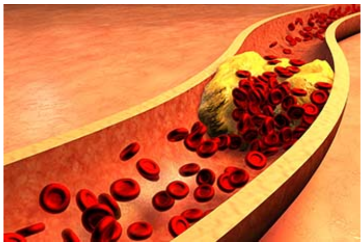

Is There Enough Diversity in Your CRE Loan Portfolio?

FDIC lending risk management CRE

Summary: Responding to rising levels of CRE loans and recent bank failures, the FDIC has issued new guidance on risks. We review portfolio concentration red flags and risk factors.

In science, measuring the concentration of a substance can be an important test. For example, blood tests measure the concentration of a variety of substances. Too high of a concentration of something, such as cholesterol, can be unhealthy and lead to more serious health conditions.

Testing for portfolio concentration in financial institutions is a little like measuring cholesterol levels in the bloodstream. Too much of a concentration in one area can be bad for a bank's health — even catastrophic, as some banks have discovered.

Monitoring Commercial Loan Portfolio Risk

Identifying portfolio concentration risk can be trickier than it seems, especially when it comes to commercial real estate (CRE) loans. For example, a portfolio might have several different loans on several different commercial projects in different locations. That might seem at first like a balanced group of loans. But if all are related to the same borrower, then there is name concentration risk across all of those loans. If that one borrower encounters financial trouble, all the loans might be in jeopardy.

Or perhaps a financial institution has many office loans on its books. That could be seen as concentration risk, unless there are enough dissimilarities among the loans to make them less correlated as a group, such as some office loans being used for healthcare providers and others being used as space for tech companies. Recent bank failures have placed more attention on concentration risk. For community financial institutions (CFIs), one key area of focus is on commercial real estate loans, which often make up a big part of those institutions' portfolios.

New FDIC Guidance Issued

CRE loans have been on the rise and could result in new portfolio concentration problems, so the FDIC has alerted financial institutions to the risks of CRE loan concentration and issued an update to an advisory on the subject first released in 2006. The new advice, posted in July, offers some background on past bank failures related to CRE loan concentration like those in the 1980s and 1990s, as well as updated cautions for today's CRE markets.

The FDIC says that it is particularly concerned about CRE loans that are dependent on cash flow from rent to pay off loans, rather than having that real estate used as collateral for a loan. Loans that depend on the sale of the underlying property for repayment are also flagged as potential problems.

Here are specific **CRE concentration levels that are red flags**, according to the new guidance:

1. Total loans for construction, land, and development that represent 100% or more of a bank's total capital

2. Total CRE loans that represent 300% or more of a bank’s total capital
3. A CRE loan portfolio that has increased by 50% or more over the past 36 months

Portfolio Concentration Risk Factors

The FDIC pointed out that its caution does not represent strict limits on CRE concentration. It is simply a wake-up call about potential issues. Portfolio concentration is far more nuanced, with varying risk characteristics. Still, the potential for heightened risk is real, meaning that financial institutions should pay close attention.

Here are a few of the more common risk factors that should be monitored:

1. **Name risk.** A single borrower or group of borrowers can be risky if they make up too much of a CFI’s portfolio. Loans that may be otherwise diversified could actually be correlated if they are too closely linked to one name.
2. **Geography.** Loans in a particular area or region could represent heightened risk if that region undergoes an economic dislocation. Different borrowers and different loan types could all be impacted.
3. **Sector.** Loans that are clustered around one sector, such as retail buildings, hospitality, or office space could all be impacted during a slump in that sector.

Correlation is a key factor to look for in a loan portfolio. Spotting it can sometimes be a complex task, but failure to do so can spell trouble, should problems develop. It may also affect a broader swath of a portfolio than might otherwise be expected.

Portfolio risk can sometimes be easy to spot, such as when a single name represents an outsized portion of a bank’s loans. But more often, portfolio risk is less straightforward. CFIs should take a sophisticated approach for monitoring and evaluating portfolio risk, and pay particular attention to even subtle correlations to ensure that their portfolios are diverse enough.

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ECONOMY & RATES

Rates As Of: 09/11/2023 05:42AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	5.55	-0.01	1.13
6M	5.49	0.01	0.73
1Y	5.39	0.03	0.69
2Y	4.98	0.12	0.55
5Y	4.41	0.16	0.41
10Y	4.29	0.18	0.41
30Y	4.37	0.16	0.41

FF Market	FF Disc	IORB
5.33	5.50	5.40
SOFR	**Prime**	**OBFR**

5.30	8.50	5.31