

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



Office of the
Comptroller of the Currency

Contents

Introduction.....	1
Overview	1
Authority and Limits	2
Equity Investments in Real Estate	3
Real Estate Lending Standards and Interagency Guidelines for Real Estate	
Lending	4
CRE Industry, Property Types, and Loan Types	4
Acquisition, Development, and Construction Loans	5
Interest Reserves	7
Income-Producing CRE Loans	9
High-Volatility CRE Loans	9
Risks Associated With CRE Lending	10
Credit Risk	11
Construction Issues	11
Market Conditions	11
Concentration Risk.....	12
Regulatory Changes	12
Interest Rates.....	12
Environmental Liability	12
Interest Rate Risk	13
Liquidity Risk	13
Operational Risk	14
Compliance Risk.....	15
Strategic Risk	15
Reputation Risk.....	16
Price Risk	16
Risk Management	17
Management and Board Oversight	17
Strategic Planning	17
Governance Structure.....	18
Management and Board Reports.....	18
Loan Policies.....	19
Loan Portfolio Management Considerations	20
Underwriting Standards	21
Acquisition, Development, and Construction Policies	22
Investor-Owned Residential Real Estate Lending Standards	25
Supervisory Loan-to-Value Limits	26
Excluded Transactions	27
Loans Exceeding Supervisory Loan-to-Value Ratio Limits	28
Exceptions to General Lending Policy	28
Underwriting Practices.....	29
Analysis of Borrower's and Guarantor's Financial Condition	29
Underwriting Acquisition, Development, and Construction Loans.....	30

Construction Concerns.....	31
Evaluating the Developer Borrower	32
Determining Project Feasibility	32
Collateral Valuation for Acquisition, Development, and	36
Construction Loans	36
Underwriting Income-Producing CRE Loans.....	39
Loan Structure.....	39
Covenants.....	41
Income-Generating Capacity of CRE	42
Debt-Service Coverage Ratio	43
Debt Yield.....	43
Value Analysis	43
Loan-to-Value Ratio	44
Credit Administration	44
Acquisition, Development, and Construction Credit Administration.....	45
Monitoring Progress of Construction Projects.....	45
Disbursement Processes.....	48
Income-Producing Property Credit Administration.....	49
Investor-Owned Residential Real Estate	50
File Documentation.....	51
Risk-Rating CRE Loans.....	53
Analyzing Repayment Capacity of the Borrower	53
Evaluating Guarantees	54
Assessing Collateral Values.....	54
Other Considerations	55
Risk-Rating Investor-Owned Residential Real Estate Loans	57
Classification of CRE Loans.....	57
Special Mention	58
Substandard.....	58
Doubtful	59
Loss	60
Appraisals and Evaluations.....	60
Appraisal and Evaluation Program	63
Appraisal and Evaluation Reviews	64
Environmental Risk Management.....	65
Loan Workouts and Restructures.....	68
Accrual Status	69
Troubled Debt Restructurings.....	71
Allowance for Credit Losses.....	71
Foreclosure.....	71
Concentration Risk Management.....	71
Key Elements for CRE Concentration Risk Management.....	73
Control Systems	73
Credit Risk Review	74
Internal Audit	74
Third-Party Risk Management.....	75

Examination Procedures	76
Scope	76
Quantity of Risk.....	79
Quality of Risk Management.....	85
Policies	85
Processes	87
Personnel.....	89
Control Systems	90
Conclusions	92
Internal Control Questionnaire	95
Verification Procedures	109
 Appendixes.....	 111
Appendix A: Quantity of Credit Risk Indicators.....	111
Appendix B: Quality of Credit Risk Management Indicators	113
Appendix C: Supervisory Loan-to-Value Limits	116
Appendix D: Underwriting Considerations by Property Type.....	119
Appendix E: Appraisal Review Worksheet.....	132
Appendix F: Evaluation Review Worksheet	136
Appendix G: Glossary	137
Appendix H: Abbreviations.....	143
 References.....	 144

Introduction

The Office of the Comptroller of the Currency's (OCC) *Comptroller's Handbook* booklet, "Commercial Real Estate Lending," is prepared for use by OCC examiners in connection with their examination and supervision of national banks, federal savings associations (FSA), and federal branches and agencies of foreign banking organizations (collectively, banks). Each bank is different and may present specific risks and issues. Accordingly, examiners should apply the information in this booklet consistent with each bank's individual circumstances. When it is necessary to distinguish between them, national banks and FSAs and covered savings associations (CSA) are referred to separately.¹

For purposes of this booklet, **commercial real estate (CRE) lending**² comprises **acquisition, development, and construction (ADC) lending** and the financing of **income-producing real estate**. Income-producing real estate comprises real estate held for lease to third parties and nonresidential real estate that is occupied by its owner or a related party.

This booklet addresses the risks inherent in CRE lending, risks unique to specific CRE lending activities and property types, and prudent risk management. This booklet includes expanded examination procedures for examiners to use when a bank's CRE lending activities warrant review beyond the core assessments in the "Community Bank Supervision," "Federal Branches and Agencies Supervision," and "Large Bank Supervision" booklets of the *Comptroller's Handbook*. This booklet also includes an internal control questionnaire and verification procedures to further support the supervision process.

Overview

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. 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

¹ Generally, references to "national banks" throughout this booklet also apply to federal branches and agencies of foreign banking organizations unless otherwise specified. Refer to the "Federal Branches and Agencies Supervision" booklet of the *Comptroller's Handbook* for more information regarding applicability of laws, regulations, and guidance to federal branches and agencies. Certain FSAs may elect to operate as CSAs. For more information, refer to OCC Bulletin 2019-31, "Covered Savings Association Implementation: Covered Savings Associations."

² Terms that are **boldfaced** on first mention in this booklet are defined in appendix G, "Glossary," of this booklet.

losses from CRE lending to a manageable level, even when markets experience significant stress.

Authority and Limits

Banks are permitted by statute to engage in real estate lending. The authority for national banks and CSAs is found in 12 USC 371, while the authority for FSAs is found in 12 USC 1464(c).³

No aggregate exposure limit applies to a national bank's or CSA's real estate lending activities as long as the volume and nature of the lending do not pose unwarranted risk to the bank's financial condition. Permissible real estate exposures for FSAs are described in 12 USC 1464; 12 USC 1464(c)(1)(B) authorizes FSAs to invest in residential real estate loans, including multifamily residential real estate loans, without limit, as long as the volume and nature of the lending does not pose unwarranted risk to the FSA's financial condition. Nonresidential real estate lending is limited to 400 percent of total capital⁴ under 12 USC 1464(c)(2)(B).

Note that concentration concerns may arise with aggregate exposure of substantially less than 400 percent of capital.⁵ An FSA that makes a loan secured by nonresidential real estate also has the option to classify that loan as a commercial loan as authorized under 12 USC 1464(c)(2)(A).⁶ Refer to the "Concentration Risk Management" section of this booklet for a discussion of the risks posed to a bank from significant concentrations of CRE.

Loans and extensions of credit by national banks are subject to the legal lending limits on loans to one borrower under 12 USC 84 and 12 CFR 32.⁷

³ Refer to 12 CFR 160.30 and Thrift Bulletin 78a, "Investment Limitations Under the Home Owners' Loan Act" (FSAs).

⁴ Without regard to any limitations of this part, an FSA may make or invest in the fully insured or guaranteed portion of nonresidential real estate loans insured or guaranteed by the Economic Development Administration, the Farmers Home Administration or its successor the Farm Service Agency, or the Small Business Administration. Unguaranteed portions of guaranteed loans must be aggregated with uninsured loans when determining an association's compliance with the 400 percent of capital limitation for other real estate loans.

⁵ The OCC may approve an exception to the nonresidential real estate lending limit pursuant to 12 USC 1464(c)(2)(B)(ii) upon determining that the exception poses no significant risk to safe and sound operation and is consistent with prudent operating practice. If an exception is granted, the OCC will closely monitor the FSA's condition and lending activities to confirm that nonresidential real estate loans are made in a safe and sound manner in compliance with all relevant laws and regulations.

⁶ Under 12 CFR 1464(c)(2)(A), FSAs may invest up to 20 percent of their assets in commercial loans, provided that amounts in excess of 10 percent of total assets are used only for small business loans.

⁷ The "Lending Limits" section under 12 USC 84 applies to FSAs pursuant to 12 USC 1464(u)(1).

Equity Investments in Real Estate

National banks and CSAs are generally not permitted to engage in real estate development.⁸ Under certain circumstances, however, a service corporation of an FSA is permitted to hold real estate for investment and engage in real estate development subject to the limitations of 12 CFR 5.59. There are other circumstances in which a bank might obtain an ownership interest in real estate incidental to its provision of financing. For example, banks are permitted under 12 CFR 7.1006 to take as consideration for a loan (1) a share in the profit, income, or earnings from a business enterprise of a borrower or (2) a stock warrant issued by the business enterprise of a borrower provided the bank does not exercise the warrant. This is often referred to as a **participating mortgage** or **equity kicker**. A bank may take the share or stock warrant in addition to, or in lieu of, interest, even if the business enterprise holds real estate that would otherwise be impermissible for the bank; however, the bank may not condition the borrower's ability to repay principal on the value of the profit, income, earnings of the business enterprise, or the value of the warrant received.

Banks are also permitted under 12 CFR 7.1025 to hold a passive equity investment in a project generating tax credits as part of a tax equity finance (TEF) transaction. As defined in 12 CFR 7.1025(b), a TEF transaction occurs when a bank provides equity financing to fund a project that generates tax credits and other tax benefits and the use of an equity-based structure allows the transfer of those tax credits and other tax benefits to the bank. A national bank or FSA may engage in a TEF transaction under its lending authority if it is the functional equivalent of a loan and satisfies all other requirements of 12 CFR 7.1025. Although the project entity may have interests in real estate, the bank may not rely on appreciation of value in the project or property rights underlying the project for repayment.

Accounting Standards of Codification (ASC) paragraph 310-10-25 includes standards for determining whether an arrangement should be recorded as a loan, joint venture, or real estate loan investment. When the bank receives greater than 50 percent of the profits generated from the property, the bank should account for the relationship as a real estate investment and the profits or losses should be recorded in accordance with ASC Topic 970. When the bank receives 50 percent or less of the profits, the arrangement should be accounted for as a loan or joint venture, depending on the circumstances.

An arrangement with risks and rewards that are similar to a loan (discussed in ASC 310-10-25-20) or when the arrangement is supported by a qualifying personal guarantee should be recorded as a loan with interest and fees recognized as income subject to recoverability, in accordance with ASC Topic 974. Otherwise, the arrangement should be accounted for as a joint venture consistent with ASC Subtopics 970-323 and 970-835.

There are times when an ADC arrangement is initially appropriately classified as an investment or joint venture but subsequently should be reclassified as a loan. To determine whether the arrangement should be reclassified as a loan under ASC 310-10-35-56, the lender should complete an evaluation when the risk diminishes significantly.

⁸ This section of the booklet is not intended to address development of other real estate owned. For more information, refer to the "Other Real Estate Owned" booklet of the *Comptroller's Handbook*.

Real Estate Lending Standards and Interagency Guidelines for Real Estate Lending

Banks are subject to a uniform regulation on real estate lending.⁹ These regulatory standards apply to all extensions of credit that are secured by liens on or interests in real estate. The standards also apply to loans made for the purpose of financing the construction of a building or other improvements whether or not secured by real estate.

The “Interagency Guidelines for Real Estate Lending Policies” describe key elements of a real estate lending policy.¹⁰

Real Estate Lending Standards and Interagency Guidelines for Real Estate Lending

Specific requirements or criteria from the real estate lending standards or “Interagency Guidelines for Real Estate Lending” are noted in text boxes like this one throughout the booklet.

In addition, the “Interagency Guidelines Establishing Standards for Safety and Soundness” include provisions in regard to loan documentation, credit underwriting, asset quality, and asset growth that apply to CRE lending.¹¹

CRE Industry, Property Types, and Loan Types

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 the level of economic activity can vary widely from state to state and among metropolitan areas, cities, and towns. 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, and land available for development.

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, and residential (which includes multifamily and **one- to four-family** residential development and construction). Although all sectors are influenced by economic conditions, some sectors are more sensitive to certain economic factors than others. 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

⁹ Refer to 12 CFR 34, subpart D, “Real Estate Lending Standards” (national banks), and 12 CFR 160.101, “Real Estate Lending Standards” (FSAs).

¹⁰ Refer to 12 CFR 34, subpart D, appendix A (national banks) and the appendix to 12 CFR 160.101 (FSAs).

¹¹ Refer to 12 CFR 30, appendix A, “Interagency Guidelines Establishing Standards for Safety and Soundness.”

categories of services, particularly business services. Demand for retail space is affected by local employment levels and consumer spending, as well as trends in online shopping. 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. Banks are expected to monitor the conditions in the markets where they are active.¹²

Acquisition, Development, and Construction Loans

In its simplest form, ADC loans may finance the land acquisition, land preparation, and construction of a single residential or commercial building. Often, however, ADC lending finances a single- or multiple-phase development of many units. ADC lending is highly specialized and warrants a thorough understanding of its inherent risks.

While ADC loans can take various forms, table 1 summarizes the most common.

Table 1: Common Acquisition, Development, and Construction Loan Types

Loan type	Description
Unsecured working capital loans to finance real estate	<p>A developer may wish to borrow on an unsecured basis, often in the form of a line of credit, to acquire a building site, eliminate title impediments, pay architect or commitment fees, or meet minimum working capital requirements established by other construction lenders. Repayment of an unsecured loan used for these purposes may come from the first draw against a construction loan. In such circumstances, the bank extending such an unsecured loan typically requires the construction loan agreement to permit repayment of the working capital loan on the first draw.</p> <p>As with other unsecured credit, it is critical that the bank identify adequate sources of repayment and the intended timing of repayment. Many banks avoid making unsecured loans to an illiquid or highly leveraged borrower or when the source of repayment depends on assets in which the bank has no collateral interest. It is generally not prudent for a bank to extend unsecured working capital loans to fund a developer's equity investment in a project or to cover cost overruns, as overruns may be indicative of an undercapitalized project or an inexperienced or unskilled developer.</p> <p>Because such loans are inherently risky, it is important for the bank to employ personnel with the necessary expertise to evaluate and manage the risk before engaging in this type of lending.</p>
Land acquisition loans	<p>Land acquisition loans finance the acquisition of undeveloped land. These loans are often made in conjunction with land or lot development and construction loans. In some cases, these loans may be made for speculative purposes without plans to immediately develop the property. Such loans are among the riskiest types of CRE loans. Undeveloped land generates no cash flow in most cases and requires other sources of funds to service the debt. Analyzing the borrower's or guarantor's ability to service the debt and the plans for repayment are important components of analyzing</p>

¹² Refer to 12 CFR 34.62(c) (national banks) and 12 CFR 160.101(c) (FSAs).

Loan type	Description
	loans that finance land with no immediate and well-defined development plans. Land loans made for speculative purposes should require considerable equity and be extended infrequently.
Land development loans	Land development loans fund the preparation of land for construction, which may include infrastructure improvements required for future development, such as sewer and water pipes, utility cables, grading, and street construction. Often, acquisition and development loans are extended together to finance both the acquisition and development of land.
Tract development loans	A tract development is a project with five or more units that is constructed as a single development. A unit may refer to a residential building lot, a detached single-family home, an attached single-family home, or a residence in a condominium. Tract developments may include other multiple-unit developments, such as office or industrial parks. In addition to the site improvements previously cited, these loans may finance construction of common amenities or infrastructure, such as clubhouses and recreational facilities. The source of repayment for these loans may be proceeds from the sale of lots to other developers or from the proceeds of a construction facility extended to the original developer to finance construction of for-sale or for-lease units. Repayment of these loans is discussed further in the “Acquisition, Development, and Construction Policies” section of this booklet.
Commercial construction loans	<p>Commercial construction loans finance the construction or renovation of non-one-to four-family properties for owner occupancy, lease, or sale. This can encompass a wide variety of property types and projects, such as apartments, office buildings, retail centers, hotels, and industrial and mixed-use developments.</p> <p>Prudent underwriting includes considering the source and timing of the repayment of construction financing and determining whether the projected net operating income (NOI) of the completed project supports the expected value upon completion.</p>
Loans to finance repositioning or rehabilitation	<p>In addition to new construction, a bank might finance the acquisition of an underperforming property that the borrower intends to improve, typically by performing physical upgrades or curing deferred maintenance and improving the management. Although this can present an opportunity for the borrower to enhance a property’s value in many cases, it is important for the bank to closely examine the borrower’s assumptions to determine the likelihood that the projections can be realized and assess the borrower’s ability to achieve its objectives. An evaluation of the borrower’s track record with similar properties should be a critical consideration.</p> <p>Banks might also finance an older property’s rehabilitation, modernization, or conversion to another use that may involve extensive improvements or modifications. In such cases, it is important for the bank to review the construction budget. The bank typically obtains an independent evaluation of the budget’s adequacy from a qualified engineer or architect. It can be more difficult to accurately estimate the costs of these kinds of projects than for new construction because of unobservable conditions.</p>
Bridge loans	A bridge loan provides short-term financing to allow newly constructed or acquired commercial properties to reach stabilization. Bridge loans are usually written for a period of up to three years and allow for the lease-up and income stabilization necessary to enable either sale or qualification for permanent financing. Income and value assumptions should be well supported and carefully analyzed.
Permanent loan commitments	<p>Although not a type of ADC loan, commitments for permanent financing often play an important role in ADC financing. Permanent loans, also referred to as take-outs, are term loans that replace construction loans. Permanent financing may be provided by either the construction lender or another lender. In addition to banks, permanent financing is often provided by nonbank entities, such as life insurance companies and pension funds, and through commercial mortgage-backed securitizations (CMBS).</p> <p>Commitments for take-out financing may be provided before or after construction completion and lease-up. Commitments issued before completion and lease-up</p>

Loan type	Description
	<p>usually fall into one of two categories: standby commitments and forward commitments.</p> <p>A standby commitment provides back-up financing in case the borrower cannot obtain permanent financing. Fees are usually required at commitment with additional fees due if the commitment is funded. The fee structure and interest rate may often be intended to dissuade the borrower from exercising the commitment and to encourage obtaining other sources of funding. Borrowers may sometimes obtain standby commitments to fulfill a construction lender's requirement for a committed take-out. Construction lenders who rely on standby commitments typically review the terms and consider the likelihood that the project will meet the criteria for funding. Lenders also typically investigate the willingness and ability of the issuer to fund.</p> <p>A forward commitment for permanent financing provides a commitment to refinance a construction loan upon future completion and, almost always, lease-up. Forward commitments allow a permanent lender, frequently a life insurance company, to originate the loan earlier in the development process and usually provide the borrower the ability to lock in a fixed rate in advance of funding. These commitments tend to be more prevalent when competition for loans among permanent lenders is high and in greater demand among borrowers in periods of rising interest rates. As with standby commitments, the willingness and ability of the lender to fund and the conditions for funding should be carefully considered.</p> <p>While construction lenders consider standby or forward commitments useful, these commitments may mitigate little of the risk that the lender assumes in making the construction loan. Although these commitments can provide interest rate protection and some indication that the project meets permanent-market criteria, they require the completion of construction and, in most cases, are subject to performance criteria such as lease-up to break even or better with leases at minimum rental rates.</p> <p>Underwriting would ordinarily include analysis of the risk should the take-out commitment not be funded.</p>

Interest Reserves

An **interest reserve** is a reserve account established by the lender and used by the borrower to cover loan interest during construction and lease-up. The interest reserve is typically funded via a budget line item in the construction loan; however, the interest reserve may also be funded by the borrower into a separate escrow account as a condition of the loan. Interest reserves should be used in a manner that is consistent with safe and sound banking practices. Interest expense is an important element of a project budget and, like other construction costs, should be properly estimated and reserved for, with adequate funds identified for its payment. An appropriate interest reserve provides sufficient funds to pay interest through the project's anticipated completion and lease-up, sale, or occupancy. The presence of an interest reserve may not accurately reflect a borrower's ability to pay. Inappropriately administered reserves, however, can mask a poorly performing project, increase the bank's loss exposure, and have been a major contributor to banks' losses in ADC lending. For these reasons, examiners should thoroughly assess interest reserves.

The following are some key considerations in determining the appropriate amount of interest reserves:

- The reasonableness of the development assumptions, including potential changes in interest rates, the timing of expected disbursements and pay downs, and the time required for the completion and sale or lease-up of the project.
- If interest will not be funded by the bank, whether there is sufficient equity to permit the bank to fund the interest if necessary while keeping the loan within appropriate **loan-to-cost (LTC)** and **loan-to-value (LTV)** ratios, even if the borrower intends to pay interest from its own funds.
- Use of interest reserves to fund interest payments for loans that should be generating cash flow such as those financing stabilized properties or speculative purchases of raw land is generally not appropriate. Cash flow for stabilized properties should be sufficient to carry debt service; raw land loans are generally of higher risk with no immediate plans for repayment or construction.
- Refunding depleted interest reserves may indicate an underperforming construction process, regardless of whether the reserves are funded by banks or borrowers.

Controls to monitor the status of the project and protect the adequacy of the interest reserve are an important aspect of ADC loan administration. During the lease-up period, any cash flow from the project is ordinarily applied to pay interest before interest reserves are applied. Once the cash flow is sufficient to cover the interest, no further draws on the reserve should be permitted to prevent the diversion of income that should be used to support the project.

The budgeted interest reserve is sometimes depleted before the project is completed and lease-up or sale is achieved. This often occurs because of construction delays or a change in market conditions. In such cases, the bank generally requires the borrower or guarantor to provide additional cash to cover interest payments or replenish the reserves. At times, if the borrower or guarantor is unable or unwilling to replenish the reserves, the bank may elect to increase, or **repack**, the interest reserve by extending additional debt to keep the loan current, thereby potentially masking a nonperforming loan. The decision to revise the budget and repack the interest reserve with debt is a red flag indicating possible credit deterioration. When assessing the appropriateness of repacking interest reserves, examiners should consider the support provided by the project's viability and the borrower's repayment capacity. To properly support repacking an interest reserve, it is appropriate for the bank to obtain a new appraisal or evaluation and re-evaluate the feasibility of the project in the current market. If projections show that the timing and amount of projected cash flows will fully amortize the debt and support subsequent interest payments after the additional interest reserves are depleted, then the additional reserves and continued interest accrual may be appropriate.

Although interest can be capitalized under the terms of a loan agreement, for reporting purposes, it is only appropriate when the borrower is able to repay the debt in the normal course of business.¹³

¹³ For more information on capitalization of interest, refer to the "Rating Credit Risk" booklet of the *Comptroller's Handbook*.

Income-Producing CRE Loans

Income-producing CRE comprises real estate held for lease to third parties and nonresidential CRE that is occupied by its owner or a related party. Table 2 summarizes common types of income-producing CRE loans.

Table 2: Common Income-Producing Loan Types

Loan type	Description
Term financing	<p>Term financing may refinance construction or bridge loans on properties that have reached stabilization, refinance other term financing, or finance the acquisition of stabilized properties. Term loans that refinance construction loans are sometimes referred to as permanent loans or take-outs.</p> <p>Term loans are provided by other types of lenders, including life insurance companies, pension funds, and CMBSs, also referred to as conduits. Life insurance companies and pension funds often have long-term investment needs and find terms of 10 years or longer on a fixed-rate basis attractive. CMBS investors like the ability to buy tranches of a CMBS pool that match their preferred term, risk appetite, and yield needs. Loans from these sources usually feature loan terms of 10 years or more with fixed rates and are commonly nonrecourse.</p>
Investor-owned residential real estate (IORR) loans	<p>IORR is one- to four-family residential real estate for which the primary repayment source is rental income. The primary source of repayment may be supported by the borrower's personal income.</p> <p>Typically, IORR repayment sources have risk characteristics that are more similar to CRE than those of owner-occupied one- to four-family residential loans. Repayment sources for IORR loans may be volatile and highly leveraged when the borrowers have multiple financed properties.</p>

High-Volatility CRE Loans

A high-volatility CRE (HVCRE) is a credit facility secured by land or improved real property that meets the following criteria:¹⁴

- Primarily finances or refinances the acquisition, development, or construction of real property.
- Provides financing to acquire, develop, or improve such real property into income-producing real property.
- Depends on future income or sales proceeds from, or refinancing of, such real property.

HVCRE is a designation relevant to a bank's risk-based capital calculations. HVCRE loans carry a risk-weight of 150 percent of capital under the capital rule's standardized approach because of the risks associated with such loans.

In December 2019, the OCC revised the HVCRE exposure definition to make it consistent with the statutory definition of an HVCRE ADC loan, in accordance with section 214 of the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018. The revision

¹⁴ Ibid. [12 CFR 3.2, "Definitions."]

adds to the definition of HVCRE multiple exemptions from the heightened risk weight, including for¹⁵

- loans that finance the acquisition, development, or construction of one- to four-family residential properties including construction loans for condominiums and cooperatives.
- loans that finance community development projects and agricultural land.
- facilities that finance income-producing real property if the cash flow generated is sufficient to service the debt and the expenses of the real property, in accordance with the lending institution's applicable loan underwriting criteria for permanent financing.
- facilities that finance improvements to existing income-producing real property if they meet similar underwriting criteria.
- loans that finance projects for which the borrower has contributed a substantial amount of capital, i.e., an amount equal to 15 percent of the "as completed" appraised value of the project.

As part of the revision, ADC loans made before January 1, 2015, are exempt and not classified as HVCRE exposure.

HVCRE loans require the borrower to contribute at least 15 percent of the real property's appraised "as completed" appraised value to the project in the form of cash, unencumbered **readily marketable assets**, paid development expenses out-of-pocket, or contributed real property or improvements. Such minimum amount of capital is contributed by the borrower before any advance of loan funds and is contractually required to remain in the project until the HVCRE exposure has been reclassified as non-HVCRE exposure.

A bank can reclassify an HVCRE loan to a non-HVCRE exposure on its call report when all the following criteria are met:

- Substantial completion of the development or construction of the real property being financed by the credit facility.
- Cash flow generated by the real property being sufficient to support the debt service and expenses of the real property, in accordance with the bank's applicable loan underwriting criteria for permanent financing.

Risks Associated With CRE Lending

From a supervisory perspective, risk is the potential that events will have an adverse effect on a bank's current or projected financial condition¹⁶ and resilience.¹⁷ The OCC has defined eight categories of risk for bank supervision purposes: credit, interest rate, liquidity, price, operational, compliance, strategic, and reputation. These categories are not mutually

¹⁵ Refer to 12 CFR 3.2, "Definitions."

¹⁶ Financial condition includes impacts from diminished capital and liquidity. Capital in this context includes potential impacts from losses, reduced earnings, and market value of equity.

¹⁷ Resilience recognizes the bank's ability to withstand periods of stress.

exclusive. Any product or service may expose a bank to multiple risks. Risks also may be interdependent and may be positively or negatively correlated. Examiners should be aware of and assess this interdependence. Concentrations can accumulate within and across products, business lines, geographic areas, countries, and legal entities. Refer to the “Bank Supervision Process” booklet of the *Comptroller’s Handbook* for an expanded discussion of banking risks and their definitions.

The risks associated with CRE lending in particular are credit, interest rate, liquidity, operational, price, compliance, strategic, and reputation.

Credit Risk

Credit risk is the risk to current or projected financial condition and resilience arising from an obligor’s failure to meet the terms of any contract with the bank or otherwise perform as agreed. Factors that can affect a bank’s likelihood of receiving full repayment for CRE loans include the following.

Construction Issues

Banks that finance construction face the risk associated with a borrower’s ability to successfully complete a proposed project on time, according to construction plans, and within budget. Cost overruns can erode a borrower’s equity in the project and reduce the bank’s collateral margin or can result in total costs that exceed the property’s value when completed. Overruns can be caused by inaccurate budgets, site or environmental issues, increases in materials or transportation expenses, material or labor shortages, substandard work performed by the borrower’s employees or subcontractors that must be redone to satisfy contract performance conditions or meet local building codes, increased interest expense, or delays caused by inclement weather. Projects that rehabilitate or extensively modify existing buildings can be exceptionally vulnerable to overruns because these costs can be difficult to estimate.

Market Conditions

A property’s performance can be hurt by tenants’ deteriorating credit and lease expirations in times of softening demand caused by economic deterioration from over-supply conditions or changing consumer and business preferences. As the economic climate deteriorates, tenants could reduce their need for space or cease operations and paying rent altogether. Properties that have shorter lease terms are vulnerable to declining market values as rents decline and leases are renewed at lower rental rates. As expiring leases cause project cash flows to decline, developers could be unable to meet scheduled mortgage payments and other important obligations, such as property taxes and maintenance. Even if borrowers are able to meet their payment obligations, they could find it difficult to refinance their **balloon payment** amount at maturity because of declines in property value.

The risk from changing market conditions can be considerable in ADC financing of “for-sale” developments. Adverse changes in the market occurring between the start of

development and completion can result in slower sales rates and lower sales prices that could threaten timely and full repayment. Risk posed by changing market conditions is magnified in banks with significant CRE concentrations.

For properties under construction, demand from prospective tenants or purchasers may erode after construction begins because of a general economic slowdown or an increase in the supply of competing properties. Properties with longer construction periods are also more vulnerable to market changes because of longer lead time from initial project start to actual delivery. If actual rental rates achieved during lease-up are lower than those projected, a project's viability can be threatened by a failure to generate income sufficient to support its debt and the expected collateral value. A decline in demand or increase in the supply of for-sale properties can threaten full principal repayment.

Concentration Risk

Concentration risk is the risk posed by a bank's exposure to groups or classes of credit exposures that share common risk characteristics or sensitivities to economic, financial, or business developments. Concentrations add a dimension of risk that compounds the risk inherent in individual loans. The "Concentrations of Credit Risk Management" section of this booklet discusses practices that, while always prudent, are especially important in managing risk posed by concentrations.

Regulatory Changes

At the national or local level, changes in tax legislation, zoning, environmental regulation, or similar external conditions may affect property values and the economic feasibility of existing and proposed CRE projects.

Interest Rates

Changes in interest rates affect the cost of construction and the financial viability of a CRE project, and consequently a bank's credit risk. When a project has floating rate debt and fixed rents, increasing interest rates can have a negative effect on the borrower's repayment capacity. Interest rate changes may also result in changing **capitalization rates**, thereby affecting a property's value. Although borrowers can hedge their interest rate risk by using interest rate derivatives, mitigation is difficult and less effective for construction facilities because of the changes in the outstanding loan amount during development and the loans' relatively short **tenors**.

Environmental Liability

Environmental contamination can hurt a property's usability and can result in the loss of tenants, reduction in rental income, and the inability to develop, market, or refinance properties. Fines for not complying with environmental regulations can be significant. Because federal and many state regulations impose liability on the owners of contaminated CRE, current and past property owners can be responsible for the cost of cleanup, even if

they did not contribute to the contamination. Costs to mitigate contamination may decrease the collateral's value or render it worthless. The borrower's cost to remediate a contaminated property could severely impair the borrower's ability to repay the loan. Some property types that may pose an elevated level of environment liability include gas stations, auto repair shops, and dry cleaners.

Interest Rate Risk

Interest rate risk is the risk to current or projected financial condition and resilience arising from movements in interest rates. Interest rate risk results from differences between the timing of rate changes and the timing of cash flows (repricing risk); from changing rate relationships among different yield curves affecting bank activities (basis risk); from changing rate relationships across the spectrum of maturities (yield curve risk); and from interest-related options embedded in bank products (options risk).

The level of interest rate risk associated with the bank's CRE lending activities depends on the composition of its loan portfolio and the degree to which the structure of its loans, such as tenor, pricing, and **amortization**, expose the bank's revenue to changes in interest rates.

CRE financing can expose the bank to interest rate risk in the form of repricing, options, basis, and yield curve risk. Repricing risk arises when there are differences in rate reset periods for the CRE loan and the liability funding the CRE loan. For example, the bank's net interest margin can be adversely affected in a decreasing rate environment if a floating rate CRE loan, which is repriced annually, is funded by a certificate of deposit with a 24-month maturity. In the absence of prepayment penalties, CRE financing can expose the bank to options risk in a decreasing rate scenario. For example, when rates decrease, borrowers might prepay the loan and refinance at a lower rate, adversely affecting the bank's net interest margin. Basis risk arises from the imperfect correlations between different indexes used to price the CRE loan and the liability funding the loan. For example, a 50-basis point increase in a local index that a bank uses to price deposits may not lead to a 50-basis increase in the prime index, which the bank uses to price the CRE loan. A bank with a portfolio of fixed- or variable-rate CRE loans with long reset periods could be exposed to yield curve risk. For example, if the yield curve shifts upward, the value of a fixed CRE loan or a CRE loan with a long rate reset period would decline, affecting the price that can be obtained in the secondary market.

Liquidity Risk

Liquidity risk is the risk to current or projected financial condition and resilience arising from an inability to meet obligations when they come due. Liquidity risk includes the inability to access funding sources or manage fluctuations in funding levels (including unfunded commitments).

CRE loans are ordinarily illiquid. Converting CRE loans to cash can be accomplished by (1) the bank using the loan as collateral for borrowings;¹⁸ (2) the bank selling the loan to an investor (either on a participation, whole-loan, or portfolio basis);¹⁹ (3) the bank securitizing the loan; (4) the borrower refinancing the loan with another lender; or (5) normal borrower repayment.

Sales of CRE loans can be challenging to execute largely because of their lack of homogeneity. Unlike consumer loans, the due diligence process can be time-consuming and expensive for a prospective purchaser because of variations in property type, location desirability, tenant quality and other rent roll characteristics, underwriting, loan structures, and documentation. CRE loans tend to be even less liquid in times of market stress when potential funding sources diminish as lenders allocate fewer funds for originating or refinancing CRE. This can also make the sale of loans or their refinance by other lenders as a strategy to manage concentrations ineffective. ADC loans are particularly illiquid because of their short tenor and because the full collateral value is not realized until the project is completed and reaches a stabilized level of occupancy or is ready for sale.

Although the sale of loans through securitization can provide liquidity, there are differences in securitizing loans originated to be held by the bank versus those originated to be securitized. CRE loans originated for securitization employ underwriting, structures, and documentation that conform to standards established by market participants. This standardization permits an efficient due diligence process and results in better pricing. Loans originated to be held in the bank's portfolio may not, however, meet the standards for this market, making securitization of these assets inefficient and likely to result in prices that represent a material discount to book value. Market disruptions after origination and before sale can reduce the liquidity of loans that were originated for securitization.

Operational Risk

Operational risk is the risk to current or projected financial condition and resilience arising from inadequate or failed internal processes or systems, human errors or misconduct, or adverse external events. An effective risk management system, including proper internal controls, helps control operational risk exposures.

Effective policies, procedures, internal controls, audits, third-party risk management, business continuity planning, management information systems (MIS), and reporting are important aspects of managing operational risk. CRE lending, particularly for ADC, presents higher operational risk than many other types of lending. Ineffective processes can introduce significant operational risks that also affect the bank's exposure to other risks. For example,

¹⁸ Qualifying CRE loans may collateralize borrowings from the Federal Reserve or Federal Home Loan Banks. Refer to the "Liquidity" booklet of the *Comptroller's Handbook* for a discussion of asset liquidity including secured borrowings.

