

Commercial Real Estate Risk Management

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Agenda

- Introduction and keys to commercial real estate (CRE) lending
- Key #1 – Understanding key risk areas & enterprise risk management (ERM)
briefly covered in Foundational CLS, deeper today, built around four keys to CRE loan performance
- Key #2 – Properly developing net operating income (NOI) & cash flow available for debt service (CFADS), *covered in Foundational CLS*
- Key #3 – Understanding the non-financial risks affecting CRE lending, covered in *Foundational CLS*



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Agenda (cont.)

- **Key #4 – Differentiating properties/projects, analysis and underwriting**
- **Key #5 – Utilizing concept of sponsorship (relevant experience of owner/borrower/ guarantor)**
- **Key #6 – Developing a global analysis, *also a separate Advanced CLS class***
- **Key #7 – Following appraisal and **environmental rules/regulations** (*other Advanced CLS classes will cover appraisals*)**
- **Key #8 – Effectively administering/monitoring loans post-closing**
- **Key #9 – Maintaining portfolio diversification**

Leading Off, Key #1: Four Elements of CRE Loan Performance

1. _____
 - Stable economic conditions consistent with the property's market focus
 - Sales prices, rental rates, vacancy rates, inventory of properties, space absorption rates, construction starts and/or permits
 - More on viability of the market – all of these are somewhat beyond control of borrower and bank, and risk increased by longer amortizations
 - Economic and demographic trends
 - Generate space demand from increasing population and employment
 - Supply and demand
 - Demand meets or exceeds current and expected future supply
 - Competing properties
 - Being able to assess advantages and disadvantages of a subject property compared to competitors

Four Elements of CRE Loan Performance (cont.)

2. Sustainability of income
 - Sustainable income structure to support debt service
 - Tenant quality, lease terms, flexibility of expense reimbursements, financial leverage
3. _____
 - Property demonstrates stable, competitive characteristics that support collateral value
 - Location attributes (visibility, condition, access), experienced property management
4. Capability of borrower/sponsor
 - Demonstrates capable credit and non-credit support?
 - Depth of management team; financial resources, liquidity and flexibility; overall investment portfolio



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Five Risks to Sustainable Cash Flow

1. Tenant rollover risk
 - Ability to re-lease space over life of project and amortization of loan
 - “Overhang” – typical lease lengths shorter than full amortization period of debt
 - More of a concern for business-tenant properties
2. Change in market fundamentals
 - External forces such as economy and CRE cycles affecting supply/demand



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Five Risks to Sustainable Cash Flow (cont.)

3. _____

- Ability to adapt to changes in the nature, demands and expectations of market

4. Operational risk

- Internal factors such as management team, maintenance and vacancy

5. _____

- Adequate capital and resources to support changes to property to meet market needs

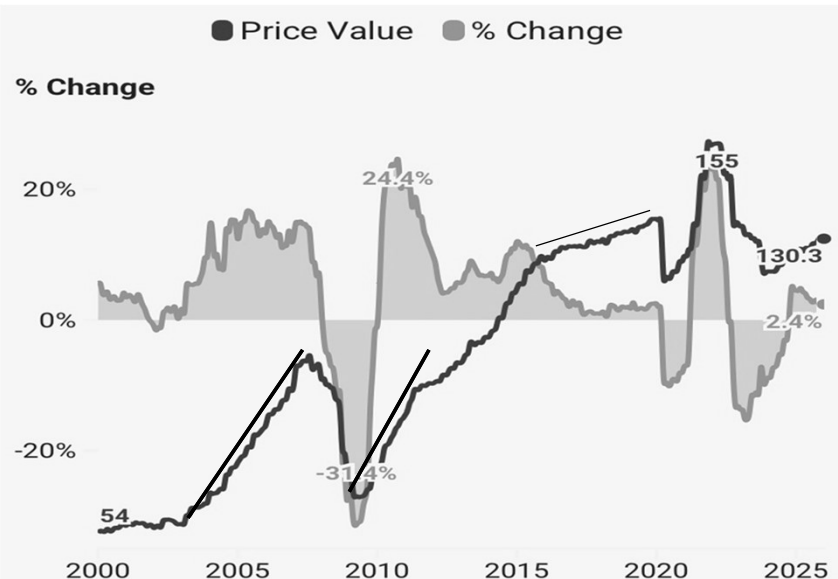


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Pre-Pandemic CRE Prices Were Relatively Flat, Fell 10% During Pandemic, Then Zoomed Up 24% in 2021, Peaked in March 2022, Then Down 21% as Fed Raised Interest Rates, Then Up 5% in 2024 and Up 2.4% in 2025

