Commercial real estate risk management

OSFI regulatory notice

February 2024

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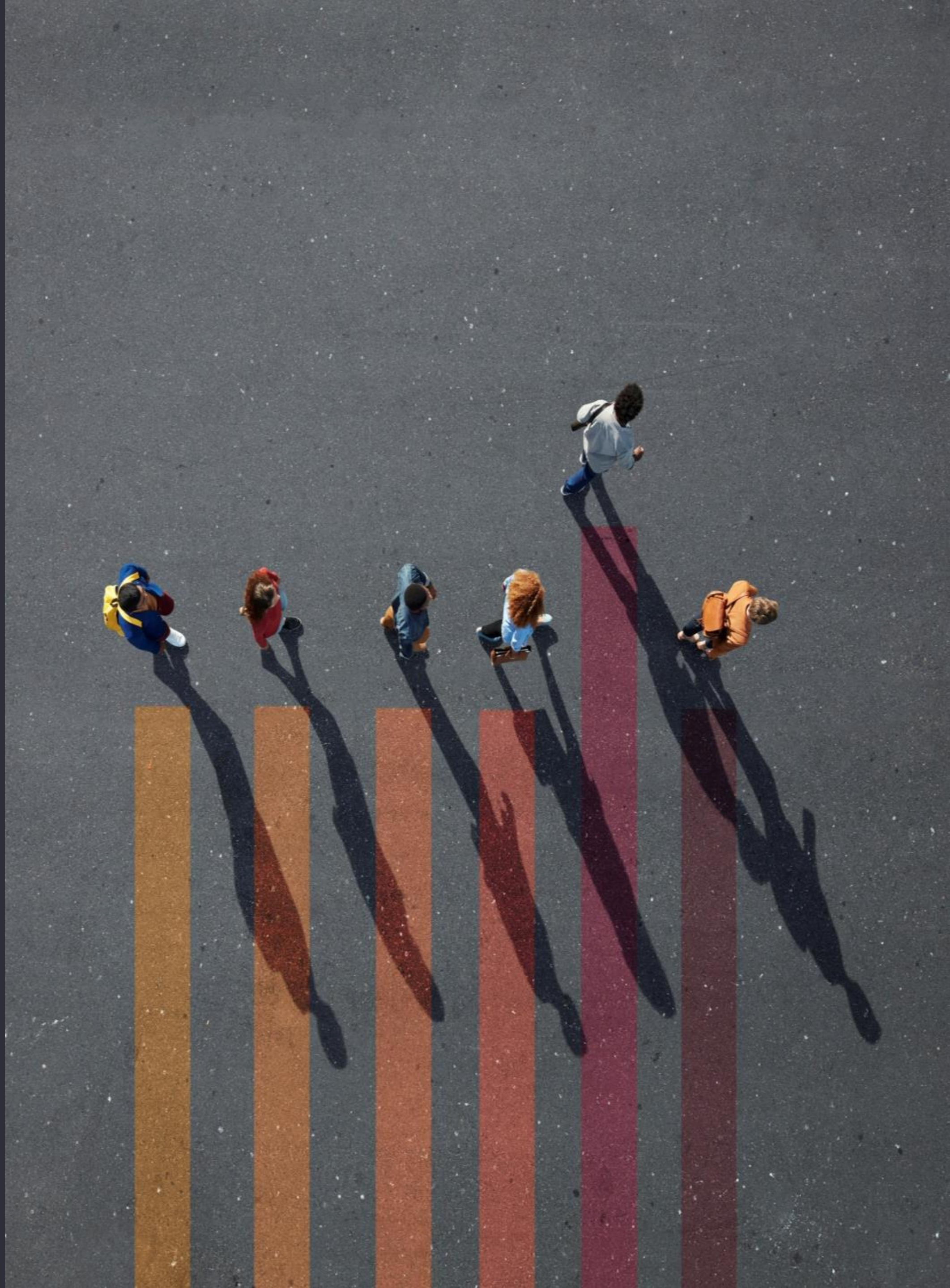

