KPMG

# Regulatory Alert

Regulatory Insights for Financial Services

**January 2024**

## Commercial Real Estate (CRE): Expanded Regulatory Focus

***KPMG Insights:***

— ***CRE – Ties to Credit, Liquidity & Capital:*** *A growing focus on financial institutions' management of CRE challenges, particularly to credit, liquidity and capital financial risks.*

— ***CRE Risk Management:*** *Expectation for heightened CRE risk management (e.g., maintaining strong capital levels, diversifying funding sources, and leveraging stress tests).*

— ***Potential CRE Distress and Modifications:*** *Recognition of potential CRE distress (e.g., due to elevated interest rates, shifting occupancy levels, etc.) and need for transactional modifications and strategic corporate change.*

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Recent reports and guidance showcase regulators' continued focus on the potential impacts of challenges in the commercial real estate (CRE) sector on financial institutions, and include:

— Interagency Policy Statement on Prudent CRE Loan Accommodations and Workouts

— Federal Deposit Insurance Corporation (FDIC): Financial Institution Letter on managing CRE concentrations

— Federal Reserve Board (FRB): Fall 2023 Supervision and Regulation Report

— National Bureau of Economic Research (NBER): Working Paper: Monetary Tightening, Commercial Real Estate Distress, and US Bank Fragility

The releases are outlined in detail below.

### Interagency Policy Statement

In June 2023, the FRB, FDIC, Office of the Comptroller of the Currency (OCC), and the National Credit Union Administration (NCUA), in consultation with state bank and credit union regulators, released a final policy statement updating guidance on CRE loan accommodations and workouts, including risk management, loan classification, regulatory reporting, and accounting considerations on estimating loan losses.

### FDIC Financial Institution Letter

The FDIC's recent Financial Institution Letter focuses on bank management of commercial real estate (CRE) concentrations in light of "the challenging economic environment," influenced by the aftermath of the COVID-19 pandemic, rising interest rates, and an inverted yield curve.

The advisory highlights six (6) key risk management practices for banks:


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| Action | Key Points |
|---|---|
| 1<br>Maintaining Strong Capital Levels | — Construction and development (C&D) and CRE exposures relative to capital (e.g., potential elevated risk losses)<br>— Proactive boards and management actions |
| 2<br>Ensuring Appropriate Credit Loss Allowances | — Allowances for credit losses (ACLs) to cover expected credit losses on individually evaluated loans (CRE and others) and in the remainder of the loan portfolio.<br>— Effects of past events, current conditions, and reasonable and supportable forecasts on the collectability of the bank's loans. |
| 3<br>Closely Managing CRE and C&D Loan Portfolios | — Prudent lending standards and credit administration practices (e.g., management information systems to provide board and management with data on concentrations and market conditions) that consider risks of material C&D and CRE concentrations.<br>— Portfolio and loan level stress tests or sensitivity analysis to:<br>  — Identify and quantify impacts of changing economic conditions and loan-level fundamentals on asset quality, earnings, and capital.<br>  — Adjust risk management processes, capital planning, liquidity management, collateral valuation processes, and workout procedures.<br>— Strong credit review and risk rating systems to identify deteriorating credit trends. |
| 4<br>Maintaining Updated Financial and Analytical Information | — Maintain recent borrower financial statements (e.g., property cash flow statements, rent rolls, guarantor personal statements, tax return data, and other income property performance information).<br>— Global financial analysis of obligors (pending loan maturities, lease expirations, concentrations of individual property owners, builders, or developers in a loan portfolio).<br>— Relevance of appraisals and evaluations, updating collateral valuation information as necessary. |
| 5<br>Bolstering Loan Workout Infrastructure and Processes | — Sufficient staffing and appropriate skillsets to manage an increase in problem loans and workouts.<br>— Ready network of legal, appraisal, real estate brokerage, and property management professionals to handle prospective workouts. |
| 6<br>Maintaining Adequate Liquidity and Diverse Funding Sources | Processes for identifying, measuring, monitoring, and controlling liquidity and funding risks, including:<br>— Appropriate levels of cash and cash equivalents.<br>— Usable, stable, and diverse ranges of funding mechanisms.<br>— Tested sources of contingent liquidity, including access to the Federal Reserve Discount Window. |

The advisory also encourages banks to:

- Analyze the collectability of their exposures periodically.
- Establish diverse funding sources.
- Maintain strong risk rating systems.
- Effectively manage interest reserves and loan accommodations.
- Leverage stress tests to quantify the impact of changing loan-level fundamentals and economic conditions.

*(NOTE: In March 2022, the OCC published a revised version of the "Commercial Real Estate Lending" booklet of the Comptroller's Handbook, discussing risks and risk management practices associated with commercial real estate. The updates provide supervisory guidance for sound risk management practices for CRE, as well as a framework for examiners' evaluation of banks' commercial real estate lending activities.)*

### FRB Supervision and Regulation Report

The FRB's Fall 2023 Supervision and Regulation Report highlights its assessment of banking system conditions, as well as regulatory and supervisory developments in 2023 and priorities for 2024 (for more information on the report, see KPMG's Regulatory Alert, here). In its report, FRB notes the following related to CRE:

- "While the banking system is generally sound", delinquencies for CRE loans increased from low levels in the first half of 2023, with the largest firms experiencing the most substantial increases in delinquency rates, particularly within the office loan segment. In response, many banks have increased their credit loss provisions.
- FRB continues to monitor potential credit deterioration, particularly in the CRE lending segment, including internal loan risk rating accuracy, steps taken to mitigate the risk of loss, and risk reporting to boards of directors and senior management.

### NBER Working Paper

NBER's working paper analyzes the effects of credit risk on the solvency of U.S. banks in a rising interest rate environment with a focus on CRE loans, which are estimated to account for approximately 25 percent of assets for the

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average bank and almost $2.7 trillion of bank assets in aggregate.

The paper notes several findings in light of recent declines in property values (following higher interest rates) and adoption of hybrid working patterns:

- Approximately 14 percent of all loans and 44 percent of office loans appear to be in "negative equity," meaning that current property values are less than the outstanding loan balances.
- Approximately 33 percent of all loans and the majority of office loans may face "substantial cash flow problems and refinancing challenges".

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