¹⁹ For more information about loan participations, refer to the "Loan Portfolio Management" booklet of the *Comptroller's Handbook* (national banks) and *Office of Thrift Supervision Examination Handbook*, section 201, "Lending Operations and Portfolio Risk Management" (FSAs). Refer also to OCC Bulletin 2020-81, "Credit Risk: Risk Management of Loan Purchase Activities."

failure to properly monitor construction progress and manage the disbursement of loan proceeds is a control weakness that increases the bank's credit risk. A bank's failure to confirm that property taxes, property insurance premiums, and workers and suppliers are paid can threaten its collateral interests.

Insufficient staffing or lack of staff expertise can increase operational risk. For example, operational risk increases when the bank does not have sufficient management and staff with the knowledge and experience to identify, measure, monitor, and control the risks unique to CRE.

Examiners assess operational risk by evaluating the adequacy of governance and risk management of all activities in the origination and management of CRE lending, including the engagement of any third parties in the processes.

Compliance Risk

Compliance risk is the risk to current or projected financial condition and resilience arising from violations of laws or regulations, or from nonconformance with prescribed practices, internal bank policies and procedures, or ethical standards.

Failure to comply with laws and regulations pertaining to CRE lending can present serious risk to a bank's earnings and capital. For example, failure to comply with lending limit regulations²⁰ can expose the bank's capital to excessive risk. There are also consumer protection-related regulations applicable to CRE lending that include fair lending (Equal Credit Opportunity Act²¹), flood insurance, building and zoning requirements, and consumer disclosures (for IORR).

Failure to comply with environmental laws and regulations can generate significant liability to a bank that is greater than the value of the collateral. Although this liability typically manifests itself when a bank takes title to the collateral in satisfaction of debt, a bank most often undertakes this risk at origination by not implementing appropriate controls to mitigate potential environmental issues.

Strategic Risk

Strategic risk is the risk to current or projected financial condition and resilience arising from adverse business decisions, poor implementation of business decisions, or lack of responsiveness to changes in the banking industry and operating environment.

The board of directors' failure to establish prudent CRE lending objectives that are compatible with the bank's risk appetite or strategic plan and to provide effective oversight of CRE lending activities can increase a bank's risk profile and affect interdependent risks, such as credit and reputation risks. Imprudent CRE lending can result in significant loan

²⁰ Refer to 12 CFR 32.

²¹ Refer to 12 CFR 1002.

losses and has been a cause of failure in banks with significant CRE exposure. Insufficient staffing can also increase strategic risk. For example, strategic risk increases when the bank does not have sufficient management and staff with the knowledge and experience to identify, measure, monitor, and control the risks unique to CRE.

Reputation Risk

Reputation risk is the risk to current or projected financial condition and resilience arising from negative public opinion.

Failure to meet the needs of the community (including failure to consider impacts of a financed project on the community), inefficient loan delivery systems, and lender liability lawsuits are some of the factors that may tarnish the bank's reputation. Imprudent risk-taking in CRE lending, or significant control weaknesses, can cause a bank to experience excessive losses or to foreclose on assets, rendering the bank unable to continue providing needed CRE financing in the market that the bank serves.

Price Risk

Price risk is the risk to current or projected financial condition and resilience arising from changes in the value of either trading portfolios or other obligations that are entered into as part of distributing risk.

For loans secured by CRE, price risk can arise upon a bank's foreclosure or physical possession of a property, whereby the collateral is booked into other real estate owned (OREO). During the holding period, OREO must be carried at fair value less estimated costs to sell.²² Economic trends that played a role in the bank's acquisition of the property as OREO could continue to affect the property's value and reduce proceeds realized by the bank upon the property's disposal.²³

²² ASC Subtopic 820-10 is the accounting standard that applies to measuring the fair value of OREO property. Although the fair value of the property normally is based on an appraisal (or other evaluation), the valuation should be consistent with the price that a market participant pays to buy the property at the measurement date.

²³ For more information, refer to the "Other Real Estate Owned" booklet of the *Comptroller's Handbook*.

Risk Management

Each bank should identify, measure, monitor, and control risk by implementing an effective risk management system appropriate for the bank's size, complexity, and risk profile. When examiners assess the effectiveness of a bank's risk management system, they consider the bank's policies, processes, personnel, and control systems. Refer to the "Corporate and Risk Governance" booklet of the *Comptroller's Handbook* for an expanded discussion of risk management. Refer also to the "Loan Portfolio Management" booklet of the *Comptroller's Handbook* (national banks) and the former *Office of Thrift Supervision Examination Handbook*, section 201, "Overview: Lending Operations and Portfolio Risk Management" (FSAs) and the control risks section of this booklet.

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; and (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.

Management and Board Oversight

The board's role is to oversee the bank's activities, provide credible challenge to management, and hold management accountable.²⁴ The board or risk committee and senior management play critical roles in the bank's risk governance by (1) setting the tone at the top, (2) setting the bank's strategic objectives and risk appetite, and (3) establishing an appropriate risk management system to manage the risks associated with meeting the strategic objectives.

Strategic Planning

A CRE strategy typically states the bank's intent by product type, product risk appetite, economic sector, geographic location, and anticipated profitability. Decisions to offer a new product, change terms on an existing product, or expand into new markets are strategic decisions that should be supported by sound, documented analysis and due diligence. This analysis extends to the risk assessment exercise and typically addresses

- competitive environment.
- capabilities and expertise.
- operational capacity.
- staffing and training needs.

²⁴ For more information, refer to the *Director's Reference Guide to Board Reports and Information* and the "Corporate and Risk Governance" booklet of the *Comptroller's Handbook*.

- control systems in place and those needed.
- compliance requirements.
- reporting and operational systems.
- funding sources (capital) and financial projections.

Once senior management and the board adopt strategic objectives, business line managers prepare a business plan. Business plan development should involve knowledgeable staff from key functional areas, including credit policy, credit administration, credit risk review, internal audit and other key areas. Individuals representing each area should have strong knowledge of their area's resources and capabilities so they can provide informed input into business plans and proposals. Common topics in a CRE business plan address product mix and profile, concentration and risk limits, key performance monitoring measures, and capital and the allowance for loan and lease losses (ALLL) or allowance for credit losses (ACL) requirements.

Examiners should pay particular attention to how banks implement new business strategies, including the rollout of new products or initiatives. This is especially important when changes could significantly affect the bank's size, operating approach, or risk profile. Examiners should consider whether effective change management processes exist, including realistic assessments of costs and resource requirements (including adequate and knowledgeable staffing, effective policies, operating procedures, and internal controls).

Governance Structure

Many banks use management and board committees to oversee lending activities, including CRE lending. Management committees may be used to facilitate oversight of day-to-day banking activities. For example, a bank may have a commercial credit committee that is responsible for approving loans over a certain threshold, approving certain exceptions to policy, and overseeing a bank's commercial credit risk. Some banks have a board-level credit committee that serves a similar role at the board level.

Management and Board Reports

Management and the board typically review a variety of information in overseeing a bank's CRE lending activities. The following are examples of information that management and the board typically review related to CRE lending:

- Loan risk ratings
- ALLL or ACL information
- Rating migration
- Concentrations of credit
- Supervisory LTV exceptions
- Delinquent, nonaccrual, nonperforming, and charged-off loans
- Policy, credit, and collateral exceptions
- Risk layering

- Credit risk review conclusions
- Portfolio credit quality measures
- Loan workout measures

Loan Policies

Real Estate Lending Standards

Real estate lending policies must

- be consistent with safe and sound banking practices.
- be appropriate to the size of the bank and the nature and scope of its operations.
- establish loan portfolio diversification standards.
- establish prudent underwriting standards, including LTV limits that are clear and measurable.
- establish loan administration procedures for the real estate portfolio.
- establish documentation, approval, and reporting requirements to monitor compliance with the bank's real estate lending policy.
- be reviewed and approved by the board at least annually.

A bank's loan policies should establish clear underwriting standards consistent with the types of CRE lending performed.²⁵ Loan policies should establish standards for sound loan structure such as tenor, amortization, guarantees, equity, and covenants that are within the risk parameters approved by the board and consistent with regulations.

When evaluating the adequacy of CRE loan policies, examiners should consider the

- nature and scope of the bank's CRE lending activities.
- size, complexity, condition, and risk profile of the portfolio.
- quality of management and internal controls.
- expertise and size of the lending and loan administration staff.
- market conditions.

The regulations also require the bank to monitor conditions in the real estate market in its lending area to ensure that its real estate lending policies continue to be appropriate for current market conditions. In addition, the regulations specify that a bank's real estate lending policy should reflect consideration of the "Interagency Guidelines for Real Estate Lending Policies," which are in appendix A to subpart D of 12 CFR 34 (national banks) and in the appendix to 12 CFR 160.101 (FSAs). These guidelines describe key elements of a real estate lending policy, including

- loan portfolio management considerations.
- underwriting standards.
- LTV and supervisory loan-to-value (SLTV) limits.
- exceptions to general lending policy.
- loan administration.

²⁵ Refer to 12 CFR 30, appendix A, II.D, "Credit Underwriting."

The next sections of this booklet provide an overview of the first four elements. Loan administration is discussed in the “Credit Administration” section of this booklet.

Loan Portfolio Management Considerations

Interagency Guidelines for Real Estate Lending

The lending policy should contain a general outline of the scope and distribution of the bank’s credit facilities and the manner in which real estate loans are made, serviced, and collected. In particular, the bank’s policies on real estate lending should

- identify the geographic areas in which the institution will consider lending.
- establish a loan portfolio diversification policy and set limits for real estate loans by type and geographic market (e.g., limits on higher risk loans).
- identify appropriate terms and conditions by type of real estate loan.
- establish loan origination and approval procedures, both generally and by size and type of loan.
- establish prudent underwriting standards that are clear and measurable, including LTV limits, and consistent with these supervisory guidelines.
- establish review and approval procedures for exception loans, including loans with LTV percentages that exceed supervisory limits.
- establish loan administration procedures, including documentation, disbursement, collateral inspection, collection, and credit risk review.
- establish real estate appraisal and evaluation programs.
- require that management monitor the loan portfolio and provide timely and adequate reports to the board.

The bank should consider both internal and external factors in the formulation of the bank’s loan policies and strategic plan. Factors that should be considered include

- the size and financial condition of the bank.
- the expertise and size of the lending staff.
- the need to avoid undue concentrations of risk.
- compliance with all real estate-related laws and regulations, including the Community Reinvestment Act, anti-discrimination laws, and for savings associations, the Qualified Thrift Lender test.
- market conditions.

A bank’s policies may include limits and sublimits. For example, sublimits may be established for property types, geographic markets, and other relevant factors, as appropriate. These are generally expressed as a percentage of capital.

Banks’ policies typically reflect consideration of risks posed by individual loans as well as aggregate portfolio risk. Even when individual loans are prudently underwritten, groups of loans that are similarly affected by internal and external market factors can expose banks to a heightened level of risk, which may warrant management attention and additional capital support.²⁶ All loans have risk; prudent lending, however, includes identifying risks, assessing the risks’ nature and magnitude, and structuring the loan in a way that sufficiently mitigates the risks.

²⁶ For more information, refer to the “Concentrations of Credit” booklet of the *Comptroller’s Handbook*.

Underwriting Standards

Interagency Guidelines for Real Estate Lending

The lending policies should reflect the level of risk that is acceptable to the board of directors and provide clear and measurable underwriting standards that enable the bank's lending staff to evaluate these credit factors. The underwriting standards should address at a minimum

- the maximum loan amount by type of property.
- maximum loan maturities by type of property.
- amortization schedules.
- pricing structure for different types of real estate loans.
- LTV limits by type of property.

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 **debt-service coverage ratio** (DSCR).
- LTV limits by property type.
- Maximum loan tenor.
- Minimum **debt yield**.
- Amortization criteria, including standards for the acceptability of and limits on nonamortizing loans. For condominium and single-family residential projects that convert to rentals and tend to depreciate at an accelerated rate relative to owned units, amortization periods of less than 30 years generally would be reasonable. The determination of what is reasonable depends on an evaluation of the individual project. Some banks restructure these types of loans as mortgage loans in the developer's name. Such developer loans should fit into those prudent underwriting parameters outlined in the bank's loan policies.
- Pricing and profitability objectives.
- Minimum standards of documentation consistent with the type of lending performed.
- For construction loans, effective construction risk management with disbursement controls confirming construction draws are commensurate with verified improvements and that the budget remains in balance with 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** (e.g., cash or unencumbered investment in the underlying property).

- 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 commercial real estate.
- Preleasing requirements for income-producing property.
- Presale and minimum release requirements for tract development financing.
- 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.

Acquisition, Development, and Construction Policies

This section of the booklet addresses specific considerations for ADC lending policies.

Interagency Guidelines for Real Estate Lending

For development and construction projects, and completed commercial properties, the policy should establish, commensurate with the size and type of the project or property,

- requirements for feasibility studies and sensitivity and risk analyses (e.g., sensitivity of income projections to changes in economic variables such as interest rates, vacancy rates, or operating expenses).
- minimum requirements for initial investment and maintenance of hard equity by the borrower (e.g., cash or unencumbered investment in the underlying property).
- minimum standards for net worth, cash flow, and debt service coverage of the borrower or underlying property.
- standards for the acceptability of and limits on nonamortizing loans.
- standards for the acceptability of and limits on the use of interest reserves.
- pre-leasing and pre-sale requirements for income-producing property.
- pre-sale and minimum unit release requirements for non-income-producing property loans.
- limits on partial recourse or nonrecourse loans and requirements for guarantor support.
- requirements for takeout commitments.
- minimum covenants for loan agreements.

The bank's lending policy typically defines acceptable tenors for various types of construction loans. The appropriate tenor is generally based on the time needed for construction and stabilization or sale and would not be shorter than that required for completion. The bank may wish to provide construction financing that covers the expected construction period with the facility converting to bridge financing for the expected stabilization period. The lending policy may include extension options, but the length of the extension options should be consistent with the expected construction time plus the projected absorption period.

Prudent policies typically establish loan limits as a maximum percentage of cost (i.e., LTC) as well as market value (i.e., LTV) to ensure that the borrower contributes sufficient equity.

Appropriate terms of repayment are critical when financing multiple-unit developments. Multiple-unit ADC financing is usually provided by separate development and construction facilities with lot repayment for the development loan being made from the first draw of the construction loan. A prudent development and construction loan policy includes requirements for principal curtailments to allow for periodic re-margining if sales or sales prices fall short of projections. Credit analysis should assess the borrower's or guarantor's ability to meet any curtailment requirements.

Typically, the construction loan agreement permits a limited number of speculative units and models, allowing the builder to have units available for marketing and sale and enabling the bank to minimize its exposure to the project. The expected **absorption rate** is an important consideration when establishing limits on the construction of speculative units.

Construction loans that finance multiple units or phases are ordinarily structured for repayment to appropriately follow unit sales. Loan agreements typically require adequate pay downs as the collateral is sold and the liens are released. For multiple-unit developments, a bank typically requires full repayment before the sale of all units. To accomplish this, the amount that the bank requires to release its unit lien (the **release price**) is typically some multiple of the lot or unit's proportional share of the total value of the entire project. This is commonly referred to as **acceleration**.

For example, assume a developer is developing 100 single-family lots projected to sell on average for \$30,000 each. Also, assume that the project appraised for \$2 million, reflecting the discounted net cash flows from the lot sales. The bank agrees to lend \$1.5 million (75 percent of the appraised value of the project) and wants to be fully paid with the sales of 80 percent, or 80, of the lots.

To be fully paid with the sale of the 80th lot, the construction loan agreement would specify a release price of 125 percent (100/80). If the lots were equal in value, the release price would be calculated as follows: $\$1,500,000/100 = \$15,000 \times 125\% = \$18,750$. Alternatively, if the bank wishes to be paid out over the sale of 75 percent of the lots, the release price would be 134 percent (100/75 rounded up) of the proportionate debt or $\$15,000 \times 134\% = \$20,100$. When values among lots differ, separate release prices can be established for each lot. A development that generates little developer profit on the lots, i.e., the sales price is not sufficiently greater than the cost, will have difficulty paying off lots on an accelerated basis.

For multiple-unit loans, such as those for lot development or condominiums, the maximum number of units that may be financed should consider the tenor and anticipated rate of unit sales. For example, if the maximum term is 24 months, units are expected to be absorbed at an average rate of 10 per quarter, the bank wishes to be paid off after the sale of 80 percent of the units (acceleration of 1.25X), and it is expected to take six months for units to be available for sale, the maximum number of units that could be financed, given the maximum 24-month tenor, would be 24 months – 6 months = 18 months or 6 quarters x 10 lots/quarter

$\times 1.25 = 75$ units. This may also be used to determine the required tenor to finance a given number of units.

Most banks finance larger tract developments in phases to better control risk. A prudent practice is to finance each phase with separate loans or sublimits with the funding of subsequent phases dependent on the performance of the previous phase. Financing development in phases may require the construction of amenities such as clubhouses and recreational facilities or site improvements that benefit all phases even though their cost is funded with the first phase. Banks typically apply a portion of the unit release prices to pay down the loan amount associated with these common improvements using a method similar to the phased development approach with an emphasis on proceeds from the earlier units when possible. This may be best accomplished by providing a separate facility for the common improvements. This method can also be used to repay a facility that finances models.

Banks' policies also may require bonds for projects of a material size in which the borrower and contractor are separate entities (a contractor related to the borrower cannot generally be bonded).²⁷

Covenants

Appropriate covenants for construction or development loans may include

- a limit on the permissible number of speculative units and models for the subject property.
- a limit on the number or dollar amount of unsold units including speculative units and models a builder may have for all projects at any one time, and for projects financed by the bank.
- a limit on raw land inventory or the number of attached projects in progress at any one time.
- limits on additional debts, guarantees, and liens.
- the borrower's or guarantor's minimum liquidity, net worth, debt-to-worth ratios, etc.
- maximum distributions, or restrictions on distributions to partners or owners, before loan repayment.

Borrowing Base Lending

Tract development is often funded using a **borrowing base**. The borrowing base is a revolving credit agreement that limits the bank's legally binding commitment to advance funds to the borrower. The borrowing base specifies the maximum amount that the bank will lend to the borrower as a function of the collateral's type, value, eligibility criteria, and **advance rates**. The credit agreement also specifies a maximum commitment amount regardless of the amount of the borrowing base availability.

²⁷ Refer to the "Underwriting ADC Loans" section of this booklet for more information about bonds.

Typically, the borrowing base formula establishes different advance rates for each collateral type, such as land, developed lots, homes under construction and completed, model homes, and sold and unsold (speculative or spec) homes. The amount of collateral in each category and the corresponding advance rates limit the borrower's ability to draw additional funds. The advance rates are generally higher for collateral with lower development, construction, and marketing risk. For example, the advance rate for developed lots is likely to be lower than that for a completed home. In addition, advance rates may vary among borrowers. Generally, banks grant more liberal advance rates to borrowers that have greater financial strength and more experience. Collateral must meet eligibility criteria specified in the loan agreement to be included in the borrowing base. These criteria commonly include limitations on the number of speculative units and the duration of time a completed unsold unit or finished vacant lot may remain in the borrowing base.

This type of facility enables the bank to control loan advances and proceeds from home sales. The funds available under the revolver are based on frequent (usually monthly) borrower-prepared reports, commonly referred to as a borrowing base certificate. The borrowing base certificate details and certifies the quantity and value of collateral in each category that meets the borrowing-base eligibility criteria and the total amount of the borrowing base (the outstanding balance of the facility plus any available funds). Banks ordinarily perform periodic on-site verification of the information provided by the borrower. The borrowing base should be compared to the monthly financial statements, and the balance sheet should reflect the inventory reported on the borrowing base certificate. Any discrepancy may be an indication of potential problems.

When developing the borrowing base formula, it is prudent for the bank to require the borrower to maintain appropriate levels of cash (or cash equivalent) equity throughout the project's construction and marketing periods.

Investor-Owned Residential Real Estate Lending Standards

Standards for IORR lending should generally be consistent with the standards for CRE lending as discussed in this booklet. It is important that the policy address an appropriate amortization period for IORR loans that considers both the property's useful life and the predictability of its future value. Controls to monitor and control risks associated with IORR lending may include the use of loan covenants, requirements for periodic financial analysis, and the need for a willing and financially capable guarantor. Further, IORR loan policies typically establish underwriting standards pertaining to appropriate owner equity (e.g., LTV), acceptable appraisal or valuation methods, insurance requirements, and ongoing collateral monitoring.

Supervisory Loan-to-Value Limits

Interagency Guidelines for Real Estate Lending

Banks should establish their own internal LTV limits for real estate loans. These limits should not exceed the following supervisory limits:

Loan category	SLTV limit (less than or equal to)
Raw land	65%
Land development or improved lots	75%
Construction:	
Commercial, multifamily, ^a and other nonresidential	80%
One- to four-family residential	85%
Improved property:	
Commercial, multifamily, and other nonresidential	85%
Owner-occupied one- to four-family and home equity	90% ^b

^a Multifamily construction includes condominiums and cooperatives.

^b An LTV limit has not been established for permanent mortgage or home equity loans on owner-occupied, one- to four-family residential property; however, for any such loan with an LTV ratio that equals or exceeds 90 percent at origination, the bank should require appropriate credit enhancement in the form of either mortgage insurance or **readily marketable collateral**.

SLTV limits should be applied to the underlying property that collateralizes the loan. For loans that fund multiple phases of the same real estate project (e.g., a loan for both land development and construction of an office building), the appropriate LTV limit is the limit applicable to the final phase of the project funded by the loan; however, loan disbursements should not exceed actual development or construction outlays. When a loan is fully cross-collateralized by two or more properties or secured by a collateral pool of two or more properties, the appropriate maximum loan amount under SLTV limits is the sum of the value of each property, less senior liens, multiplied by the appropriate LTV limit for each property. To ensure that collateral margins remain within the supervisory limits, lenders should redetermine conformity whenever collateral substitutions are made to the collateral pool.

In establishing internal LTV limits, each lender is expected to carefully consider the bank-specific and market factors listed under “Loan Portfolio Management Considerations,” as well as any other relevant factors, such as the particular subcategory or type of loan. For any subcategory of loans that exhibits greater credit risk than the overall category, a lender should consider establishing an internal LTV limit for that subcategory that is lower than the limit for the overall category.

The LTV ratio is only one of several pertinent credit factors to be considered when underwriting a real estate loan. Other credit factors to be taken into account are highlighted in the “Underwriting Standards” section. Because of these other factors, the establishment of these supervisory limits should not be interpreted to mean that loans at these levels will automatically be considered sound.

LTV means the percentage or ratio that is derived at the time of loan origination by dividing an extension of credit by the total value of the property(ies) securing or being improved by the extension of credit plus the amount of any readily marketable collateral and other acceptable collateral that secures the extension. The total amount of all senior liens on or interests in such property(ies) should be included in determining the LTV ratio. When mortgage insurance or collateral is used in the calculation of LTV ratio, and such credit enhancement is later released or replaced, the LTV ratio should be recalculated.

The LTV is calculated by dividing the loan amount by the market value²⁸ of the property securing the loan plus the amount of any readily marketable collateral and other acceptable

²⁸ The “Interagency Guidelines for Real Estate Lending” define “value” as an opinion or estimate, set forth in an appraisal or evaluation, whichever may be appropriate, of the market value of real property, prepared according to the agency’s appraisal regulations and guidance. For loans to purchase an existing property, the term “value” means the lesser of the actual acquisition cost or the estimate of value.

collateral²⁹ that secures the loan. The total amount of all senior liens on or interests in such property should be included. Refer to appendix C of this booklet for more information regarding calculating LTV, including

- standby letters of credit.
- applying SLTV limits to loans financing various stages of development.
- calculating LTV for loans financing tract development.
- calculating LTV for loan collateralized by two or more properties.

Excluded Transactions

Interagency Guidelines for Real Estate Lending

The SLTV guidelines recognize that there are a number of lending situations in which certain factors may outweigh the need to apply the SLTV limits. These include the following:

- Loans guaranteed or insured by the U.S. government or its agencies, provided that the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the SLTV limit.
- Loans or portions of loans backed by the full faith and credit of a state government, provided that the amount of the assurance is at least equal to the portion of the loan that exceeds the SLTV limit.
- Loans guaranteed or insured by a state, municipal, or local government, or an agency thereof, provided that the amount of the guaranty or insurance is at least equal to the portion of the loan that exceeds the SLTV limit, and provided that the bank has determined that the guarantor or insurer has the financial capacity and willingness to perform under the terms of the guaranty or insurance agreement.
- Loans that are to be sold promptly after origination, without recourse, to a financially responsible third party.
- Loans that are renewed, refinanced, or restructured without advancing new funds or an increase in the line of credit (except for reasonable closing costs), or loans that are renewed, refinanced, or restructured in connection with a loan workout with or without advancing new funds, when consistent with safe and sound banking practices and part of a clearly defined and well-documented program to achieve orderly liquidation of the debt, reduce risk of loss, or maximize recovery on the loan.
- Loans that facilitate the sale of real estate acquired by the bank in the ordinary course of collecting a debt previously contracted in good faith.
- Loans for which the bank takes a lien on or interest in real property as additional collateral through an abundance of caution. For example, an abundance of caution exists when the bank takes a blanket lien on all or substantially all of the assets of the borrower, and the value of the real property is low relative to the aggregate value of all other collateral. When the real estate is the only form of collateral, this exclusion would not apply.
- Loans, such as working capital loans, in which the bank does not rely principally on real estate as security and the extension of credit is not used to acquire, develop, or construct improvement on real property.
- Loans for the purpose of financing permanent improvements to real property, but not secured by the property, if such security interest is not required by prudent underwriting practice.

²⁹ “Other acceptable collateral” means any collateral in which the lender has a perfected security interest that has a quantifiable value and is accepted by the lender in accordance with safe and sound lending practices. Other acceptable collateral should be appropriately discounted by the lender consistent with the lender’s usual practices for making loans secured by such collateral. Other acceptable collateral includes unconditional irrevocable standby letters of credit for the benefit of the lender.

Loans Exceeding Supervisory Loan-to-Value Ratio Limits

Interagency Guidelines for Real Estate Lending

The interagency guidelines recognize that appropriate LTV limits vary not only among categories of real estate loans but also among individual loans. Therefore, it may be appropriate in individual cases for the bank to originate or purchase loans with LTV ratios in excess of the SLTV limits, based on the support provided by other credit factors. Such loans should be identified in the bank's records, and their aggregate amount reported at least quarterly to the bank's board.

The aggregate amount, or basket, of all loans in excess of the SLTV limits at origination should not exceed 100 percent of total capital, as defined in 12 CFR 3.2. Moreover, within the aggregate limit, total loans for all commercial, agricultural, multifamily or other non-one- to-four-family residential properties should not exceed 30 percent of total capital. A bank will come under increased supervisory scrutiny as the total of such loans approaches these levels. Loans that met SLTV limits at origination for which the collateral subsequently declined in value do not constitute SLTV exceptions and are not included in the calculation of the aggregate amount.

The commercial, agricultural, multifamily, or other non-one-to-four-family residential properties exceeding the SLTV limits are often referred to as the “commercial basket.” The remainder of the total basket (up to 100 percent of total capital) is available for all categories of nonconforming loans on one- to four-family residential property. Refer to the “SLTV Limits” section of this booklet for a list of SLTV limits.

When determining exposure versus the aggregate SLTV limits, the entire outstanding balance is included, not just the portion exceeding the limit. If the bank holds a first and second lien on a parcel of CRE and the combined commitment exceeds the appropriate SLTV limit, both loans would be reported in the bank's nonconforming loan totals. Although the “Interagency Guidelines for Real Estate Lending” state that for loans funding multiple phases of the same real estate project the supervisory LTV limit should be applicable to the final phase of the project, it is still prudent for the bank to consider the SLTV for each phase separately from a risk management perspective. A loan would no longer be reported as part of the aggregate totals when a reduction in principal or senior liens, or additional contribution of collateral or equity (e.g., improvements to the real property securing the loan), brings the LTV within SLTV limits.

Exceptions to General Lending Policy

Examiners should determine whether the bank monitors compliance with its real estate loan policies, including those related to appraisals, construction and engineering management controls, and environmental risk management.

Examiners also should review lending policy exception reports to assess the frequency and nature of policy exceptions and to determine whether exceptions to the bank's loan policy are adequately documented, approved, reported, and appropriate in light of relevant credit considerations.³⁰ An excessive or significantly increasing number of exceptions to the CRE

³⁰ Refer to the “Loan Portfolio Management” booklet of the *Comptroller's Handbook* (national banks) and *Office of Thrift Supervision Examination Handbook*

lending policy could indicate that the bank is unduly relaxing its underwriting practices, needs to revise its loan policy, or that its policies are inconsistent with the board's risk tolerance. With respect to frequency and nature of policy exceptions, it is prudent for the bank to consider aging of all exceptions with sufficient stratification to identify trends in volumes, loan officer, and types.

Interagency Guidelines for Real Estate Lending

Some provision should be made for the consideration of loan requests from creditworthy borrowers whose credit needs do not fit within the bank's general lending policy. A bank may provide for prudently underwritten exceptions to its lending policies, including LTV limits, on a loan-by-loan basis. However, any exceptions from the SLTV limits should conform to the aggregate limits on such loans.

The board of directors is responsible for establishing standards for the review and approval of exception loans. Each bank should establish an appropriate internal process for the review and approval of loans that do not conform to its own internal policy standards. The approval of any such loan should be supported by a written justification that clearly sets forth all the relevant credit factors that support the underwriting decision. The justification and approval documents for such loans should be maintained as a part of the permanent loan file. Each bank should monitor compliance with its real estate lending policy and individually report exception loans of a significant size to its board of directors.

Underwriting Practices

Underwriting commercial real estate loans is a comprehensive process that involves borrower/guarantor financial analysis, project feasibility, loan structuring, and collateral valuation.

Analysis of Borrower's and Guarantor's Financial Condition

An important part of the underwriting process is the analysis of the borrower's overall financial condition and resources, the financial responsibility of any guarantor, the nature and value of any underlying collateral, and the borrower's capacity and willingness to repay as agreed.

The bank should obtain appropriate financial information on the borrower(s) and guarantor(s), as applicable, including income, liquidity, cash flow, contingent liabilities, and other relevant information to support sound underwriting. Loan documents typically include covenants requiring the periodic submission of financial information that allows the bank to adequately monitor the borrower's and guarantor's overall financial soundness and capacity to support the credit.

Underwriting includes determining whether the borrower demonstrates the capacity to meet a realistic repayment plan from available cash flow and liquidity. Cash flow from the underlying property or other indicators of borrower capacity is evaluated to determine whether, and to what extent, the borrower can adequately service interest and principal on a prospective loan.

Cash flows should be assessed on a global basis. Global cash-flow analyses can be complex and may require integrating cash flows from business financial statements, tax returns, and Schedule K-1 forms for multiple partnerships, limited liability companies, and corporations. The analysis should consider required and discretionary cash flows from all activities and any actual or contingent liabilities and their potential effect on repayment capacity. The analysis should focus on recurring cash flows and anticipated capital gains when income has been shown to be historically capital-gain dependent. Realistic projections of such expenses as personal debt payments, property and income taxes, and living expenses should be considered. Comprehensive global cash-flow analyses should be performed despite the presence of significant liquid assets as those assets may be needed to fund other actual or contingent liabilities and other cash flow shortfalls.

When evaluating guarantor support, examiners should consider whether the guarantor has both the willingness and ability to provide support for the credit, and whether the guarantee is legally enforceable. A presumption of willingness to provide borrower (project) support, when the guarantor has an economic incentive, is usually appropriate unless there is evidence to the contrary. Examiners should consider whether a guarantor has demonstrated willingness to fulfill previous obligations, has sufficient economic incentive, and has a significant investment in the project. Analysis should consider the liquidity of any assets that collateralize the guarantee. A guarantor's unpledged assets should not be considered a substitute for project equity. Guarantor liquidity should be verified by the bank.

Some guarantees may be limited in nature, such as interest only, construction completion only, partial principal, reduced (stepped-down) in amount, or released during the loan term as certain conditions are met. The bank should monitor and assess the achievement of these conditions before releasing a guarantor of their obligation.

Some loans may be made on a nonrecourse basis in which the lender may only look to the collateral for repayment, rather than the guarantor, in the event of default. In such cases, a guarantee is usually executed with carve-out provisions that limit the guarantor's liability to losses incurred as a result of certain acts or omissions of the borrower (or "bad acts") such as fraud or misrepresentation, voluntary bankruptcy, environmental issues, unapproved liens, waste of the collateral, prohibited transfers, and the diversion of funds. Commonly, there are certain carve-out provisions that cause the loan to become full recourse.

Underwriting Acquisition, Development, and Construction Loans

ADC lending presents unique risks not encountered in the term financing of existing CRE. Assessing performance on an ADC loan can be challenging because most are underwritten without required amortization or project-generated interest payments. Absent such objective performance measures, examiners should evaluate the projected cash flow of the project, compare actual progress to the initial plan and appraisal assumptions, and when applicable, analyze guarantor support. This analysis should consider the feasibility of the project, given current conditions, planned construction, and the level of debt once fully funded.

Analysis should also include the timing and type of equity required. Allowing the contribution of borrower equity to be deferred can significantly increase completion risk. The bank's policy should state that equity be contributed before disbursements of the construction loan commence. When the injection of any equity is deferred for contribution at a later point in the development process, the bank should be assured that this equity is, and will remain, available. Deferred developer's profit, unearned developer fees, incurred overhead expenses, or interest or other holding fees paid or accrued on contributed land do not contribute to the value of the project and are generally not considered equity.

Construction Concerns

Construction loans finance the creation of collateral with repayment dependent on the construction completion. These are some of the factors that can pose threats to successful completion:

- Fraudulent diversion of construction funding draws.
- Liens filed by contractors, subcontractors, or material suppliers for nonpayment.
- Delays caused by labor disputes or failure of major suppliers to deliver materials.
- Failure of the contractor or a subcontractor to complete construction or complete to specifications. This may be due to inadequate experience, negligence, or financial failure.
- Cost overruns due to unforeseen conditions, such as inaccurate budgets, increases in materials or transportation expense, material or labor shortages, increased interest expense, inadequate soil or other subsurface conditions, or delays caused by inclement weather.
- Loan administration errors.

While many of these risks are beyond the bank's control, some can be mitigated by (1) scrutiny of the plans and budget; (2) frequent and routine inspections; (3) thoroughly investigating the financial condition and reputation of the borrower, contractor, and subcontractors; and (4) effective loan administration processes.

The use of payment and performance bonds and title insurance can further mitigate this risk. A payment bond mitigates the risk of priority liens being recorded by insuring the payment of subcontractors and material suppliers. A performance bond insures the completion of the project by the subcontractor. The bank's policy may require bonds for all projects of a material size when the borrower and contractor are separate entities (a contractor related to the borrower cannot generally be bonded). Title insurance can protect the lender from losses due to fraud and construction liens.

The bank can mitigate the risk of cost overruns by requiring the borrower to enter into a fixed-price contract with the contractor. If the borrower and contractor are the same or are related, the contract should specify cost plus a fee with a guaranteed maximum price. Regardless of whether the borrower employs a third-party contractor or the borrower acts as the contractor, prudent underwriting generally includes determining whether the contractor has sufficient expertise and financial capacity.

Evaluating the Developer Borrower

Because the expected value of the project is not realized until the project is completed, prudent underwriting includes an assessment of the borrower's ability to complete the project within budget, on time, and according to the construction plans.