Executive Summary

The current risk environment causes an **increased** potential for a rise in commercial real estate **(CRE) borrower defaults** globally

Office of the Superintendent of Financial Institutions (OSFI) has issued an **interim guidance** with **CRE-specific** focus areas and expectations

OSFI requests domestic systematically important banks **(D-SIBs)** to conduct exercises and reporting on **sample profiles** as benchmarks for the next step

All federal regulated financial institutions (FRFIs) should expect more detailed **guidelines** and **reviews** from OSFI
What we expect to happen:

D-SIBs
Minor changes, e.g. stress scenario buffer

OTHER FIs
Larger impact, e.g. full re-scoring, data upgrade

Since COVID — Sept 29, 2023 — Ongoing — Future

➢ **Examples of existing OSFI findings for FIs with significant CRE concentration and their remediation timeline:**

Theme	Issue description	OSFI timeline	EY supporting
Static data	• **Static** net operating income (NOI) at inception is used to establish loan-to-value (LTV) or debt service coverage (DSC)	2 years ⚡	✓
Collateral valuation	• The collateral valuation was **not** a fair reflection of current market condition, resulting in unreliable borrower risk rating (BRR).	2 years ⚡	✓
Risk rating design	• The cut-off for investment grade quality was **not** aligned with the account risk characteristics observed, resulting in ~ 40% of the inherently high risk CRE portfolio currently maps to investment grade risk.	2 years ⚡	✓
Sensitivity analysis	• Sensitivity analysis was **not** conducted at origination or regularly throughout loan term. • The analysis was based on **static** income data, unrealistic vacancy factor, etc., resulting in inconsistent scenarios.	8 months	✓
Guarantor assessment	• There was **little or no** assessment of liquidity/cash flow from the guarantor, resulting in cost overruns or debt servicing shortfalls not taking consideration. • Contingent liabilities were generally **not** assessed.	10 months	✓

⚡ : OSFI interim review unsatisfactory

New expectations: governance

- Financial institutions (FIs) should be ready to demonstrate CRE-specific diversification policy and concentration limits.
- OSFI expects FIs to have CRE-specific stressed scenarios in their risk appetite framework.
- FIs should have explicit arrangements in policy, procedure and management regarding multi- and co-lender loans.

New expectations: data

- Timely and meaningful: no static data.
    - E.g. collateral value, net operating income (NOI), financial statements.
- Consistent and accurate: no redundant conflicting data or reporting.
    - E.g. unreasonable balance change, inconsistent security/property type or purpose.
- FIs are expected to own the capacity of continuous data collection and updating.
    - E.g. database design enables hosting and retrieval of periodically updated data.

EY

New expectations: risk assessments

- Market monitoring: sufficient granularity, e.g. product type, property type, region.
- Stress testing: FIs should demonstrate their test has the buffer level fitting the current risk environment and the capacity of early warning.
- Debt service coverage (DSC) assessments: OSFI requires it to be forward-looking, with year-to-year variations of NOI, and assess systematic risk.
- Sensitivity analysis: required to be on account level, regularly (not one-time/term), with updated data.
- Liquidity risk: should demonstrate considerations of proper stressed scenarios and secondary effects.

New expectations: portfolio management

- SICR assessments: FIs assessing under IFRS9 should use information without undue cost, e.g. interest rate forecasts, vacancy expectations.
- Guarantor assessments: required to assess liquidity and cashflow, as well as contingent liabilities.
  - FIs with high CRE concentration and risk should be ready to demonstrate matching level of guarantor due diligence.
- Underwriting criteria: should have detailed documents ready with limits regarding:
  - Property / loan type
  - Maximum loan amount
  - Term length and amortization schedules
  - Loan-to-value (LTV)

EY strength and offering

- Credit Risk management related services tailored to a wide range of FIs, including D-SIBs, SMSBs, Credit Unions, Insurance.
- A dedicated team with average ~10 years of industry experience in wholesale credit risk front to back.
- First-of-its-kind, OSFI-compliant standardization tool for CRE underwriting and assessments, including risk scoring and other regulatory expectations.
- Engagement experiences in CRE underwriting and modeling, AIRB, ICAAP, IFRS9 with multiple Canadian Fis.