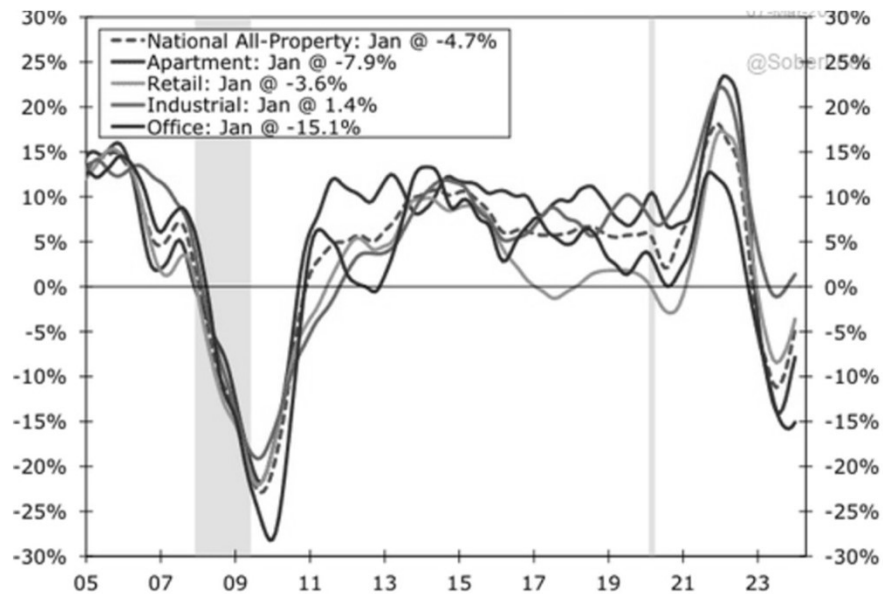
“Quiet year ahead for property pricing” with cap rates not changing much and values inching higher, similar to 2025.



Source: Green Street • All Property CPPI weights: retail (20%), apartment (15%), health care (15%), industrial (12.5%), office (12.5%), lodging (7.5%), data center (5%), net lease (5%), self-storage (5%), manufactured home park (2.5%). Retail is mall (50%) & strip retail (50%).

 American Bankers Association

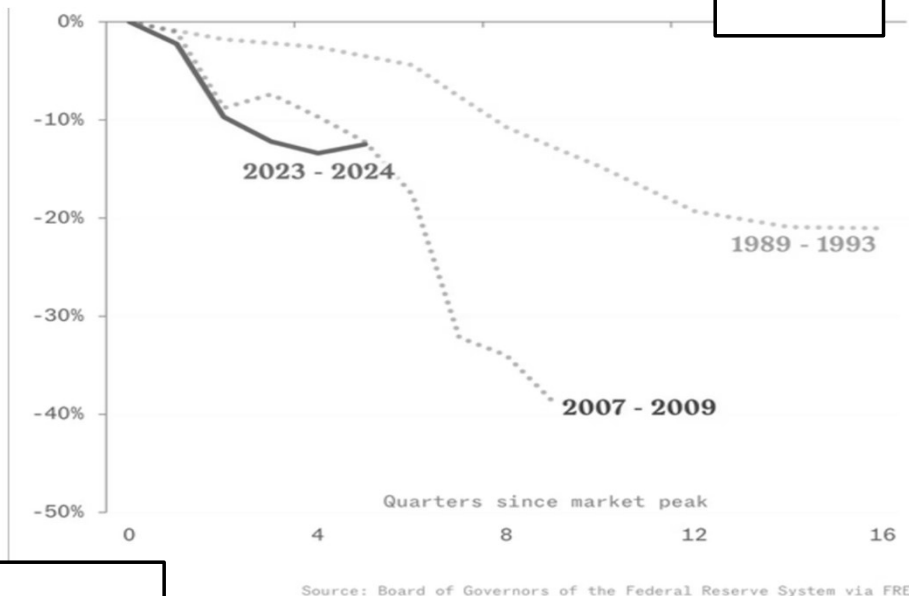
**Real Capital
Analytics
Commercial
Property Price
Index
Year-Over-Year
Change as of Q4
2023**



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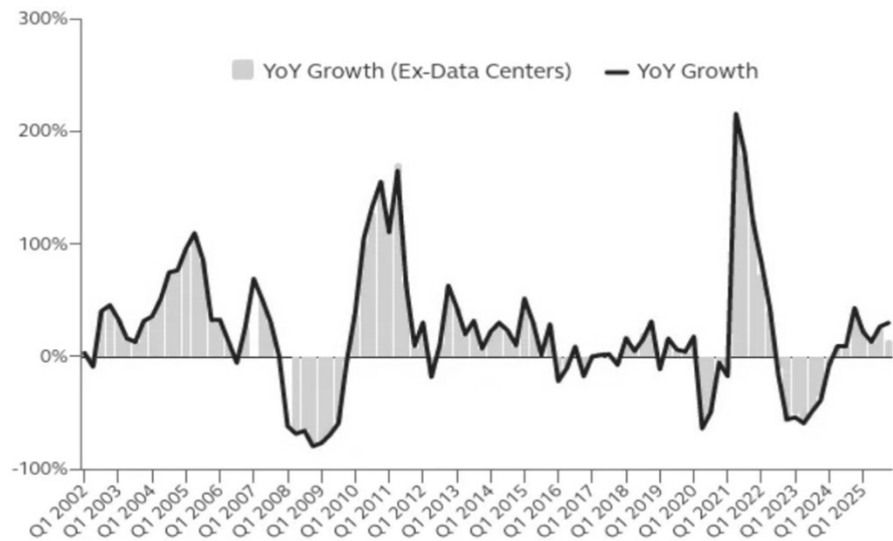
**For a Little
More History,
Decline in CRE
Index,
Peak to Trough,
by Years**