Before issuing a commitment to finance proposed construction, the bank should analyze and document the borrower's background, including reputation and experience, to determine the project's likelihood of success. This should include a review of the contractor's and major subcontractors' ability to successfully complete the type of project to be undertaken.

Analysis of the borrower's financial condition should include a determination of whether the borrower has sufficient financial capacity for project completion. This is discussed in the "Analysis of Borrower's and Guarantor's Financial Condition" section of this booklet.

Determining Project Feasibility

Prudent underwriting includes determining the project's feasibility. Feasibility describes the likelihood that the project as proposed will be economically successful. Feasibility studies can be included as part of an independent appraisal or as a separate analysis; however, feasibility studies commissioned by the borrower may be biased and should be critically reviewed. While studies and appraisals can be helpful in providing useful information and analysis, the bank should conduct its own analysis of the project. Further, the person conducting the analysis of the project should have the requisite knowledge and skills to assess project feasibility.

Construction Plans and Budget

The construction budget, along with the project pro forma, is one of the most critical elements in determining project feasibility. Developers typically give the bank a detailed line-item budget along with plans, proposed schedules, geotechnical reports, and other supporting documents that should be reviewed by a qualified individual to assess the appropriateness and reasonableness of the budget and give the lender an adequate understanding of the proposed improvements.

The budget typically includes a contingency account to fund unanticipated cost overruns. Contingency allowances vary based on the project's size or complexity but usually range between 5 and 10 percent of the overall budget. Common uses of contingency funds include an unexpected increase in material costs or a buyer-mandated redesign.

Construction budgets typically categorize costs as hard and soft costs. **Hard costs** generally include on- or off-site improvements, building construction costs, other reasonable and customary costs paid to construct or improve a project, **general conditions costs**, general contractor's fees, and other expenses normally included in a construction contract such as bonding and contractor insurance. General conditions costs are the contractor's costs associated with the jobsite management of the project, including trailers, vehicles, dumpsters,

and cleanup. General conditions should not be fully funded up front; instead, they are typically funded with each loan advance as the contractor incurs additional project expenses.

Soft costs include interest and other development costs such as fees and related predevelopment expenses. Project costs payable to related parties such as developer fees, leasing expenses, brokerage commissions, and management fees may be included in the soft costs provided that the costs are reasonable in comparison to the cost of similar services from third parties. Interest or preferred returns payable to equity partners or subordinated debt holders should not be included in the construction budget. Other items that should not be included in the construction budget are the developer's general corporate overhead and selling costs that are to be funded out of sales proceeds such as brokerage commissions and other closing costs.

The budget and schedules should be reviewed to determine whether they realistically reflect the cost and time required to construct the improvements in accordance with the plans and whether the improvements are sufficiently functional and compare favorably to competitive properties in the market. Budgets that lack detail or appear to be overly optimistic should be thoroughly evaluated. An inaccurate budget can lead to cost overruns and a need to advance additional funds for completion. Cost increases do not necessarily result in an increase in value.

The economic purpose of developing a property is to create value greater than the project's cost. This difference between the **prospective market value** and cost to construct is the developer's profit. This profit is the incentive for a developer to assume the risk of construction and sale or lease-up and varies depending on the development's complexity and risk; a development that does not create this incentive (prospective market value is not sufficiently higher than its cost) is generally not feasible. Furthermore, a project budget with modest or no developer profit leaves inadequate room for cost overruns. Additionally, if the bank takes possession of an incomplete project via foreclosure, the lack of profit available to a prospective purchaser for completion complicates the bank's efforts to dispose of the property in its incomplete state and may necessitate completion by the bank or its sale at a price that may result in a loss.³¹

The developer's profit should generally be funded by sales, by construction loan funds upon construction completion and lease-up, or by subsequent term financing. Funding a developer's profit for an incomplete project diminishes the developer's incentive to complete and lease or sell the units in a CRE project and can lead to problems for lenders.

A developer fee (distinct from developer profit) is often included in the project budget. This fee represents compensation for the management of the project and the developer's overhead directly incurred for that project only. In practice, the disbursement of the developer fee may be either deferred or disbursed based on the percentage of the project's completion. This fee varies but typically does not exceed 4 percent of the project cost.

³¹ For more information, refer to the "Other Real Estate Owned" booklet of *Comptroller's Handbook*.

Evaluating LTC in addition to LTV helps ensure that the borrower contributes sufficient equity. Equity provides for both the borrower's continued economic interest in the success of the property and cushion for cost overruns and leasing or sales shortfalls. Examples of common types of equity include cash, marketable securities, land purchased with cash, and initial costs paid up front by the developer such as architect and engineering fees and permits. Prudent policies clearly state the requirements for borrower equity such as specifying the amounts required, the acceptable types and sources of equity, and the timing of the equity contribution.

For a construction project, the budget should reflect sufficient funds for completion. Approving a loan to finance partial construction without committed funds for completion (either from the bank or an external source) is generally considered to be a liberal underwriting practice. Exceptions to this may be financing for later phases of phased developments or loans that finance the development of lots but when unit construction financing is expected to be provided by other lenders.

Preleasing

Prudent loan policies seek to mitigate market risk by establishing minimum levels of preleasing or sales as a condition of commitment or funding. Experience has shown, however, that presales may not be a reliable indicator of actual future sales because these purchase commitments may not result in sales if values decline. Banks typically analyze and monitor presales and preleasing, determining whether they represent bona fide commitments, and that deposits have been collected and are meaningful.

Pro Forma Financial Statements

Credible pro forma projections are a key determinant of a project's feasibility. Prudent underwriting includes reviewing the pro forma statement to determine whether the underlying assumptions and related projections are reasonable based on knowledge of the market and income and expenses for similar properties. When key underlying assumptions change, the borrower should provide revised projections to the bank that reflect current conditions.

Regardless of the cost to construct a property, the value of an income-producing property depends to a great degree on the expected NOI. For this reason, expected costs and the value supported by the NOI should be considered together. Construction costs that closely approach or exceed the expected value of the project's income generally indicate that a project is not feasible for reasons discussed under the "Construction Plans and Budget" section of this booklet.

For projects that involve unit sales, prudent underwriting includes analyzing the timing of expected cash inflows from loan and sales proceeds along with cash outflows for development costs to determine whether sufficient cash will likely be available throughout the development period. The analysis should include stress testing to analyze sensitivity to

changing economic conditions under a variety of scenarios (e.g., absorption rates, interest rates, and capitalization rates).

Site Analysis

The site analysis should consider the site's suitability for the proposed development. The site analysis includes the project type, location, ingress, egress, physical dimensions, prior and current use of the property, location, geologic conditions, topology, easements, and availability of public utilities, zoning, and development costs. The site analysis also should consider environmental factors.³²

Demographic Analysis

Demographics should be analyzed to determine the likelihood of the project's immediate and longer-term success. Demographic analysis could consider whether household formation is growing, and whether income levels in the property's market area support projected rents, sales prices, or the types of retail providers. The U.S. Census Bureau can be a useful source of demographic information.

Market Analysis

Construction lending activities are particularly sensitive to market conditions. For this reason, a thorough market analysis is a critical component of the underwriting process. The market analysis typically includes a review of the supply and demand characteristics and project desirability as well as existing and anticipated comparable properties. Market analysis may include an analysis of effective rental rates, sales prices, vacancy rates, building starts, and absorption. The analysis should consider the amenities and physical characteristics of the subject property and compare them with those of competitive properties. The results of this review should support the revenue assumptions relied on in the pro forma financial statements.

While supply considerations are important for CRE, they are especially critical when evaluating a construction project. As with any other product, an increase in demand generally spurs an increase in production and, in turn, an increase in supply. Unlike many other products, however, CRE has a long production cycle. While properties may be built for sale or lease to a purchaser or tenant that has already been identified, properties—or a portion of them—are often built on a speculative basis. Because of the length of the development and construction process, speculatively developed properties should meet demand that exists at a point in the future rather than the demand that exists when development begins.

To evaluate future demand and supply, it is important to understand the current and planned development activity in the local market. Information on local building permits and construction starts is usually available from data services or directly from local government offices. Projecting the level of future supply can be difficult and cannot accurately account for future permits and construction that may begin after development of the property has

³² For more information, refer to the "Environmental Risk Management" section of this booklet.

commenced. Because of this, supply often overestimates the expected demand resulting in prolonged lease-up and sales periods and declines in rental rates and sales prices.

Collateral Valuation for Acquisition, Development, and Construction Loans

Appraisals used to support construction loans must include the current market value of the property (often referred to as the “as is” value of the property),³³ which reflects the property’s actual physical condition, use, and zoning designation as of the current effective date of the appraisal. If the highest and best use of the property is for redevelopment to a different use, the cost of demolition and site preparation should be considered in the analysis. OCC Bulletin 2005-32, “Frequently Asked Questions: Residential Tract Development Lending,” provides guidance in the valuation of collateral for ADC loans.

The construction loan appraisal should include a prospective market value.³⁴ The prospective market value upon completion (referred to as the “**as complete**” value) is an estimate of the property’s market value as of the time that development is expected to be completed. A prospective market value upon stabilization (referred to as the “**as stabilized**” value) is an estimate of the property’s market value as of the date the property is projected to achieve stabilized occupancy. Stabilized occupancy is the occupancy level that a property is expected to achieve after the property is exposed to the market for lease-up over a reasonable period of time and at comparable terms and conditions to other similar properties.

Market values for proposed construction or renovation, partially leased or vacant buildings, nonmarket lease terms, and tract developments with unsold units must include analysis for appropriate deductions and discounts.³⁵

Appraisals of Tract Developments

As with all appraisals, an appraisal for a residential tract development must meet the minimum appraisal standards in the appraisal regulations. Appraisals for these properties must reflect appropriate deductions and discounts.³⁶ In some circumstances, the bank may rely on appraisals of the individual units to meet the agencies’ appraisal requirements and to determine market value for calculating the LTV ratio.

When the bank finances the purchase of raw land, lot development, or lot acquisition as part of a residential tract development, the bank must obtain an appraisal assigning a market value

³³ Refer to 12 CFR 34.44(e) and 12 CFR 34.42(h).

³⁴ For more information, refer to section VIII, “Minimum Appraisal Standards,” of the “Interagency Appraisal and Evaluation Guidelines” conveyed by OCC Bulletin 2010-42, “Sound Practices for Appraisals and Evaluations: Interagency Appraisal and Evaluation Guidelines.”

³⁵ Refer to 12 CFR 34.44(d).

³⁶ For more information, refer to 12 CFR 34.44, “Minimum Appraisal Standards,” and OCC Bulletins 2010-42 and 2005-32.

of the entire tract of raw land or all lots that includes appropriate deductions and discounts.³⁷ For such transactions, the market value should reflect the property's actual physical condition, use, and zoning designation (referred to as the "as is" value of the property), as of the effective date of the appraisal. For properties where improvements are to be constructed, a bank may request a market value upon completion of land improvements, if applicable. The land improvements could include the construction of utilities, streets, and other infrastructure necessary for future development. An appraisal of raw land to be valued as developed lots should reflect a reasonable time frame during which development occurs. The feasibility study or the market analysis in the appraisal should support the absorption period for the developed lots; otherwise, a portion of the tract development should be valued as raw land and factored into the discounting process.³⁸

The bank can exclude **presold units** to determine whether an appraisal of a tract development is required. A unit may be considered presold if a buyer has entered into a binding contract to purchase the unit and has made a substantial and nonrefundable earnest money deposit. The bank would typically obtain sufficient documentation to determine that the buyer has entered into a legally binding sales contract and has obtained a written prequalification or commitment for permanent financing.

Appraisals of Residential Models

For residential models, the bank ordinarily obtains an appraisal for each model or floor plan that a borrower is planning to build and offer for sale. The model appraisal typically includes the value of a base lot in a particular development without consideration to the costs of, or value attributed to, specific options, upgrades, or lot premiums. If the bank finances optional features, such as a finished basement or upgraded finishes or fixtures, the value of these items offered by the builder usually is included in the appraisal.

If the bank finances the construction of a residential tract development, an appraisal of the model(s) provides relevant information for the appraiser to consider in providing a market value of the development. That is, the value attributable to the models is used as a basis for estimating a market value for the tract development by reflecting the mix of units and adjusting for options, upgrades, and lot premiums. The market value must also reflect an analysis of appropriate deductions and discounts. Deductions and discounts can include holding costs, marketing costs, and entrepreneurial profit.³⁹

For construction of units that are not part of a tract development, a model's appraisal may be used to estimate the market value of the individual home if the model and base lot are substantially the same as the subject home and the appraisal meets the OCC's appraisal requirements and is still valid. In assessing the appraisal's validity, the bank should consider

³⁷ Refer to 12 CFR 34.44.

³⁸ For more information, refer to OCC Bulletin 2010-42.

³⁹ For more information, refer to 12 CFR 34.44 and OCC Bulletin 2005-32.

the passage of time and current market conditions.⁴⁰ When underwriting a loan to finance construction of a single home, the bank typically considers the value of the particular lot and any options and upgrades relative to the values in the appraisal of the model.

Appraisal Requirements for Construction of Condominiums

Appropriate deductions and discounts for condominiums typically include holding costs, marketing costs, and entrepreneurial profit during the sales absorption of the completed units.⁴¹ The bank may not use the aggregate retail sales prices of the individual units as the market value to calculate the LTV ratio. For purposes of this booklet, condominium buildings are distinguished from other types of residential properties if construction of the entire building has to be completed before any one unit is occupied.

If the bank finances the construction of a single condominium building with fewer than five units per building, or a condominium project with multiple buildings with fewer than five units per building, the bank may rely on appraisals of the individual units if the bank can demonstrate through an independently obtained feasibility study or market analysis that all units collateralizing the loan can be constructed and sold within 12 months.⁴²

More information on appraisals can be found in “Interagency Appraisal and Evaluation Guidelines” conveyed by OCC Bulletin 2010-42; OCC Bulletin 2018-10, “Appraisals for Commercial Real Estate Transactions: Final Rule”; and OCC Bulletin 2018-39, “Appraisals and Evaluations of Real Estate: Frequently Asked Questions.” The “Interagency Appraisal and Evaluation Guidelines” conveyed by OCC Bulletin 2010-42 provide an expanded discussion of deductions and discounts in a discounted cash-flow analysis.

When an Appraisal Might Not Require Deductions and Discounts

There are circumstances when an appraisal might not require deductions or discounts. If all the units to be developed can be built and sold within a 12-month period, the bank may use appraisals of the individual units to satisfy the agencies’ appraisal requirements and as a basis for computing the LTV ratio.⁴³ The bank should be able to demonstrate, through a feasibility study or market analysis conducted independently of the borrower and the bank, that all units collateralizing the loan are expected to be constructed and sold within 12 months. For LTV purposes, the “value” in this isolated case is the lower of the sum of the individual appraised values of the units (or “sum of the retail sellout values”) or the borrower’s actual development and construction costs. The borrower should maintain appropriate levels of hard equity (for example, cash or unencumbered investment in the underlying property) throughout the construction and marketing periods.

⁴⁰ Refer to the “Appraisals and Evaluations” section of this booklet for a detailed discussion of the criteria for determining the validity of an appraisal or evaluation.

⁴¹ Refer to *Uniform Standards of Professional Appraisal Practice* (USPAP), Advisory Opinion 3.

⁴² For more information, refer to OCC Bulletin 2010-42.

⁴³ For more information, refer to OCC Bulletin 2010-42.

If the bank finances a unit's construction under a revolving line of credit in which a borrowing base sets the availability of funds, the bank may be able to use appraisals on the individual units to satisfy the agencies' appraisal requirements and as a basis for computing the LTV ratio. This is the case if the bank limits the number of construction starts and completed, unsold homes included in the borrowing base and if the bank satisfies the conditions described in the preceding paragraph. If the borrowing base includes developed lots or raw land to be developed into lots, the appraisal obtained by the bank must reflect appropriate deductions and discounts.⁴⁴

Underwriting Income-Producing CRE Loans

Banks are expected to establish clear underwriting standards consistent with the type of income-producing CRE lending performed.⁴⁵ This section of the booklet discusses key underwriting considerations for income-producing CRE loans.⁴⁶

The performance of income-producing CRE is significantly influenced by local and regional economic conditions. A bank must monitor conditions in the real estate market in its lending area to ensure that its real estate lending policies continue to be appropriate for current market conditions.⁴⁷ Periodic market analysis should be performed for the various property types and geographic markets represented in the bank's portfolio. Sales prices, rental rates and lease terms, vacancy rates, available inventory, absorption rates, construction starts, and permits granted are examples of useful market data. The level of detail and complexity of the analysis should correspond to the level of risk inherent in the bank's lending activities. This should also include analysis on the size of out-of-area lending activities and controls (e.g., concentration limits, and exception and approval reporting) around those.

Loan Structure

Banks engaged in income-producing CRE lending are expected to extend prudently underwritten and structured loans consistent with the risk profile of the property and the risk appetite of the bank.

Tenor

Proper tenor can help mitigate risks that are associated with future events. Although banks may view longer tenors as helping to win business and retain assets longer, longer tenors also bring higher risks. When CRE markets deteriorate and property performance declines, a longer tenor may prevent the bank from requiring the borrower to contribute additional equity or otherwise restructuring the loan in a way that considers a property's performance.

⁴⁴ Refer to 12 CR 34.44(d).

⁴⁵ Refer to 12 CFR 30, appendix A, II.D.

⁴⁶ For more information, refer to the "Underwriting Standards" section and appendix D, "Underwriting Considerations by Property Type," of this booklet.

⁴⁷ Refer to 12 CFR 34, subpart D, appendix A (national banks) and appendix to 12 CFR 160.101 (FSAs).

Loan covenants that establish standards for property performance can serve to mitigate this risk. Tenors on interest-only loans are typically shorter than amortizing CRE loans, usually three to five years maximum.

Amortization

The timing of repayment, as determined by the amortization period and method of principal curtailments, is a critical consideration in prudent loan structuring.

Although there are no regulatory maximum amortization periods, prudent lenders generally consider 30 years to be a reasonable maximum for income-producing CRE. Although a property may have a longer useful life, a matching amortization period may result in such nominal principal reduction during the initial years that maintaining adequate collateral coverage throughout the loan term becomes uncertain. Properties with volatile income streams or weak prospects for future value usually merit shorter amortization periods.

For income-producing properties, a range of 15 to 30 years is appropriate in most cases, with stabilized multifamily dwellings at the higher end (up to 30 years), hotels at the lower end (generally not more than 20 years), and office, retail, and industrial properties in the middle (generally 25 years). These are general parameters only, and other factors should also be considered, such as construction quality, physical condition, effective age, lease terms, and the stability and financial strength of the tenant base. It is also useful to consider the outlook for factors influencing the future value of the property such as rent rates compared with the market economic and demographic trends, employment, local market supply and demand, and population growth.

Although interest-only terms or long amortization periods can decrease the likelihood of payment default by providing higher debt-service coverage, such terms can increase the loss given default and the balloon or full repayment risk at maturity if not properly mitigated. The loss given default risks can be mitigated by a more conservative loan amount at origination consistent with the bank's usual policy requirements for amortization, if the policy is within acceptable parameters.⁴⁸ Even if the terms of a loan permits interest-only payments, the property should nonetheless meet the bank's repayment capacity (debt service coverage) requirements as though the loan were amortizing in a manner that is consistent with the bank's underwriting standards and safe and sound banking practices. Generally, LTV and as-if amortizing debt-service coverage requirements for interest-only loans are more conservative than LTV and debt-service coverage requirements for amortizing CRE loans.

A renewal, refinancing, or extension of a loan on an interest-only basis can indicate a troubled loan. Unless adequately mitigated by strong LTV and debt service coverage assuming amortization, interest-only periods should generally be limited to construction or

⁴⁸ For example, assume that a bank's loan policy would permit a loan of \$1 million on a particular property for five years with an amortization period of 25 years at a rate of 6 percent. The balance at maturity would be \$899,000 (the present value of the \$6,443 monthly payments for the remaining term of 20 years). In an interest-only scenario, to offset this risk, a mitigant would be to lower the loan amount at origination to \$899,000; this mitigates the additional risk posed by the lack of amortization under the interest-only terms.

stabilization periods when property cash flow is temporarily insufficient to support principal payments. The amortization for these restructured CRE loans should also be reasonable and reflect the underlying project risk. For a single-family residential development loan in which the project is slow but sales continue, and the guarantor has the ability and willingness to supplement payment through re-margining the credit, an amortization period of up to 10 years may be appropriate. Conversely, for a project that has completely stalled and has no guarantor that can reliably supplement principal payments, such an amortization schedule would not be appropriate. The workout plan for such a loan should include repayment terms more similar to those for the purchase of raw land.⁴⁹

For condominium and single-family residential projects that convert to rentals and tend to depreciate at an accelerated rate relative to owned units, amortization periods of less than 30 years generally would be reasonable. Much of the determination of what is reasonable depends on an evaluation of the individual project. Some banks restructure these types of loans as mortgage loans in the developer's name. Such developer loans should fit into those prudent underwriting parameters outlined in the bank's loan policies.

Some types of income-producing property loans have a built-in restructuring trigger, for example, a loan with a five-year tenor and payments based on a 20-year amortization. In these situations, the bank is able to periodically review the strength of the primary and secondary repayment sources and re-underwrite the credit. A common question from examiners in these situations is whether, at the end of the first five-year period (or at any renewal date), it would be inappropriate for the bank to re-amortize the remaining balance over 20 years. The answer depends on the specific transaction. If the sources of repayment, remaining useful life, and other structural components are, in combination, adequate to protect the lender over the next 20 years, then re-amortizing the remaining balance may be supportable. Re-amortizing the remaining balance over the original period reduces the payment amount, which in effect diverts cash flow from the bank to the borrower. The rationale for accepting diversion of that cash flow should be clearly addressed in the bank's credit approval document.

Covenants

Appropriate financial covenants for income-producing loans CRE loans may include

- debt yield.
- DSCR.
- LTV.
- LTC.
- borrower/guarantor minimum net worth or liquidity.

These are the most common financial covenants; there may be other financial covenants for income-producing commercial real estate loans, depending on the complexity or type of loan.

⁴⁹ For more information, refer to the "Loan Workouts and Restructures" section of this booklet.

Income-Generating Capacity of CRE

Repayment of loans that finance income-producing CRE typically depends on the property's ability to service debt from cash flow. Because collateral value is largely determined by a property's NOI, it is important to analyze and understand its income-generating capacity including whether cash flow and NOI projections are reasonable and supported. Inadequately supported or questionable analysis should be challenged. The analysis typically considers the following:

- Historical, current, and projected rental rates, operating expenses, capital expenditures, and vacancy and absorption rates.
- Lease renewal trends and anticipated rents.
- Volume and trends in past-due leases.
- Comparable rental rates, operating expenses, and sales prices.
- Terms of current leases.
- Direct capitalization rates and, if appropriate, **discount rates**.

Each of the factors should be considered under both normal and stressed conditions. For example, as real estate income and prices rise in periods of economic growth, capitalization rates, interest rates, and DSCRs should be stress-tested to determine whether a property will likely remain viable during a period of economic stress.

Unlike cash-flow analysis, the NOI analysis may assume market vacancy rates that are above or below actual vacancy rates, and expenses that may not represent an actual or immediate cash expense, such as management fees and reserves for capital replacements. When loan documents contain debt-service coverage covenants, the definitions of income and expenses should be clearly defined. Debt-service coverage calculations for covenant compliance may differ from the DSCR used for underwriting and risk-rating analysis.

While tax returns can be helpful in analyzing property income and expenses, some capital expenditures that are used to calculate NOI may not be shown as an expense on tax returns. For example, funds for recurring capital expenditures, such as replacing heating, ventilation, and air conditioning systems, roofs, and parking lots, are captured in a replacement reserve. Furthermore, some tax returns are prepared on a cash basis, which reflects only the income and expenses that were actually received or paid during the year. For example, a tax return for a property for which real estate taxes were not paid during that year would understate expenses and overstate income compared with financial statements prepared on an accrual basis.

This can also be the case with operating statements that are prepared on a cash basis. For this reason, it is helpful to compare reported expenses with expenses incurred by comparable properties, adjusted for supported variances and lease terms. An important objective of the underwriting process is to develop an NOI that represents a stabilized estimate of income and expenses.

In addition to assessing property cash flows, the ability and willingness of the borrower or guarantor(s) to provide support when needed should also be analyzed.⁵⁰

Debt-Service Coverage Ratio

The DSCR, calculated by dividing the NOI by the annual debt service requirements, measures the borrower's ability to service its debt. The determination of an appropriate DSCR should consider the loan amortization period and the expected volatility of the cash flow. In some cases, a lower DSCR may be a prudent trade-off for a shorter amortization period or appropriate for properties with stable and certain cash flows, such as those with long-term **net leases** to highly creditworthy tenants. Properties that have volatile cash flows, such as hotels or owner-occupants with uneven earnings, may warrant a higher ratio.

Debt Yield

Debt yield is the ratio of NOI to debt. It is calculated by dividing the NOI by the loan amount with the quotient expressed as a percent. Debt yield provides a measurement of risk that is independent of the interest rate, amortization period, and capitalization rate. Lower debt yields indicate higher leverage. This measure can be especially useful during periods of low interest and capitalization rates, periods during which loan amounts established by using the DSCR and LTV ratio may be prudent only as long as the low rate environment is sustained. Debt yields that reflect normalized or higher-rate levels can be used to establish stressed loan amounts that are less vulnerable to higher-rate environments. Debt yield provides a common metric to quickly size up a loan or assess its risk. Debt yields vary according to market conditions and property types, with higher debt yields recommended for riskier properties. Debt yield, when used, should be considered along with other criteria and loan amounts and be supported by prudent DSCR and LTV ratios.

Value Analysis

Various approaches can be used when determining property value. The **income approach** to value converts expected future NOI into present value through direct capitalization or discounted cash-flow analysis. Direct capitalization estimates the value of a property by capitalizing the NOI using an appropriate capitalization rate (commonly referred to as the cap rate). This is accomplished by dividing the NOI by the capitalization rate. This method is appropriate when applied to a stabilized NOI and the future income stream is expected to be stable. The discounted cash-flow method discounts expected future NOI over a specified holding period and adds the expected net sales price at the end of that period, both discounted by an appropriate discount rate to determine the net present value of a property. This method is useful in estimating the **as-is market value** of properties that have not reached stabilized occupancy or values of properties that are expected to experience material fluctuations in income.

⁵⁰ For more information, refer to the "Analysis of Borrower's and Guarantor's Financial Condition" section of this booklet.

The discount and cap rates used in estimating property income and values should reflect reasonable expectations for the rate of return that investors and lenders require under normal, orderly, and sustainable market conditions. Rising interest rates may lead to higher capitalization rates and lower property values without any change to the actual property's fundamentals.

Other factors that should be considered in the underwriting process include effective age, remaining useful life, condition, location, and how the property compares with competitive properties, including a comparison of rental rates, expenses, and sales prices. The financing of unique or specialized types of property can present heightened or unique risks and difficult valuation issues. Unique or specialized properties are normally less marketable and more difficult to liquidate should the borrower default, particularly if a bank is forced to sell the property during periods of CRE market weakness. Marketing and holding costs and the cost to convert the property to alternative uses with greater market demand are some of the valuation issues presented by these properties.⁵¹

The **sales comparison approach** values a property using sales data of similar properties to determine the value. An appraiser typically compares the subject property to at least three recently sold properties in the area with similar characteristics.

The **cost approach** values a property by estimating the cost of the land, plus costs of construction, less depreciation.

Loan-to-Value Ratio

The determination of an appropriate LTV is based on the same criteria as those for amortization. Loans secured by properties having less volatility in cash flow and value may merit higher LTVs while loans secured by higher-risk properties should mitigate this higher risk with more equity. SLTVs are important for reporting, supervisory, and risk management purposes; however, they do not establish a safe harbor.⁵² The determination of an appropriate LTV should consider the particular risks presented by each loan.

Credit Administration

The credit administration function manages the credit process, such as loan closings, construction advances, payment processing, collateral administration, and receipt of financial statements.

A prudently administered CRE lending operation generally establishes appropriate processes for the following:

⁵¹ Collateral considerations for various property types are discussed in the “Underwriting Considerations by Property Type” section of this booklet.

⁵² For more information, refer to the “Supervisory Loan-to-Value Limits” section of this booklet.

- Request, receipt, verification, and maintenance of financial statements and other borrower and guarantor information, including covenant tracking.
- Types and frequency of collateral valuations.
- Loan closing and disbursements controls.
- Payment processing.
- Escrow administration.
- Collateral administration.
- Loan payoffs.
- Delinquency and collections.
- Deed-in-lieu of foreclosure.
- Claims processing.
- Seeking satisfaction from a financial guarantor or insurance.
- Servicing and loan participation guidelines.

Acquisition, Development, and Construction Credit Administration

Effective credit administration includes control procedures in place for making sound loan advances and properly paying and releasing liens. Effective controls include segregation of duties, site inspections, lien searches before disbursement, budget monitoring, and dual approval of loan disbursements. Accurate and complete record-keeping ordinarily includes documentation sufficient to demonstrate whether remaining funds are adequate to complete the project. Effective controls provide for independent review of the records.

Credit administration is particularly critical in construction lending and should be independent of the loan origination function when possible. If not possible, compensating controls with adequate segregation of duties should be in place. Banks that finance construction projects are expected to maintain sound credit administration and monitoring programs. Timely monitoring of construction is essential to evaluating construction progress by assessing the appropriateness of disbursement requests alerting the bank to potential problems (such as significant cost overruns or project delays) and verifying that sales proceeds are applied to principal in a manner consistent with the loan agreement. Banks typically require architect or engineering inspection reports with each draw to verify that work is done according to specification. A representative for the bank typically conducts periodic site inspections to confirm that work is completed as reported. Inspection reports typically state compliance with plans and specifications, support disbursements typically based on percentage complete, and state whether the project is progressing as anticipated. Banks typically confirm that the budget remains in balance with sufficient funds available to fund completion and construction conforms to the agreed schedule.

Monitoring Progress of Construction Projects

Sound ADC credit administration includes monitoring the progress of financed projects to verify that the borrower's request for funds is appropriate for the particular stage of development with adequate funds remaining for completion. Accurate and timely inspection

reports reflecting the status of the project are important in identifying when the project is not proceeding as represented or planned.

Periodically reviewing the developer's financial statements is an important control for detecting a developer's or project's financial problems. This review should include assessing the developer's liquidity, debt capacity, and cash flow. The review can help detect problems not only with the bank's own loan, but also potential problems arising from one of the developer's other projects that could strain the developer's resources and consequently affect the bank's loan. Sound monitoring includes reviewing the borrower's major sources of cash and ascertaining whether the sources depend on the ongoing sale of real estate or infusions of capital.

An updated credit report can be used to determine whether there are any unpaid bills, whether vendors are being paid late, or whether suits or judgments have been entered against the borrower or guarantor(s). In many localities, banks may also access weekly legal reports and trade reports to monitor the borrower's standing. Monitoring should include verifying property tax payments and assessing whether the developer has sufficient resources to make them and to help ensure that delinquent taxes do not create a lien on the collateral.

Most construction budgets include amounts allocated for contingencies. These amounts are intended to cover reasonable but unexpected increases in construction costs, such as price increases in materials, the need to pay overtime because of delays in the shipment of materials, or adverse weather. Cost overruns on a project may also be the result of poor projections or management. In these cases, the increased cost would ordinarily be covered by the borrower rather than by a draw-down on the loan amount budgeted for contingencies.

Controls should also guard against funds being misused to pay for extra costs not stipulated in the loan agreement. Examples of extra costs include rebuilding to meet specification changes not previously disclosed, starting a new project, paying subcontractors for work performed elsewhere, or paying for the developer's general overhead. Examiners should be aware of the practice of front loading, whereby a builder deliberately overstates the cost of the work to be completed in the early stages of construction. If the bank does not detect front loading in the early stages of construction, there will almost certainly be insufficient loan funds to complete construction if there is a default.

Monitoring Commercial Construction Projects

An established credit administration process that continually monitors each project's progress, costs, and loan disbursements is essential to effectively controlling commercial construction risk. Effective credit administration includes performing periodic physical inspections of the project and evaluating the work performed against project design and budget. Banks often retain an independent construction consulting firm if they do not have the necessary in-house engineering, architectural, and construction expertise to perform a physical inspection.

Sound monitoring includes obtaining monthly reports of work completed, costs-to-date, costs-to-complete, construction deadlines, and loan funds remaining. Changes in construction plans should be reviewed by competent staff or a construction consulting firm and approved and documented by the bank and take-out lender, if any. A significant number of change orders could indicate poor planning or project design, or problems in construction, and should be tracked and reflected in the project's budget.

Monthly leasing reports with rent rolls should be obtained from the borrower during the lease-up period, as applicable. The reports should be analyzed to monitor the progress of lease-up and to compare actual lease rates and other key terms with the underwriting pro forma projections and assumptions used in the appraisal. Material deviations from the plan can have an adverse effect on the value of the collateral and affect debt-service coverage. This could result in a higher-than-expected LTV upon completion or insufficient cash flow and can endanger timely repayment. Extended lease-up periods can deplete the interest reserve prematurely and render the construction budget inadequate, requiring a contribution of additional equity or an unplanned increase in the loan amount.

It is important for banks to monitor economic factors that could affect the project's success upon completion. Because the development, construction, and lease-up of a commercial project can span several years, it is important to continually assess the project's marketability and whether demand will continue to exist when the project is completed.

Monitoring Residential Tract Development Projects

In addition to periodically inspecting each house or unit during construction, sound monitoring includes obtaining periodic reports of the project's progress compared with budgeted projections. Borrowers typically provide monthly progress reports that identify each lot or unit by number. For each unit, reports typically note the style of house it may be improved with, its state of completion, the release and offering prices, and loan balance, the selling price, dates of sale for sold units, and the date of contract or closing.

Existing inventory, construction starts, and sales should be monitored to avoid excessive inventory buildup. The absorption rate can be influenced by the housing product type as custom homes or homes on larger lots often tend to sell at a slower pace than homes built in tract developments.

Banks typically establish criteria necessary to consider a unit "presold." OCC Bulletin 2010-42 states that a unit may be considered presold if a buyer has entered into a binding contract to purchase the unit and has made a substantial and nonrefundable earnest money deposit. The bank should obtain sufficient documentation that the buyer has entered into a legally binding sales contract and has obtained a written prequalification or commitment for permanent financing.⁵³

Lower than projected selling prices, slow sales, or excessive inventories relative to sales indicate that the borrower may have difficulty repaying the loan. Other problems, such as

⁵³ For more information, refer to OCC Bulletin 2010-42.

higher than expected costs or delays in completing construction, can also weaken the borrower's capacity to repay.

Sound ADC credit administration includes monitoring general economic conditions and other economic factors that could affect the marketing and selling of residential properties in the bank's lending areas. These factors could include housing prices, housing inventory, mortgage interest rates, consumer confidence, unemployment rate and job creation, existing and new home sales, household formation, and residential rental rates.

Disbursement Processes

Sound processes governing the loan disbursement process are fundamental in controlling risk. It is important that the bank's minimum borrower equity requirements are maintained throughout the development and construction periods and that sufficient funds are available to complete construction. Typical disbursement controls include inspection processes, documentation of construction progress, monitoring of preleasing activity and tracking presold units, and monitoring and reporting of exceptions. Funds should not be advanced unless the funds are to be used solely for the project being financed and as stipulated in the draw request and consistent with the loan agreement.