Experience for each area:

1 Risk governance framework

- Risk governance framework
- Lending policy reviews
- Policy, standard, position paper documentation
- Latest industry insights

2 Risk data

- Data quality assessment
- Database gap assessment and remediation
- Data modeling
- Infrastructure enhancement

3 Risk measurement and testing

- Risk rating models
- Stress testing
- Early-warning models
- Detailed sensitivity analysis
- Key metrics for borrower re-evaluation

4 Liquidity and portfolio management

- Liquidity risk and SICR assessment
- Sponsor or guarantor re-evaluation

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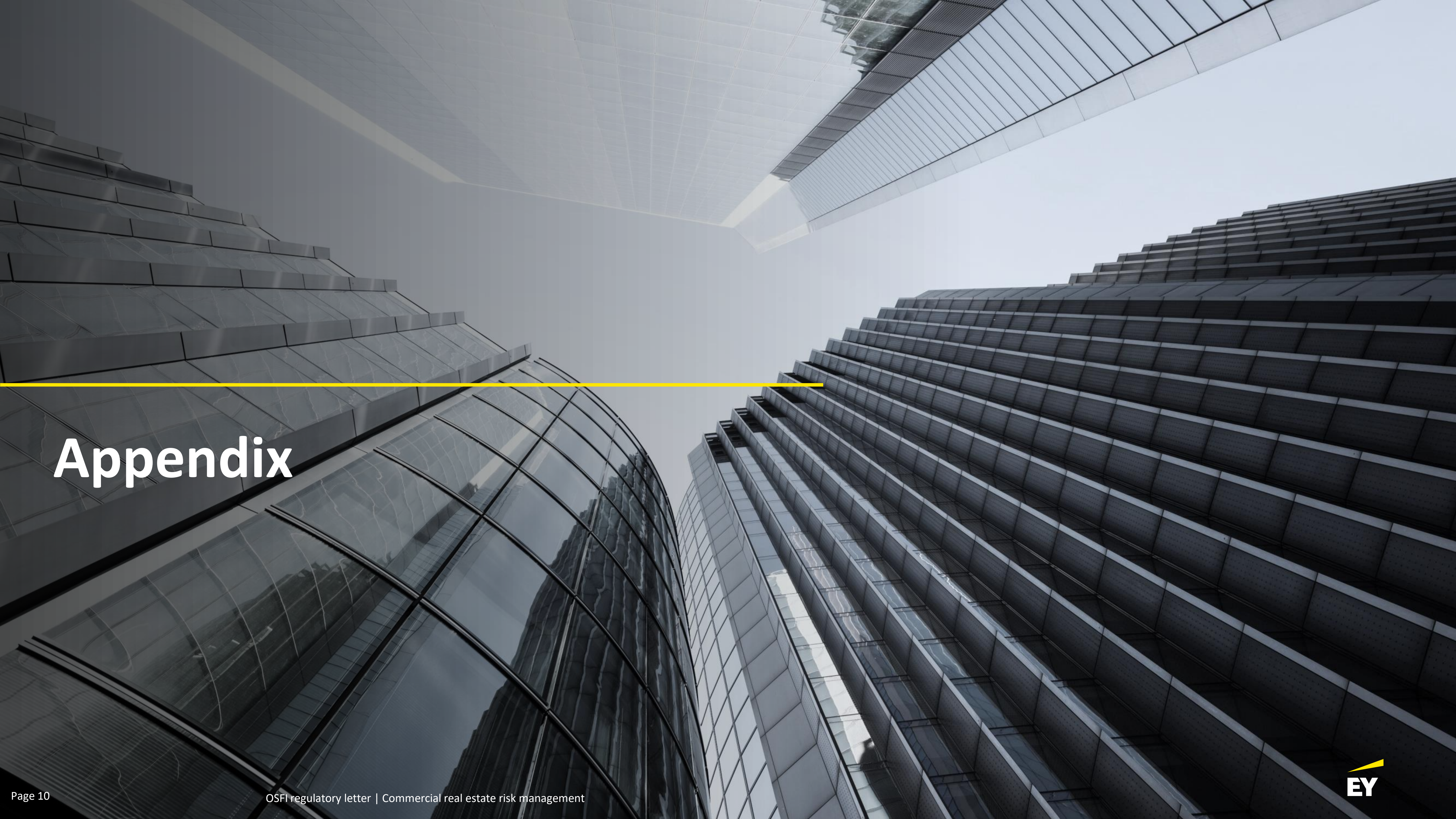

