COMMERCIAL REAL ESTATE LENDING
Core Analysis Procedures

Examiners are to consider these procedures but are not expected to perform every procedure at every institution. Examiners should complete only the procedures relevant for the institution's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures not included below. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

References

- *Interagency Guidelines Establishing Standards for Safety and Soundness (FRB: 12 CFR 208, Appendix D-1; FDIC: 12 CFR 364, Appendix A)*
- *Interagency Guidelines for Real Estate Lending Policies (FDIC: 12 CFR Part 365, Appendix A; FRB: 12 CFR Part 208, Appendix C)*
- *Appraisal Regulations (FDIC: 12 CFR Part 323; FRB: 12 CFR 225.61-67)*
- *Interagency Advisory on the Use of Evaluations in Real Estate-Related Financial Transactions (FDIC: FIL-16-2016; FRB: SR 16-5)*
- *Interagency Appraisal and Valuation Guidelines (FRB: SR 10-16; FDIC: FIL-82-2010)*
- *Frequently Asked Questions on the Appraisal Regulations and the Interagency Appraisal and Evaluation Guidelines (FRB: SR 18-9; FDIC: FIL-62-2018)*
- *Statement on Prudent Risk Management for CRE Lending (FRB: SR 15-17; FDIC: FIL-62-2015)*
- *Interagency Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts (FDIC: FIL-34-2023; FRB: SR 23-5)*
- *Managing Commercial Real Estate Concentrations in a Challenging Environment (FDIC: FIL 64-2023)*
- *Interagency Guidance on Concentrations in Commercial Real Estate (FRB: SR 07-01; FDIC: FIL 104-2006)*

Considerations and Background

This module is intended for those extensions of credit collateralized by liens on or interests in income producing properties, owner occupied properties, or those commercial purpose loans in which real estate is held as collateral.

Findings and Conclusions

Document findings and conclusions here, and include a summary of these findings and conclusions in the Core Analysis Decision Factors in the appropriate Primary or Supplemental modules.

Preliminary Review

1. Review documents that may identify issues relating to commercial real estate lending, such as:

- **Prior examination reports and work papers**
- **Exam planning memoranda and file correspondence**
- **Loan review reports**
- **Internal and external audit reports**

- **Loan committee minutes**
- **Documentation of action taken by management to address prior recommendations**

2. Obtain and analyze internal management reports relating to commercial real estate lending, such as:

- **Lending activities (e.g., type, volume, and location)**
- **Problem loans**
- **Workout strategies**

3. Assess the quality of market-analysis reports, considering:

- **Information provided in reports**
- **Reporting on specific market segments**
- **Economic developments in the markets served**
- **Variety in sources used**
- **Timeliness of information**

Policy Considerations

4. Assess the commercial real estate (CRE) lending policy within the context of the institution's size, complexity, and risk profile. Determine whether policies address:

- **Target market area(s) and circumstances under which the institution may extend CRE credits on properties located outside the target market**
- **Portfolio diversification standards and limits, such as:**
    - **Geographic market and property type**
    - **Income producing properties**
    - **Owner-occupied properties**
    - **Commercial loans with real estate held as collateral (including lines of credit with a security interest in real estate pledged as additional collateral)**
- **Terms and conditions by type of real estate loan**
- **Appraisal guidelines, including compliance with federal and state laws and regulations**
- **Loan origination and approval procedures by loan size and type**
- **Concentration risks**
- **Limitations on the total amount of loans purchased/sold, and limits by loan type and source**
- **Maximum loan amounts and maturities, amortization schedules, and pricing structures for each type of real estate loan**
- **Collateral valuation and appraisal review requirements**
- **Loan-to-Value (LTV) limits in accordance with the Interagency Guidelines for Real Estate Lending Policies**
- **Guidelines for reviewing and approving exception loans, including reporting requirements for loans in excess of supervisory limits**

- **Guidelines for minimum debt-service coverage ratios**
- **Consideration of the overall creditworthiness of the borrower**
- **The level of the borrower's equity invested in the property**
- **Loan covenant requirements, including monitoring and board reporting requirements**
- **Secondary repayment sources**
- **Credit enhancements, such as guarantees, mortgage insurance, or takeout commitments**
- **Loans involving partial or no recourse to the borrower**
- **Credit-risk assessments and stress testing under favorable and declining economic conditions**
- **Guidelines for ongoing collateral inspections**
- **Identification, monitoring, and reporting of weak and problem credits**
- **Guidelines that address impaired real estate values and appropriateness of allowances for credit losses (ACLs) for loan and leases.**
- **Loan workout arrangements**
- **Guidelines for initiating foreclosure actions**[1]