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CRE Transaction Volume 2022-Present



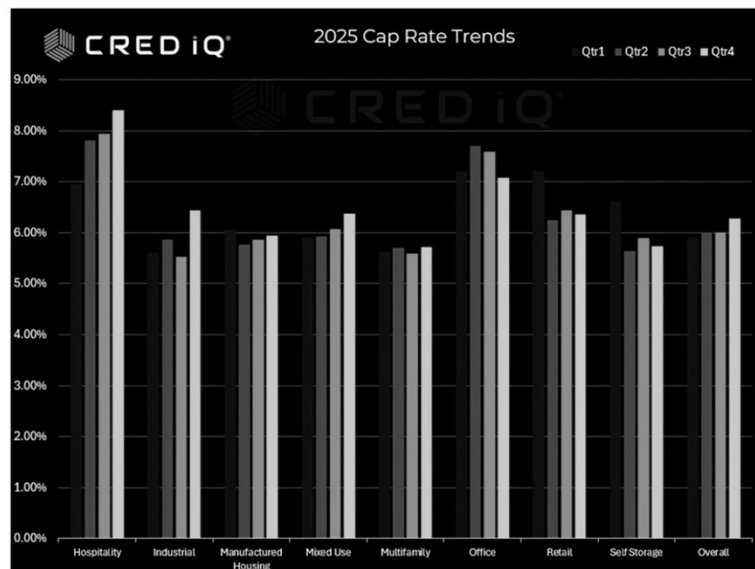
Source: MSCI, Real Capital Analytics, Principal Real Estate. Data as of 4Q 2025.

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Cap Rates in 2025, Quarterly by Property Type (for Large Transactions)

Cap rates across CRE widened modestly, with hospitality and industrial properties seeing the sharpest increases, while multifamily and retail showed resilience and compression



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Interagency Policy Statement on Prudent CRE Loan Accommodations and Workouts, June 29, 2023 (FIL-34-2023)

- Updates October 30, 2009 Policy Statement on Prudent Commercial Real Estate Loan Workouts (2009 Statement) after considering comments received on the Proposed Guidance (August of 2022)
- Discusses the importance of working constructively with CRE borrowers experiencing financial difficulty and is appropriate for all supervised financial institutions engaged in CRE lending
- Addresses sound principles and supervisory expectations about a bank's handling of loan accommodations and workouts on matters including (1) risk management, (2) classification of loans, (3) regulatory reporting, and (4) accounting considerations, and includes updated references to supervisory guidance
- Recognizes that prudent CRE loan accommodations and workouts are often in the best interest of both the bank and the borrower
- Reaffirms the key principles from the 2009 Statement
 1. Financial institutions that implement prudent CRE loan accommodation and workout arrangements **after performing a comprehensive review of a borrower's financial condition** will not be subject to criticism for engaging in these efforts, even if these arrangements result in modified loans that have weaknesses that result in adverse classification; and

Interagency Policy Statement on CRE Loan Accommodations/Workouts (cont.)

2. Modified loans to borrowers who have the ability to repay their debts **according to reasonable terms** will not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the outstanding loan balance.
- Includes five appendix items
 - Appendix 1 contains examples of CRE loan workout arrangements illustrating the application of this statement to classification of loans and determination of nonaccrual treatment
 - Appendix 2 lists selected relevant rules as well as supervisory and accounting guidance for real estate lending, appraisals, allowance methodologies, restructured loans, fair value measurement, and regulatory reporting matters such as nonaccrual status
 - Appendix 3 discusses valuation concepts for income-producing CRE
 - Appendix 4 provides the special mention and adverse classification definitions used by the Board, FDIC, and OCC
 - Appendix 5 addresses the relevant accounting and supervisory guidance on estimating loan losses for financial institutions that use the current expected credit losses (CECL) methodology

Advisory: Managing CRE Concentrations in a Challenging Economic Environment, December 18, 2023 [FIL-64-2023]

- The advisory also identifies key risk-management actions for financial institutions with significant CRE concentrations to manage through changes in market conditions:
 - Maintain strong capital levels,
 - Ensure that credit loss allowances are appropriate,
 - Manage construction and development (C&D) and CRE loan portfolios closely,
 - Maintain updated financial and analytical information,
 - Bolster the loan workout infrastructure, and
 - Maintain adequate liquidity and diverse funding sources.
- Institutions are encouraged to continue making CRE credit available in their communities using prudent lending standards that rely on strong underwriting and loan administration practices.

