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FDIC Issues Advisory on Managing Concentration Risks in Commercial Real Estate*

On December 18, 2023, the FDIC issued an advisory to insured state non-member banks and savings associations (the "FDIC-supervised institutions") entitled "Managing Commercial Real Estate Concentrations in a Challenging Economic Environment" (the "CRE Advisory"). The FDIC issued the CRE Advisory to re-emphasize the importance of strong capital, appropriate credit loss allowance levels, and robust credit risk-management practices when managing commercial real estate (CRE) concentrations in challenging economic times.

The CRE Advisory explains the current economic challenges that may negatively impact the CRE market. Additionally, the FDIC identifies several risk management practices FDIC-supervised institutions should consider implementing to appropriately manage their risk with regard to CRE loans. A summary of important issues addressed in the FDIC Advisory are discussed below.

Current Economic Challenges. The CRE Advisory discusses economic challenges and weaknesses in the CRE sector that have raised the FDIC's overall concern for FDIC-supervised institutions with concentrations of CRE loans. For instance, CRE investment property capitalization rates have not kept pace with recent rapid increases in long-term interest rates and CRE vacancy rates are rising (most notably in the office sector). The FDIC notes that the demand for traditional office space has slowed due to the popularity of remote work and office attendance being at approximately 50 percent of its pre-pandemic level. In addition, there are high levels of office loans and office leases maturing or expiring in the next few years.

The FDIC's concerns also extend to the subset of banks with elevated construction and development (C&D) concentrations. Banks with significant exposure to C&D loans had substantial credit losses during the 2008 to 2013 banking crisis, and banks currently engaged in C&D lending could be affected by weaknesses in the current economic environment and real estate fundamentals.

As a result of these challenges, the FDIC continues to be concerned that institutions with concentrated CRE exposures may be vulnerable to real estate downturns. The FDIC strongly recommends that, as market conditions warrant, institutions with CRE concentrations (particularly in office lending) increase capital to provide ample protection from unexpected losses should market conditions further deteriorate.

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Managing CRE Concentrations. In the CRE Advisory, the FDIC identifies six key risk-management actions to help institutions with significant C&D and CRE concentrations manage through changes in market conditions. These include the following:

- **Maintain strong capital levels.** Institutions with significant C&D and CRE exposures may require more capital due to uncertainty surrounding market conditions causing an elevated risk of unexpected losses. As market conditions warrant, institutions should be proactive and take steps to increase capital levels to support significant CRE concentrations and mitigate the impact of potential loss.

- **Ensure that credit loss allowances are appropriate.** Prudent credit management includes periodic analysis (at least quarterly) of the collectability of CRE and all other exposures and maintenance of allowance for credit losses (ACL) at a level that is appropriate to cover expected credit losses on individually evaluated loans, as well as expected credit losses for the remainder of the loan portfolio. In reviewing their ACL methodology, institutions with significant C&D and CRE concentrations are advised to consult recent supervisory guidance, such as the Interagency Policy Statement on Allowances for Credit Losses (FIL-17-2023; revised April 2023).

- **Manage C&D and CRE loan portfolios closely.** Institutions should maintain prudent lending standards and credit administration practices that consider the risks of material C&D and CRE concentrations. This includes management information systems that provide the board and management with relevant data on concentrations levels and related market conditions, including for concentration or market segments, as appropriate. Additionally, portfolio and loan level stress tests or sensitivity analysis can be an invaluable tool in identifying and quantifying the impact of changing economic conditions and changing loan level fundamentals on asset quality, earnings, and capital.

- **Maintain updated financial and analytical information.** Institutions should also maintain up to date borrower financial statements, such as property cash flow statements, rent rolls, guarantor personal statements, tax return data, and other income property performance information to better understand their borrowers' ability to repay and overall financial condition and enable timely identification of adverse trends.

- **Bolster the loan workout Infrastructure.** Institutions should ensure they have sufficient staff and appropriate skill sets to properly manage an increase in problem loans and workouts. Likewise, the guidance notes that institutions that have a ready network of legal, appraisal, real estate brokerage, and property management professionals to handle additional prospective workouts will be better situated for more positive outcomes.

- **Maintain adequate liquidity and diverse funding sources.** It is also important for institutions to have a comprehensive management process for identifying, measuring, monitoring, and controlling liquidity and funding risks, especially in complex economic and interest rate environments. The guidance notes that institutions that have identified appropriate levels of cash and cash equivalents, have diversified and stable funding mechanisms, and have identified and tested sources of contingent liquidity—including establishing and testing access to the Federal Reserve Discount Window—will be better positioned to support CRE concentrations.

Institutions can read the CRE Advisory at: **https://www.fdic.gov/news/financial-institution-letters/2023/fil23064.html**. For more information or questions about the advisory, please contact Joel Cook at **JCook@ABLawyers.com**.