The lender's title policy should be updated with each draw. The title company confirms that there are no outstanding liens on the project. **Mechanics liens**, or liens filed by parties who have supplied labor or materials to improve the property, are the most common form of lien. In some jurisdictions, mechanics liens can take priority over the bank lien. In such jurisdictions, it is important for the lender to update the title policy with each draw.

Banks generally disburse construction loan funds according to a standard payment plan or a progress payment plan. Either plan should be structured so that the amount of each construction draw is commensurate with improvements made as of the date of the inspection or certification provided by the bank.

Occasionally, rather than pay on a standard or progress payment plan, banks disburse funds on a voucher basis whereby each bill or receipt is presented and either paid or reimbursed by the lender. This can increase the lender's administrative control but can also increase the lender's administrative burden.

Standard Payment Plan

A standard payment plan is normally used for residential and smaller commercial construction loans. Because residential construction projects usually consist of houses in various stages of construction, this plan establishes a predetermined schedule for fixed payments at the end of each specified stage of construction.

A standard payment plan for residential construction most commonly consists of five equal installments. The first four disbursements are made when construction has reached agreed-upon stages, verified by actual inspection of the property. As each house is completed and

sold and the predetermined release price is paid to the bank, the bank releases its lien on that particular house. Except for some workout situations, excess net sales proceeds are remitted to the borrower. The final payment is made only after the legally stipulated period for mechanics liens has expired.

Progress Payment Plan

A progress payment plan is normally used for commercial projects. Under a progress payment plan, the bank releases funds as the borrower completes certain phases of construction. The bank normally retains, or holds back, 10 to 20 percent of each payment to cover project cost overruns or outstanding bills from suppliers or subcontractors.

Under a progress payment plan, the borrower requests payment from the bank in the form of a construction draw request or certification of payment, which sets forth the funding request by construction phase and cost category. The borrower also certifies that the conditions of the loan agreement have been met, e.g., all requested funds are being used for the project and that suppliers and subcontractors have been paid. The construction draw request should include waivers from the project's subcontractors and suppliers indicating that payment has been received for the work completed. After reviewing the draw request and independently confirming the progress of work, the bank then disburses funds for construction costs incurred, less the holdback.

The final draw on a commercial construction loan usually includes payment of the holdback as stipulated in the loan agreement. The borrower uses the draw to pay all remaining expenses. Before releasing the final draw and disbursing the holdback, important controls include

- confirming that the borrower has obtained all waivers of liens or releases from the project's contractors, subcontractors, and suppliers.
- reviewing the final inspection report to confirm that the project is complete and meets building specifications.
- confirming that the builder has obtained a certificate of occupancy from the governing building authority.

Income-Producing Property Credit Administration

Loan covenants should require the submission of periodic financial information pertaining to the project, borrowing entities, and guarantors, if any. The frequency of the required property information should consider the stability of the property. For a property with few tenants and long-term leases that extend beyond the loan term or stabilized multifamily properties, annual operating statements and rent rolls may be adequate. Properties that are in lease-up or nonresidential properties that have many tenants or frequent lease expirations, however, could warrant the collection of monthly, quarterly, or semiannual information. The information that is collected should be analyzed in a timely manner to assess financial performance, tenant rollover risk, and compliance with any financial or performance covenants.

Sound credit administration includes processes for collecting and analyzing information. Receipt and analysis should be tracked so management can evaluate the effectiveness of the bank's monitoring program. Ensuring that all borrowers and guarantors submit the information in a timely manner can be challenging and full compliance may be challenging to achieve. Nevertheless, banks with sound credit administration processes demonstrate that when borrowers or guarantors do not respond to information requests the bank's efforts to collect this information remain continuous and diligent.

Sound credit administration includes processes to monitor the timely payment of real estate taxes. Delinquent real estate taxes threaten the bank's interest in the collateral and are nearly always an indicator of a distressed property, borrower, or guarantor. Some banks engage third parties to monitor the payment of real estate taxes. Most governmental units now make this information available online, and this information may enable a bank's own staff to monitor tax delinquencies directly.

Periodic property inspections should be performed to verify that the property is being adequately maintained and that tenants and vacancies have been accurately reported in the rent roll. Particular attention should be given to troubled properties and properties with troubled borrowers or guarantors.

Investor-Owned Residential Real Estate

To effectively manage risks associated with IORR lending, banks typically identify IORR loans separately from other residential loans. Borrowers may be able to convert homes into rentals without notifying their banks, and banks may not have historically identified or structured loans to allow for the heightened monitoring that should be conducted for IORR loans. Examiners should consider whether banks have properly identified, monitored, and structured IORR loan relationships. Such efforts would include banks taking steps to strengthen their ability to monitor and control the credit relationship, when possible, on known IORR loans. Banks that have not previously distinguished between IORR loans and owner-occupied one- to four-family residential loans should implement methods to draw clear distinctions.

Loan loss allowance methodologies should appropriately consider factors to reflect the risk of loss inherent in the IORR portfolio and evaluate them consistent with current accounting principles, including ASC Subtopic 310-10, ASC Subtopic 450-20, and ASC Topic 326. Until a bank's systems are capable of identifying and segmenting IORR loans, banks typically consider this unquantified risk when making qualitative adjustments to the ALLL or ACL analysis. Amounts incorporated into the loan loss allowance methodology for IORR loans may be reflected within a pool that is separate from owner-occupied one- to four-family residential loans.

Banks should report IORR loans that meet the call report instructions' definition of one- to four-family residential lending in that category. IORR loans qualify for the 50 percent risk-based capital category if certain regulatory requirements are met. For FSAs, IORR loans

qualify as residential real property loans under the Home Owners' Loan Act.⁵⁴ IORR loans that do not meet the criteria fall into a higher risk-based capital category.⁵⁵

File Documentation

12 CFR 30, appendix A, "Interagency Guidelines for Establishing Standards for Safety and Soundness," requires banks to establish and maintain loan documentation practices that

- enable the bank to make an informed lending decision and assess risk on an ongoing basis.
- identify the purpose of a loan and the source of repayment and assess the ability of the borrower to repay the loan in a timely manner.
- ensure that the claims against the borrower are legally enforceable.
- take into account the size and complexity of the bank's loans.

Documents that banks typically maintain within loan files include

- an approval memorandum that documents the loan approval and provides sufficient information to approvers to permit a fully informed credit decision. The terms of the loan documents should be consistent with the approval document and any subsequent amendments.
- signed financial statements for borrowers and guarantors, and operating statements and rent rolls for the property, as applicable.
- a title insurance policy.
- a recorded mortgage or deed of trust securing the collateral, promissory note, lease assignments, and security agreement. Bank staff should confirm that the property descriptions on the mortgage or deed of trust, security agreement and assignments, title insurance policy, survey, and property tax statement are identical.
- copies of all leases and executed tenant estoppels, insurance policies, and proof of premium payment that show the bank's interest is adequately protected against hazard, liability, and, when appropriate, loss of rents and flood.
- the appraisal or evaluation and the bank's appraisal or evaluation review. The engagement letter and qualifications of the appraiser or person performing the evaluation should be included.
- property survey showing the location of the improvements on the site and any easements or encroachments.
- partnership or corporate organizational documents, borrowing resolutions, and certificates of good standing, as appropriate.
- evidence that property taxes have been paid to date and that the collateral property has its own parcel identification number(s). The identification number(s) and tax parcel description must be consistent with the legal description in the collateral documents and

⁵⁴ The Home Owners' Loan Act is codified at 12 USC 1464(c) et seq. (FSAs).

⁵⁵ For more information, refer to the call report instructions and 12 CFR 3, "Capital Adequacy Standards."

not include other parcels that do not secure the loan. Otherwise, a parcel split is needed to sell the property, presenting a serious and possibly fatal impediment to liquidation.

- any environmental reports deemed necessary, given the location, type of project, and historical use.
- for purchased loans, documentation of transfer, servicing, events of default, collections, and recourse arrangements outlining the rights and obligations of each party.⁵⁶

Construction loan files also typically contain

- a construction loan agreement describing the rights and obligations of the bank and borrower, conditions for advancing funds, repayment criteria including any mandatory principal curtailments and release prices, as appropriate, and events of default. The agreement should include a detailed budget and should identify all costs funded by the construction loan.
- information on the borrower or contractor that substantiates the expertise necessary to complete the project.
- a title insurance policy updated with each advance of funds if such additional protection is available.
- pro forma projections on property cash flows.
- appraisals estimating the market value of the property on an as-is and as-completed or as-stabilized basis and stating when stabilized occupancy is expected to be achieved or sales projections for for-sale projects.
- project plans, feasibility study, and construction budget showing the development plans, project costs, marketing plans, and borrower's equity contributions. The documentation should include a detailed cost analysis for the land development and hard construction costs, as well as the indirect or soft costs for the project, such as administrative costs and architectural, engineering, and legal fees. If necessary internal expertise is not available, a review of the construction plans, budget, and third-party reports should be performed by an independent, qualified professional and documented in the file.
- executed construction contracts.
- soil reports.
- a foundation survey conducted after the foundation has been constructed and before further work is done to confirm that the placement of the improvements is consistent with the site plan, the proper setback requirements are met, and construction does not encroach on easements or adjoining property.
- a completion and payment bond.
- builder's risk insurance.
- all construction draw requests and inspection reports.

Documentation files for tract development loans frequently contain a master note for the gross amount of the loan for the entire project and a master mortgage or deed of trust covering all the land involved in the project. The files should include an appraisal for the tract development as well as an individual model appraisal for each type of house to be built. The appraisal should also include a market analysis for the entire development that provides

⁵⁶ For more information, refer to OCC Bulletin 2020-81.

an estimated rate of absorption. The appraisal should indicate that the homes to be constructed are in sufficient demand, given the project's location, unit styles, and unit sales price.

A developer also might seek confirmation from the U.S. Department of Housing and Urban Development's Federal Housing Administration and the U.S. Department of Veterans Affairs that the tract development meets the Federal Housing Administration and Veterans Affairs building standards. This allows the developer to market the homes to individuals who wish to obtain mortgages through the Federal Housing Administration or Veterans Affairs mortgage insurance programs.

Risk-Rating CRE Loans

Examiners should assess banks' credit risk identification processes to determine the bank's ability to produce accurate, timely risk ratings. Accurate, timely risk identification is critical to identifying problem loans in a timely manner, which enhances the bank's flexibility in problem loan resolution, contributes to the timely recognition of losses, and enables the maintenance of an appropriate ALLL or ACL balance. Credit risk ratings should be reviewed and updated whenever relevant new information is received. The "Rating Credit Risk" booklet of the *Comptroller's Handbook* and OCC Bulletin 2009-32, "Commercial Real Estate (CRE) Loans: Guidance on Prudent CRE Loan Workouts," provide information and guidance on the risk rating of CRE loans.

Analyzing Repayment Capacity of the Borrower

The primary focus of an examiner's review of a commercial loan and binding commitments is the borrower's capacity to repay the loan. The review should assess the borrower's willingness and ability to repay the loan under reasonable terms and the cash flow potential of the underlying collateral or business.⁵⁷

When analyzing a commercial borrower's repayment capacity, examiners should consider

- nature and degree of protection provided by the cash flow from business operations or the collateral, including evaluation on a global basis that considers the borrower's total debt obligations.
- the borrower's character, overall financial condition, resources, and payment record.
- market conditions that could influence repayment prospects and the cash flow potential of the business operations or underlying collateral.
- prospects for repayment support from any financially responsible guarantors.

⁵⁷ For more information, refer to the "Analysis of Borrower's and Guarantor's Financial Condition" section of this booklet.

Evaluating Guarantees

A guarantor can provide a secondary source of repayment that can favorably affect the credit's risk rating when the primary source of repayment becomes inadequate. When the primary source of repayment is satisfactory, the strength of the guarantor is supplemental in importance in determining the risk rating.⁵⁸

The presence of a guarantee from a financially responsible guarantor may improve the prospects for repayment of the debt obligation when the primary source of repayment is compromised and may be sufficient to preclude classification or reduce the severity of classification. Attributes of a financially responsible guarantor include the following:

- The guarantor has both the financial capacity and ability to provide support for the credit through ongoing payments, curtailments, or re-margining.
- The guarantee is adequate to provide support for repayment of the indebtedness, in whole or in part, during the remaining loan term.
- The guarantee is written and legally enforceable.

Examiners should consider whether a guarantor has demonstrated the willingness and ability to fulfill all current and previous obligations, has sufficient economic incentive, and has a significant investment in the project. An important consideration is whether previously required performance under guarantees was voluntary or the result of legal or other actions by the lender to enforce the guarantee.

Obtaining sufficient information on the guarantor's global financial condition, income, verified liquidity, cash flow, contingent liabilities, and other relevant factors is important in supporting the assessment of the guarantor's financial capacity to fulfill the obligation. The assessment for the guarantor should include consideration of the total number and amount of guarantees currently extended to all lenders, to evaluate whether the guarantor has the financial capacity to fulfill the contingent claims that exist.

Assessing Collateral Values

Collateral value is generally a tertiary source of repayment and may become an important consideration in the risk-rating process when the primary and secondary sources of repayment become inadequate or questionable. In such circumstances, examiners should consider the reasonableness of the facts and assumptions associated with the value of the property, including the following:

- Current and projected vacancy and absorption rates.
- Lease renewal trends and anticipated rents.
- Effective rental rates or sale prices, considering sales and financing concessions.
- Time frame for achieving stabilized occupancy or sellout.
- Volume and trends in past-due leases.

⁵⁸ For more information, refer to the "Income-Generating Capacity of Real Estate" section of this booklet.

- NOI of the property as compared with budget projections, reflecting reasonable operating and maintenance costs.
- Discount rates and direct capitalization rates.

Examiners should use the appropriate market-value conclusion in their collateral assessments. For example, when the bank plans to provide the resources to complete a project, examiners may consider the project's prospective market value in the computation of the committed loan amount in their analysis.

Examiners generally are not expected to challenge the underlying valuation assumptions, including discount and capitalization rates, used in appraisals or evaluations when these assumptions differ only in a limited way from norms that would generally be associated with the collateral under review. The estimated value of the underlying collateral may be adjusted for credit analysis purposes when the examiner can establish that any underlying facts or assumptions are inappropriate or can support alternative assumptions. Examiners should discuss these adjustments with the bank when determining the risk rating.

CRE borrowers may have other indebtedness secured by other business assets, such as furniture, fixtures, equipment, inventory, and accounts receivable. For these commercial loans, the bank should have appropriate policies and practices for quantifying the value of such assets, determining the acceptability of the collateral, and perfecting its security interest. The bank also should have appropriate procedures for ongoing monitoring of the value of its collateral interests and security protection.⁵⁹

Other Considerations

Changing economic conditions can have a significant effect on the performance of CRE portfolios. Factors such as changes or imbalances in supply and demand can significantly influence a number of variables including vacancy and rental rates that affect the value of CRE. For these reasons, examiners should understand current and projected economic conditions, particularly within the bank's lending area, and the potential effect on collateral values. Although the magnitude of economic changes can be difficult to predict, management's ability to recognize early warning signs, understand credit risk, and plan for changing market conditions can be the difference between a bank's successful weathering of economic turmoil and failing.

Although a loan's payment history should be considered when determining a loan's risk rating, timely payments are not, by themselves, a fully reliable indicator of a loan's future performance. Being contractually current on payments can be misleading as to the credit risk embedded in the loan and can mask a troubled loan when sources of repayment are inadequate or other obligations go unpaid. It is not enough that cash flow be sufficient to cover the individual loan's debt service. Rather, cash flow should be sufficient to cover payments on all the borrower's obligations. A troubled borrower often makes payments their highest priority and may divert funds required to pay real estate taxes, maintenance, vendors,

⁵⁹ For more information, refer to the "Appraisals and Evaluations" section of this booklet.

or other critical expenses to meet their debt obligations. Expenses should be analyzed to verify that all expenses are accounted for and appropriate for that particular property. This is particularly important when analyzing cash-basis financial statements that reflect only expenses that have been paid in cash instead of all expenses that have been incurred as in accrual-basis statements. Rather than being an early indicator of distress, late or missed payments may not occur until a credit has already experienced significant deterioration.

A troubled loan can also be masked when the loan's underwriting structure or the liberal use of extensions or renewals obscures a borrower's inability to meet reasonable repayment terms. This may occur, for example, when interest reserves continue to be applied to interest payments, keeping the loan current even though expected leases or sales have not occurred, or when property values have fallen below the original underwritten market value, and the full collectability of the loan may be in doubt. In these situations, adverse classification of the loan may be appropriate.

As a general principle, examiners should not adversely risk-rate or require the recognition of a partial charge-off on a performing commercial loan solely because the value of the underlying collateral has declined to an amount that is less than the loan balance. It is appropriate, however, to adversely risk-rate a performing loan when well-defined weaknesses exist that jeopardize debt repayment.

Close monitoring to allow timely recognition of potential issues and the ability to recognize and anticipate financial difficulties are important tools in effectively controlling risk. Warning indicators can include

- delinquent real estate taxes.
- declining sales prices or rental rates.
- cancellations of sales contracts or reservations.
- liberal sales concessions or unusually generous concessions including rent, tenant improvement allowances, moving allowances, and lease buyouts.
- slower absorption of space than anticipated.
- delinquent lease payments from major tenants.
- increasing vacancy and turnover rates.
- changes to the initial concept or development plan (for example, a condominium construction project converts to an apartment project).
- construction budget overruns, changes to construction plans, materials, finishes, and borrower requests for significant reallocation of funds to other budget line items.
- draw requests ahead of schedule for work yet to be completed.
- construction delays or other unanticipated events that could lead to cost overruns.
- liens due to worker or supplier payment disputes.
- borrower requests for additional financing due to unanticipated costs or expenses.
- deterioration in the performance of the borrower's other properties or businesses.
- interest reserves that have been repacked.
- late or delinquent payments.

Easing underwriting standards can also reflect changing market conditions. Increasingly liberal underwriting can be a response to increased competition among banks for loans or an increase in risk appetite. Examples of underwriting weaknesses that may be indicative of credit deterioration and increasing credit risk include

- underwriting analyses that fail to consider possible stressed market conditions.
- loans with limited hard equity contributions by the borrower.
- loans on speculative undeveloped property for which the only source of repayment is sale of the property.
- loans for commercial development projects without significant preleasing or presales commitments without adequate mitigants or when prospects for permanent financing are compromised.
- loans to borrowers with development plans that are not viable because of weakening market conditions.
- projections that rely on speculative or unrealistic assumptions relative to current market conditions such as higher than current rents or occupancy rates.
- failure to require principal curtailments when appropriate.
- loans that are renewed on an interest-only basis without appropriate mitigants.
- rewrites or renewals for the sole purpose of deferring repayment.
- loans with liberal provisions with respect to non- or partial-recourse.
- loans that lack guarantor support without adequate mitigants.

Risk-Rating Investor-Owned Residential Real Estate Loans

Applying a rating system similar to that used for CRE lending is generally appropriate for an IORR portfolio. In some cases, however, the bank may have a separate rating system designed specifically for this type of lending. The risk assessment and rating process should not rely solely on delinquency status. The complexity of the ongoing analysis and risk-rating should be commensurate with the number of properties financed globally by the borrower.

IORR loans are not specifically addressed within the scope of the interagency “Uniform Retail Credit Classification and Account Management Policy.”⁶⁰ Banks have sometimes applied the classification time frames and the 180-day delinquency charge-off for real estate loans from this policy to IORR loans, which is generally acceptable as an outer limit for IORR loans. Banks should, however, generally use classification and charge-off practices similar to those used for other CRE loans.⁶¹

Classification of CRE Loans

As with other types of loans, CRE loans that are adequately protected by the current sound

⁶⁰ Refer to OCC Bulletin 2000-20, “Uniform Retail Credit Classification and Account Management Policy: Policy Implementation.”

⁶¹ For more information regarding CRE risk management practices and classification, refer to OCC Bulletin 2009-32.

worth and debt service capacity of the borrower, guarantor, and the underlying collateral generally should not be adversely risk-rated. Similarly, loans to sound borrowers that are refinanced or renewed in accordance with prudent underwriting standards should not be adversely risk-rated unless potential or well-defined weaknesses exist, including those that jeopardize repayment. Further, loans should not be adversely classified solely because the borrower is associated with a particular industry that is experiencing financial difficulties or because the collateral has declined in value.

When the bank's restructurings are not supported by adequate analysis and documentation, examiners are expected to exercise reasonable judgment in reviewing and determining loan risk ratings until the bank is able to provide information to support management's conclusions and internal loan grades.⁶²

Special Mention

A special mention asset has potential weaknesses that deserve management's close attention. If left uncorrected, these potential weaknesses may result in deterioration of the repayment prospects for the asset or in the bank's credit position in the future. Special mention assets are not adversely classified and do not expose the bank to sufficient risk to warrant adverse classification.

Potential weaknesses in CRE loans may include construction delays, changes in concept or project plan, slower than projected leasing, rental concessions, deteriorating market conditions, impending expiration of a major lease, or other adverse events that do not currently jeopardize repayment. Such loans should receive an elevated level of monitoring.

Substandard

A substandard asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. Substandard assets are characterized by the distinct possibility that the bank could sustain some loss in the aggregate if the deficiencies are not corrected.

Well-defined weaknesses in a CRE loan may include

- slower than projected leasing or sales activity that may result in protracted repayment or default.
- lower than projected lease rates or sales prices that jeopardize repayment.
- changes in concept or plan due to unfavorable market conditions.
- delinquent property taxes.
- construction or tax liens.

⁶² For more information on credit risk-rating classifications, refer to the "Rating Credit Risk" booklet of the *Comptroller's Handbook*.

- inability to obtain necessary zoning or permits necessary to develop the project as planned.
- diversion of needed cash from an otherwise viable property to satisfy the liquidity needs of a troubled borrower or guarantor.
- material imbalances in the construction budget.
- significant construction delays.
- expiration of a major lease or default by a major tenant, without a replacement lease or remedy to default in the near term.
- poorly structured or overly liberal repayment terms.
- material collateral damage or other significant casualty losses.
- bankruptcy or replacement of the general contractor, major subcontractors, or suppliers.
- fraud or the misapplication of loan proceeds.

Although substandard assets exhibit loss potential in the aggregate, an individual substandard asset may not exhibit loss in the aggregate (e.g., because of adequate collateral coverage). If full collection of interest or principal is in doubt, the loan should be placed on nonaccrual.⁶³

A substandard classification is typically warranted when a project has slowed or stalled and the guarantor is providing some support but the loan has not been restructured, unless the guarantor is providing support of principal payments sufficient to pay off the debt under reasonable terms. If the guarantor is keeping interest payments current and shows a documented willingness and ability to do so in the future, and collateral values protect against loss, the loan should generally be left on accrual. This level of support, however, does not fully mitigate the well-defined weaknesses in the credit and does not preclude a substandard classification.

Doubtful

An asset classified as doubtful has all the weaknesses inherent in one classified substandard with the added characteristic that the weaknesses make collection or liquidation in full highly questionable and improbable based on existing facts, conditions, and values.

The amount of the loan balance in excess of the fair value of the real estate collateral less costs to sell, or portions thereof, can be rated as doubtful when the exposure may be affected by the outcomes of certain pending events and the amount of the loss cannot be reasonably determined. If warranted by the underlying circumstances, an examiner may use a doubtful classification on the entire loan balance. Examiners should, however, use a doubtful classification for a limited time to permit the pending events to be resolved. Circumstances that might warrant a doubtful classification for CRE loans could include collateral values that are uncertain due to a lack of comparables in an inactive market, pending changes such as zoning classification, environmental issues, or the pending resolution of legal issues that could affect the realization of value in a sale.

⁶³ For more information, refer to the “Accrual Status” section of this booklet.

Loss

Assets classified as a loss are considered uncollectible and of such little value that their continuance as bankable assets are not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather that it is not practical or desirable to defer writing off this basically worthless asset even though partial recovery may be realized in the future.

As a general classification principle, for a troubled CRE loan that is dependent on the operation or the sale of collateral for repayment, any portion of the loan balance that exceeds the amount that is adequately secured by the market value of the real estate collateral less costs to sell should be classified as a loss if that portion of the loan balance amount is deemed uncollectible. This principle applies when repayment of the debt is provided solely by the underlying real estate collateral and when there are no other reliable sources of repayment available.

For more information on the classification of real estate loans, refer to OCC Bulletin 2009-32, which conveys interagency guidance on the topic, and the “Rating Credit Risk” booklet of the *Comptroller’s Handbook*.

Appraisals and Evaluations

12 CFR 34, subpart C, “Appraisals,” specifies which transactions require the services of an appraiser and whether the appraiser must be state-certified or state-licensed. These regulations also prescribe minimum appraisal standards, requirements for appraiser independence, appraisal reviews, and competency. The “Interagency Appraisal and Evaluation Guidelines” conveyed by OCC Bulletin 2010-42 describe supervisory expectations for real estate appraisals and evaluations, and provide clarification on the OCC’s expectations for prudent appraisal and evaluation policies, procedures, and practices. The OCC may require an appraisal or evaluation whenever the agency believes it is necessary to address safety and soundness concerns.⁶⁴

While valuations are generally required for almost all real-estate related transactions secured by real estate,⁶⁵ the appraisal regulations permit the use of evaluations in lieu of appraisals for transactions

- in which the loan amount is \$500,000 or less,

⁶⁴ Refer to 12 CFR 34.43(c), “Appraisals to Address Safety and Soundness Concerns.”

⁶⁵ 12 CFR 34, subpart C, exempts certain other transactions from the requirements for an appraisal or evaluation such as when a loan is guaranteed by the federal government or a federal agency. Refer to the regulations and OCC Bulletin 2010-42 for a full description of exempted transactions.

- in which the transaction is a business loan of \$1 million or less and income from the sale or rental of real estate⁶⁶ is not the primary source of repayment,
- representing an existing extension of credit when there is no new money advanced other than to cover reasonable closing costs, or
- representing an existing extension of credit when new money is advanced, provided there has been no obvious and material change in market conditions or the physical aspects of the property that would threaten the adequacy of the collateral.

The services of a state-certified appraiser are required for

- all loans or other transactions of \$1 million or more,
- nonresidential loans or other transactions of \$500,000 or more, including one- to four-family construction loans, or
- complex residential loans or other transactions of \$500,000 or more.

For all other real-estate related loans or transactions, appraisals may be performed by either state-certified or state-licensed appraisers.

For transactions requiring an appraisal or evaluation, a bank does not need to obtain a new appraisal or evaluation to comply with these regulations if it has a valid, compliant appraisal or evaluation that was previously obtained in connection with the real estate loan. The “Interagency Appraisal and Evaluation Guidelines” conveyed by OCC Bulletin 2010-42 state that banks should establish criteria for assessing whether an existing appraisal or evaluation remains valid and discusses factors that should be considered, such as⁶⁷

- passage of time.
- volatility of the local market.
- changes in terms and availability of financing.
- natural disasters.
- limited or over supply of competing properties.
- improvements to the subject property or competing properties.
- lack of maintenance of the subject or competing properties.
- changes in underlying economic and market assumptions, such as capitalization rates and lease terms.
- changes in zoning, building materials, or technology.
- environmental contamination.

An arbitrary period of time, such as 12 months, should not be used as the decisive criteria for determining the validity of an appraisal or evaluation. The passage of time is just one component of that assessment, and other factors that affect value should be considered in

⁶⁶ The term “real estate” as used here includes any real estate and is not limited to the property that collateralizes the loan.

⁶⁷ Refer to section XIV, “Validity of Appraisals and Evaluations” of the “Interagency Appraisal and Evaluation Guidelines.”

making such a determination. The bank should maintain documentation that provides the facts and analysis used to support the bank's conclusion that an existing appraisal or evaluation remains valid and may continue to be used in support of the property's market value.

A bank may take a lien on real estate without obtaining an appraisal or evaluation if the lien is taken in an abundance of caution.⁶⁸ To qualify for this exemption, the extension of credit must be well supported by the borrower's cash flow or other collateral. The bank should verify and document the adequacy and reliability of these repayment sources and conclude that knowing the market value of the real estate is unnecessary to support the credit decision. This exemption does not apply if the transaction would not be adequately secured by sources of repayment other than the real estate, even if the contributory value of the real estate collateral is low relative to the entire collateral pool and other repayment sources.⁶⁹

Appraisals of hotel properties and similar properties such as residential health care, in addition to the market value of the real estate, may also include values of personal property such as furniture, fixtures, and equipment (FF&E), and intangibles such as goodwill. The sum of these values is sometimes referred to as the **going concern value**. An appraisal report that elicits a value of the enterprise, such as going concern value, must allocate that value among the components of the total value.⁷⁰ Traditionally, the three components are described as (1) market value of the real estate, (2) personal property value, and (3) value of intangibles. Although the real estate's market value is the main value used to support the transaction, the "Interagency Guidelines for Real Estate Lending" and "Real Estate Lending Standards" state that "other acceptable collateral" may be included in determining the SLTV.⁷¹ FF&E may meet the requirements for "other acceptable collateral" if the FF&E is secured by a perfected security interest, has a quantifiable value, and is accepted by a lender in accordance with safe and sound lending practices. To be considered as "other acceptable collateral," the FF&E should be appropriately discounted in the appraisal consistent with the bank's policy for making loans on this type of collateral. Business enterprise value⁷² does not meet the definition of "other acceptable collateral" and would not be used in SLTV calculations.⁷³

⁶⁸ Refer to 12 CFR 34.43(a)(2).

⁶⁹ For more information, refer to OCC Bulletin 2010-42.

⁷⁰ Refer to 12 CFR 34.44.

⁷¹ Refer to 12 CFR 34, subpart D (national banks), and 12 CFR 160.101 (FSAs).

⁷² The Appraisal Institute defines "business enterprise value" as "a term applied to the concept of the value contribution of the total intangible assets of a continuing business enterprise such as marketing and management skill, an assembled work force, working capital, trade names, franchises, patents, trademarks, contracts, leases, and operating agreements."

⁷³ For more information, refer to OCC Bulletin 2010-42.

Appraisal and Evaluation Program

The “Interagency Appraisal and Evaluation Guidelines” conveyed by OCC Bulletin 2010-42 state that the bank’s real estate appraisal and evaluation policies and procedures should be reviewed as part of the examination of the bank’s overall real estate-related activities.

Independence of the appraisal function is critical to an effective valuation program. The appraisal function should be isolated from influence by the loan production and collection staff and have independent reporting lines. Small banks for which this independence is not achievable should clearly demonstrate that they have prudent safeguards in place that isolate their valuation programs from influence or interference from the loan production process.

Communication between the bank’s valuation staff and the appraiser or person performing the evaluation is essential for conveying information about the bank’s policies and processes. Loan officers may ask the appraiser to consider additional information about the subject property or about comparable properties, provide additional supporting information about the basis for a valuation, or correct factual errors in an appraisal. However, bank personnel should not directly or indirectly coerce, influence, or otherwise encourage an appraiser or a person who performs an evaluation to misstate or misrepresent the property’s value.⁷⁴ Inappropriate communication includes

- communicating a predetermined, expected, or qualifying estimate of value or a loan amount or target LTV ratio to an appraiser or person performing an evaluation.
- specifying a minimum value requirement for the property that is needed to approve the loan or as a condition of ordering the valuation.
- conditioning a person’s compensation on loan consummation.
- not compensating a person because a property is not valued at a certain amount.
- implying that current or future retention of a person’s services depends on the amount at which the appraiser or person performing an evaluation values a property.
- excluding a person from consideration for future engagement because a property’s reported market value does not meet a specified threshold.

The bank’s policies and procedures should specify methods for communication that promote independence in the collateral valuation function.

The selection and engagement of a competent, qualified, and independent appraiser for each assignment is a regulatory requirement and a prudent business practice.⁷⁵ The bank should establish standards for the independent selection, evaluation, and monitoring of appraisers or persons performing evaluations.

⁷⁴ Ibid. [OCC Bulletin 2010-42.]

⁷⁵ Refer to 12 CFR 34.43(d), “Transactions Requiring a State Certified Appraiser”; 12 CFR 34.43(e), “Transactions Requiring Either a State Certified or Licensed Appraiser”; 12 CFR 34.45, “Appraiser Independence”; and 12 CFR 34.46, “Professional Association Membership; Competency.”

A bank's use of a borrower-ordered or borrower-provided appraisal violates the agencies' appraisal regulations.⁷⁶ A borrower can, however, inform the bank that a current appraisal exists, and the bank may request it directly from the financial services institution that commissioned it. The bank is permitted to rely on an appraisal performed for another financial services institution if (1) the appraiser was selected and engaged by the institution transferring the appraisal; (2) the appraiser had no direct or indirect, financial or otherwise, interest in the property or parties to the transaction; (3) the bank determines that the appraisal remains valid; (4) the bank determines that the appraisal conforms to the OCC's appraisal regulations; and (5) the appraisal is otherwise appropriate for the transaction.⁷⁷ A bank should perform a more thorough review of the appraisal when accepting an appraisal from another financial services institution to confirm that the appraisal complies with regulation and has sufficient information and analysis to support the lending decision. Further, the regulated institution accepting the appraisal should determine whether appropriate documentation is available to confirm that the financial services institution (not the borrower) ordered the appraisal.

Banks should establish processes for selecting and approving appraisers and for monitoring appraiser performance. If the bank uses an approved appraiser list, the bank should have a process for qualifying an appraiser for initial placement on the list and periodic monitoring of the appraiser's performance and credentials to assess whether to retain the appraiser on the list. The bank should establish processes governing the removal of an appraiser from the list and should support reasons for removal that do not diminish appraiser independence. The list's use should be reviewed periodically to confirm that effective processes and controls are in place to support independence in the list's development, administration, and maintenance.

The bank should use written engagement letters when ordering appraisals. The letters should identify the client and intended use and user(s), as defined in the Uniform Standards of Professional Appraisal Practice (USPAP), and also may specify whether there are any legal or contractual restrictions on sharing the appraisal with other parties. The bank should include engagement letters in its credit file. To avoid the appearance of a conflict of interest, the appraiser or person performing the evaluation should not begin work on the assignment until they have been engaged.

Appraisal and Evaluation Reviews

Reviews of appraisals and evaluations should be performed to determine whether the methods, assumptions, and value conclusions are reasonable. The reviews should determine whether the appraisal or evaluation complies with the appraisal regulations as well as the bank's policies, and address whether the appraisal or evaluation contains sufficient information and analysis on which to base a sound credit decision.

Banks should establish qualification criteria for persons who are eligible to review appraisals and evaluations. Persons who review appraisals and evaluations should be independent of the

⁷⁶ Refer to 12 CFR 34.44.

⁷⁷ Refer to 12 CFR 34.45(b)(1).

transaction, have no direct or indirect interest, financial or otherwise, in the property or transaction, and be independent of and insulated from any influence by loan production staff. Small or rural institutions or branches with limited staff should implement prudent safeguards for reviewing appraisals and evaluations when absolute lines of independence cannot be achieved. Reviewers should possess the requisite education, expertise, and competence to perform the review commensurate with the complexity of the transaction, type of real property, and market.

Banks should implement a risk-based approach for determining the depth of the review needed to verify that appraisals and evaluations have sufficient information and analysis to support the institution's decision to engage in the transaction.

For more information, refer to section XV, "Reviewing Appraisals and Evaluations," of the "Interagency Appraisal and Evaluation Guidelines" conveyed by OCC Bulletin 2010-42.