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For Future Reference

- After this class you can utilize and refer to the OCC's *CRE Lending Handbook* available at www.occ.gov
 - Even if your bank is not a national bank
 - Most other regulators "agree" with content
- This session will review key items, excluding sections on appraisals, problem loans and construction, since you have other CLS classes on those topics

Comptroller's Handbook

Safety and Soundness

Capital Adequacy (C) Asset Quality (A) Management (M) Earnings (E) Liquidity (L) Sensitivity to Market Risk (S) Other Activities (O)

Commercial Real Estate Lending

Version 2.0, March 2022

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CRE Lending Handbook: Overview (OCC p. 3)

- CRE lending is an important line of business for the banking industry, and CRE activities contribute significantly to the U.S. economy.
- Many banks rely on revenue from this business to grow and prosper. Imprudent risk-taking and inadequate risk management, particularly during periods of rapid economic growth, can lead to significant levels of problem assets and loan losses and can contribute to bank failures.
- One of the key elements of risk in this type of lending is the **cyclical nature** of real estate markets. As markets peak and decline, banks with large concentrations of CRE loans can suffer considerable distress.

CRE Lending Handbook: Overview (cont.)

- Although the banking industry cannot accurately predict or control the timing of the real estate business cycle, banks that consistently engage in prudent **risk management practices** can more effectively manage risk from CRE lending and keep losses from CRE lending to a manageable level, even when markets experience significant stress.



CRE Lending Handbook: The CRE Industry (OCC p. 4)

- The CRE industry is highly cyclical and is affected by changes in local and national economic conditions.
 - Although national conditions affect the overall CRE industry, national conditions' influence on local conditions is also important.
- Factors such as
 - Rates of employment
 - Consumer demand
 - Household formation, and
 - Level of economic activity can vary widely from state to state and among metropolitan areas, cities, and towns.

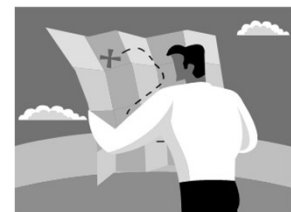


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CRE Lending Handbook: The CRE Industry (cont.)

- Metropolitan markets comprise various submarkets where property values and demand can be affected by many factors, such as
 - Demographic makeup
 - Geographic features
 - Transportation
 - Recreation
 - Local government
 - School systems
 - Utility infrastructure
 - Tax burden
 - Building-stock age
 - Zoning and building codes
 - Changes in telework trends
 - Land available for development



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CRE Lending Handbook: Property Types (OCC p. 4)

- In addition to geographic considerations, markets can be defined by property type.
- A bank's CRE lending strategy may target one or more of the five primary CRE sectors:
 - Office
 - Retail
 - Industrial
 - Hospitality
 - Residential
 - Includes **multifamily** and **one- to four-family** residential development and construction



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CRE Lending Handbook: Property Types (cont.)

- Although all sectors are influenced by economic conditions, some sectors are more sensitive to certain economic factors than others.
- Overall, banks are expected to monitor the conditions in the markets where they are active
 - For example, the demand for office space depends on office-related employment, which tends to be concentrated in the finance, insurance, technology, and CRE industries, as well as some categories of services, particularly business services.
 - As another example, demand for retail space is affected by local employment levels and consumer spending, as well as trends in online shopping.

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CRE Lending Handbook: Property Types (cont.)

- Demand for industrial space tends to be influenced by proximity to labor, transportation infrastructure, local tax rates, population centers, and the presence of a similar or related industry.
- The hospitality sector is affected locally by the level of business activity but is also influenced by consumer spending, the cost of travel, and the strength of the U.S. dollar.
- In the residential sector, demand is heavily influenced by the local quality of life, demographics, affordability of homeownership, the rate of household formations, and local employment conditions.



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CRE Lending Handbook: Property Types (cont.)

- The Handbook includes sections on
 - Acquisition, development and construction (ADC) loans, and
 - High-volatility CRE (HVCRE) loans
- Group discussion #1: What other types of CRE factor prominently in your bank's portfolio? What are some key areas of focus in these?

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OCC Appendix D: Underwriting Considerations by Property Type (OCC p. 119)

- Office
- Retail
- Industrial
- Multifamily
- Hospitality
- Residential health care
- Religious organizations
- Residential rental homes
- Ground leases
- Affordable housing
- REITs
- Owner-occupied properties



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Let's Look at an Example of Underwriting Considerations, Time Permitting (pp. 14-15)

- Well take a moment to review the apartment/multifamily discussion
- Based on your experiences, what would you add or edit?



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(Time Permitting) To get a feel for how the OCC lays out the **Underwriting Considerations**, please read/review the **Multifamily** section below:

MULTIFAMILY

Multifamily rental properties fill an important need in many communities; they can be more affordable than owner-occupied housing and offer relatively short-term housing solutions. Multifamily, or apartment, properties have historically been one of the most stable property types, despite typical leases of one year and higher rates of tenant turnover than other property types. Like office buildings, multifamily buildings are graded for quality from A to C.

