loan balance of $10.0 million.

- CRE office loan graded **“Pass-Watch”**
  - Loan balance is $10.0 million.
  - Collateral value is $10.5 million.
  - The bank has a policy of measuring loans graded **“*Substandard, nonaccrual*”** or worse individually.
  - Pooled CRE office loans have an average loss rate of 1.5 percent.
  - This loan is allocated **$150,000** ($10.0 million times 0.015) in the ACL.

Key Takeaway: Measuring loans individually for expected credit losses that still share similar risk characteristics with other loans can lead to an understated ACL.

Closing

- Current CRE market conditions are challenging.
- Information on a CRE loan’s collateral value and loan performance is critical in determining a loan’s classification.
- This information is also key to assessing the adequacy of a bank’s allowance for CRE credit losses.

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Acronyms/Abbreviations

- ACL – allowances for credit losses
- ADC – acquisition, development, and construction
- CECL – current expected credit losses
- CLO – collateralized loan obligation
- CMBS – commercial mortgage-backed security
- CRE – commercial real estate
- DSC – debt service coverage
- FASB – Financial Accounting Standards Board
- FDIC – Federal Deposit Insurance Corporation
- Fed – Federal Reserve
- IO – interest-only
- LTV – loan-to-value
- MF – multifamily
- NOI – net operating income
- P&I – principal and interest
- PSOR – primary source of repayment

Resources

SR Letters

- SR Letter 23-5, "Prudent Commercial Real Estate Loan Accommodations and Workouts"
- SR Letter 20-12, "Interagency Policy Statement on Allowances for Credit Losses"
- SR Letter 19-8, "Frequently Asked Questions on the Current Expected Credit Losses Methodology (CECL)"
- SR Letter 18-9, "Frequently Asked Questions on the Appraisal Regulations and the Interagency Appraisal and Evaluation Guidelines"
- SR Letter 16-5, "Interagency Advisory on the Use of Evaluations in Real Estate-Related Financial Transactions"
- SR Letter 16-2, "Interagency Advisory on External Audits of Internationally Active U.S. Financial Institutions"
- SR Letter 15-17, "Interagency Statement on Prudent Risk Management for Commercial Real Estate Lending"
- SR Letter 10-16, "Interagency Appraisal and Evaluation Guidelines"
- SR Letter 07-1, "Interagency Guidance on Concentrations in Commercial Real Estate"

Other Resources

- Ask the Regulators (9/14/23): Commercial Real Estate Loan Accommodations and Workout Guidance
- Federal Reserve System's CECL Resource Center

Thanks for joining us.

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