Environmental Risk Management

Environmental contamination can hurt the value of real property collateral as well as create potential liability for the bank under various environmental laws. Therefore, the bank's policy should establish a program for assessing the potential adverse effect of environmental contamination and include appropriate controls to limit the bank's exposure to environmental liability associated with real estate taken as collateral. For more information, refer to the "Loan Policies" section of this booklet.

The Comprehensive Environmental Response, Compensation, and Liability Act of 1980 (CERCLA),⁷⁸ also known as Superfund, was enacted to address abandoned hazardous waste sites in the United States. The law was amended by the Superfund Amendments and Reauthorization Act of 1986 and the Small Business Liability Relief and Brownfields Revitalization Act of 2002.⁷⁹ Under CERCLA, the U.S. Environmental Protection Agency (EPA) is charged with identifying contaminated property, finding the parties responsible for the contaminated property, and requiring the parties to either clean up the property or reimburse the EPA for its cleanup. In addition to federal laws, states have their own environmental laws. Lenders should be familiar with the laws in their market areas.

The EPA's All Appropriate Inquiry Final Rule (AAI)⁸⁰ establishes standards for due diligence that can allow a property owner to qualify for defenses to liability under CERCLA and some state laws. This rule created new standards (ASTM E1527-05)⁸¹ for what is commonly known as a "Phase I" environmental assessment.

⁷⁸ Refer to 42 USC 9601 et seq.

⁷⁹ Refer to Pub. L. 99-499 and 107-118.

⁸⁰ Refer to 40 CFR 312, "Innocent Landowners, Standards for Conducting All Appropriate Inquiries."

⁸¹ Standard established by ASTM International, formerly known as the American Society for Testing and Materials.

Banks that hold mortgages on property as secured lenders are exempt from CERCLA liability if certain criteria are met. CERCLA section 101(20) contains a secured creditor exemption that eliminates owner/operator liability for lenders that hold ownership in a CERCLA facility primarily to protect their security interest in the facility, provided they do not “participate in the management of the facility.” Generally, “participation in the management” may apply if a bank exercises decision-making control over a property’s environmental compliance or exercises control at a level similar to that of a manager of the facility or property. “Participation in management” does not include such actions as property inspections, requiring a response action to be taken to address contamination, providing financial advice, or renegotiating or restructuring the terms of the security interest. In addition, the secured creditor exemption provides that simply foreclosing on a property does not result in liability for a bank, provided that the bank takes “reasonable steps” to divest itself of the property “at the earliest practicable, commercially reasonable time, on commercially reasonable terms.” Generally, a bank may maintain business activities and close down operations at a property, so long as the property is listed for sale shortly after the foreclosure date or at the earliest practicable, commercially reasonable time.

Although these exemptions may limit a lender’s liability for cleanup, they do not protect the lender from the decline in value that contamination can cause because of the cost of remediation that may have to be undertaken by the bank or a prospective purchaser, or the stigma associated with a contaminated property. Further, the exemptions do not protect a responsible borrower from liability for cleanup, the cost of which may severely impair the borrower’s ability to repay the loan. For these reasons, a bank should perform an evaluation of the borrower’s or tenant’s business activities and any property taken as collateral before funding a loan and before taking title in satisfaction of debt. The evaluation should be commensurate with the risk of loss that collateral contamination or borrower liability poses to the bank. While the lender’s exemption from liability under CERCLA does not require that the evaluation meet the standards under AAI, an AAI-compliant study can provide the best assessment of a property’s environmental condition, potential liability for a borrower, and disposition strategies upon foreclosure.

An appropriate environmental risk management program reflects the level and nature of the bank’s CRE lending activities, its risk profile, and consideration of applicable environmental laws. The program should be reviewed and approved with its lending policies annually by the bank’s board or a designated board committee.

An effective environmental risk management program typically

- includes policies and processes that consider potential environmental risks associated with lending in markets and to industries served by the bank. Policies should clearly specify the bank’s requirements for determining potential environmental concerns. For example, policies and associated procedures should include guidelines for the lending staff to follow in conducting an initial analysis of potential environmental impact. Procedures should also specify the circumstances in which a more detailed environmental assessment, such as an AAI-compliant evaluation, should be conducted by a qualified professional.

- provides for the receipt and evaluation of environmental risk assessment reports before the bank finally commits to lend on a transaction.
- establishes procedures for assessing environmental concerns associated with assets before acquisition by the bank in workout or foreclosures as well as the bank's investment in CRE assets for its own use.
- includes employment or engagement of persons responsible for evaluating environmental risk who have relevant knowledge, skill, and competence. The bank's program should specify selection criteria to evaluate and monitor the performance of third-party professionals, such as environmental experts or legal counsel, who may be consulted to assess environmental risk.
- provides guidelines for monitoring properties that present potential environmental concerns. These should include assessing changes in business activities that might result in an increased risk of environmental contamination associated with the property, thus adversely affecting the collateral value.
- maintains guidelines for loan documentation that protect the bank from environmental liability and related losses. Loan documentation should include contractual provisions, such as rights of access, and be sufficient to facilitate AAI-compliant evaluations.

A bank's policies and procedures should reflect adequate consideration of the EPA's AAI rule. Such a policy should incorporate certain key elements, including

- an analysis of current environmental laws and due diligence requirements for borrowers and the bank.
- risk thresholds based on property type, use, and loan amount for determining when and what type of due diligence is required.
- varying due diligence methods depending on the type of loan, the amount of the loan, and the risk category, including borrower questionnaires or screenings, site visits, government records review, historical records review, or testing or inspections using qualified professionals.
- the potential for significant impact resulting from requirements to disclose the presence of hazardous materials, such as asbestos and lead-based paint, that the appraisers would include in their reports.
- criteria for evaluating environmental risk factors and costs in the loan approval process.
- criteria for determining the circumstances in which the bank would normally decline loan requests based on environmental factors.
- environmental provisions for incorporation into transaction documentation:
 - for commitment letters: extent of due diligence required, borrower costs, approval contingencies, reporting obligations, documentation requirements, etc.
 - for loan documentation: representations and warranties, inspection requirements, reporting requirements, lien covenants, indemnification provisions, and provisions allowing for the acceleration of the loan, refusal to extend funds under a line of credit, or exercise other remedies in the event of foreclosure.
- collateral monitoring and periodic inspection requirements throughout the loan term for properties with higher environmental risk.

- a means of evaluating potential environmental liability risk and environmental factors that could affect the ability to recover loan funds in the event of a foreclosure.
- guidelines for maintaining lender liability exemptions, avoiding owner/operator liability, and for qualifying for landowner liability protections under CERCLA and AAI if the bank acquires ownership of the property.

Loan Workouts and Restructures

Prudent loan workouts are often in the best interest of both banks and borrowers, particularly during difficult economic conditions. OCC Bulletin 2009-32 conveys the interagency “Policy Statement on Prudent CRE Loan Workouts.” The guidance addresses supervisory expectations for risk management of loan workout programs and arrangements, risk-rating loans, and regulatory reporting and accounting considerations. Examples of loan workouts and their effect on loan classification and accounting treatment are provided in the guidance.

A bank’s policies and practices for renewing and restructuring CRE loans should be appropriate for the complexity and nature of its lending activity and consistent with safe and sound lending practices and relevant regulatory reporting requirements. These policies and practices should address

- management infrastructure to identify, control, and manage volume and complexity of the workout activity.
- documentation standards to verify the borrower’s financial condition and collateral values.
- adequacy of internal controls, systems, and reports to identify and track loan performance and risk, including concentration risk.
- management’s responsibility to prepare regulatory reports consistent with regulatory reporting requirements (including generally accepted accounting principles (GAAP)).
- effectiveness of loan collection procedures.
- adherence to statutory, regulatory, and internal lending limits.
- collateral administration to help ensure proper lien perfection of collateral interests for both real and personal property.
- ongoing credit risk review.

Banks that implement prudent loan workout arrangements will not be subject to examiner criticism for engaging in such efforts, even if the restructured loans have weaknesses that result in adverse credit classification, if management has executed

- a prudent workout policy.
- a well-conceived and prudent workout plan for an individual credit or portfolio of credits.
- an analysis of the borrower’s global debt service.
- the ability to monitor the ongoing performance of the borrower and guarantor under terms of the workout.
- an accurate and consistent internal loan grading system.

- a credit loss allowance methodology that is consistent with GAAP and recognizes credit losses in a timely manner through provisions and charge-offs, as appropriate.

Key elements of a prudent workout plan include

- updated and comprehensive financial information on the borrower, real estate project, and any guarantor(s).
- current valuations of the collateral supporting the loan.
- analysis and determination of an appropriate loan structure (e.g., term and amortization schedule), curtailment, covenants, or re-margining requirements.
- appropriate legal documentation for any changes to loan terms.

Loan workouts can take many forms, including a renewal or extension of loan terms, extension of additional credit, or a restructuring with or without concessions. A renewal or restructuring of a troubled credit should improve a bank's prospects for repayment of principal and interest. A bank should consider a borrower's repayment capacity, the support provided by guarantors, and the value of the collateral pledged on the debt.

Renewed or restructured loans to borrowers with the ability to repay their debts under reasonable, modified terms should not be subject to adverse classification solely because the value of the underlying collateral has declined to an amount that is less than the loan balance.

Adverse classification of a restructured loan would be appropriate if, after the restructuring, well-defined weaknesses exist that jeopardize the orderly repayment of the loan in accordance with reasonable, modified terms. The presence of a guarantee from a financially responsible guarantor may improve the prospects for repayment of the debt obligation and may be sufficient to preclude classification or reduce the severity of classification.

Accrual Status

Banks should follow the call report instructions when determining the accrual status for CRE loans. As a general rule, banks shall not accrue interest, amortize deferred net loan fees or costs, or accrete discount on any asset if

- the asset is maintained on a cash basis because of deterioration in the financial condition of the borrower,
- payment in full of principal or interest is not expected in accordance with original terms, or

- principal or interest has been in default for 90 days or more unless the asset is both well secured and in the process of collection.⁸²

The call report instructions provide one exception to the general rule for commercial loans: Purchased credit-impaired loans need not be placed in nonaccrual status when the criteria for accrual of income under the interest method are met, regardless of whether the loans had been maintained in nonaccrual status by the seller.⁸³

As a general rule, a nonaccrual loan may be returned to accrual status when

- none of its principal and interest is due and unpaid, and the bank expects repayment of the remaining contractual principal and interest, or
- it otherwise becomes well secured and is in the process of collection.

The OCC's *Bank Accounting Advisory Series* and the "Rating Credit Risk" booklet of the *Comptroller's Handbook* provide more information on nonaccrual loans, including the appropriate treatment of cash payments for loans on nonaccrual.

For a restructured loan that is not already in nonaccrual status before the restructuring, the bank needs to consider whether the loan should be placed in nonaccrual status to ensure that income is not materially overstated. A loan that has been restructured so as to be reasonably assured of repayment of principal and interest and of performance according to prudent modified terms need not be maintained in nonaccrual status, provided the restructuring and any charge-off taken on the asset are supported by a current, well-documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured loan must remain in nonaccrual status.

In assessing accrual status, management should consider the borrower's sustained historical repayment performance for a reasonable period before the date on which the loan is returned to accrual status. A sustained period of repayment performance generally is a minimum of six months and involves payments of cash or cash equivalents. In returning the asset to accrual status, sustained repayment performance for a reasonable time before the restructuring may be taken into account.

For more information about placing a loan in nonaccrual status and returning a nonaccrual loan to accrual status, refer to the call report instructions.

⁸² An asset is "well secured" if it is secured (1) by collateral in the form of liens on or pledges of real or personal property, including securities, that have a realizable value sufficient to discharge the debt (including accrued interest) in full, or (2) by the guarantee of a financially responsible party. An asset is "in the process of collection" if collection of the asset is proceeding in due course either (1) through legal action, including judgment enforcement procedures, or, (2) in appropriate circumstances, through collection efforts not involving legal action that are reasonably expected to result in repayment of the debt or in its restoration to a current status in the near future.

⁸³ For more information, refer to the call report instructions' "Glossary" section, entry "Purchased Credit-Impaired Loans and Debt Securities."

Troubled Debt Restructurings

All restructured loans should be evaluated to determine whether the loan should be reported as a troubled debt restructuring (TDR). For reporting purposes, a restructured loan is considered a TDR when the bank, for economic or legal reasons related to a borrower's financial difficulties, grants a concession to the borrower in modifying or renewing a loan that the bank would not otherwise consider. Guidance on reporting TDRs, including characteristics of modifications, is in the call report instructions and OCC Bulletin 2012-10, "Troubled Debt Restructurings: Supervisory Guidance on Accounting and Reporting Requirements."⁸⁴

Allowance for Credit Losses

For performing CRE loans, the credit loss allowance does not necessarily need to increase solely because the value of the collateral has declined to an amount less than the loan balance. Declines in collateral values should be considered, however, when calculating loss rates for affected groups of loans when estimating loan losses under the ASC Subtopic 450-20 (for banks that have not adopted the current expected credit losses methodology) or Subtopic 326-20, "Financial Instruments-Credit Losses" (if the bank has adopted the current expected credit losses methodology).⁸⁵

Foreclosure

Acquiring properties in satisfaction of debt (either for the bank or as servicer for another mortgagee) results in new or expanded risks, including operational risk and market valuation issues, compliance risk, and reputation risk. The "Other Real Estate Owned" booklet of the *Comptroller's Handbook* discusses some of the risks presented by the foreclosure of commercial properties.

Concentration Risk Management

The effectiveness of a bank's risk management practices is a key component of the supervisory evaluation of a bank's CRE concentrations. Examiners discuss concentrations with management to assess CRE exposure levels and risk management practices. Banks that have experienced recent, significant growth in CRE lending typically receive closer

⁸⁴ Refer to the call report instructions for applicable reporting requirements. In November 2021, the Financial Accounting Standards Board (FASB) proposed updates to "Financial Instruments—Credit Losses (Topic 326): Troubled Debt Restructuring and Vintage Disclosures" that would change TDR measurement and reporting for banks that have adopted CECL. Risk ratings and accrual treatment would continue to apply.

⁸⁵ For more information, refer to OCC Bulletin 2006-47, "Allowance for Loan and Lease Losses (ALLL): Guidance and Frequently Asked Questions (FAQs) on the ALLL," the "Allowance for Loan and Lease Losses" and "Allowances for Credit Losses" booklets of the *Comptroller's Handbook*; OCC Bulletin 2020-49, "Current Expected Credit Losses: Final Interagency Policy Statement on Allowances for Credit Losses," and the OCC's *Bank Accounting Advisory Series*.

supervisory review. For more information, refer to the “Concentrations of Credit” booklet of the *Comptroller’s Handbook*.

OCC Bulletin 2006-46, “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices: Interagency Guidance on CRE Concentration Risk Management,” describes criteria that, when approached or exceeded, may prompt further supervisory analysis of the level, nature, and management of a bank’s CRE concentration risk:⁸⁶

- Total reported loans for construction, land development, and other land⁸⁷ represent 100 percent or more of the bank’s total capital;⁸⁸ or
- Total non-owner-occupied CRE loans⁸⁹ represent 300 percent 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.

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).

Although consideration of these factors should not change the method of identifying a credit concentration, these factors may mitigate the risk posed by the concentration.

The “Concentrations of Credit” booklet of the *Comptroller’s Handbook* addresses risk management, stress testing, and capital planning aspects of concentration management.

Examiners are reminded that, as with other concentrations, CRE concentrations should be reported in the “Concentrations” section of the report of examination (ROE) when these concentrations pose challenges to management or present unusual or significant risk to the

⁸⁶ These criteria are not CRE lending limits.

⁸⁷ As reported in the call report FFIEC 031 and 041, schedule RC–C—Loans and Lease Financing Receivables part I, item 1a.i.a. and Memorandum item 3.

⁸⁸ For purposes of OCC Bulletin 2006-46, refer to OCC Bulletin 2020-29, “Credit Concentrations: Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach,” for the calculation of total capital. For banks that have implemented the current expected credit losses (CECL) methodology, examiners calculate credit concentration ratios using tier 1 capital plus the allowance for credit losses attributed to loans and leases as the denominator. For banking organizations that have not adopted CECL, the agencies’ examiners calculate credit concentration ratios using tier 1 capital plus the entire allowance for loan and lease losses as the denominator. Tier 1 capital is reported in the call report FFIEC 031 and 041, schedule RC-R-Regulatory Capital, item 26.

⁸⁹ As reported in the call report FFIEC 031 and 041, schedule RC–C, part I, items (1.a., 1.d., 1.e.(2), and Memorandum item 3.

bank. CRE concentrations of credit approaching or exceeding the thresholds described in OCC Bulletin 2006-46 should be reported in the “Concentrations” section of the ROE, and any supervisory concerns regarding such concentrations of credit should be discussed in other appropriate narrative sections of the ROE. For more information, refer to the “Report of Examination” section of the “Bank Supervision Process” booklet of the *Comptroller’s Handbook*.

Key Elements for CRE Concentration Risk Management

Excerpt from “Interagency Guidance on Commercial Real Estate Lending, Sound Risk Management Practices”

The sophistication of an institution’s CRE risk management processes should be appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risk to the institution. Institutions should address the following key elements in establishing a risk management framework that effectively identifies, monitors, and controls CRE concentration risk:

- Board and management oversight.
- Portfolio management.
- Management information systems.
- Market analysis.
- Credit underwriting standards.
- Portfolio stress testing and sensitivity analysis.
- Credit risk review function.

Refer to the “Interagency Guidance on Commercial Real Estate Lending, Sound Risk Management Practices” conveyed by OCC Bulletin 2006-46 for full text of the guidance. The following issuance provide more information relevant to concentration risk management:

- OCC Bulletin 2012-14, “Stress Testing: Interagency Stress Testing Guidance,” for Banking Organizations With Total Consolidated Assets of More Than \$10 Billion outlines general principles for a satisfactory stress testing framework.
- OCC Bulletin 2012-33, “Community Bank Stress Testing: Supervisory Guidance,” provides guidance to banks with \$10 billion or less in total assets on using stress testing to identify and quantify risk in loan portfolios.
- OCC Bulletin 2020-50, “Credit Risk: Interagency Guidance on Credit Risk Review Systems” (national banks and FSAs).
- “Concentrations of Credit” booklet of the *Comptroller’s Handbook*.

Control Systems

Control systems are the functions (such as internal and external audits, risk review, quality control, and quality assurance) and information systems that bank managers use to measure performance, make decisions about risk, and assess the effectiveness of processes and personnel. Control system reviews can detect mistakes caused by carelessness, errors in judgment, or unclear instructions, in addition to fraud or deliberate noncompliance with laws, regulations, and bank policies. Credit risk control systems help maintain credit risk exposure within parameters set by the board and senior management. Establishing and enforcing

internal controls, operating limits, and other practices help maintain credit risk exposures within acceptable levels, and these systems collectively provide assurance that loan officers and others are working in accordance with specified policies and operating procedures. For CRE lending, control systems typically include risk management, credit risk review, third-party risk management, QA and QC, and internal audit. QA and QC activities for CRE lending typically occur during underwriting, pre-funding, and post-closing. Many of the controls described throughout the “Risk Management” section of this booklet can be included as part of quality control or quality assurance. Additionally, banks should have credit risk review processes and internal audit coverage of CRE lending activities.

Credit Risk Review

Periodic independent reviews should be conducted to verify the accuracy of ratings and the operational effectiveness of the bank’s risk-rating processes. Objective reviews of credit risk levels and risk-management processes are essential to effective portfolio management and provide senior management and the board with an objective, independent, and timely assessment of the overall quality of the CRE portfolio. Credit risk review is a key internal control and an element of the safety and soundness standards that are described in the “Interagency Guidelines Establishing Standards for Safety and Soundness” found in appendix A of 12 CFR 30. For more information, refer to the “Loan Portfolio Management” booklet of the *Comptroller’s Handbook* (national banks); *OTS Examination Handbook* section 201, “Overview: Lending Operations and Portfolio Risk Management” (FSAs); and OCC Bulletin 2020-50 (national banks and FSAs).

The heightened credit risks created by loan concentrations make a credit risk review function even more critical in determining whether originations are consistent with the bank’s loan policy and accurately reflect the board’s stated risk appetite and strategic plan. The foundation of the bank’s credit risk review function is an effective, accurate, and timely risk-rating system. Risk ratings should be objective, and appropriate for the types of CRE loans originated by the bank. If credit risk review processes have previously been determined to be effective for the bank and the findings are current, the examiners may use these processes during the examination process.

Internal Audit

Internal audit objectively and independently reviews and evaluates CRE lending activities, including accounting systems, management reporting, and operations. Internal audit gives the board important information about the efficiency and effectiveness of credit risk management activities, specifically whether existing internal controls are sufficient and working as intended. Internal audit does this by⁹⁰

- evaluating the reliability, adequacy, and effectiveness of accounting, operating, and administrative controls.

⁹⁰ For more information, refer to the “Internal and External Audits” booklet of the *Comptroller’s Handbook*.

- determining whether internal controls result in timely and accurate recording of transactions and safeguarding of assets.
- determining whether the bank complies with laws and regulations and whether personnel adhere to established bank policies, procedures, and processes.
- determining whether management is taking appropriate and timely steps to address current and prior control deficiencies and audit report recommendations.
- ensuring that audit activities are performed by a qualified person.

CRE lending audits typically focus on underwriting, disbursement, credit administration, workout activities, and ALLL or ACL processes. Most audit reviews include credit and loan documentation file samples to review specific transactions for adherence once policies and operating procedures are considered adequate. Many internal audit reviews also include the proper processing of cash disbursements, loan payoffs, and loan charge-offs. Internal audit also typically reviews and reconciles important management reports, including testing the accuracy and timeliness of reports provided to the board and senior management.

As explained in the “Interagency Guidance on Credit Risk Review Systems,” the credit risk review function is expected to be independent of a bank’s internal audit function. Coordination of credit risk review with the internal audit function can facilitate the reporting of material risk and control issues to the audit committee, increase the overall effectiveness of these monitoring functions, better use available resources, and enhance the bank’s ability to comprehensively manage risk. Although there are advantages to coordination, an effective internal audit function maintains the ability to independently audit the credit risk review function.⁹¹

Third-Party Risk Management

The OCC expects a bank to practice effective risk management regardless of whether the bank performs the activity internally or through a third party. A bank’s use of third parties does not diminish the responsibility of its management to ensure that the activity is performed in a safe and sound manner and in compliance with applicable laws. The OCC expects a bank to have risk management processes that are commensurate with the level of risk and complexity of its third-party relationships and the bank’s organizational structures.⁹²

Common third-party relationships related to CRE lending include appraisers, appraisal reviewers, appraisal management companies, inspectors, engineers, auditors, and credit risk review. Such third parties should be incorporated into the bank’s third-party risk management processes.

⁹¹ For more information, refer to OCC Bulletins 2003-12, “Interagency Policy Statement on Internal Audit and Internal Audit Outsourcing: Revised Guidance on Internal Audit and Its Outsourcing,” and 2020-50.

⁹² For more information, refer to OCC Bulletins 2013-29, “Third-Party Relationships: Risk Management Guidance,” and 2020-10, “Third-Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013-29.”

Examination Procedures

This booklet contains expanded procedures for examining specialized activities or specific products or services that warrant extra attention beyond the core assessment contained in the “Community Bank Supervision,” “Federal Branches and Agencies Supervision,” and “Large Bank Supervision” booklets of the *Comptroller’s Handbook*. Examiners determine which expanded procedures to use, if any, during examination planning or after drawing preliminary conclusions during the core assessment.

Scope

These procedures are designed to help examiners tailor the examination to each bank and determine the scope of the CRE lending examination. Examiners should consider work performed by internal and external auditors, independent risk management, and other examiners reviewing related areas. Examiners should perform only those objectives and procedures relevant to the scope of the examination as determined by the following objectives. Seldom is every objective or step of the expanded procedures necessary.

Objective: To determine the scope of the CRE lending examination and identify examination objectives and activities necessary to meet the needs of the supervisory strategy for the bank.

- Review the examination scope memo and discuss examination goals and objectives with the examiner-in-charge (EIC) or loan portfolio manager examiner.
- Review the following sources of information to identify issues related to CRE lending that require follow-up:
 - Scope memorandum.
 - Previous supervisory activity work papers.
 - Previous supervisory letters and reports of examination, and management’s response.
 - Supervisory strategy.
 - Bank correspondence regarding CRE lending.
 - Audit reports and internal credit review reports and work papers, as necessary, including management’s responses.
 - Customer complaints and litigation. Examiners should review customer complaint data from the OCC’s Customer Assistance Group, the bank, and the Consumer Financial Protection Bureau (when applicable). When possible, examiners should review and leverage complaint analysis already performed during the supervisory cycle to avoid duplication of effort.
- Review the Uniform Bank Performance Report and OCC reports or analytical tools. Identify trends in growth rates, portfolio composition, concentrations, portfolio performance, pricing, and other factors that may affect the risk profile of the bank.

- Review the bank's
 - CRE lending policies and loan procedures.
 - portfolio strategies, risk tolerance parameters, and risk management guidelines.
 - loan commitment report showing commitments and undisbursed funds.
 - internal credit risk review reports.
 - loan trial balance, past-due accounts, and loans in nonaccrual status.
 - credit risk-rating reports, including a list of “watch” credits.
 - problem loan reports for adversely rated CRE and construction loans.
 - concentration reports and board-approved concentration limits.
 - exception reports, including aggregate SLTV exception reports.
 - financial statement tracking reports.
 - real estate tax monitoring reports.
 - board or loan committee reports and minutes related to CRE lending activities.
 - loans for which terms have been modified by a reduction of the interest rate or principal payment, by a deferral of interest or principal, or by other restructuring of payment terms.
 - loans on which interest has been capitalized subsequent to initial underwriting.
 - over-disbursed loans.
 - loan participations purchased and sold since the previous examination.
 - shared national credits, if applicable, including downgrades since the last CRE target exam.
 - information regarding the composition of the credit department including the organizational chart, resumes of senior staff, and lending authorities.
 - loans to insiders of the bank or any affiliate of the bank.
- Discuss the bank's CRE lending activities with management. Discussions should address
 - management's strategy for the CRE lending function, including
 - growth goals.
 - existing and potential sources of loan demand.
 - new loan types, property types, or geographic regions.
 - new marketing strategies and initiatives.
 - the staff's experience and ability to implement strategic initiatives and achieve strategic goals.
 - current and projected concentrations of credit, as well as management's plans to manage concentrations.
 - significant changes in policies, procedures, underwriting, personnel, and control systems.
 - internal or external factors that could affect the portfolio.
 - individual borrower and portfolio-wide stress testing practices.
 - observations from examiner review of internal bank reports, as well as OCC and other third-party generated reports.
 - the extent of syndicated distribution and participation activities as a buyer and a seller, if applicable.

- Based on analysis of the information received and discussions with bank management, determine the factors behind changes in loan growth, loan portfolio composition, customer or product types, underwriting criteria, or market focus. Consider
 - growth and acquisitions.
 - board or management changes.
 - changes in risk tolerance limits including concentrations.
 - changes in external factors, such as
 - national, regional, and local economies.
 - CRE markets.
 - industry outlook.
 - regulatory framework.
 - technological changes.
- As examination procedures are performed, test for compliance with applicable laws, rules, regulations, and established policies. Confirm the existence of appropriate internal controls. Identify any areas that have inadequate supervision or pose undue risk. Discuss with the EIC the need to perform additional procedures.
- Based on findings resulting from the previous steps and in consultation with the EIC and other appropriate supervisors, determine the examination's scope and volume of testing necessary to meet supervisory objectives. Select from the following expanded procedures, internal control questions, and verification procedures necessary to meet the examination objectives.

Quantity of Risk

Conclusion: The quantity of each associated risk is (low, moderate, or high).

Determine the quantity of risk associated with CRE lending activities. Consider the “Quantity of Credit Risk Indicators” in appendix A of this booklet, as appropriate.

Credit Risk

Objective: To determine the quantity of credit risk associated with CRE lending.

1. Analyze the quantity of credit risk. The analysis should consider such factors as the products, markets, geographies, technologies, volumes, size of the exposures, quality metrics, and concentrations.
2. Assess the effect of external factors, including economic, industry, competitive, and market conditions.
3. Assess the effect of potential legislative, regulatory, accounting, and technological changes.
4. Obtain the loan trial balance and select a sample of loans to be reviewed. Selection of the sample should be consistent with the examination objectives, supervisory strategy, and district business plans. Refer to the “Sampling Methodologies” booklet of the *Comptroller’s Handbook*. Consider
 - new, large loans.
 - new loan types.
 - loans originated in new geographic regions.
 - loans at or above the legal lending limit.
 - loans to insiders of the bank or any affiliates.
 - over-disbursed loans.
 - loans with multiple renewals or extensions, particularly construction loans.
 - construction loans with no disbursements in the past 90 days.
 - loans for property types that are not typical of the portfolio.
 - special mention loans or classified loans.
 - loans with significant policy or underwriting exceptions.
 - loans with existing or recent covenant violations.
 - loans with modified repayment terms.
5. Obtain and review credit files for all borrowers in the sample and prepare line sheets for the sampled credits. Line sheets should contain sufficient analysis to determine the credit

rating; support any criticisms of underwriting, servicing, or credit administration practices; and document any violations of law. In particular, file readers should:

A. Determine the primary source of repayment of each loan and evaluate its adequacy.

- For income-producing properties, assess the adequacy of cash flow to meet debt service requirements. Comment as necessary on trends in NOI, vacancy, and expenses. Review current rent rolls and leases and assess the quality and mix of tenants. Note any significant volume of leases scheduled to expire. Analyze the potential effect on future debt-service coverage from tenant turnover.
- For owner-occupied buildings, concentrate analysis on the ability of the owner's cash flow to service debt.
- For construction loans (including tract financing),
 - determine whether project feasibility supported the bank's decision to extend credit.
 - evaluate the construction budget and determine whether cost estimates appear reliable.
 - evaluate the adequacy of the construction completion schedule in the pre-loan feasibility review.
 - evaluate the basis of disbursements, e.g., costs incurred, percentage of completion, cost to complete, and assess the adequacy of records and approvals maintained by the bank.
 - assess the project's status to determine whether it is progressing according to plan and in conformance with the agreed timeline.
 - verify the improvements are constructed as proposed.
 - determine whether material changes have been made to the plans and whether these changes are reflected in the construction budget.
 - determine whether material changes have been made to the construction budget and the reasons for these changes.
 - determine whether sufficient funds remain available in each category of the construction budget to complete the project.
 - assess adequacy of the interest reserve in light of construction progress.
 - review adequacy of reports used to monitor construction progress, advances, sales, leasing, etc. Ascertain whether inspection reports support disbursements to date and are performed by a party not reporting to the loan origination function.
 - verify the documentation of liens, foundation endorsements, recording of mortgages or deeds of trust, and other pertinent documentation.
 - verify the documentation of exceptions and approvals in files of record.
 - determine the source of permanent financing. If different from the current lender, determine whether take-out arrangements have been secured and assess compliance with take-out covenants.
 - for tract financing, understand the repayment strategy, its adequacy, and any variance from the original plan.

- B. Evaluate the quality of underwriting if the loan was originated, renewed, or restructured in the past 12 months.
 - C. Evaluate external factors, such as economic conditions, and the effect on supply and demand, rental rates, vacancy rates, interest rates, capitalization rates, and NOI.
 - D. Analyze secondary sources of repayment provided by guarantors, financial sponsors, or endorsers. If the financial condition of the borrower warrants concern, determine the guarantor's, sponsor's, or endorser's capacity and willingness to repay the credit.
 - E. Evaluate sufficiency of collateral coverage. Determine whether the appraisals or evaluations were obtained consistent with regulatory requirements (12 CFR 34, subpart C) and meet USPAP. File reviewers should consider
 - timing of the appraisal and loan origination date.
 - whether the appraisal was commissioned independent of the lending function.
 - appraiser qualifications specific to the type of real estate.
 - appropriateness of the valuation method used and the definition of value provided.
 - reasonableness and documentation of assumptions used to derive the collateral value.
 - quality and timing of appraisal review.
 - whether new appraisals or evaluations were obtained when conditions warranted.
 - whether LTV ratios are accurately calculated, and whether LTV exceptions are appropriately documented and approved.
 - F. Determine whether the borrower is in compliance with the loan agreement and financial covenants.
 - G. Document all significant loan policy and underwriting exceptions and whether exceptions were appropriately approved.
 - H. Assign risk ratings to the sampled credits. Refer to risk-rating guidance and information in this booklet, OCC Bulletin 2009-32, and the "Rating Credit Risk" booklet of the *Comptroller's Handbook*.
6. Review completed line sheets and summarize loan sample results. The examiner responsible for the CRE lending review should
- identify recommended loan risk-rating downgrades and ensure that such decisions are appropriately documented.
 - maintain a list of structurally weak loans reviewed. If applicable, complete one or more of the three available Credit Underwriting Assessment (CUA) modules to evaluate underwriting practices and determine the direction of practices since the previous supervisory activity and determine the appropriate assessment rating. The three available CUA modules for CRE lending are CRE Lending – General, CRE

Lending – Permanent, and CRE Lending – Construction. Please see separate guidance for additional information on the CUA modules.

- maintain a list of loans not supported by current and complete financial information and loans in which collateral documentation is deficient.
- summarize whether policy, underwriting, or documentation exceptions were appropriately identified and approved. If exceptions are not being accurately identified and reported, including SLTV exceptions, determine the cause and discuss with management.

7. If the bank actively engages in loan participation purchases and sales,

- test participation agreements to determine whether the parties share in the risks and contractual payments on a pro rata basis.
- determine whether the books and records properly reflect the bank's asset or liability.
- determine whether the bank exercises similar controls over loans serviced for others as for its own loans.
- investigate any loans or participations sold immediately before the examination to determine whether any were sold to avoid criticism during the examination.

8. If the bank actively engages in the interagency Shared National Credit (SNC) program,

- determine whether qualifying credits were recently sampled as part of the SNC review process. For each loan in the sample that is also a SNC, transfer appropriate information to the line sheets. Grade the loan the same as was done at the SNC review and do not perform any additional file work on the SNC loan.
- determine whether the bank, as lead or agent in a credit, exercises similar controls and procedures over syndications and participations sold as it exercises for loans in its own portfolio.
- determine whether the bank, as a participant in a credit where another party is agent, exercises similar controls over those participations purchased as it exercises for loans it has generated directly.

9. If the bank actively engages in Federal Housing Administration-insured loans,

- determine whether a valid certificate of insurance or guaranty is on file by reviewing management's procedures to obtain such insurance or guaranty or by testing a representative sample of such loans.
- determine whether required delinquency reports are being submitted.

10. Discuss the results of the loan sample with the EIC or loan portfolio manager examiner and bank management.

Associated Risks

In addition to credit risk, CRE lending can generate interest rate risk, liquidity risk, operational risk, compliance risk, strategic risk, and reputation risk. These risks and how CRE lending can expose the bank to these risks are discussed in the “Introduction” section of this booklet.

Objective: To determine the quantity of other risks associated with CRE lending activities.