- Class A properties are newer, luxury apartments in prime areas with tenant amenities, such as high-end fixtures, pools, and gyms
- Class B properties are usually older than 15 years, well maintained, and average quality
- Class C properties are generally in less desirable locations, not as well maintained, and have building infrastructure that is older than 20 years

Property management ability is critical to the success of these properties; inept or inexperienced management is a major cause of difficulty for loans financing multifamily dwellings. Managing tenant turnover requires a constant marketing effort to attract new tenants; further, management must keep tenants when possible by being attentive to their needs.

In addition to attracting and keeping tenants, management must do an effective job of collecting rents. Even though a review of the rent roll might indicate a high rate of occupancy, actual collections should be examined to determine the true economic occupancy and evaluate the competency of property management and the effectiveness of its collection efforts. Whether properties are self-managed or managed by a third party, the property manager's ability and experience should be carefully evaluated.

Important considerations for multifamily properties include:

- **Demographics:** income levels, age distribution, rate of household formations, and household sizes.
- **Economic factors:** affordability of entry-level single-family housing versus renting, strength of local economy, local employment conditions including current levels and trends, trends in the value of single-family housing, current levels and trends for local rents, and vacancy
- **Location factors:** local quality of life; proximity to shopping, recreation, and employment; school system; and availability of land for future residential development.
- **Local and state laws:** rent control and or stabilization programs, co-op/condominium conversion rules, low income housing programs

Property-specific considerations include

- Occupancy history
- Collection losses
- Rents as compared with competitive properties

- Management quality
- Ingress and egress
- Quality of construction, age, and condition of improvements
- Parking availability and convenience
- Amenities as compared with competitive properties
- Availability of individual unit metering for utilities

Lack of proper maintenance can pose a significant risk to the viability of multifamily properties. Undercapitalized borrowers may neglect needed maintenance when cash flows are inadequate, and that can result in increased turnover and vacancies. Deferred maintenance can significantly affect loan losses and expenses in the event of foreclosure. An inspection of the property should determine how many of the vacant units are rentable in their current condition; cash-strapped borrowers sometimes “cannibalize” vacant units of appliances, heating units, and other items when replacements are needed. It is important that banks monitor property maintenance and improvements to verify they are timely and appropriate. Banks should assess whether cash flow is adequate to provide for necessary replacements and upgrades over time.

Historical operating expenses should be carefully analyzed. Operating expenses would usually range from 35 to 45 percent of revenue. Older properties, those with more amenities, and properties where the landlord provides heat, water, or electricity as part of the rent (usually because of lack of separate metering) represent the upper end of the range.

A multifamily property is typically underwritten with management fees of 5 percent of revenues. Replacement reserves for multifamily properties are underwritten on an annual per unit basis and vary based on the age and condition of the property.

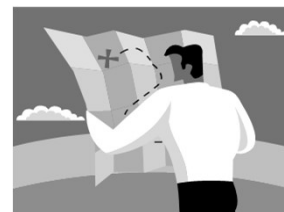
What can you add to the OCC’s comments about multifamily?

Risks Associated with CRE Lending (OCC pp. 10-16)

- All banking products and service have some level of almost all of these risks
 - Key: Which risks can that line of business control, for the most part, and which ones require “help” from other areas of the bank? (This is the concept of **ERM** or enterprise risk management.)
1. Credit risk
 - Construction issues
 - Market conditions
 - Concentration risk
 - Regulatory changes
 - Interest rates
 - Environmental liability
 2. Interest rate risk
 3. Liquidity risk
 4. Operational risk
 5. Compliance risk
 5. Strategic risk
 6. Reputation risk
 7. Price risk

Risk Management Overview (OCC p. 17)

- Each bank should identify, measure, monitor, and control risk by implementing an effective risk management system appropriate for the bank’s ____, ____, and **risk profile**.
- When examiners assess the effectiveness of a bank’s risk management system, they consider the bank’s
 - Policies
 - Processes
 - Personnel
 - Control systems
 - Referencing various other regulatory booklets and publications.



Risk Management Overview (cont.)

- A common risk management system used in many banks, formally or informally, involves three lines of defense:
 1. Frontline units, business units, or functions that create risk
 2. Independent risk management, credit risk review, compliance officer, and chief credit officer to assess risk independent of the units that create risk
 3. Internal audit, which provides independent assurance.
 - Control systems include internal and external audits, credit risk review, quality control (QC), and quality assurance (QA).
- The structure and function of risk management systems and their components can vary depending on the size and complexity of the bank's CRE lending operations.