Administration

5. Review the institution's underwriting practices. The following situations may indicate inappropriate underwriting practices:

- **Inadequate credit documentation**
- **Incomplete loan-approval review and documentation by the appropriate signing authority**
- **Inadequate collateral documentation, such as title policies without complete legal descriptions**
- **Special-use properties, or real estate collateral located in unfamiliar or distant market areas**
- **Loan terms (e.g., low interest rates, extended interest-only periods, limited recourse to the borrower, and weak LTV requirements) that appear to be based on competitive factors rather than underlying credit risk**
- **Minimal, or no, borrower liquidity or equity**
- **Real estate collateral values that may have been driven up by rapid turnover of ownership (without material property improvements or supportable income projections) to justify the increased values**[2]
- **Advances to service an existing loan**
- **Renewals, extensions, and refinancings lacking credible support for full repayment or reasonable repayment schedules**
- **Speculative loans made with repayment dependent upon collateral appreciation**
- **Loan disbursements prior to the completion of all conditions of approval**

6. Evaluate the process for ensuring real estate taxes are current and appropriate insurance is carried on properties held as collateral.

[1] **Refer to the Other Assets and Liabilities module.**

[2] **Uniform Standards of Professional Appraisal Practice (USPAP) require a discussion of the property's recent sales history in the real estate appraisal.**

7. Assess ongoing credit and collateral monitoring practices. Consider:

- **Independent loan reviews**
- **Periodic credit memoranda**
- **Loan covenant compliance**
- **Loan performance reports**
- **Borrower contacts**
- **Collateral inspections[3]**
- **Property tax status**
- **Building code violations**
- **Deviations from loan policy dictates**

8. Assess valuation processes and collateral valuations:

- **Determine whether all CRE transactions requiring an appraisal had appraisals performed by a certified appraiser**
- **Review procedures for valuing collateral when an appraisal is not required or obtained, and determine whether values and assumptions appear reasonable**
- **Determine whether collateral reassessments are appropriate and appropriately supported, such as when done prior to refinancing, when repayment problems arise, or when property-usage plans materially deviate from original valuation assumptions**

9. Determine whether management maintains a list of approved appraisers and whether the appraiser selection process is independent from the loan production and credit decision process.[4] Determine whether management periodically reviews information from the appropriate state agency to validate appraisers' licenses.

10. Assess appraisal and evaluation review procedures, including determining whether:

- **Persons conducting in-house reviews are sufficiently qualified and independent from the loan origination and approval functions**
- **Appraisal reviews appropriately focus on verifying the reasonableness of the assumptions that support the property values rather than serving as an administrative checklist**
- **Appraisal reviews (in-house or external) are conducted prior to disbursement of loan proceeds**

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[3] Effective inspections typically identify evidence of deferred maintenance, deteriorating property or neighborhood conditions, and increased vacancies, when applicable, which could cause collateral values to decline or reduce property revenue.

[4] Refer to the Real Estate Appraisal Program Reference Module.

11. Determine whether governance practices for renewing and restructuring loans are consistent with safe and sound lending practices and regulatory reporting requirements. Consider whether the practices appropriately address issues such as:

- **Processes to identify, report, and manage the volume and types of workout activities**
- **Requirements to verify and document borrowers' financial conditions and collateral values**
- **Controls to identify, report, and monitor loan performance and risks, including concentration risk**
- **Management's responsibility for filing regulatory reports that are consistent with regulatory reporting requirements (including GAAP) and supervisory guidance**
- **Identification and reporting of loan modifications to borrowers experiencing financial difficulty**
- **Nonaccrual and ACL methodology guidelines**
- **Loan collection procedures**
- **Adherence to statutory, regulatory, and internal lending limits**
- **Collateral administration to ensure proper lien perfection of real and personal property**
- **Ongoing credit review practices**

12. Evaluate management's practices regarding loan modifications or extensions, and determine whether the practices result in under-reported delinquency levels.