1. Assess the effect of CRE lending on the quantity of interest rate risk. Consider
 - the effect of interest rate changes on both the borrowers and the bank.
 - underwriting terms such as tenor and management’s pricing structure, e.g., fixed versus variable interest rates and the potential exposure to different pricing indices.
 - off-balance-sheet exposures.
 - the quality and results of sensitivity analysis and portfolio stress testing.
2. Assess the effect of CRE lending on the quantity of liquidity risk. Consider
 - CRE and construction portfolio growth rates and the corresponding funding strategies.
 - the composition of the CRE portfolio and the ability to convert the loans to cash. Consider the level of properties under construction or completed properties that have not reached stabilization as these properties are less liquid.
 - current market conditions.
3. Assess the effect of CRE lending on the quantity of operational risk. Consider
 - any operational losses resulting from the CRE lending function.
 - control weaknesses identified by audit, credit risk review, or any other control group.
 - effectiveness of credit administration processes such as construction controls, documentation standards, staffing turnover, and experience levels affecting the CRE function.
 - responses to the Internal Control Questionnaire.
4. Assess the effect of CRE lending on the quantity of compliance risk. Consider
 - the bank’s history of compliance with lending related laws and regulations, including applicable fair lending, particularly those established regarding applications, appraisals, insider lending activities, legal lending limits, and affiliates, as well as safe and sound banking practices.
 - for FSAs, whether the association is approaching or has exceeded its Home Owners’ Loan Act investment limit of 400 percent of total capital for nonresidential real estate loans (12 USC 1464(c)).

- the quality of the bank's environmental risk management program and losses attributed to liabilities resulting from environmental risk.
 - the quality of the controls over CRE lending activities.
 - compliance with internal policies and procedures.
5. Assess the effect of CRE lending on the level of strategic risk. Consider
- management's strategy regarding CRE lending and the potential effect on risk including those posed by concentrations.
 - board oversight of strategic initiatives.
 - the adequacy of the bank's program for monitoring economic and market conditions.
 - the ability of the staff to implement CRE strategies without exposing the bank to unwarranted risk.
 - the adequacy of CRE risk management systems in light of growth plans and strategic risk initiatives.
6. Assess the effect of CRE lending on the level of reputation risk. Consider
- the bank's effectiveness in meeting the CRE and construction credit needs of the communities it serves.
 - the volume of foreclosures and the nature of foreclosure practices.
 - the volume of litigation related to CRE lending activities.

Quality of Risk Management

Conclusion: The quality of risk management is (strong, satisfactory, insufficient, or weak).

Determine the quality of risk management considering all risks associated with CRE lending. Consider the “Quality of Credit Risk Management Indicators” in appendix B of this booklet, as appropriate.

Policies

Policies are statements of actions adopted by a bank to pursue certain objectives. Policies guide decisions, often set standards (on risk limits, for example), and should be consistent with the bank’s underlying mission, risk appetite, and core values. Policies should be reviewed periodically for effectiveness and approved by the board or designated board committee.

Objective: To determine whether the board has adopted effective policies that are consistent with safe and sound banking practices and appropriate to the size, nature, and scope of the bank’s CRE lending activities.

1. Evaluate relevant policies to determine whether they provide appropriate guidance for managing the bank’s CRE lending activities, reflecting consideration of the “Interagency Guidelines for Real Estate Lending Policies” (subpart D of 12 CFR 34 for national banks and 12 CFR 160.101 for FSAs), the bank’s size and nature and scope of its operations, and the level of risk that is acceptable to its board. Do the bank’s policies
 - establish prudent underwriting standards, including LTV limits that are clear and measurable?
 - establish credit administration procedures for the CRE portfolio?
 - establish documentation, approval, and reporting requirements to monitor compliance with the bank’s real estate lending policy?
 - require the monitoring of conditions in the bank’s real estate lending market to confirm that its lending policies continue to be appropriate for current market conditions?

Consider

- the size, risk profile, and financial condition of the bank.
- significant CRE concentrations.
- current and projected market conditions.
- credit administration policies.
- construction risk management policies.
- environmental risk management policies.

- loan documentation standards.
 - the loan workout function.
 - compliance with the real estate lending standards outlined in 12 CFR 34, subpart D (national banks) and 12 CFR 160.101 (FSAs).
2. Determine whether policies establish risk limits or positions and delineate prudent actions to be taken if the limits are exceeded.
 3. Evaluate the bank's construction administration policies and procedures. Determine whether policies
 - provide for clear separation of origination and servicing functions (e.g., ordering, performing, and reviewing related due diligence.)
 - support that related reports have sufficient information and analysis to guide credit and disbursement decisions.
 4. Evaluate the bank's appraisal and evaluation policies for consistency with 12 CFR 34, subpart C, and OCC Bulletin 2010-42. Determine whether policies
 - provide for the independence of the persons ordering, performing, and reviewing appraisals or evaluations.
 - establish selection criteria and procedures for engaging appraisers and persons who perform evaluations.
 - establish criteria and procedures to evaluate and monitor the ongoing performance of appraisers and persons who perform evaluations.
 - contain sufficient requirements for appraisals to comply with the agencies' appraisal regulations.
 - support that appraisals and evaluations contain sufficient information and analysis to inform the credit decision.
 - maintain criteria for the content and appropriate use of evaluations consistent with safe and sound banking practices.
 - provide for the receipt of the appraisal or evaluation report in a timely manner to facilitate the credit decision.
 - provide for the review of the appraisal or evaluation report and the documentation of the review in a timely manner to facilitate the credit decision.
 - develop criteria to assess whether an existing appraisal or evaluation may be used to support a subsequent transaction.
 - implement internal controls that promote compliance with these program standards, including those related to monitoring third-party arrangements.
 - establish criteria for monitoring collateral values.
 - establish criteria for assessing and documenting whether an existing appraisal or evaluation, when relied upon, remains valid.
 - establish criteria for obtaining appraisals or evaluations for transactions that are not otherwise covered by the appraisal requirements of the agencies' appraisal regulations.

5. Evaluate the bank's policies regarding CRE concentrations. In particular, assess the adequacy of the bank's policies with respect to

- CRE concentration limits and assessments.
- board and management oversight.
- MIS.
- market analysis.
- credit underwriting standards.
- portfolio stress testing and sensitivity analysis.
- the credit risk review function.

For more information, refer to the "Concentrations of Credit" booklet of the *Comptroller's Handbook* and OCC Bulletin 2006-46.

6. Verify that the board periodically reviews and approves the bank's CRE lending policies.
7. Reach and document conclusions and findings from the review of the bank's commercial lending policies. Examiner conclusions and findings of the bank's commercial lending policies can also support the CUA modules in Examiner View.

Processes

Processes are the procedures, programs, and practices that impose order on a bank's pursuit of its objectives. Processes define how daily activities are carried out and help manage risk. Effective processes are consistent with the underlying policies and are governed by appropriate checks and balances (such as internal controls).

Objective: To determine the adequacy of the bank's processes for how CRE lending activities are carried out.

1. Evaluate whether processes are effective, consistent with underlying policies, and effectively communicated to appropriate staff. Consider
 - whether the board has clearly communicated objectives and risk limits for the CRE loan portfolio to management and staff.
 - whether communication to key personnel within the CRE function is timely.
2. Determine whether appropriate internal controls are in place and functioning as designed. Complete the Internal Control Questionnaire in this booklet, if necessary, to make this determination. Consider
 - nature and scope of the bank's CRE lending activities.
 - size and financial condition of the bank.
 - quality of management and internal controls.
 - expertise and size of the lending and credit administration staff.

- market conditions.
3. Determine the quality of credit administration. Consider observations from the loan sample, including
 - the volume, trend, and nature of loan policy and underwriting exceptions.
 - the soundness of underwriting and adherence to standards and policies.
 - the timeliness of financial statements and their analysis.
 - loan covenant monitoring and enforcement.
 - risk-rating changes.
 - construction loan administration including draw and disbursement practices.
 - credit risk review or audit findings pertaining to credit administration.
 4. Assess and reach a conclusion on underwriting practices for CRE lending and complete the appropriate sections of the CUA.
 5. Evaluate the bank's appraisal and evaluation program. Consider the quality, timing, and independence of the appraisal and appraisal review functions, and management's criteria for obtaining, updating, or determining the validity of appraisals or evaluations when appropriate. Are the bank's processes designed so that
 - persons selected possess the requisite education, expertise, and experience to competently complete the assignment?
 - persons selected to perform appraisals hold the appropriate state certification or license at the time of the assignment?
 - appraisal reports and evaluations are reviewed, and the review is documented?
 - persons selected are independent and have no direct, indirect, or prospective interest, financial or otherwise, in the property or the transaction, and are capable of rendering an unbiased opinion?
 - methods, assumptions, and value conclusions are reasonable and contain sufficient information and analysis on which to base sound credit decisions?
 - appraisals or evaluations comply with the agencies' appraisal regulations and supervisory guidelines as well as the bank's policies?
 6. If the bank has third-party relationships that involve critical activities for CRE lending, assess the adequacy of the bank's third-party risk management. Refer to OCC Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance"; OCC Bulletin 2020-10, "Third-Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013-29"; and OCC Bulletin 2017-7, "Third-Party Relationships: Supplemental Examination Procedures." Consider reviewing a sample of due diligence and ongoing monitoring documentation for critical CRE third parties.
 7. Determine whether appropriate internal controls are in place and functioning as designed. Complete the Internal Control Questionnaire, if necessary, to make this determination.

Personnel

Personnel are the bank staff and managers who execute or oversee processes. Personnel should be qualified and competent, have clearly defined responsibilities, and be held accountable for their actions. They should understand the bank's mission, risk appetite, core values, policies, and processes. Banks should design compensation programs to attract and retain personnel, align with strategy, and appropriately balance risk-taking and reward.

Objective: To determine management's ability to supervise CRE lending in a safe and sound manner.

1. Given the scope and complexity of the bank's CRE activities, assess the management structure and staffing. Consider
 - the level of staffing.
 - the staff's ability to support current operations and planned growth.
 - whether reporting lines encourage open communication and limit the chances of conflicts of interest.
 - the level of staff turnover.
 - the use of outsourcing arrangements.
 - capability to address identified deficiencies.
 - responsiveness to regulatory, accounting, industry, and technological changes.
2. Given the scope and complexity of the bank's CRE activities, assess the experience, education, training, and demonstrated expertise and competency of management and staff. Consider
 - the suitability of the incumbent's experience and training for their position.
 - the availability, adequacy, and requirements for training to keep management and staff current with regulatory and other changes affecting the bank.
 - the experience and training or education of individuals responsible for the bank's appraisal and evaluation program including licensing or certification for any staff appraisers.
3. Assess performance management and compensation programs. Consider whether these programs measure and reward performance that aligns with the bank's strategic objectives and risk tolerance.

If the bank offers incentive compensation programs, determine whether the programs (1) provide employees with incentives that appropriately balance risk and reward; (2) are compatible with effective controls and risk management; and (3) are supported by strong corporate governance, including active and effective board oversight. Refer to OCC Bulletin 2010-24, "Incentive Compensation: Interagency Guidance on Sound Incentive Compensation Policies."

Control Systems

Control systems are the functions (such as internal and external audits, credit risk review, and quality assurance) and information systems that bank managers use to measure performance, make decisions about risk, and assess the effectiveness of processes. Control functions should have clear reporting lines, adequate resources, and appropriate access and authority. MIS should provide timely, accurate, and relevant feedback.

Objective: To determine whether the bank has systems in place to provide accurate and timely assessments of the risks associated with its CRE lending function.

1. Evaluate the effectiveness of monitoring systems to identify, measure, and track concentrations and exceptions to policies and established limits.
2. Evaluate the quality and results of portfolio stress testing.
3. Assess the adequacy of management and board reports regarding CRE. Consider the adequacy, timeliness, and distribution of reports. Consider whether reports address
 - growth.
 - asset quality.
 - concentrations.
 - performance and other trends.
 - risk levels in the bank's CRE activities.
4. Assess the scope, frequency, effectiveness, and independence of the internal and external audits of the CRE lending function. Consider the qualifications of audit personnel and evaluate accessibility to necessary information and the board.
5. Assess the effectiveness of credit risk review. Evaluate the scope, frequency, effectiveness, and independence of credit risk review, as well as credit risk review's ability to identify and report emerging problems. Determine whether credit risk review reports address the
 - classification of loans.
 - identification and measurement of impairments.
 - loan documentation.
 - quality of the CRE portfolio.
 - trend in portfolio quality.
 - quality of significant relationships.
 - level and trend of policy, underwriting, and pricing exceptions.
6. Assess the effectiveness of the bank's controls for the quality and independence of appraisals and evaluations. Consider

- whether reporting lines are independent of loan production and collection.
- the effectiveness of review procedures.
- the effectiveness of the appraiser engagement process.

Conclusions

Conclusion: The aggregate level of each associated risk is (low, moderate, or high).

The direction of each associated risk is (increasing, stable, or decreasing).

Objective: To determine, document, and communicate overall findings and conclusions regarding the examination of the bank's CRE lending activities.

1. Determine preliminary examination findings and conclusions with the EIC, including
 - effect on the core assessment of asset quality and management.
 - quantity of associated risks (as noted in this booklet's "Introduction" section).
 - quality of risk management.
 - aggregate level and direction of associated risks.
 - overall risk in CRE lending activities.
 - the CUA of the bank's loan policy standards and practices, if required.
 - violations of laws and regulations or deficient practices.
2. If substantive safety and soundness concerns remain unresolved that may have a material, adverse effect on the bank, further expand the scope of the examination by completing verification procedures.
3. Discuss examination findings with management, including violations, deficient practices, and conclusions about risks and risk management practices. If necessary, obtain commitments for corrective action.
4. Complete the following table summarizing credit and other risks (interest rate, liquidity, operational, compliance, strategic, and reputation) in the bank's CRE lending activities.

Summary of Risks Associated With CRE Lending				
Risk category	Quantity of risk	Quality of risk management	Aggregate level of risk	Direction of risk
	(Low, moderate, high)	(Weak, insufficient, satisfactory, strong)	(Low, moderate, high)	(Increasing, stable, decreasing)
Credit				
Interest rate				
Liquidity				
Price				
Operational				
Compliance				
Strategic				
Reputation				

5. Complete the CUA for CRE lending if included in the examination scope, including assessment of credit underwriting policy standards, credit underwriting practices, and direction of underwriting practices.
6. Compose conclusion comments, highlighting any issues that should be included in the ROE or supervisory letter. Include conclusions, as applicable, for
 - the portfolio's asset quality.
 - adequacy of policies and procedures and reasonableness of underwriting standards.
 - volume, trend, and severity of underwriting and policy exceptions.
 - CRE concentrations and the appropriateness of concentration risk management.
 - loan sample results including risk-rating changes, compliance with loan policy, and quality of underwriting.
 - quality of board oversight and portfolio supervision.
 - appropriateness and attainability of strategic goals.
 - quality of staffing.
 - accuracy and timeliness of management and board reports.
 - effectiveness of credit administration and internal controls.
 - effectiveness of the bank's appraisal and evaluation program.
 - reliability and timeliness of internal risk ratings.
 - the extent to which CRE lending activities and risk-management practices affect interrelated risks such as interest rate risk, liquidity risk, operational risk, compliance risk, strategic risk, and reputation risk.
 - compliance with applicable laws and regulations.
7. If necessary, compose matters requiring attention and violation write-ups.
8. Update the OCC's supervisory information systems and any applicable ROE schedules or tables.

9. Document recommendations for the supervisory strategy (e.g., what the OCC should do in the future to effectively supervise CRE lending, including the amount of time allotted, staffing, and workdays required).
10. Update, organize, and reference work papers in accordance with OCC policy.
11. Appropriately dispose of or secure any paper or electronic media that contain sensitive bank or customer information.

Internal Control Questionnaire

An internal control questionnaire helps the examiner assess a bank's internal controls for an area. Internal control questionnaires typically address standard controls that provide day-to-day protection of bank assets and financial records. The examiner decides the extent to which it is necessary to complete or update internal control questionnaires during examination planning, after reviewing the findings and conclusions of the core assessment, or after reviewing the conclusions from expanded procedures.

Policies

1. Has the board, consistent with its duties and responsibilities, adopted CRE loan policies consistent with safe and sound banking practices and appropriate to the size of the bank and to the nature and scope of its operations? In particular, do the bank's policies
 - identify the geographic areas in which the bank considers lending?
 - establish a loan portfolio diversification policy and set limits for CRE loans by type and geographic market (e.g., limits on construction and other types of higher risk loans)?
 - establish policies for identifying, monitoring, reporting, and managing concentrations?
 - identify appropriate terms and conditions by type of CRE and by size and type of loan?
 - establish prudent underwriting standards that are clear and measurable, such as
 - maximum loan amount by type of property?
 - maximum loan maturities by type of property?
 - amortization schedules?
 - pricing structure for different types of CRE loans?
 - LTV limits no greater than specified in the "Interagency Guidelines for Real Estate Lending Policies" found in subpart D of 12 CFR 34 (national banks) and the appendix to 12 CFR 160.101 (FSAs)?
2. For development and construction projects, and completed commercial properties, do the bank's underwriting standards also establish
 - requirements for feasibility studies and sensitivity and risk analyses (e.g., sensitivity of income projections to changes in economic variables such as interest rates, vacancy rates, and operating expenses)?
 - minimum requirements for initial investment and maintenance of hard equity by the borrower (e.g., cash or unencumbered investment in the underlying property)?
 - minimum standards for net worth, cash flow, debt yield, and debt-service coverage of the borrower or underlying property?
 - standards for the acceptability of and limits on nonamortizing loans?
 - standards for the acceptability of and limits on the financing of the borrower's soft costs on a project?

- standards for the acceptability of and limits on the use of interest reserves?
 - preleasing and presale requirements for income-producing property?
 - presale and minimum unit release requirements for ADC loans?
 - limits on partial recourse or nonrecourse loans and requirements for guarantor support?
 - requirements for loan agreements for construction loans?
 - requirements for take-out commitments, if applicable?
 - minimum covenants for loan agreements?
3. Has the bank established credit administration policies for its CRE portfolio that address
- documentation, including
 - type and frequency of financial statements, including requirements for verification of information provided by the borrower?
 - type and frequency of collateral appraisals and evaluations?
 - loan closing and disbursement procedures, including the supervised disbursement of proceeds on construction loans?
 - payment processing?
 - escrow administration?
 - collateral administration, including inspection procedures for construction loans?
 - loan payoffs?
 - collection and foreclosure, including
 - delinquency and follow-up procedures?
 - foreclosure timing?
 - extensions and other forms of forbearance?
 - acceptance of deeds in lieu of foreclosure?
 - claims processing (e.g., seeking recovery on a defaulted loan covered by a government guaranty or insurance program)?
 - servicing and participation agreements?
4. Are procedures in effect to monitor compliance with the bank's CRE lending policies?
- Are exception loans of a significant size reported individually to the board?
 - Are the numbers and types of exceptions monitored so the loan policy and lending practices can be periodically evaluated?
 - Are loans in excess of the SLTV limits identified in the bank's records and their aggregate amount reported at least quarterly to the board?
 - Are concentrations monitored and measured against established limits?
5. Does the bank monitor conditions in the CRE market(s) in its lending area(s) to confirm that its CRE lending policies continue to be appropriate, given market conditions?
6. Are the bank's CRE lending policies reviewed and approved by the board at least annually?

Appraisal and Evaluation Program

7. Does the board approve the bank's policy or procedures for appraisals and evaluations at least annually?
8. Are the bank's policy and procedures for appraisals and evaluations in writing and readily available to bank personnel?
9. If the bank has an appraisal department, is it independent and isolated from influence by loan production and collection staff?
10. Does the bank have separate policies and procedures for each department or line of business?
11. Does the bank have an internal review procedure to determine whether appraisal policies and procedures, including those related to monitoring third-party relationships, are being followed consistently and comply with regulations?
12. Does appraisal policy address when appraisals are required?
13. Does appraisal policy address when appraisals are not required but evaluations are?
14. Does appraisal policy address when neither appraisals nor evaluations are required?
15. Does the bank's policy or procedures provide for the monitoring of real estate collateral values for OREO?
16. Does the bank's policy or procedures provide for the monitoring of collateral values for portfolio loans (e.g., monitoring values for CRE loans with potential or well-defined weaknesses)?

Appraisals—External

17. Are appraisals ordered by the appraisal department or an entity or employee that is independent of loan production and collection functions?
18. Are appraisers selected and engaged for each assignment based on their competency and experience in appraising similar properties in the subject property's market?
19. Does the bank maintain an approved appraiser list?
20. If the bank maintains a list of approved appraisers,
 - does the bank investigate the qualifications of appraisers before placing them on the list of approved appraisers?

- does the bank periodically confirm that the appraisers on the bank's list continue to be certified or licensed?
- does the bank periodically test appraisals to verify that inadequate appraisers are not being used and are removed from the approved list if one is used?
- does the bank have procedures in place for removing and reinstating appraisers from the approved list if one is used?

21. Does the policy state that the loan officers cannot recommend an appraiser to be considered for or excluded from an assignment?

22. Are there procedures for appraisal ordering?

23. Does the bank provide written instructions or engagement letters to the engaged appraiser?

24. Is the appraiser instructed to develop an opinion of market value as defined in the appraisal regulation?

25. Is the appraiser isolated from influence, pressure, or coercion?

26. Does the bank confirm that appraisers are paid a customary and reasonable fee?

Appraisals—Internal

27. Are staff appraisers appropriately licensed or certified and competent for the assignment?

28. Does the bank occasionally have appraisals performed by staff reviewed by external appraisers?

Appraisal Review Processes

29. Does the bank's policy require that every CRE appraisal be reviewed and each review documented?

30. Does the bank have procedures to evaluate and address the independence, education, training qualifications, and role of reviewers?

31. Does the bank's policy establish a process for resolving any deficiencies in appraisals or evaluations and set forth documentation standards for the review and the resolution of noted deficiencies?

32. Are appraisals reviewed and approved before funds are advanced?

33. Are any appraisal reviews outsourced to a third party? If so,

- does bank policy state when such outsourcing is to occur?

- are procedures in place to test the quality of outsourced reviews?
- does the reviewer use bank-developed review documentation and specifications?
- does the bank have a quality control procedure in place for these reviews?

34. For internally performed reviews, is the employee independent of the loan production and collection functions?

Evaluations

35. Has the bank developed appropriate procedures for when and how evaluations may be performed?

36. Has the bank developed procedures to evaluate the experience and competency of evaluators?

37. Do bank employees outside the appraisal department prepare evaluations? Is their independence supported by precluding them from the loan production and collection functions?

38. Is there a list of approved internal evaluators?

39. Is there training for internal evaluators?

40. Is there a standard evaluation form?

41. Are procedures in place to review evaluations before funds are advanced?

42. Are all evaluations reviewed and is each review documented?

Other

43. Does the bank require that documentation files (e.g., credit or collateral files) include appraisal reports?

44. Does the bank require that documentation files (e.g., credit or collateral files) include appraisal reviews?

45. Does bank policy note that residential (one- to four-unit) appraisals must be provided to borrowers upon request?⁹³

46. Are appraisal fees paid directly by the bank?

47. Are appraisal fees the same amount regardless of whether the loan is granted?

⁹³ Refer to 12 CFR 1002, "Equal Credit Opportunity Act (Regulation B)."

Construction Loans

Questions 48 through 56 focus on CRE construction lending. Additional questions concerning other applicable internal controls for CRE lending resume with question 57.

48. Does the board approve the bank's construction loan policy at least annually?
49. Are the bank's policy and procedures for construction loans in writing and readily available to bank personnel?
50. If the bank has a construction risk department, is it independent and isolated from influence by loan production and collection staff?
51. Does the bank require
 - detailed resumes of the contractor's and major subcontractors' construction experience, as well as other projects under construction?
 - current and historical financial statements?
 - trade reputation checks?
 - credit checks?
 - bonding company checks?
 - construction completion schedule?
 - construction reviews and inspections?
52. Do project cost estimates include
 - land and construction costs?
 - off-site improvement expenses?
 - cost of legal services?
 - loan interest, supervisory fees, and insurance expenses?
53. Does the bank require a line-item budget or cost breakdown for each construction stage?
54. Does the bank require that plans, schedules, and cost estimates of more complicated projects be reviewed by qualified personnel, e.g., architect, construction engineer, or construction consultant?
55. Do cost budgets include the amount and source of the builder's or owner's equity contribution?
56. Do budgets include a contingency allowance for costs not included in the agreement with the contractor?

Loan Agreements and Other Documents

57. Are the loan agreement and other documents reviewed by counsel and other experts to determine that improvement specifications conform to

- building codes?
- subdivision regulations?
- zoning and ordinances?
- title or ground lease restrictions?
- health regulations?
- known or projected environmental protection considerations?
- specifications required under the National Flood Insurance Program?
- provisions in tenant leases?
- specifications approved by the permanent financier when applicable?
- specifications required by the completion bonding company or guarantors?

58. Does the bank require all change orders to be approved in writing by

- the bank?
- permanent financier if permanent funding not provided by the bank?
- architect or supervising engineer?
- prime tenants bound by firm leases or letters of intent to lease?
- completion bonding company?

59. Does the loan agreement establish a date for project completion?

60. Does the loan agreement require that

- on-site inspections be permitted?
- disbursement of funds be made as work progresses?
- the lender approve in advance changes to the improvements?
- the disbursement of funds for deposits and materials not yet installed at the property is at the lender's discretion?
- the bank be allowed to withhold disbursements if work is not performed in accordance with approved specifications?
- a portion of the loan proceeds be retained pending satisfactory completion of the construction?
- the lender be allowed to assume prompt and complete control of the project in the event of default and an assignment of all development and construction-related contracts and agreements?
- the contractor carry builder's risk and workmen's compensation insurance?
- builder's risk insurance be on a nonreporting form or a reporting form that requires periodic increases in the project's value to be reported to the insurance company?
- the bank authorize individual tract housing starts?
- the tract developer submits periodic sales reports?

- the tract developer submits periodic reports on tract houses occupied under rental or lease purchase option agreements?
- the tract developer submits periodic reports on the status of any other projects in which the developer may be involved?

Collateral

61. Does the bank place primary collateral reliance on first liens on CRE?

62. Does the bank temper the collateral reliance placed on

- ground leases?
- conditional sales contracts?

63. Does the bank require that construction loans

- be limited to a percent of the completed cost or market value of the project?
- be subject to the bank's own take-out commitment be limited to a percent of the appraised value of the completed project?
- be limited to the floor of a take-out commitment predicated on achievement of rents or lease occupancy?

64. Do construction loan policies preclude the issuance of standby commitments to "gap finance" projects with take-out conditions regarding rentals or occupancy?

65. Are unsecured credit lines to contractors or developers who are also being financed by secured construction loans supervised by

- the construction loan department?
- the officer supervising the construction loan?

Inspections

66. Are inspection requirements noted in

- the loan documents the loan agreement, mortgage, or deed of trust?
- take-out commitment and tri-party buy and sell agreement, if applicable?

67. Are inspections conducted on an irregular schedule?

68. Are inspection reports sufficiently detailed to support disbursements?

69. Are inspectors competent and independent of the loan origination function?

70. Are spot checks made of the inspectors' work?

71. Do inspectors determine compliance with plans and specifications as well as progress of work?

Disbursements

72. Are disbursements

- advanced on a prearranged disbursement plan?
- made only after reviewing written inspection reports?
- subject to advance, written authorization by the
 - contractor?
 - borrower?
 - inspector?
 - lending officer?
- reviewed by a bank employee who had no part in granting the loan?
- compared with original cost estimates?
- checked against previous disbursements?
- made directly to subcontractors?
- supported by invoices describing the work performed and the materials furnished?

73. Does the bank update its title policy by obtaining a “date down” endorsement with each draw in jurisdictions when applicable?

74. Does the bank obtain waivers of subcontractors’ and materialmen’s liens as work is completed and disbursements made?

75. Are periodic reviews made of undisbursed loan proceeds to verify the construction loan is in balance with adequate funds remaining to complete the projects?

76. Does the bank confirm that a certificate of occupancy has been obtained before final disbursement?

77. Does the bank obtain sworn and notarized releases of mechanics’ liens at the time construction is completed and before final disbursement?

78. Are independent proofs made at least monthly of undisbursed loan proceeds and contingency or escrow accounts? Are statements on such accounts regularly mailed to customers?

Take-Out Commitments

79. In the event loan repayment is dependent on take-out financing,

- are take-out agreements reviewed for acceptability by legal counsel?

- are financial statements obtained and reviewed to determine the financial responsibility of permanent lenders?
- is a tri-party buy and sell agreement signed before the construction loan is closed?
- does the bank require take-out agreements to include an “act of God” clause, which provides for an automatic extension of the completion date if construction delays occur for reasons beyond the builder’s control?
- does the bank accept standby commitments for “gap financing” of limited take-out commitments?

Completion Bonding Requirements

80. Does the bank require a completion insurance bond for all construction loans?
81. Does counsel review completion insurance bonds for acceptability?
82. Has the bank established minimum financial standards for borrowers who are not required to obtain completion bonding? Are the standards observed in all cases?

Documentation

83. Does the bank require and maintain documentary evidence of

- the contractor’s payment of
 - employee withholding taxes?
 - builder’s risk insurance?
 - workmen’s compensation insurance?
 - public liability insurance?
- the property owner’s payment of
 - real estate taxes?
 - hazard insurance premiums?

84. Does the bank require that documentation files include

- loan applications, if used?
- loan commitments?
- financial statements for the
 - borrower?
 - builder?
 - proposed prime tenant?
 - take-out lender?
 - guarantors?
- credit and trade checks on the
 - borrower?
 - builder?
 - major subcontractor?

- proposed tenants?
 - a copy of plans and specifications?
 - a copy of the building permit?
 - a survey of the property?
 - soil report?
 - environmental assessment?
 - loan commitment?
 - loan agreement?
 - appraisal or evaluation?
 - mortgage or deed of trust?
 - ground leases?
 - assignment of tenant leases or letters of intent to lease?
 - rent rolls?
 - tenant estoppels?
 - copies of any other legally binding agreements between the borrower and tenants (e.g. co-tenancy clauses, go-dark clauses)?
 - reports of past-due leases, including delinquent expense reimbursements?
 - a copy of take-out commitment, if applicable?
 - a copy of the borrower's application to the take-out lender?
 - a tri-party buy and sell agreement?
 - inspection reports?
 - disbursement authorizations?
 - undisbursed loan proceeds and contingency or escrow account reconcilements?
 - title and hazard insurance policies?
 - evidence of zoning or a zoning endorsement to the title policy?
 - evidence of the availability of utilities to the site?
85. Does the bank employ standardized checklists to control documentation for individual files?
86. Do documentation files note all the borrower's other loan and deposit account relationships?
87. Does the bank use tickler files that
- control stage advance inspections and disbursements?
 - assure prompt administrative follow-up on items sent for
 - recording?
 - attorney's opinion?
 - expert review?
88. Does the bank maintain tickler files that will provide at least 30 days advance notice before expiration of
- take-out commitment?

- hazard insurance?
- workmen's compensation insurance?
- public liability insurance?

CRE Loan Records

89. Is the preparation and posting of subsidiary loan records performed or adequately supervised by persons who do not also
 - issue official checks or drafts singly?
 - handle cash?
90. Are the subsidiary loan records reconciled daily with the appropriate general ledger accounts and are reconciling items investigated by persons who do not also handle cash?
91. Are loan statements, delinquent account collection requests, and past-due notices checked to the trial balances used in reconciling loan subsidiary records to general ledger amounts, and are they handled only by persons who do not also handle cash?
92. Are inquiries about loan balances received and investigated by persons who do not also handle cash?
93. Are documents supporting recorded credit adjustments checked or tested subsequently by persons who do not also handle cash (if so, explain briefly)?
94. Is a daily record maintained summarizing note transaction details, that is, loans made, payments received, and interest collected, to support applicable general ledger account entries?
95. Are frequent note and liability ledger trial balances prepared and reconciled to controlling accounts by employees who do not process or record loan transactions?
96. Are subsidiary payment records and files pertaining to serviced loans segregated and identifiable?
97. Are properties under foreclosure proceedings segregated?
98. Is an overdue accounts report generated frequently? If so, how frequently?

Loan Interest and Commitment Fees

99. Is the preparation, addition, and posting of interest and fees records performed or reviewed by persons who do not also
 - issue official checks or drafts singly?
 - handle cash?

100. Are any independent interest and fee computations made and compared, or adequately tested, with initial interest records by persons who do not also

- issue official checks or drafts singly?
- handle cash?

101. Are fees and other charges collected in connection with loans accounted for in accordance with ASC Subtopic 310-20, “Nonrefundable Fees and Other Costs”?

Other Areas of Interest

102. Does the bank take steps to determine whether there are environmental hazards associated with the CRE proposed to be mortgaged? Are policies in place for the bank to

- identify, evaluate, and monitor potential environmental risks associated with its lending operations?
- determine the extent of due diligence necessary to protect the bank’s business interests?
- assesses the potential adverse effect of environmental contamination on the value of real property securing its loans, including any potential environmental liability associated with foreclosing on contaminated properties?

103. When there is reason to believe that there may be serious environmental problems associated with property that it holds as collateral, does the bank

- take steps to monitor the situation to minimize any potential liability on the part of the bank?
- seek the advice of experts, particularly when the bank may be considering foreclosing the contaminated property?

104. Are all CRE loan commitments issued in written form?

105. Are loan officers prohibited from processing loan payments?

106. Is the receipt of loan payments by mail recorded upon receipt independently before being sent to and processed by a note teller?

107. Regarding mortgage documents,

- has the responsibility for the document files been established?
- does the bank use a check sheet to ensure that required documents are received and on file?
- are safeguards in effect to protect notes and other documents?
- does the bank obtain a signed application form for all CRE mortgage loan requests?
- are separate credit files maintained?

- is there a program of systematic follow-up to determine that all required documents are received?
- does a designated employee conduct a review after loan closing to determine whether all documents are properly drawn, executed, and in the bank's files?
- are all notes and other instruments pertaining to paid-off loans returned promptly to the borrower, cancelled and marked paid, when appropriate?

108. Regarding insurance coverage,

- does the bank have a mortgage errors and omissions policy?
- is there a procedure for determining that insurance premiums are current on properties securing loans?
- does the bank require that the policies include a loss payable clause to the bank?
- are escrow accounts reviewed at least annually to determine whether monthly deposits cover anticipated disbursements?
- do records showing the nature and purpose of the disbursement support disbursements for taxes and insurance?
- if advance deposits for taxes and insurance are not required, does the bank have a system to determine that taxes and insurance are being paid?

109. Are properties to which the bank has obtained title immediately transferred to OREO?

110. Does the bank have a written schedule of fees, rates, terms, and types of collateral for all new loans?

111. Are approvals of CRE advances reviewed, before disbursement, to determine that such advances do not increase the borrower's total liability to an amount in excess of the bank's legal lending limit?

112. Are procedures in effect to promote compliance with the requirements of government agencies insuring or guaranteeing loans?

113. Are detailed statements of account balances and activity mailed to mortgagors at least annually?

Conclusion

114. Is the foregoing information an adequate basis for evaluating internal controls?
Are there any significant additional internal auditing procedures, accounting controls, administrative controls, or other circumstances that impair any controls or mitigate any weaknesses? Explain negative answers briefly, and indicate conclusions as to their effect on specific examination or verification procedures?

115. Based on the answers to the foregoing questions, internal controls for CRE lending are considered (strong, satisfactory, insufficient, weak).

Verification Procedures

Verification procedures are used to verify the existence of assets and liabilities, or test the reliability of financial records. Examiners generally do not perform verification procedures as part of a typical examination. Rather, verification procedures are performed when substantive safety and soundness concerns are identified that are not mitigated by the bank's risk management systems and internal controls.