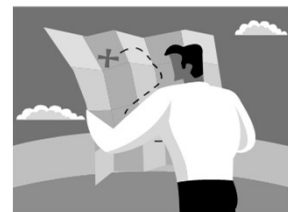


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Risk Management Components (OCC p. 17)

- Management and board oversight, including
 - Strategic planning
 - Governance structure
 - Management and board repots
 - Loan policies
 - CRE lending standards
 - Loan portfolio management considerations
 - Underwriting standards



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CRE Lending Standards (OCC p. 19)

- All banks should have written policies that are appropriate for the bank's size and the nature of its CRE lending and risk tolerance of its board of directors
- Key elements, from *Interagency Guidelines for Real Estate Lending Policies*
 1. Loan portfolio management considerations
 2. Underwriting standards, such as DSC, LTV, creditworthiness, borrower equity, credit enhancements and additional elements for each loan program or property type including acquisition, development and construction (ADC), which has a large section by itself in the handbook
 3. Loan administration
 4. LTV limits, including supervisory limits (SLTVs) and extended comments on how to calculate in various scenarios
 5. Exceptions to general lending policy
- Factors examiners should consider for evaluating adequacy of a bank's CRE policies

CRE Lending is Policy-Intense, so “Pick Your Battles”

- The CRE lending process is policy-intense, and regulators advocate having a differentiated or risk-based approach
- Controlling any segment of the loan portfolio is a **balancing act** – you can't do everything with every credit
 - Larger credits and riskier situations deserve more attention
 - Smaller credits and less risky situations need a more streamlined process and monitoring
- Benchmarks or guidelines from a consultant or another bank may not fit the unique aspects of your portfolio or targeted areas of expansion, by property type or geography
- Your loan policies are an extension of your credit culture



Stratifying Bank Loan Policies

- The key for balance is to stratify your policies where possible
- Four critical factors for stratifying
 1. Know some general lending practices (universal issues) that transcend bank size or portfolio composition, but are keyed to loan or project size
 2. Know where the “80/20 rule” affects your existing portfolio
 3. Know where your bank’s “threshold of pain” is
 4. Identify areas for special handling, regardless of size



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Stratifying Bank Loan Policies (cont.)

1. Some examples of universal issues
 - CRE project size (not loan size) of \$10 million or larger should have a bonded general contractor
 - Borrower’s equity goes into construction project first or with first draw
 - SLTVs and related tracking
 - All appraisals get at least a compliance review
2. For non-universal issues, find the 80/20 rule
 - Portfolio-specific
 - List all CRE notes or loans in descending order of size
 - Find point where 1/5th of the loans comprise 4/5th of dollars outstanding
 - This is the heart of credit risk management – saving increased due diligence, loan documentation and monitoring for the larger credits – get “bang” for your policy “buck”
 - Otherwise, portfolio-wide procedures not effectively stratified at the proper size levels will lead to unmanageable workload and staffing issues
 - Example portfolio . . .



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Example Small Community Bank Portfolio

- Total CRE Outstanding = \$72,800,000
- Total # of Relationships = 226 (most consisted of one note)
- Top 20% Relationships = 45
 - Cumulative \$ Outstanding through #45 = \$55,772,000
 - 77% of total, so very close to 80/20
 - Relationship #45 = \$496,000 Outstanding
- Recommended stratification target level of \$500,000 for various policies
 - Focus more intense policies on these larger loans (only about 1 out of 5, or 45 out of 226) places more attention on about 80% of dollars outstanding
 - Very powerful tool for workload and time management



Stratifying Bank Loan Policies (cont.)

2. Some examples of 80/20 issues
 - **Levels of appraisal review, over and above compliance mandate**
 - Third party construction inspections and other controls such as funding
 - Loan authorities (committees or individuals)
 - Frequency of periodic financial updates, lease verification
 - Length and complexity of loan package and memorandum
3. Determine bank's threshold of pain (TOP)
 - Usually smaller than where the 80/20 rule appears to be
 - Size level of possible problem loans or losses that management clearly wishes to minimize
 - More subjective than objective
 - Be careful to limit number of policies keyed to this dollar size, or you create workload issues
 - Graphically . . .



Stratifying Bank Loan Policies (cont.)

\$^^^^	1/5 th
\$XXX^	Universal Issues^^
\$XX^	4/5 th 80/20 Rule^^
\$X^	Threshold of Pain^^



Stratifying Bank Loan Policies (cont.)

3. Some examples of TOP issues
 - Outside attorney to close
 - Require an appraisal or other formal evaluation at lower size limits
 - Exceptions to bank's defined market area
 - Negative pledge not allowed (formal lien required)
4. Identify areas for special handling, any size
 - Higher risk properties
 - Property or loan types where your staff expertise is limited
 - Loan with complex or labor-intensive monitoring
 - Loans with major policy exceptions
 - Known problem assets
 - Graphically . . .



Stratifying Bank Loan Policies (cont.)

\$^^	1/5 th	Nursing Homes	Convenience Stores	Major Policy Exception (LTV, etc.)
\$XXX^	Universal Issues^^			
\$XX^	4/5 th 80/20 Rule^^			
\$X^	Threshold of Pain^^			



Stratifying Bank Loan Policies (cont.)