Documentation

13. Review loan files to determine whether all basic documentation is included and accurately completed, such as:

- **Recorded mortgage or deed of trust**
- **Signed note**
- **Loan guarantees**
- **Attorney's title opinion or title insurance policy**
- **Evidence of appropriate insurance (such as property, liability, and flood)**
- **Assignments of leases**
- **Copies of leases**

14. Review loan files to determine whether all basic credit-analysis documentation is included and appropriately considered, such as:

- **Loan presentation and approval memoranda**
- **Commitment letter (final signed versions)**
- **Settlement sheet**
- **Borrower or project operating statements**
- **Tax returns**
- **Rent rolls**

- **Institution prepared financial analysis**
- **Reviews of other repayment sources**
- **Appraisal or collateral evaluations**
- **Appraisal or collateral-evaluation reviews**
- **Guarantees (including the extent of guarantor liability)**
- **Loan officer's comment sheets**
- **Pertinent correspondence**

Credit Analysis

15. Review real estate market analyses of the areas where the institution finances CRE. Assess management's awareness of and responsiveness to changes in market conditions. The following indicators may be useful for evaluating market conditions:

- **New construction permits**
- **Estimated absorption periods**
- **Employment and demographic trends**
- **Vacancy and capitalization rates for various property types**
- **Tenant lease incentives**
- **The level and trend in rental rates**
- **Regulatory agency newsletters and publications**

16. Determine whether repayment sources involve any inter-company borrower transactions.

17. Assess the accuracy of rent-roll income by comparing reported levels to rental income reflected in tax returns or terms of individual leases.

18. Determine whether problems or weaknesses exist in individual CRE projects, such as:

- **Past-due loan or tax payments**
- **Loans secured by junior liens**
- **Protracted amortization programs or maturity dates**
- **Excessive number of similar projects in the same trade area**
- **Inadequate feasibility studies or analyses**
- **Changes in project plans (e.g., a condominium project converted to an apartment project)**
- **Projects supported by real estate financed at the peak of the real estate cycle**
- **Projects refinanced for non-project related purposes**
- **Rent concessions that decrease cash flows below the levels projected in the original loan analysis, appraisal, or evaluation**

• **Special purpose properties, especially those with weak cash flows** • **Lease buyouts or concessions on finishing tenant space or moving expenses** • **Slow leasing, lack of sustained sales activity, or numerous sales cancellations** • **Purchase money financing based on collateral values that are higher than actual purchase prices** • **Outstanding lawsuits against the project, property, or borrower** • **Land values that assume future rezoning** • **Indications of property mismanagement or new competition** • **Borrowers inexperienced in managing the type of property financed** • **Environmental risks**

19. Evaluate the credit quality of sampled loans:
• **Determine whether cash flow from the property can repay the loan within a reasonable period**
• **Review the borrower's repayment performance**
• **Assess the borrower's willingness and ability to repay the loan using other resources (if necessary)**
• **Consider whether cash flows from the borrowing entity or underlying collateral will be negatively affected by market conditions**
• **Assess the support from guarantors, with emphasis on excess liquidity, global cash flow, and demonstrated willingness to honor guaranty agreements**
• **Consider the support provided by guarantors, by determining whether:**
  o **The guarantee is written and legally enforceable**
  o **The guarantor has both the financial capacity and willingness to support the credit through ongoing payments, curtailments, or re-margining**
  o **The guarantee is adequate to provide material repayment support during the remaining loan term**

20. Determine whether management conducts initial and ongoing sensitivity analysis on significant loans.[5]
21. Determine whether management reviews tenant leases as part of the original underwriting process and periodically throughout the life of the loan.[6]

[5] Management generally assesses the sensitivity of cash flows or collateral values based on changes to key variables such as rental rates, vacancy levels, operating expenses, or capitalization rates.

[6] As income-property loans mature, existing property leases may rollover, renew with modified terms, or be replaced with new leases. The economics of the contracts may differ from originally anticipated results and should therefore be periodically reviewed.