1. Reconcile the trial balance to the general ledger. Include loan commitments and other contingent liabilities in the testing.
2. Using an appropriate sampling technique, select loans from the trial balance and
 - prepare and mail confirmation forms to borrowers. (Loans serviced by other institutions, either whole loans or participations, should be confirmed only with the servicing institution. Loans serviced for other institutions, either whole loans or participations, should be confirmed with the other institution and the borrower. Confirmation forms should include the borrower's name, loan number, original amount, interest rate, current loan balance, contingency and escrow account balance, and a brief description of the collateral.)
 - After a reasonable time, mail second requests.
 - Follow up on any no-replies or exceptions and resolve differences.
 - examine notes for completeness and reconcile date, amount, and terms to trial balance.
 - In the event any notes are not held at the bank, request confirmation with the holder.
 - See that required initials of approving officer are on the note.
 - See that the note is signed, appears to be genuine, and is negotiable.
 - compare collateral held in files with the description on the collateral register. List and investigate all collateral discrepancies.
 - determine whether any collateral is held by an outside custodian or has been temporarily removed for any reason. Request confirmation for any collateral held outside the bank.
 - determine whether each file contains documentation supporting guarantees and subordination agreements, when appropriate.
 - determine whether any required insurance coverage is adequate and that the bank is named as loss payee.

- review participation agreements making excerpts, when deemed necessary, for such items as rate of service fee, interest rate, retention of late charges, and remittance requirements, and determine whether the customer has complied.
 - review loan agreement provisions for hold back or retention, and determine whether undisbursed loan funds or contingency or escrow accounts are equal to retention or hold-back requirements.
 - if separate reserves are maintained, determine whether debit entries to those accounts are authorized in accordance with the terms of the loan agreement and are supported by inspection reports, certificates of completion, individual bills, or other evidence.
 - review disbursement ledgers and authorizations, and determine whether authorizations are signed in accordance with the terms of the loan agreement.
 - reconcile debits in the undisbursed loan proceeds accounts to inspection reports, individual bills, or other evidence supporting disbursements.
3. Review the accrued interest accounts, and
- review procedures for accounting for accrued interest and handling of adjustments.
 - scan accrued interest and income accounts for any unusual entries, and follow up on any unusual items by tracing to initial and supporting records.
4. Obtain or prepare a schedule showing the amount of monthly interest income and the CRE loan balances at the end of each month since the last examination, and
- calculate or check yield.
 - investigate significant fluctuations or trends.
5. Using a list of nonaccruing loans, check loan accrual records to determine whether interest income is not being accrued.

Appendixes

Appendix A: Quantity of Credit Risk Indicators

Examiners should consider the following indicators when assessing the effect of CRE lending activities on credit risk.

Low	Moderate	High
The level of CRE loans outstanding is low relative to capital.	The level of CRE loans outstanding is moderate relative to capital.	The level of CRE loans outstanding is high relative to capital.
CRE growth rates are supported by local, regional, or national economic trends. Growth, including off-balance-sheet activities, has been planned for and is commensurate with management and staff expertise, as well as operational capabilities.	CRE growth rates exceed local, regional, or national economic trends. Growth, including off-balance-sheet activities, has not been planned for or exceeds planned levels and may test the capabilities of management, credit staff, and MIS.	CRE growth rates significantly exceed local, regional, or national economic trends. Growth, including off-balance-sheet activities, has not been planned for or exceeds planned levels and stretches the experience and capability of management, credit staff, and MIS. Growth may also be in new products or outside the bank's traditional lending area.
Interest and fee income from CRE lending activities is not a significant portion of loan income.	Interest and fee income from CRE lending activities is an important component of loan income; however, the bank's lending activities remain diversified.	The bank is highly dependent upon interest and fees from CRE lending activities. Management may seek higher returns through higher risk types of products or customers. Loan yields may be disproportionate relative to risk.
The bank's CRE portfolio is well diversified with no single large concentrations or a few moderate concentrations. Concentrations are well within reasonable internal limits. The CRE portfolio mix does not materially affect the risk profile.	The bank has a few material CRE concentrations that may be approaching internal limits. The CRE portfolio mix may increase the bank's credit-risk profile.	The bank has large CRE concentrations that may exceed internal limits. The CRE portfolio mix increases the bank's credit-risk profile.
CRE underwriting is conservative. Policies and procedures are reasonable. CRE loans with structural weaknesses or underwriting exceptions are occasionally originated; however, the weaknesses are effectively mitigated.	CRE underwriting is satisfactory. The bank has an average level of CRE loans with structural weaknesses or exceptions to underwriting standards. Exceptions are reasonably mitigated and consistent with competitive pressures and reasonable growth objectives.	CRE underwriting is liberal and policies are inadequate. The bank has a high level of CRE loans with structural weaknesses or underwriting exceptions the volume of which expose the bank to loss in the event of default.

Low	Moderate	High
Collateral requirements for CRE loans are conservative. Appraisals and evaluations are reasonable, timely, and well supported. Reviews are appropriate and reliable.	Collateral requirements for CRE loans are acceptable. Some collateral exceptions exist but are reasonably mitigated and monitored. A moderate volume of appraisals or evaluations are not well supported or are not always obtained in a timely manner. A moderate volume of reviews may not be appropriate or reliable.	Collateral requirements for CRE loans are liberal, or if policies are conservative, substantial deviations exist. Appraisals and evaluations are not always obtained, frequently unsupported or unreliable, or reflect inadequate protection. Updated appraisals or evaluations are not obtained in a timely manner. Reviews are often not performed or are inadequate.
The level of CRE loan documentation or collateral exceptions is low and has minimal effect on the bank's risk profile.	The level of CRE loan documentation or collateral exceptions is moderate; however, exceptions are reasonably mitigated and corrected in a timely manner, if applicable. The risk of loss from these exceptions is not material.	The level of CRE loan documentation or collateral exceptions is high. Exceptions are not mitigated and not corrected in a timely manner. The risk of loss from the exceptions is heightened.
CRE loan distribution across the pass category is consistent with a conservative risk appetite. Migration trends within the pass category favor the less risky ratings. Lagging indicators, including past dues and nonaccruals, are low and stable.	CRE loan distribution across the pass category is consistent with a moderate risk appetite. Migration trends within the pass category may favor riskier ratings. Lagging indicators, including past dues and nonaccruals, are moderate and may be slightly increasing.	CRE loan distribution across the pass category is heavily skewed toward riskier pass ratings. Lagging indicators, including past dues and nonaccruals, are moderate or high, and the trend is increasing.
The volume of classified and special mention CRE loans is low and is not skewed toward more severe risk ratings.	The volume of classified and special mention CRE loans is moderate but is not skewed toward more severe ratings.	The volume of classified and special mention CRE loans is moderate or high, skewed to the more severe ratings, and increasing.
CRE refinancing and renewal practices raise little or no concern about the quality of CRE loans and the accuracy of reported problem loan data.	CRE refinancing and renewal practices pose some concern about the quality of CRE loans and the accuracy of reported problem loan data.	CRE refinancing and renewal practices raise substantial concerns about the quality of CRE loans and the accuracy of reported problem loan data.
The volume of CRE loans with environmental concerns is not significant. Environmental evaluations are timely, appropriate, and well supported.	The volume of CRE loans with environmental concerns is moderate; however, the risks are identified and reasonably mitigated. Environmental evaluations are not always performed in a timely manner.	The volume of CRE loans with environmental concerns is material if left uncorrected. Environmental evaluations are not performed in a timely manner, or management's response to identified environmental concerns is not appropriate.

Appendix B: Quality of Credit Risk Management Indicators

Examiners should consider the following indicators when assessing the effect of CRE lending activities on credit risk management.

Strong	Satisfactory	Insufficient	Weak
There is a clear, sound CRE credit culture. The tolerance for risk is well communicated and fully understood.	The intent of CRE lending activities is generally understood, but the culture and risk tolerances may not be clearly communicated or uniformly implemented throughout the institution.	The tolerance for risk is not well understood or effectively communicated.	The CRE credit culture is absent or materially flawed. Risk tolerances may not be well understood.
CRE initiatives are consistent with a conservative risk appetite and promote an appropriate balance between risk-taking and strategic objectives. New CRE loan products are well researched, tested, and approved before implementation.	CRE initiatives are consistent with a moderate risk appetite. Generally, there is an appropriate balance between risk-taking and strategic objectives; however, anxiety for income may lead to higher-risk transactions. New CRE loan products may be implemented without sufficient testing, but risks are generally understood.	CRE lending initiatives may not be consistent with a moderate risk appetite. Anxiety for income is resulting in higher-risk transactions, and new products are being launched without sufficient testing. Risk-taking is evident and severe enough to warrant supervisory concerns.	CRE initiatives are liberal and encourage risk-taking. Anxiety for income dominates planning activities. New CRE loan products are implemented without conducting sufficient due diligence.
The appraisal and evaluation program is fully effective. Policies reflect regulatory requirements and sound risk management. Processes are sufficient to promote consistent implementation of policies. Staff responsible for performing or oversight of appraisals and evaluations, and reviews are competent, independent, and have the appropriate experience and training.	The appraisal and evaluation program is effective in most respects, but improvement is needed in one or more areas such as sufficient personnel, independence, review, engagement, or collateral monitoring; policies and processes may require some modification or some improvement may be needed. Staff may require additional training in some areas.	The appraisal and evaluation program is ineffective in many respects, and improvement is needed in a number of areas; policies and processes may require modification or improvement may be needed. Staff may require training in some areas.	The appraisal and evaluation program is ineffective. Policies and processes do not adequately reflect regulations or sound risk management or are not implemented. Staff performing appraisal-related duties do not have sufficient training or experience. Collateral values in general may be unreliable.
Management is effective. The CRE lending staff possesses sufficient expertise to effectively administer the risk assumed. Responsibilities and accountability are clear, and appropriate remedial or corrective action is taken when needed.	Management satisfactorily manages CRE risk, but improvement may be needed in one or more areas. CRE staff generally possesses the expertise to administer assumed risks; however, additional expertise may be required in one or	Management of CRE risk is satisfactory in some respects, but improvement is needed in a number of areas. CRE staff possess some of the expertise to administer assumed risks but more expertise is needed. Responsibilities and accountability	CRE risk management is deficient. CRE staff may not possess sufficient expertise or may demonstrate an unwillingness to effectively administer the risk assumed. Responsibilities and accountability may not be clear. Corrective actions

Strong	Satisfactory	Insufficient	Weak
	more areas. Responsibilities and accountability may require some clarification. In general, appropriate remedial or corrective action is taken when needed.	require some clarification, and appropriate or corrective action may be required.	are insufficient to address root causes of problems.
Concentration risk management is effective. CRE concentration limits are set at reasonable levels. CRE concentration risk-management practices are sound, including management's efforts to reduce or mitigate exposures. Management effectively identifies and understands correlated risk exposures and their potential effect.	Concentration risk management is adequate, but certain aspects may need improvement. CRE concentrations are identified and reported, but limits and other action triggers may be absent or moderately high. Concentration management efforts may be focused at the individual loan level, while portfolio level efforts may be inadequate. Correlated exposures may not be identified, and their risks not fully understood.	Concentration risk management is adequate in some aspects, but other aspects need improvement. Concentrations may not be fully identified and reported, or limits and other action triggers are absent. Concentration management efforts are focused at the individual loan level, and portfolio-level efforts are inadequate. Correlated exposures are not identified, and their risks not understood.	Concentration risk management is passive or deficient. Management may not identify concentrations, or take little or no action to reduce, limit, or mitigate the associated risk. Limits may be established but represent a significant portion of capital. Management may not understand exposure correlations and their potential effect. Concentration limits may be exceeded or raised frequently.
Loan management and personnel compensation structures provide appropriate balance between loan or revenue production, loan quality, and portfolio administration, including risk identification.	Loan management and personnel compensation structures provide reasonable balance between loan or revenue production, loan quality, and portfolio administration.	Some imbalances exist between loan management and personnel compensation structures. Loan or revenue production, loan quality, and portfolio administration are not well balanced.	Loan management and personnel compensation structures are skewed to loan or revenue production. There is little evidence of substantive incentives or accountability for loan quality and portfolio administration.
CRE staffing levels and expertise are appropriate for the size and complexity of CRE activities. Staff turnover is low, and the transfer of responsibilities is orderly. Training programs facilitate ongoing staff development.	CRE staffing levels and expertise are generally adequate for the size and complexity of CRE activities. Staff turnover is moderate and may result in some temporary gaps in portfolio management. Training initiatives are adequate.	CRE staffing levels and expertise need improvement in some areas. Staff turnover has resulted in some gaps in portfolio management.	CRE staffing levels and expertise are deficient. Turnover is high. Management does not provide sufficient resources for staff training.
CRE lending policies effectively establish and communicate portfolio objectives, risk tolerances, and loan underwriting and risk-selection standards.	CRE lending policies are fundamentally adequate. Enhancement, although generally not critical, can be achieved in one or more areas. Specificity of risk tolerance or underwriting standards may need improvement to fully communicate policy requirements.	CRE lending policies require improvement and enhancement in a number of areas. Specificity of risk tolerance or underwriting standards need improvement to communicate policy requirements.	CRE lending policies are deficient in one or more ways and require significant improvements. Policies may not be clear or are too general to adequately communicate portfolio objectives, risk tolerances, and underwriting and risk-selection standards.

Strong	Satisfactory	Insufficient	Weak
Staff effectively identifies, approves, tracks, and reports significant policy, underwriting, and risk-selection exceptions individually and in aggregate, including risk exposures associated with off-balance-sheet activities.	Staff identifies, approves, and reports significant policy, underwriting, and risk-selection exceptions on a loan-by-loan basis, including risk exposures associated with off-balance-sheet activities. Little aggregation or trend analysis is conducted, however, to determine the effect on portfolio quality.	Staff identifies, approves, and reports significant policy, underwriting, and risk-selection exceptions in many but not all cases, including risk exposures associated with off-balance-sheet activities. Aggregation or trend analysis may not be adequate to determine the effect on portfolio quality.	Policy exceptions may not receive appropriate approval, significant policy exceptions may be approved but not reported individually or in aggregate, or their effect on portfolio quality is not analyzed. Risk exposures associated with off-balance-sheet activities may not be considered.
Credit analysis is thorough and timely both at underwriting and periodically thereafter.	Credit analysis appropriately identifies key risks and is conducted within reasonable time frames. Post-underwriting analysis may need some strengthening.	Credit analysis may not appropriately identify key risks in many cases. Post-underwriting analysis may be deficient in some areas and need strengthening.	Credit analysis is deficient. Analysis is superficial and key risks are overlooked. Credit data are not reviewed in a timely manner.
Risk-rating and credit risk review and identification systems are accurate and timely. Credit risk is effectively stratified for both problem and pass credits. Systems serve as effective early warning tools and support risk-based pricing, the ALLL or ACL, and capital allocations.	Risk-rating and credit risk review and identification systems are adequate. Problem and emerging problem credits are adequately identified, although room for improvement exists. The number of rating categories for pass credits may need to be expanded to facilitate early warning, risk-based pricing, or capital allocations.	Risk-rating and credit risk review and identification systems need improvement in some key areas. Problem and emerging problem credits are not adequately identified in some cases, and improvement is required.	Risk-rating and credit risk review and identification systems are deficient. Problem credits may not be identified accurately or in a timely manner resulting in misstated levels of portfolio risk. The number of rating categories for pass credits is insufficient to stratify risk for early warning or other purposes.
Special mention ratings do not indicate any administration issues within the CRE portfolio.	Special mention ratings generally do not indicate administration issues within the CRE portfolio.	Special mention ratings indicate administration issues within the CRE portfolio in some cases.	Special mention ratings indicate management is not properly administering the CRE portfolio.
Management and board reports provide accurate, timely, and complete CRE portfolio information. Management and the board receive appropriate reports to analyze and understand the effect of CRE activities on the bank's credit-risk profile, including off-balance-sheet activities. MIS facilitate timely reporting of exceptions.	Management and board reports are adequate. Management and the board generally receive appropriate reports to analyze and understand the effect of CRE activities on the bank's credit-risk profile; however, modest improvement may be needed in one or more areas. MIS facilitate generally timely reporting of exceptions.	Management and board reports need improvement in some key areas. Management and the board may not receive all appropriate reports to fully analyze and understand the effect of CRE activities on the bank's credit-risk profile; improvement is needed in key areas. Exception reporting requires some improvement.	Management and board reports are deficient. The accuracy or timeliness of information may be affected in a material way. Management and the board may not be receiving sufficient information to analyze and understand the effect of CRE activities on the bank's credit-risk profile. Exception reporting requires significant improvement.

Appendix C: Supervisory Loan-to-Value Limits

The SLTV limits represent the maximum permissible LTV that meets the supervisory guidelines. The LTV ratio is only one of several important credit factors to be considered when underwriting a CRE loan. Because of these other factors, the establishment of these supervisory limits should not be interpreted to mean that loans underwritten to these limits are automatically considered sound. The following sections provide more information regarding determining the appropriate SLTV.

Standby Letters of Credit

Standby letters of credit secured by the property that are issued to governmental authorities to ensure the completion of certain improvements, the cost of which are to be funded by the loan, need not be included in the loan amount for the purpose of calculating the SLTV. When the cost of the improvements is to be funded from other sources, however, the standby letter of credit should be included.

The value used in calculating the SLTV can be as-is, as-complete, or as-stabilized. An as-is value would be appropriate for calculating the SLTV for raw land or stabilized properties. For an owner-occupied building or a property to be constructed that is preleased, the as-completed value should generally be used. An as-stabilized value would be appropriate for an existing property that is not stabilized or a property to be constructed that is not preleased to stabilized levels. For definitions of as-completed and as-stabilized, refer to appendix G of this booklet.

Applying SLTV Limits to Loans Financing Various Stages of Development

SLTV limits should be applied to the underlying property that collateralizes the loan. For loans that fund multiple stages of the same CRE project (for example, a loan for land acquisition, land development, and construction of an office building), the appropriate LTV limit for the completed project is the limit applicable to the final stage of the project funded by the loan. Total disbursements for each element of the development, however, are subject to its particular SLTV limits. This can be illustrated by considering the various development stages.

A land development loan is defined in 12 CFR 34, subpart D (national banks), and 12 CFR 160.101 (FSAs) as “an extension of credit for the purpose of improving unimproved real property before the erection of structures. The improvement of unimproved real property may include the laying or placement of sewers, water pipes, utility cables, streets, and other infrastructure necessary for future development.” Finished lot loans and buildable lot loans are synonymous with land development loans. The SLTV ratio for a land development loan, a finished lot loan, or a buildable lot loan is 75 percent. The LTV may not exceed 75 percent until construction of a permanent building begins.

The bank may use the higher appropriate LTV ratio when actual construction begins at the next stage of development. For example, the bank may advance 65 percent for raw land and

up to 75 percent when converting the raw land into finished lots. The bank may advance up to 80 percent of the appraised market value when construction of a permanent commercial, multifamily, or other nonresidential building begins or up to 85 percent when construction of one- to four-family residences begins.

If the bank commits to finance only one phase of development or construction rather than an entire multi-phase tract development project, the loan amount is the legally binding commitment for that stage for purposes of calculating LTV.

Disbursements should not exceed actual development or construction outlays while ensuring that the borrower maintains appropriate levels of hard equity throughout the term of the loan as discussed in the “Underwriting Standards” and “Underwriting Practices” sections of this booklet.

Calculating SLTV for Loan Financing Tract Development

For residential tract developments, the loan amount is the total amount of a loan, line of credit, or other legally binding commitment. For a line of credit, the legally binding commitment amount is based on the term of the credit agreement. For facilities that use a borrowing base formula to determine the funds available to the borrower, the loan amount is the bank’s legally binding commitment (that is, the outstanding balance of the facility plus any availability under the borrowing base). Value is the lesser of the borrower’s actual development or construction costs or the prospective market value of completed units securing the loan multiplied by their percentage of completion.

The value of the CRE collateral for the calculation of the LTV ratio is the market value as defined in the interagency appraisal regulations. (For a definition of market value, refer to appendix G of this booklet.) The appraisal should reflect a market value upon completion of construction of the home(s) and the market value of any other collateral, such as lots or undeveloped land. Further, the appraisal must consider an analysis of appropriate deductions and discounts.⁹⁴ For loans to purchase land or existing lots, “value” means the lesser of the actual acquisition cost or the current market value.

The LTV ratio should be calculated at the time of loan origination and recalculated whenever collateral is released or substituted. If the LTV ratio exceeds the SLTV limits, the bank should comply with guidelines for loans exceeding the SLTV limits.

Calculating SLTV for Loan Collateralized by Two or More Properties

If a loan is cross-collateralized by two or more properties or is secured by a collateral pool of two or more properties, the appropriate maximum loan amount under SLTV limits is the sum of, for each property, the market value of that property, less senior liens on that property, multiplied by the appropriate LTV limit for that property.

⁹⁴ For more information, refer to 12 CFR 34.44, OCC Bulletin 2005-32, and OCC Bulletin 2010-42.

If the total equals or exceeds the loan amount, the loan conforms to the supervisory limits. If the results are less than the loan amount, the loan does not conform to the SLTV limits.

As shown in the following example, if a collateral pool comprises raw land valued at \$75,000 (subject to a \$25,000 prior lien) and an improved commercial property valued at \$250,000 (subject to a \$125,000 prior lien), the maximum total aggregate amount that could be loaned against the collateral pool is \$138,750.

$$\begin{array}{rcl} (\$75,000 - \$25,000) \times 65\% & = & \$ 32,500 \\ (\$250,000 - \$125,000) \times 85\% & = & 106,250 \\ \hline & & \$ 138,750 \end{array}$$

To assess whether collateral margins remain within the SLTV limits, the bank should recalculate the loan's LTV for conformity with these limits whenever collateral substitutions are made to or collateral is released from the collateral pool.

Appendix D: Underwriting Considerations by Property Type

Examiners should understand the unique characteristics and risks associated with various types of properties, and banks should establish prudent policies that consider these characteristics and risks for each loan type they finance. General considerations for the primary property types are discussed in this section. Underwriting metrics are provided only for general information and vary by market, property type, and building characteristics. Appraisals of similar properties and third-party surveys can provide information that is more specific to a property's characteristics and market.

Office

Office buildings can be characterized as suburban or central business district properties and graded in terms of quality from A to C. Class A properties are newer, recently rehabilitated, or very well-maintained properties built of high-quality materials offering retail and other amenities. Class B properties are older or of average construction with few or no amenities and average desirability, while Class C offers space that may be outdated or plain but functional.

Important characteristics to consider when evaluating an office property are the aesthetics of the design and quality of materials, availability of parking, access to public transportation or major roads, and proximity to hotels, shopping, and other amenities. Also important are the size and configurability of the floors (the floor plate) to accommodate tenants requiring various amounts of space, adequacy of elevator service, and the ability to meet current and future technology requirements.

Medical office buildings have unique requirements, including additional plumbing and wiring to accommodate examination room fixtures and equipment. Consequently, costs for construction and tenant improvements are higher than conventional office buildings. These buildings are often located near other medical service providers, such as hospitals, and may feature pharmacies and lab facilities.

Office buildings are usually leased on a gross basis (expenses paid by the landlord) with the tenant typically responsible for expenses directly related to occupancy such as utilities and janitorial. Because terms can vary from lease to lease, however, lease agreements should always be reviewed to determine which expenses are the landlord's responsibility. Lease terms are typically for periods of three, five, or seven years.

Replacement reserves for office properties are typically underwritten on an annual, per-square-foot basis and vary depending on the property's age and condition. Management fees are typically underwritten from 3 percent to 5 percent of **effective gross income**, depending on the number of tenants.

Costs to re-lease space are important underwriting considerations. These costs include leasing commissions and the cost of tenant improvements for new and renewing tenants. Leasing commissions are calculated as a percentage of total lease payments with typical

underwriting assumptions of 4 percent for new leases and 2 percent for renewals. Expenses for tenant improvements are higher for new tenants than for renewing tenants and can vary widely depending on the market and building class. The re-leasing costs can be projected by analyzing the rent roll and using an assumption about the probability of renewals. Re-leasing costs are not always considered as an operating expense in calculating NOI but are an important consideration when analyzing cash flow.

Retail

There are many types of retail properties. They may be anchored, with major tenants that generate traffic for other tenants and provide financial stability, or unanchored. They range in size from very small neighborhood centers serving their immediate communities to super regional malls that may have 1 million square feet or more drawing from very large trade areas.

Demographics, including population concentration and income levels, along with vehicular traffic volume, site configuration, ease of ingress and egress, parking, surrounding residential density, and tenant mix are all important in determining the success of retail properties.

Appropriate site characteristics are critical to the success of retail properties. Some things to consider include the following.

- The traffic count should be suitable for the retail type; small neighborhood centers can be successful on tertiary or secondary roads while larger properties, such as power centers or major malls, require location on or access to primary arteries.
- Properties and signage should be readily visible to passing traffic; sites that are parallel to the primary source of traffic flow are generally superior to sites that are perpendicular to the road, having less frontage and visibility.
- Traffic control devices and turning lanes should permit easy access for vehicles passing in either direction at all times of the day.

Lease terms generally vary by retail type and tenant. Considerations include the following.

- Lease terms typically range from five to 10 years with anchor tenants often signing leases of 20 to 25 years with options to renew.
- Leases are commonly written on a net basis with tenants reimbursing the landlord for common area maintenance, including landscaping, refuse collection, taxes, insurance, and lighting of parking lots and walkways, with the landlord usually responsible for the roof and outer walls. Because terms can vary from lease to lease, however, lease agreements should always be reviewed to determine which expenses are the landlord's responsibility.
- Anchor tenants may pay a flat rate plus a percentage of their annual sales (percentage rent). Percentage rents may vary considerably and are inherently less predictable. The flat rate should be high enough to dissuade the tenant from ceasing operations while maintaining possession to prevent the landlord from leasing to a competitor. It is desirable for an anchor tenant's lease to require continued operations so the tenant may be replaced if it ceases to operate.

- Some lease clauses may call for a decrease in rents or permit termination if an anchor tenant ceases operations (co-tenancy clauses). These clauses make the success of anchor tenants even more critical to the viability of the property.

Retail properties can be at high risk of environmental contamination, especially because of gas station and dry-cleaning activities, and merit close review of past and intended uses and investigation of their current environmental condition.

Tenant improvements provided for retail tenants tend to be minimal, with the landlord usually delivering a so-called “white box” (primed drywall and a concrete floor) to the tenant, who is responsible for finishing the space.

Replacement reserves for retail properties are typically underwritten on an annual per-square-foot basis and vary depending on the property’s age and condition. Management fees are typically underwritten at 3 to 5 percent of effective gross income, exclusive of reimbursements.

Re-leasing costs consist mostly of leasing commissions, which are usually underwritten at 4 percent of the total lease payments for new tenants and 2 percent for renewing tenants as determined by the underwriting assumptions with respect to tenant renewal.

Industrial

Industrial properties include manufacturing, light industrial, warehouse, and distribution facilities. While industrial properties can be in either older or redeveloped urban areas or in the suburbs, their proximity to transportation is an important factor. This is especially true of distribution facilities where access to major highways is crucial.

Industrial buildings can vary widely in size, typically ranging from several thousand to several hundred thousand square feet and may be single- or multi-tenant. Office space usually comprises about 10 to 20 percent of the total square footage of these properties.

Physical characteristics that can accommodate the operations of prospective tenants are critical considerations. Industrial properties usually feature ceiling heights that range from 18 to 30 feet and require sufficient truck bays with a site large enough to permit the maneuvering of large trucks. Electrical capacity and floor thickness are also important considerations. Properties that do not meet these criteria may be at a significant disadvantage relative to competing properties.

Industrial properties with a higher percentage of office space, sometimes 50 percent or more, are commonly referred to as flex, research and development, or high-tech. The industrial portions of these buildings tend to have office-like ceiling heights with few or no truck bays. These properties share many characteristics with office properties, and these characteristics should be considered when the properties are underwritten.

Industrial properties as a group pose the highest risk of environmental contamination and merit close review of past and intended uses and investigation of their current environmental condition.

Manufacturing facilities are often built to accommodate a specific user's needs. The adaptability of the building to meet the needs of other potential users is an important underwriting consideration.

Leases for single-tenant industrial properties are usually written on a net basis with the landlord responsible for maintaining only the roof and outer walls. Because terms can vary from lease to lease, however, lease agreements should always be reviewed to determine which expenses are the landlord's responsibility.

Landlords of multi-tenant properties are typically responsible for common area maintenance and require reimbursement from the tenant. Lease terms of three to five years are common. Replacement reserves for industrial properties are underwritten on an annual per-square-foot basis and vary depending on the age and condition of the property. Management fees typically range from 3 to 5 percent, depending on the number of tenants.

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.

Hospitality

The hospitality industry is highly sensitive to trends in leisure and business spending. Hospitality properties have historically experienced considerable volatility in income and value. Hotel operations can be complex and may have a sizable non-real estate component.

Successful hotel lending requires specialized knowledge and should not be undertaken without an adequate understanding of the hospitality business.

Hotels may be full or limited service. Full-service hotels offer a number of amenities including dining and room service, convenience retail, staff that provide higher levels of service, banquet and convention facilities, recreational facilities, and business support services. Consequently, full-service hotels derive a significant portion of their income from non-room-related activities. Non-room revenue and expense centers include banquet and food and beverage.

Limited-service hotels and motels offer no or limited food service and limited meeting space. Location in close proximity to restaurants is an important consideration for limited-service hotels.

A hotel's franchise, or "flag," is an important factor in the success of a hotel. Flagged hotels benefit from a central reservation service and guest loyalty programs. Other franchise benefits include brand identity, operating guidance, uniform standards, training, and marketing and sales support. To maintain a flag, hotels may be required to meet rigorous maintenance and upkeep requirements which should be factored into operating expenses.

In addition to economic conditions, the following property-specific factors should be considered:

- Current and historical profitability and trends.
- Management quality.
- Reputation of the franchisor.
- Franchise agreement including duration and termination rights.
- Property age, condition, and amenities.
- Age, condition, and quality of FF&E and replacement needs.
- Revenue seasonality.
- Proximity to transportation and demand generators such as office and recreational facilities.
- Adequacy and convenience of parking.

Common performance metrics for hotels are occupancy and average daily rate (ADR) and revenue per available room (RevPAR). The ADR is calculated by dividing the room revenue by the number of rooms occupied for a given period. This calculation should exclude complimentary rooms or other occupancies that do not generate revenue. RevPAR is calculated by multiplying a hotel's ADR by its occupancy rate.

Other income and expenses, such as for food and beverage, banquet, telephone, or internet use, are typically segregated into separate departments. Typical expenses that are not directly attributable to a department, such as management, franchise, sales and marketing fees, and repairs and maintenance, are recorded as unallocated expenses. Real estate taxes and insurance are allocated to fixed expenses.

Studies of industry performance metrics provide an important comparative reference in underwriting loans to hotels. These studies are commercially available and should be used in the bank's underwriting process. While an analysis of historical income and expenses should include a comparison with industry benchmarks to test for reasonableness, the following underwriting considerations are typically reviewed in analyzing a hotel's income and expenses.

- **Franchise fees:** Usually underwritten at the higher of actual or 4 to 6 percent of total revenues.
- **Management fees:** Typically expected to be 4 to 5 percent of gross revenues.
- **Fixed expenses:** Expenses for property taxes, real and personal, should reflect the actual property tax assessment. These expenses should be greater if a reassessment is likely, which frequently happens after a property's sale or renovation. Insurance should reflect the actual expense and include premiums for insuring the real and personal property.
- **Replacement reserves:** Reserves for FF&E typically range from 4 to 6 percent of total revenues.
- **Profit margins:** Vary according to type, franchise, and location. Margins for full-service properties typically range from 20 to 30 percent, and limited-service properties generally range from 30 to 40 percent. Luxury resorts typically range from 20 to 25 percent with extended-stay suites usually ranging from 35 to 42 percent.

Hotel appraisals often include separate values for personal and intangible property that present unique issues when calculating the LTV. For more information, refer to the "Appraisals and Evaluations" section of this booklet.

Residential Health Care

Residential health care facilities typically include independent living, assisted living, and nursing homes. The most significant distinction among these is the level of care provided. While facilities are most often dedicated to one level of care, some may provide a continuum of services.

Independent living, sometimes referred to as congregate care, provides the lowest level of care. The residents do not require daily assistance with living activities and have a high degree of mobility. The facilities share many of the features and amenities of multifamily properties with such additional features as dining rooms and communal living areas. The facilities may offer meals, laundry, and housekeeping. No health care is provided. These properties are not regulated and do not qualify for government reimbursement. Income is generated mostly from unit rental.

Assisted-living facilities provide a range of services for the elderly and disabled that can include meals, laundry, housekeeping, transportation, and assistance with daily living activities, such as dressing and bathing. Assisted-living facilities may be subject to state regulation with varying levels of health care permitted. When more acute medical care is permitted and provided, government reimbursement may be available.

Nursing homes provide 24-hour, non-acute medical care and provide the highest level of living assistance and medical care. Nursing homes are highly regulated and, like hospitals, are subject to state certificates of need. Government reimbursement is a common source of payment.

The demand for residential health care facilities is strongly correlated with local demographics; residents typically want to live in locations convenient to their families, with older populations generating greater demand. The bank should consider the quality, reputation, and experience of the facility's management. Other considerations are adequacy of staffing, staff turnover, the condition and location of the facility, and the quality of care and services.

Assisted-living facilities and nursing homes are sensitive to government reimbursement programs; state and federal policies affecting qualification criteria and reimbursement rates are important considerations in the analysis of these properties. The mix of private and government pay can be a useful measurement in determining the sensitivity of these properties to changes in government reimbursement policies.

Religious Organizations

Religious organizations are nonprofit, corporate entities that are either owned by the membership or by part of a denominational hierarchy. Loans to religious organizations are generally for the acquisition, construction, or expansion of facilities used in worship, community programs, schools, or other related activities.

Unlike many other CRE loans, reliance on collateral liquidation as a secondary source of repayment for these properties can be complicated by the highly specialized nature of the collateral and the reputation risk presented by foreclosure.

Underwriting a loan to a religious organization involves assessing the trend, level, and stability of income and expenses and determining the cash flow available for debt service. Primary income generally consists of tithes, offerings, other ongoing contributions or giving, and other sources of revenue, such as school or day-care income. Nonrecurring income, such as special one-time gifts and income from fund drives or capital campaigns, are regarded as secondary sources of income. Underwriting should assess a religious organization's primary income over at least a three-year period, and significant variances should be examined. Focus should include analysis on the number and trends in **giving units** (a group of family members that regularly support the church). Fixed expenses include general and administrative expenses, debt expenses, and clergy and staff expenses.

Discretionary expenses can include ministry, outreach, and mission program-related expenses. A comprehensive financial analysis should consider the ratio of the loan amount to the gross annual receipts and the ratio of proposed annual debt service to gross annual receipts. Because facilities used for worship are not income-producing properties per se, valuation of these facilities relies heavily on the market and cost approaches.

Sound due diligence typically includes

- history of the organization and membership trends.
- trends in giving units
- history or prior experience with building programs.
- stability and experience of clergy, staff, and lay member leaders.
- hierarchical structure and governance in order to assess other obligors and assets available to support the loan.
- level of commitment from the members.

The collateral, loan terms, and interest rates on the loans necessarily vary depending on the nature of the religious organization and its activities. Ongoing monitoring should generally include an assessment of trends in revenues, expenses, and membership.