4. Some examples of special handling issues

- Formal feasibility study for CRE project, both marketing and plans/costs
 - Such as new or renovated hotels, nursing homes, convenience stores, certain multi-family or self-storage
- Third party draw inspections
- Third party review of plans and budget
- Attorney review of leases and construction contract
- And many others . . .



Key #4 – Differentiating Analysis/Underwriting by Property Types

- Effective CRE lending policies generally reflect the following **for each type of loan or property**:
 - Minimum standards for borrower or project net worth, support provided by guarantees (if applicable), borrower and guarantor cash flow, and DSC
 - LTV limits by property type.
 - Maximum loan tenor or length
 - Minimum **debt yield**
 - Amortization criteria
 - Pricing and profitability objectives



Differentiating Analysis/Underwriting (cont.)

- Effective CRE lending policies generally reflect the following **for each type of loan or property (cont.)**:
 - Minimum standards of documentation consistent with the type of lending performed.
 - For construction loans, effective construction risk management with disbursement controls sufficient funds available to fund completion.
 - Standards for evaluating borrower and guarantor creditworthiness and global financial condition, including
 - Assets (type, amount, and liquidity)
 - Global cash flow
 - Direct and contingent liabilities
 - Any tertiary repayment sources that may be available to a bank in the event of recourse.
 - Minimum requirements for the borrower's initial **hard equity** (such as cash or unencumbered investment in the underlying property)

Differentiating Analysis/Underwriting (cont.)

- Effective CRE lending policies generally reflect the following **for each type of loan or property (cont.)**:
 - Expectations for evaluating project feasibility and sensitivity to changes in economic conditions, including the sensitivity of projections to changes in market variables, such as interest rates, vacancy rates, and operating expenses
 - Expectations for reviewing construction and site plans and construction budgets
 - Deterioration or damage to improvements that may materially affect property value
 - Standards for the acceptability of and limits on the use of interest reserves
 - Requirements and limits on interest-only loans for stabilized CRE
 - Preleasing requirements for income-producing property
 - Presale and minimum release requirements for tract development financing

Differentiating Analysis/Underwriting (cont.)

- Effective CRE lending policies generally reflect the following **for each type of loan or property (cont.)**:
 - Limits on partial and nonrecourse loans
 - Requirements for takeout commitments
 - Requirements for affirmative and negative loan covenants
 - Requirements for borrower equity such as specifying the amounts required, the acceptable types and sources of equity, and the timing of the equity contribution
 - Environmental risk management standards



Key #5 – The Concept of Sponsorship

- Ability of customer to support the subject property
- Re-labeling your guarantor/borrower/owner to expand the analytical focus
- Two Primary Areas
 1. Financial resources
 2. Experience: Ability to build, lease or manage THIS type of property in THIS or very similar market, including the use qualified third parties, such as
 - Property managers
 - Project managers
 - Leasing agents
 - CPA/legal/insurance team



Sponsorship Sometimes Involves the Sponsor Being Able to Have and Explain a Strategy, Some Examples



- Maximize cash flow
 - Withdraw net rental cash flow for bus. or personal use
 - Construct properties for fee/profit upon sale at completion
- Grow the business
 - Reinvest net cash flow into purchases of additional properties or projects
- Maximize future value
 - Hold properties to realize price appreciation
 - Purchase troubled properties and lease up to stabilization
 - What is exit strategy?
- Minimize tax liabilities
 - Take advantage of depreciation and interest cost “shield” for as long as possible

Great Quote Applicable to CRE Lending and Carefully Understanding the Relevant Experience of Your Owner/Borrower/Guarantor/Whatever

- *“When a person with money meets a person with experience, the person with the experience ends up with the money and the person with the money ends up with the experience.”*
 - Harvey Mackey, author, speaker and business owner

Key #7 – Following Appraisal and Environmental Rules/Guidelines

- Three environmental risks to CRE lenders
 1. Environmental contamination could significantly impair the value of the real estate
 2. Clean-up or mitigation costs and liabilities could compromise a borrower's credit worthiness
 3. Upon foreclosure, the bank could become liable for environmental cleanup costs
- See appendix for more environmental information/updates



Key #8 – Effectively Administering & Monitoring Loans Post-Closing (Excluding Construction)



- _____
 - From project or borrower
 - Rent rolls
 - Tax returns (Personal – Form 1040, Schedule E or Business – Form 1065/1120s, Form 8825)
 - Financial statements
 - From guarantors/sponsors
 - From sole or key/credit tenants
- Compute NOI, then updated DSC, LTV and estimated value

Loan Monitoring (cont.)