22. Assess the support provided by the real estate collateral. When a formal appraisal is required, determine whether: • **The market analysis section provides a thorough, well-supported analysis of market conditions** • **Sales comparisons are actually comparable (adjusted values of comparison properties that include undue adjustments may indicate the properties are not actually comparable)** • **The operating statement in the appraisal (under the direct capitalization approach) is comparable to the actual operating results, or supported by market lease rates** • **The appraiser's reconciliation of the three approaches to value is reasonable and any material variations among the valuation approaches are explained**

23. Assess the reasonableness of the assumptions used in recent appraisals and evaluations.[7]
• **Consider:**
  o **Current and projected vacancy and absorption rates**
  o **Lease renewal trends and anticipated rates**
  o **Volume and trend in past due leases**
  o **Feasibility studies and market surveys (to assess the assumptions concerning future supply and demand factors)**
  o **Rental rates or sales prices (taking into account all sales and financing concessions)**
  o **Operating expenses (amounts and categories)**
  o **Deferred maintenance**
  o **Net operating income of the property as compared with budget projections, reflecting reasonable operating and maintenance costs**
  o **Discount and capitalization rates**
  o **Marketing period or exposure time estimated to achieve stabilized occupancy or sellout as well as appraised value**
  o **Conclusions**
• **In the case of stale appraisals or if material deviations from facts or assumptions are determined, adjust the estimated value of the property, if reasonably possible and supportable, for the purpose of the credit analysis and classification.[8, 9]**

Dealing with Problem Loans and Workout Situations

[7] **Appraisal assumptions made by qualified appraisers that are appropriate to the property should be given a reasonable amount of deference. Examiners should not challenge assumptions that deviate slightly from what would otherwise be associated with the type, condition, and location of the property under review.**

[8] **Adjustments to collateral value made for credit analysis purposes should not be based on worst-case scenarios that are unlikely to occur.**

[9] **Examiners generally should not challenge underlying assumptions if the assumptions differ only marginally from the norms generally associated with the collateral; however, examiners can adjust the estimated value for credit and classification purposes when examiners can establish that facts or assumptions provided by management are irrelevant or inappropriate, or examiners can support alternative assumptions based on available information.**

24. Determine whether management creates reasonable workout plans to collect principal and interest payments and reduce the risk of financial losses. Key elements of sound workout programs and individual workout plans include:

- **Experienced workout officers**
- **Use of current, comprehensive financial information on the borrower, project, and guarantor**
- **Reasonable collateral appraisals and valuations**
- **Establishment of appropriate loan structures (e.g., rates, terms, and amortization schedules), curtailments, covenants, or re-margining requirements**
- **Appropriate legal documentation for any changes to loan terms or collateral**
- **Procedures for identifying and reporting loan modifications to borrowers experiencing financial difficulty;**
- **Proper accounting and regulatory reporting treatment for problem loans;**
- **The ability to modify workout plans if target goals are not achieved or collateral values decline**
- **Specific triggers for further risk-rating downgrades**
- **Where warranted, appropriate strategies to foreclose or move the credit out of the financial institution**

25. Evaluate the overall effectiveness of workout plans and programs. Consider associated recovery rates and the appropriateness of related reports that workout personnel prepare for management and the board.

26. Determine how the workout function captures and documents expenses associated with workouts, such as legal expenses, appraisal or collateral evaluation fees, consulting fees, and collateral liquidation costs. Verify that costs are properly accounted for and not taken as a charge to the ACL for loans and leases.

Classification and Special Mention

27. Assign classifications and Special Mention designations, as appropriate.[10] When determining the appropriate classification of problem CRE loans, consider whether well-defined weaknesses are present. Examples of well-defined weaknesses may include:

- **An excess of similar projects under construction**
- **Lack of analysis that reflects current and reasonably anticipated market conditions**
- **Rent concessions resulting in cash flow below expectations**

[10] **As a general principle, a performing real estate loan should not be automatically classified or charged off solely because the value of the underlying collateral has declined below the loan amount. Conversely, the fact that the underlying collateral value equals or exceeds the current loan balance, or that the loan is performing as agreed, does not preclude the loan from classification if well-defined weaknesses jeopardize the repayment ability of the borrower. The evaluation of each credit should be based upon the fundamental characteristics affecting the collectability of the particular credit. Additionally, a Special Mention designation should not be used as a means of avoiding a clear decision to adversely classify a loan or pass it without critique.**

- **Concessions on finishing tenant space, moving expenses, and lease buyouts**
- **Slow leasing that may reduce the property's income potential, resulting in protracted repayment or default on the loan**
- **Delinquent lease payments from major tenants**
- **Tax arrearages**
- **Loans with no or minimal borrower equity**
- **Additional advances to service an existing loan that lacks credible support for full repayment from reliable sources**
- **Renewals, extensions, and refinancings that lack credible support for full repayment from reliable sources and that do not have a reasonable repayment schedule**

End of Core Analysis.