Investor-Owned Residential Real Estate

Borrowers may finance multiple properties through one or more banks. Underwriting standards and the complexity of risk analysis should increase as the number of properties financed for a borrower and related parties increases. When a borrower finances multiple IORR properties, a comprehensive global cash-flow analysis of the borrower is generally necessary to properly underwrite and administer the credit relationship. Accordingly, it is prudent to analyze and administer the relationship on a consolidated basis by monitoring performance of all the borrower's properties, including those financed by others.

Ground Leases

Banks may finance land that is to be leased to a tenant that constructs its own improvements or finance the tenant's improvements on ground that is leased from the ground owner.

Ground lease transactions involve various property interests and values: fee-simple, leased-fee, and leasehold interests. Fee-simple interest is the ownership as unencumbered by any other interest; leased-fee interest is an ownership interest held as a landlord (the lessor) with the rights of use and occupancy conveyed by a lease to a tenant; and the leasehold interest is the right held by a tenant (the lessee) for use and occupancy as conveyed by the landlord. Care should be taken in commissioning and reviewing the appraisal to verify that the market value of the appropriate interest is obtained and used to support the loan.

At the end of the ground-lease term, the leasehold improvements revert to the lessor. For this reason, the value of a collateral leasehold interest diminishes over time and has no value upon maturity of the lease. In recognition of this, when the loan does not fully amortize before loan maturity, the expiration of the ground lease should extend sufficiently beyond the amortization period, customarily 20 years, to support refinancing and to help ensure that adequate borrower equity in the project is retained. If the loan does fully amortize during the loan term, a lease term extending 10 years beyond the loan maturity is usually considered sufficient. In calculating debt-service coverage, the ground rent should be deducted as an expense.

The leasehold lender is in the most secure position when the landowner subordinates their interest by granting the bank a first lien on the land to secure the bank's note financing the leasehold interest. If this is not possible, the bank lease agreement should include provisions for a notice to the bank of tenant default under the ground lease and give the lender the right, but not the obligation, to cure any defaults.

When the bank finances the ground lessor's leased-fee interest, the bank may lend up to the lower of 65 percent of market value or cost of the land for its acquisition and then fund up to the appropriate SLTV of the market value of the borrower's leased-fee interest upon the completed construction of the lessee's improvements. In the case of a commercial property, for example, the SLTV limit would be 85 percent of the borrower's leased-fee interest upon completion of all construction.

When the bank finances the tenant's leasehold improvements, the maximum SLTV for construction would be up to a maximum of the relevant SLTV of the market value of the leasehold interest for construction (e.g., 80 percent of the value of the leasehold interest for a commercial property), and once construction is complete, the appropriate SLTV for the type of completed property. In the case of a commercial property, this would be 85 percent of the leasehold interest market value.

When the bank holds a junior lien, the sum of the debt and all senior liens should not exceed the relevant SLTV using the fee-simple market value.⁹⁵

Ground lease arrangements can be quite complex. Banks often engage legal counsel for the review of the lease documents before commitment (or condition commitment on their review) and the drafting of loan documentation.

Affordable Housing Loans

The OCC encourages banks to extend prudent credit to promote community development. By taking the initiative in their communities, banks may establish new markets, reinforce their identity as community institutions, and enhance their performance.⁹⁶

To address the needs of low-income renters, the Tax Reform Act of 1986⁹⁷ created incentives to develop affordable housing by offering tax credits to developers. Proceeds from the sale of these credits subsidize the development costs, thereby permitting the units to be rented at below-market rates. Nearly 90 percent of affordable housing is developed with the support of this program. Many of these projects also benefit from grants and low-interest loans from

⁹⁵ For more information regarding SLTVs, refer to appendix C of this booklet.

⁹⁶ The OCC Community Affairs Department's *Community Development Insights*, "Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks," provides an overview of low-income housing tax credits and discusses key risks and regulatory issues that should be considered for banks providing project financing as lenders or equity through the purchase of tax credits.

⁹⁷ Pub. L. 99-514.

local and state government-sponsored agencies. The bank should consider this assistance in its underwriting.

Appraisers should consider the various types of financial assistance provided to affordable housing projects in estimating market value. When the benefits of such financial assistance are not appropriately reflected in a project's appraisal, the projected NOI of the project may be negatively affected, resulting in a lower market value. When this occurs, a proposed affordable housing loan may not have an LTV ratio sufficient to satisfy the standards of the agencies' real estate lending guidelines or to receive favorable treatment under the agencies' risk-based capital rules.

An appraisal of an affordable housing project should include a market value estimate that reflects the real estate collateral and typical interests in the real estate on a cash or cash-equivalent basis. The agencies' appraisal regulations permit the appraiser to include in the market value estimate any significant financial assistance that would survive sale or foreclosure, such as the value of low-income housing tax credits, subsidies, and grants.

An appraiser engaged to appraise an affordable housing project should be competent to perform such an appraisal, knowledgeable about the various types of financial assistance and programs associated with affordable housing projects, and identify and consider the effect on value of any significant amount of the financial assistance. The appraisal should include a discussion of the value of the financial assistance that would survive sale or foreclosure and how the assistance affects the market value estimate of the project. While certain types of financial assistance, such as tenant-based rent subsidies, do not necessarily transfer to new ownership upon sale or foreclosure, the effect of these items should be appropriately considered in the cash-flow analysis, when applicable.

Real Estate Investment Trusts

A real estate investment trust (REIT) is a tax designation for corporations that buy, develop, manage, and finance real estate assets. REITs qualify as pass-through entities that reduce or eliminate corporate income taxes so long as they conform to certain Internal Revenue Service provisions. For example, REITs are required to distribute at least 90 percent of their income to investors and must derive at least 75 percent of **gross income** from rents or mortgage interest to qualify as pass-through entities. Because REITs do not pay income taxes, REIT dividends are fully taxable and as such do not qualify for the capital gains tax rate. Because REITs pay out the majority of their taxable income to investors, they are reliant on borrowing or the issuance of shares to fund expansion.

There are three major types of REITs.

- **Equity REITs** own real estate and may specialize in a specific property type, such as shopping malls or industrial properties. Alternatively, the assets may be diversified, in which case the REIT owns a mix of properties of various types. Revenues from equity REITs principally come from rental income as well as capital gains from the sale of the properties.

- **Mortgage REITs** lend mortgage money, invest in real estate-backed mortgages often purchased through mortgage originators, or purchase mortgage-backed securities. Revenue from mortgage REITs is generated primarily by the interest they earn on the mortgage loans.
- **Hybrid REITs** combine the investment strategies of equity REITs and mortgage REITs by investing in both properties and mortgages. Revenue from hybrid REITs is a combination of rental and interest income.

REIT performance can be affected by economic conditions that affect each category of specialization. For example, office REITs may be affected more by employment trends than retail REITs, although performance of each property type or geographic concentration tends to follow the general conditions of the real estate market. Thus, employment trends, interest rates, and supply and demand affect certain REITs to varying degrees.

Credit considerations in lending to REITs are similar to other types of commercial lending transactions. Before lending to a REIT, the bank should be familiar with the REIT's structure, its management, the parties to its loan agreement, collateral, if applicable, and the quality of assets held in the REIT. Some REITs may be unsecured but supported by an unencumbered asset pool, or a negative pledge on a pool of properties. REIT credits should be analyzed to determine strength of repayment sources (both cash flow and collateral adequacy), and stress testing should analyze sensitivity to changing economic conditions or under a variety of scenarios, such as interest rates, capitalization rates, and DSCRs. Borrower or tenant concentrations that may exist in the REIT's loan or equity investment portfolios should be considered in the underwriting and ongoing monitoring of loans to REITs.

In analyzing a loan to a REIT, operating cash flow can be measured according to a measurement known as "funds from operations" (FFO), a measure adopted to promote uniform measurement of REIT operating performance by the National Association of Real Estate Investment Trusts. FFO is sometimes used as a supplemental measure of earnings performance to net income because GAAP requires that commercial property owners depreciate the cost of their properties to zero over a prescribed period of time (such as 20 years) even though the properties retain value for years in excess of that depreciation period; a traditional GAAP-based measure of net income tends to overstate expenses and understate earnings.

FFO is derived by adding back depreciation and real estate amortization charges to net income and excludes gains or losses from sale of properties. While FFO measures a REIT's operating cash flow before accounting for administrative and financing expense, there may be variation in the way this measurement is computed and reported in company disclosures. For example, maintenance and repair expenses and other recurring capital expenditures may not be uniformly reflected in the FFO measure. Therefore, it is important to review a company's quarterly or annual report and supplemental disclosures.

Loans Secured by Owner-Occupied Properties

For owner-occupied properties, the primary source of repayment is usually the cash flow generated by the occupying business. Sound analysis typically considers the ability of the occupying business, borrower, and guarantors, if any, to repay the debt. Nevertheless, collateral-focused guidance such as SLTV and appraisals or evaluations remains relevant to the financing of these properties. Proceeds from these loans may finance the acquisition or construction of business premises or may be used for other business purposes such as working capital.

Properties such as hospitals, golf courses, recreational facilities, and car washes are considered owner-occupied unless leased to an unaffiliated party. Hotels, motels, dormitories, nursing homes, assisted-living facilities, mini-storage warehouse facilities, and similar properties are considered non-owner-occupied.

When a property is partially leased to an unaffiliated tenant, the property's classification is determined by the primary source of repayment. If 50 percent or more of the primary source of repayment is derived from third-party, unaffiliated income, the property should be considered non-owner-occupied.⁹⁸

At times, the development of owner-occupied properties may not appear to be economically feasible. Highly specialized improvements required to meet the needs of an owner-occupant can result in a cost greater than the value that can be supported by income generated by leasing to another user. These improvements might include such features as thicker floors and higher ceilings to accommodate specialized machinery and processes. As an owner-occupied loan, the underwriting analysis should emphasize the repayment ability of the occupying business. Underwriting analysis should consider the economic value of the collateral to another user in its underwriting analysis.

In many cases, the owner of the occupying business owns the building as a separate entity and leases it to the business. Care should be taken to ensure that rents used for valuation purposes are consistent with the market to avoid relying on rental rates that have not been established in an arms-length transaction and may be inflated.

Although owner-occupied commercial properties are not included for purposes of measuring CRE concentrations within the context of OCC Bulletin 2006-46, a troubled credit that develops an increased reliance on collateral for repayment can contribute to a bank's CRE concentration risk.

⁹⁸ For more information on defining owner-occupied and non-owner-occupied properties, refer to the call report instructions, Schedule RC-C – Loans and Leases, 1.e.(1): Loans secured by owner-occupied nonfarm nonresidential properties.

Appendix E: Appraisal Review Worksheet

This appendix has a worksheet that examiners may use when reviewing CRE appraisals. The worksheet includes 12 CFR 34 requirements, USPAP requirements, and sound appraisal practices. Some items could be not applicable (NA) depending on the circumstances.

CRE Appraisal Review Worksheet		
	Yes/No/NA	Comments
Appraiser Engagement and Certifications		
1. Was the appraiser engaged directly by the bank? (12 CFR 34.45(b)		
2. If the bank accepted an appraisal prepared for another institution, did the bank determine that the appraisal conformed to the requirements of 12 CFR 34 and was otherwise acceptable? (12 CFR 34.45(b)(2))		
3. Was the appraiser free from direct or indirect interest in the property or transaction? (12 CFR 34.45(a), (b)(1), or (b)(2)(i))		
4. Did the appraiser disclose the steps taken to comply with the competency provision of USPAP?		
5. Was the appraisal performed by a state certified or licensed appraiser? (12 CFR 34.43(a), (d), and (e))		
6. Did the bank review the appraisal for compliance with USPAP? (12 CFR 34.44(c))		
Appraisal Report Content		
7. Is the type of appraisal (e.g., appraisal report or restricted appraisal report)		Type of appraisal:
8. Does the appraisal include the legal description of the property? (USPAP Standards Rule 1-2(e))		
9. Is the “as-is” market value reported?		
10. Is the property description accurate and complete? Consider whether the description includes		
a. the correct facts, such as property address, ownership interest, and square footage?		
b. the actual or approximate year built or anticipated date of completion?		
c. property condition analysis?		
d. building areas and dimensions with reference to the source of these?		
e. adequate photos of improvements?		

CRE Appraisal Review Worksheet		
	Yes/No/NA	Comments
f. overall evaluation of construction quality, design, layout, and appearance?		
11. Did the appraisal consider and analyze any current agreement of sale, option, or listing of the property? (USPAP Standards Rule 1-5(a))		
12. Did the appraisal consider and report, with reasonable detail, sales of the property occurring during the previous three years? (USPAP Standards Rule 1-5(b))		
13. Are any assumptions and limiting conditions consistent with the bank's intended collateral position in the transaction?		
14. Did the appraisal use applicable value approaches, explain omitted approaches, use appropriate techniques, and include a reasonable rationale for the reconciliation of approaches?		Value approaches used:
15. Did the appraisal analyze and report current market conditions? (USPAP Standards Rule 1-3(a))		
16. Did the appraisal report and discuss reasonable exposure time ?		
17. If the sales comparison approach is the primary approach to value, are the comparables truly comparable with respect to property characteristics and location, and does the appraiser clearly discuss and support the adjustments?		
18. Are the assumptions logical and supportable with market data?		
19. If the property is income-producing, are the historical operating statements analyzed, and are the property's projected income and expenses supportable, given the market? For example, did the report		
a. analyze and report data on current revenues, expenses, and vacancies? (USPAP Standards Rule 1-4(c) and USPAP Statement on Standards-2)		
b. include appropriate analysis of discount and capitalization rates?		
c. include an analysis of the strength of the tenants, tenant rollover risk, anticipated rents, and probability of lease renewals?		
d. analyze terms of outstanding leases and NOI compared with budgets?		
e. analyze marketing and other re-leasing costs?		

CRE Appraisal Review Worksheet		
	Yes/No/NA	Comments
f. indicate current and projected vacancy and absorption rates?		
g. indicate effective rental rates or sales prices including any concessions?		
h. discuss expertise of property management?		
i. consider effect of any planned or new construction or renovation coming in the market area?		
20. Did the appraisal analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, nonmarket lease terms, and tract developments with unsold units? (12 CFR 34.44(d). Refer also to OCC Bulletin 2005-32.)		
21. If significant differences are cited from past performance for underwriting criteria such as lease rates, expenses, and absorption, is there adequate explanation?		
22. If there are significant internal or external factors to the property that affect the future cash flow or value of the property, did the appraiser properly address them in the report? For example,		
a. did the report address whether the site and improvements are suitable for the market and can the property sustain its historical cash flow?		
b. based on the information in the report, can the reviewer determine the subject's relative position within its submarket and among its competing properties?		
c. did the report address future supply and demand? How might that affect the subject property?		
d. did the appraisal of the property anticipate the need for, and expense involved with, any replacements or improvements?		
23. For an appraisal report that elicits a value of the enterprise, such as going concern value, did the appraisal allocate that value among the three components of the total value: (1) the market value of the CRE, (2) the personal property value, and (3) the value of intangibles? (For more information, refer to the "Appraisals and Evaluations" section of this booklet.)		
24. Are the determinants of the value conclusion reasonable? For example,		

CRE Appraisal Review Worksheet		
	Yes/No/NA	Comments
a. are units of comparison (such as market prices per square foot or price per unit) consistent with those cited in comparables?		
b. is the capitalization or discount rate supportable, and does it appear reasonable in terms of the class, property type, and market conditions?		
c. does the cost exceed or closely approximate value? If the project is not economically feasible, what is the borrower's and bank's motivation to engage in the transaction?		
25. Is market value based on the definition set forth in 12 CFR 34.42?		

Appendix F: Evaluation Review Worksheet

This appendix has a worksheet that examiners may use when reviewing CRE evaluations. Some items could be not applicable (NA) depending on the circumstances.

CRE Evaluation Review Worksheet		
	Yes/No/NA	Comments
1. Does the evaluation identify the location of the property?		
2. Does the evaluation describe the property and its current and projected use?		
3. Does the evaluation provide an estimate of the property's market value in its actual physical condition, use, and zoning designation as of the date the evaluation was completed, with any limiting conditions noted?		
4. Does the evaluation describe the methods the bank used to confirm the property's actual physical condition and the extent to which an inspection was performed?		
5. Does the evaluation describe the analysis that was performed and the supporting information that was used in valuing the property?		
6. Does the evaluation describe the supplemental information that was considered when using an analytical method or technological tool?		
7. Does the evaluation indicate all sources of information, as applicable, to value the property, including		
a. external data sources (such as market sales databases and public tax and land records)?		
b. property-specific data (such as previous sales data for the subject property, tax assessment data, and comparable sales information)?		
c. evidence of a property inspection?		
d. photos of the property?		
e. local market conditions?		
8. Does the evaluation include information on the preparer when an evaluation is performed by a person, such as the name, contact information, and signature ⁹⁹ of the preparer?		

⁹⁹ The signature can be electronic or another legally permissible format.

Appendix G: Glossary

Entries marked with an asterisk (*) are as defined in the “Interagency Guidelines for Real Estate Lending Policies.” Entries marked with a double asterisk (**) are as defined in the “Interagency Appraisal and Evaluation Guidelines” conveyed by OCC Bulletin 2010-42.

Absorption rate: Rate at which available properties are leased or sold in a specific market during a given period of time. This is calculated by dividing the number of properties leased or sold by the total number of available properties.

Acceleration: Repayment of a loan before its maturity date, either in its entirety or via partial payments. For ADC loans, acceleration occurs on projects that finance multiple-unit developments. In these instances, full repayment should be required before the sale of all units; to accomplish this, the amount that the bank requires to release its unit lien (the release price) is typically some multiple of the lot’s proportional share of the total value of all the units. Acceleration can also be referred to as a clause or provision in the loan agreement that requires repayment of a loan at once if the certain conditions of the agreement are not met.

Acquisition, development, and construction (ADC) lending: In its simplest form, ADC lending may finance the land acquisition, land preparation, and construction of a single residential or commercial building. Often, however, ADC lending finances a single- or multiple-phase development of many units.

Advance rate: The percentage amount applied to the collateral value to arrive at the loan amount.

Amortization: The spreading of principal and interest payments over a specified period of time.

“As complete” market value: See “prospective market value.”

“As is” market value:** The estimate of the market value of real property in its current physical condition, use, and zoning as of the appraisal’s effective date.

“As-stabilized” market value: See “prospective market value.”

Balloon payment: A balloon payment is required at the end of the term to repay the remaining principal balance of the loan for a loan that does not fully amortize over its term.

Borrowing base: A revolving credit agreement that limits the bank’s legally binding commitment to advance funds to the borrower based on the value of the collateral and the collateral’s type, value, eligibility criteria, and advance rates.

Bridge loan: Short-term financing to allow newly constructed or acquired commercial properties to reach stabilization necessary for either sale or qualification for permanent financing.

Capitalization rate: The ratio between a property's stabilized NOI and the property's sales price to convert income into value. Sometimes referred to as an overall rate (or "cap rate") because it can be computed as a weighted average of component investment claims on NOI.

Commercial construction: Loans that finance the construction or renovation of non-one- to four-family properties for owner occupancy, lease, or sale such as apartments, office buildings, retail centers, hotels, and industrial and mixed-use developments.

Commercial real estate (CRE) lending: CRE lending comprises ADC financing and the financing of income-producing real estate. Income-producing CRE comprises real estate held for lease to third parties and nonresidential real estate that is occupied by its owner or a related party.

Cost approach: A real estate valuation method used by estimating the cost of the land, plus costs of construction, less depreciation.

Construction loan:* An extension of credit for the purpose of erecting or rehabilitating buildings or other structures, including any infrastructure necessary for development.

Curtailment: A payment used to reduce the unpaid principal balance of the loan.

Debt-service coverage ratio (DSCR): Cash flow or NOI divided by the debt service.

Debt yield: The ratio of NOI to debt, expressed as a percent.

Discount rate: A rate of return used to convert future payments or receipts into their present value.

Effective gross income: The expected revenue generated by a property after the application of a vacancy rate and deductions for expected credit losses. See also "gross income."

Equity kicker: Lender's equity position or share of income in a property in exchange for a loan. Also referred to as a participating mortgage.

Forward commitment: Permanent commitment to refinance a construction loan upon future completion and lease-up.

General conditions costs: Contractor's costs included in the general contract that are associated with the jobsite management. Examples include site administrative costs, trailer rental, and site cleanup.

Giving unit: A group of family members, or any individual, who contributes on a recurring basis to a church.

Going concern value:** The value of a business entity rather than the value of the real property. The valuation is based on the existing operations of the business and its current operating record, with the assumption that the business will continue to operate.

Gross income: The revenue generated by a property assuming full occupancy and before the application of a vacancy rate and deductions for expected credit losses. See also “effective gross income.”

Hard costs: On- or off-site improvement costs such as building construction costs, other reasonable and customary costs paid to construct or improve a project general conditions costs, general contractor’s fees, and other expenses normally included in a construction contract such as bonding and contractor insurance

Hard equity: A borrower’s tangible equity invested in a property including cash, unencumbered real estate (e.g., land), and materials for improvements.

Income approach: A real estate valuation method that converts expected future NOI into present value through direct capitalization or discounted cash-flow analysis. Direct capitalization estimates the value of a property by capitalizing the NOI using an appropriate capitalization rate (or “cap rate”).

Income-producing real estate: Commercial or residential property that is purchased or developed to earn income by leasing it to others.

Interest reserve: A reserve account established by the lender and used by the borrower to cover loan interest during construction and lease-up. The interest reserve is typically funded via a budget line item in the construction loan; however, it may also be funded by the borrower into a separate escrow account as a condition of the loan.

Investor-owned residential real estate (IORR): One- to four-family residential real estate for which the primary repayment source is rental income and may be supported by the borrower’s personal income.

Land acquisition loan: An extension of credit to finance the acquisition of undeveloped land. These loans are often made in conjunction with land or lot development and construction loans. In some cases, these loans may be made for speculative purposes without plans to immediately develop the property.

Land development loan:* An extension of credit for the purpose of improving unimproved real property before building structures. The improvement of unimproved real property may include laying or placing sewers, water pipes, utility cables, streets, and other infrastructure necessary for future development. (Loans secured by already improved residential building lots are subject to the same 75 percent LTV as land development loans.)

Loan-to-value (LTV) or loan-to-value ratio:* The percentage or ratio that is derived at the time of loan origination by dividing an extension of credit by the total market value of the property(ies) securing or being improved by the extension of credit, plus the amount of any readily marketable or other acceptable non-real estate collateral. The total amount of all senior liens on or interests in such property(ies) should be included in determining the LTV

ratio. When mortgage insurance or collateral is used in the calculation of the LTV ratio, and such credit enhancement is later released or replaced, the LTV ratio should be recalculated.

Loan-to-cost (LTC): The percentage or ratio that is derived at the time of origination by dividing an extension of credit by the total cost of the property plus all construction costs.

Loss Given Default (LGD): The amount of a loss incurred by a bank when a borrower fails to pay back the loan (defaults). The LGD is often calculated as a percentage.

Marketing period: The time it might take to sell the property interest at the appraised market value during the period immediately after the effective date of the appraisal.

Mechanics lien: A security interest in the title to property in favor of those who have supplied labor or materials to improve the property. This lien can be used for real and personal property. For real property, it is also known as a construction lien.

Net lease: A lease agreement wherein the tenant must pay operating expenses such as real estate taxes, insurance, and maintenance, either directly or by reimbursement to the landlord. Net leases may be referred to as net, double net (NN), triple net (NNN), or absolute net. Because these terms lack universally agreed-upon definitions, the lease itself should always be analyzed to determine the expenses a landlord or tenant is responsible for rather than relying on these terms. This determination is critical to developing an accurate estimate of cash flow and NOI for the property.

Net operating income (NOI): Annual gross income less operating expenses. Gross income includes all income generated through the operation of the property. In addition to rents, it may include other income such as parking fees, laundry, and vending. Tenant reimbursements may also be included if the reimbursed expenses are included in the operating expenses. Operating expenses are the costs incurred in the operation and normal maintenance of a property. They do not include interest, principal, or income taxes. Although operating expenses do not include depreciation or capital items, they do include a reserve for replacing capital items (replacement reserve). The replacement reserve is imputed for underwriting purposes irrespective of whether it is actually funded.

To determine a property's stabilized NOI for underwriting purposes, the analysis begins with determining the gross income that a property would generate when fully leased. This is then adjusted by the application of a vacancy factor to arrive at the effective gross income. The vacancy factor may be higher or lower than actual and represents an estimate of the vacancy the property is expected to experience throughout its existence. The selection of a vacancy factor should consider vacancies in comparable properties in the same market. Variable operating expenses that are directly related to occupancy may also be adjusted to reflect the vacancy assumptions

One- to four-family residential property:* Property containing fewer than five individual dwelling units, including manufactured homes permanently affixed to the underlying property (when deemed to be real property under state law).

Owner-occupied: A property is owner-occupied when the primary source of repayment is not derived from third-party, nonaffiliated, rental income associated with the property (i.e., any such rental income is less than 50 percent of the source of repayment).

Participating mortgage: See “equity kicker.”

Presold unit:** A unit may be considered presold if a buyer has entered into a binding contract to purchase the unit and has made a substantial, nonrefundable earnest money deposit. Further, the institution should obtain sufficient documentation that the buyer has entered into a legally binding sales contract and has obtained a written prequalification or commitment for permanent financing.

Prospective market value “as completed” and “as stabilized”:** According to the USPAP, an appraisal with a prospective market value reflects an effective date that is subsequent to the date of the appraisal report. A prospective market value may be appropriate for the valuation of a property interest related to a credit decision for a proposed development or renovation project. Prospective value opinions are intended to reflect the current expectations and perceptions of market participants, based on available data. Two prospective value opinions may be required to reflect the time frame during which development, construction, and occupancy occur. The prospective market value “as-completed” reflects the property’s market value as of the time that development is expected to be completed. The prospective market value “as stabilized” reflects the property’s market value as of the time the property is projected to achieve stabilized occupancy. For an income-producing property, stabilized occupancy is the occupancy level that a property is expected to achieve after the property is exposed to the market for lease over a reasonable period of time and at comparable terms and conditions to other similar properties.

Readily marketable collateral:* Insured deposits, financial instruments, and bullion in which the lender has a perfected interest. Financial instruments and bullion must be salable under ordinary circumstances with reasonable promptness at a fair market value determined by quotations based on actual transactions, on an auction or similarly available daily bid and ask price market. Readily marketable collateral should be appropriately discounted by the lender consistent with the lender’s usual practices for making loans secured by such collateral. Examples of readily marketable financial instruments include stocks, bonds, debentures, commercial paper, negotiable certificates of deposit, and shares in mutual funds.

Release price: The amount of loan repayment required to obtain either a partial or full release of the lien on the collateral securing the loan.

Repack: Increase the interest reserve by obtaining additional debt to keep the loan current, thereby potentially masking a nonperforming loan.

Replacement reserves: A reserve for the periodic replacement of such capital items as heating, ventilation, air conditioning, roof, and parking lots. A lender may or may not require that these reserves be funded. Although not a cash expense in all periods, however, reserves for replacement should be deducted from income in determining NOI.

Sales comparison approach: A real estate valuation method that values a property using sales data of similar properties to determine the value. An appraiser typically compares the subject property to at least three recently sold properties in the area with similar characteristics.

Soft costs: Costs associated with construction that are not directly related to labor or physical building materials or construction. Typical soft costs include interest and other development costs such as architecture and engineering fees, permits, and related predevelopment expenses.

Standby commitment: A loan commitment that provides back-up financing in case the borrower cannot obtain permanent financing.

Tenor: The length of time before a loan matures; may also be referred to as the loan term.

Term financing: A loan on a stabilized property with a specified repayment schedule and either a fixed or floating interest rate.

Tract development: A project with five or more units that is constructed as a single development.

Appendix H: Abbreviations

AAI	All Appropriate Inquiry Final Rule
ACL	allowance for credit losses
ADC	acquisition, development, and construction
ADR	average daily rate
ALLL	allowance for loan and lease losses
ASC	Accounting Standards of Codification
CECL	current expected credit losses
CERCLA	Comprehensive Environmental Response, Compensation, and Liability Act of 1980
CFR	Code of Federal Regulations
CMBS	commercial mortgage-backed securitization
CRE	commercial real estate
CSA	covered savings association
CUA	credit underwriting assessment
DSCR	debt-service coverage ratio
EIC	examiner-in-charge
EPA	U.S. Environmental Protection Agency
FF&E	furniture, fixtures, and equipment
FFIEC	Federal Financial Institutions Examination Council
FFO	funds from operations
FSA	federal savings association
GAAP	generally accepted accounting principles
HVCRE	high-volatility commercial real estate
IORR	investor-owned residential real estate
LTC	loan-to-cost
LTV	loan-to-value
MIS	management information systems
NN	double net
NNN	triple net
NOI	net operating income
OCC	Office of the Comptroller of the Currency
OREO	other real estate owned
QA	quality assurance
QC	quality control
REIT	real estate investment trust
RevPAR	revenue per available room
ROE	report of examination
SLTV	supervisory LTV
SNC	Shared National Credit
TDR	troubled debt restructuring
TEF	tax equity finance
USC	U.S. Code
USPAP	Uniform Standards of Professional Appraisal Practice

References

Listed referenced apply to national banks and FSAs unless otherwise noted.

Laws

- 12 USC 84, “Lending Limits” (national banks and FSAs)¹⁰⁰
- 12 USC 371, “Real Estate Loans” (national banks and CSAs)
- 12 USC 1461 et seq., “Home Owners’ Loan Act” (FSAs)
- 12 USC 1464(c), “Federal Savings Associations, Loans and Investments” (FSAs)
- 42 USC 9601 et seq., “Comprehensive Environmental Response, Compensation, and Liability Act of 1980”
- Pub. L. 99-499, “Superfund Amendments and Reauthorization Act of 1986”
- Pub. L. 99-514, “Tax Reform Act of 1986”
- Pub. L. 107-118, “Small Business Liability Relief and Brownfields Revitalization Act of 2002”

Regulations

- 12 CFR 3, “Capital Adequacy Standards”
- 12 CFR 5.59, “Service Corporations of Federal Savings Associations”
- 12 CFR 7.1006, “Loan Agreement Providing for a National Bank or Federal Savings Association Share in Profits, Income, or Earnings or for Stock Warrants”
- 12 CFR 7.1025, “Tax Equity Finance Transactions by National Banks and Federal Savings Associations”
- 12 CFR 30, appendix A, “Interagency Guidelines Establishing Standards for Safety and Soundness”
- 12 CFR 32, “Lending Limits”
- 12 CFR 34, subpart C, “Appraisals”
- 12 CFR 34, subpart D, “Real Estate Lending Standards” (national banks)
- 12 CFR 34, subpart D, appendix A, “Interagency Guidelines for Real Estate Lending” (national banks)
- 12 CFR 160.101, “Real Estate Lending Standards” (FSAs)
- 12 CFR 160.101, appendix, “Interagency Guidelines for Real Estate Lending Policies” (FSAs)
- 12 CFR 1002, “Equal Credit Opportunity Act (Regulation B)”
- 40 CFR 312, “Innocent Landowners, Standards for Conducting All Appropriate Inquiries”

¹⁰⁰ Applies to FSAs pursuant to 12 USC 1464(u)(1).

Comptroller's Handbook

Examination Process

- “Bank Supervision Process”
- “Community Bank Supervision”
- “Federal Branches and Agencies Supervision”
- “Foreword”
- “Large Bank Supervision”
- “Sampling Methodologies”

Safety and Soundness, Asset Quality

- “Allowance for Loan and Lease Losses”
- “Allowances for Credit Losses”
- “Concentrations of Credit”
- “Loan Portfolio Management” (national banks)
- “Other Real Estate Owned”
- “Rating Credit Risk”

Safety and Soundness, Liquidity

- “Liquidity”

Safety and Soundness, Management

- “Corporate and Risk Governance”

Office of Thrift Supervision Examination Handbook (FSAs)

Section 201, “Lending Operations and Portfolio Risk Management”

OCC Issuances

Bank Accounting Advisory Series

Community Developments Insights, “Low-Income Housing Tax Credits: Affordable Housing Investment Opportunities for Banks”

OCC Bulletin 2000-20, “Uniform Retail Credit Classification and Account Management Policy: Policy Implementation”

OCC Bulletin 2003-12, “Interagency Policy Statement on Internal Audit and Internal Audit Outsourcing: Revised Guidance on Internal Audit and Its Outsourcing”

OCC Bulletin 2005-32, “Frequently Asked Questions: Residential Tract Development Lending”

OCC Bulletin 2006-46, “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices: Interagency Guidance on CRE Concentration Risk Management”

OCC Bulletin 2006-47, “Allowance for Loan and Lease Losses (ALLL): Guidance and Frequently Asked Questions (FAQs) on the ALLL”

OCC Bulletin 2009-32, “Commercial Real Estate (CRE) Loans: Guidance on Prudent CRE Loan Workouts”

OCC Bulletin 2010-24, “Incentive Compensation: Interagency Guidance on Sound Incentive Compensation Policies”
OCC Bulletin 2010-42, “Sound Practices for Appraisals and Evaluations: Interagency Appraisal and Evaluation Guidelines”
OCC Bulletin 2012-10, “Troubled Debt Restructurings: Supervisory Guidance on Accounting and Reporting Requirements”
OCC Bulletin 2012-14, “Stress Testing: Interagency Stress Testing Guidance”
OCC Bulletin 2012-33, “Community Bank Stress Testing: Supervisory Guidance”
OCC Bulletin 2013-29, “Third-Party Relationships: Risk Management Guidance”
OCC Bulletin 2017-7, “Third-Party Relationships: Supplemental Examination Procedures”
OCC Bulletin 2018-10 “Appraisals for Commercial Real Estate Transactions: Final Rule”
OCC Bulletin 2018-39, “Appraisals and Evaluations of Real Estate: Frequently Asked Questions”
OCC Bulletin 2019-31, “Covered Savings Association Implementation: Covered Savings Associations”
OCC Bulletin 2020-10, “Third-Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013-29”
OCC Bulletin 2020-29, “Credit Concentrations: Joint Statement on Adjustment to the Calculation for Credit Concentration Ratios Used in the Supervisory Approach”
OCC Bulletin 2020-49, “Current Expected Credit Losses: Final Interagency Policy Statement on Allowances for Credit Losses”
OCC Bulletin 2020-50, “Credit Risk: Interagency Guidance on Credit Risk Review Systems”
OCC Bulletin 2020-81, “Credit Risk: Risk Management of Loan Purchase Activities”

Other

“FFIEC 031 Consolidated Reports of Condition and Income for a Bank With Domestic and Foreign Offices”
“FFIEC 041 Consolidated Reports of Condition and Income for a Bank With Domestic Offices Only”
“Instructions for Preparation of Consolidated Reports of Condition and Income” (call report instructions)

Accounting Standards Codification

ASC Topic 310, “Receivables”
ASC Topic 326, “Financial Instruments—Credit Losses”
ASC Topic 970, “Real Estate—General”
ASC Topic 974, “Real Estate—Real Estate Investment Trusts”
ASC Subtopic 310-10, “Receivables—Overall”
ASC Subtopic 310-20, “Nonrefundable Fees and Other Costs”
ASC Subtopic 450-20, “Loss Contingencies”
ASC Subtopic 820-10, “Fair Value Measurement—Overall”

Uniform Standards of Professional Appraisal Practice