- Updated lien status
 - Secondary liens often prohibited in loan documents
 - Complications in workout or bankruptcy
- Proper insurance coverage and payment of RE taxes
- Periodic site inspections
 - Required for construction draws
 - Also for existing, amortizing loans
 - Easy to miss, if no pending request, renewal, maturity or past due status
 - Annually as a minimum, more frequent for larger or riskier projects
 - Process
 - Unannounced preferred (planned OK)
 - Talk to tenants, take photos

Key #9 – Maintaining Portfolio Diversification

- Appropriate for size of portfolio and level and nature of concentrations and associated risk
- Key elements (based on 2006 Interagency Guidance)
 1. Board and management oversight
 2. Portfolio management
 3. Management information systems (MIS)
 4. Market analysis
 5. Credit underwriting standards
 6. Portfolio stress-testing and sensitivity analysis
 7. Credit risk review function

Maintaining Portfolio Diversification (cont.)

- Specific criteria that, when approached or exceeded, may prompt further supervisory analysis of the level, nature, and management of a bank's CRE concentration risk:
 - Total reported loans for construction, land development, and other land represent 100% or more of the bank's total capital; or
 - Total non-owner-occupied CRE loans represent 300% or more of the bank's total capital, and the outstanding balance of the bank's CRE loan portfolio has increased by 50% percent or more during the prior 36 months.



Maintaining Portfolio Diversification (cont.)

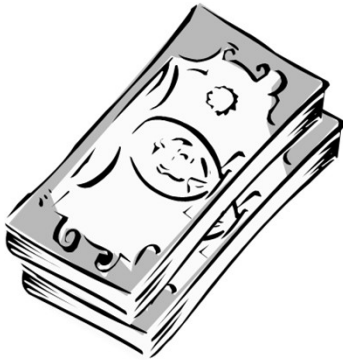
- When evaluating CRE concentrations, examiners consider a bank's analysis of its CRE portfolio, including these factors:
 - Portfolio diversification across property types
 - Geographic dispersion of CRE loans
 - Underwriting standards
 - Level of presold units or other types of take-out commitments on construction loans
 - Portfolio liquidity (ability to sell or securitize exposures on the secondary market)



Perhaps the Most Unusual and Unique CRE Risk: *of Sources of Repayment*

- Traditionally in commercial lending (and much of consumer lending), the primary source of repayment is the business or CRE cash flow
 - The secondary source of repayment is the collateral, and its value is of the cash flow
- Somewhat uniquely, the value of most income producing CRE collateral is almost totally on the cash flow it generates
 - Result: It is difficult to mitigate weakness in cash flow sustainability unless you have a strong guarantor along with strong sponsorship/support

Appendix: Evaluating Environmental Risks, plus ASTM Standards Update



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Evaluating Environmental Risks

- Typical progression of steps, lender able to stop if step shows no potential risks, with starting point or step based on transaction size and or known nature of property; if risks noted in a step, continue the progression
 1. Lender/Customer Environmental Questionnaire
 2. ASTM Transaction Screen
 3. ASTM Phase I Environmental Site Assessment
 4. ASTM Phase II Environmental Site Assessment
 5. ASTM Phase III Environmental Site Assessment



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Updated ASTM International Standards

- Seven-year revision cycles
- Ltd. Environmental Due Diligence: Transaction Screen Process (E1528-22)
 - Originally developed as a way for current or prospective property owners to gather information about potential environmental risks associated with a property believed to present a low risk of potential environmental concerns
 - 2022 revisions include
 - Completely rewritten questionnaire and guide section
 - Revised appendix with new photographs to help preparers fill out the questionnaire
 - Changes to wording to better highlight the fact it provides no Comprehensive Environmental Response, Compensation, and Liability Act (CERCLA) liability protection
 - The standard reinforces its original design with language changes intended to make the standard easier for non-professionals to understand

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Updated ASTM International Standards (cont.)

- Standard Practice for Environmental Site Assessments: Phase I Environmental Site Assessment Process (E1527-21) modifies the requirements for conducting Phase I ESAs while also clarifying ambiguities that arose while applying the prior ASTM E1527-13 standard
 1. New definition of Recognized Environmental Condition” (REC) and related term “likely”
 2. New definition of Historical RECs (HREC)
 3. A new type of REC: The new E1527-21 standard provides for a new, third type of REC, known as a Controlled Recognized Environmental Condition (CREC)
 4. Guidance in distinguishing REC vs. HREC vs. CREC
 5. Emerging contaminants remain outside the ESA scope, unless requested by user

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Updated ASTM International Standards (cont.)

- ASTM E1527-21 updates to standard (cont.)
 6. Use of the term “Subject Property” for clarity and lack of confusion among reports
 7. Shelf life of a Phase I ESA: It must be completed no more than 180 days prior to the date of acquisition to remain viable or up to one year if five specific components of the Phase I ESA have been updated
 8. Requirement to use a minimum of four standard historical sources
 9. Use of additional standard historical sources, even if historical uses not considered to be a source of contamination
 10. Interviews now part of Historical Sources of Information section, rather than separate component
 11. Significant data gaps now defined and requires discussion on their impact on RECs
 12. Broader requirements for Inclusion of maps and photographs