Appendix

Governance and risk management (section 4)

Key takeaways

- Risk appetite framework and limits for both normal and stressed scenarios
- CRE-specific policies and procedures should be in place
- CRE risk identification, measurement, monitoring, management that reflect size, scope, nature, complexity
- Ongoing monitoring and review.\

Common gaps

- Lack of stressed scenario playbook (scenario quantification, risk appetite and limit setting, response policies and procedures)
- Lack of sensitivity assessment
- Lack of rigor in borrower repayment capacity assessment, account management and monitoring
- Stale data – origination instead of timely updating

Key considerations

- Senior management as well as line of business support and synergy
- Risk limits setting, policies, and procedures for **stressed scenarios**
- Ongoing assessment framework
- Stress testing and sensitivity analysis enhancement
- Key data element quality and update frequency enhancement

Underwriting and account management (section 5)

	Key takeaways	Common gaps	Key considerations
5.1 **Detailed underwriting criteria and exception processes**	• FRFIs should have clear and prudent underwriting criteria and limits for approving CRE loans, based on the type and characteristics of the loan or property. • FRFIs should have processes for handling and reporting exceptions against the underwriting criteria and limits.	• Underwriting criteria are not sufficiently granular to reflect the risk profiles, such as income-producing vs construction, residential vs commercial purpose. • Exception processes are not consistently applied, or controlled, and do not provide sufficient justification, documentation, or mitigation for deviations from the underwriting criteria.	• Align underwriting criteria with risk appetite framework, and consider potential impact of various scenarios, such as changes in economic conditions, interest rates or market supply. • Subject exception processes to adequate oversight, audit, and to provide timely and accurate information to senior management on the nature, frequency, and impact of exceptions.
5.2 **Debt service capacity (DSC) assessments**	• FRFIs should check the borrower's ability and willingness to pay back the loan, based on the borrower's income, expenses, debts, equity, and experience. • FRFIs should also consider how the borrower's income may change over time	• Insufficient accuracy or completeness of the data and information used to calculate the DSC, such as the financial statements, tax returns, lease agreements, appraisal reports, and environmental assessments. • Lack of forward-looking DSC assessments by considering significant year-to-year variations of NOI.	• Appropriate stress tests and sensitivity analysis to the DSCR by variations of NOI through the interest rate, inflation rate, or economic growth rate, on the borrower's cash flow. • Use historical data and benchmarks analysis to determine the appropriate DSCR, or the minimum DSCR requirement.
5.3 **Borrower collateral valuations**	• Rigorous initial and ongoing valuation risk assessments of the underlying collateral for CRE lending. • Ongoing reviews should consider the borrower's current circumstances, the status of projects, and prevailing economic conditions.	• Lack of dynamic evaluation of the underlying collateral value • Collateral value is static at origination.	• Captures the dynamics of the collateral market value (i.e., property value) over time, leveraging pricing indices for scaling. • Processes for re-evaluate collateral value when the original terms and conditions of CRE loans are revised.

Underwriting and account management (section 5) - continued

	Key takeaways	Common gaps	Key considerations
5.4 **Sponsor and guarantor assessments**	• FRFIs should review the guarantor's financial strength, commitment, and willingness to support the loan, based on various factors and their track record. • FRFIs should adjust the thoroughness of the review according to the level of reliance on the guarantor.	• Inadequacies in assessment and recognition of guarantors' risk profiles, credit risk mitigation and other associated risks. • Stale guarantor and sponsor information since origination.	• Evaluate guarantor's strength (i.e., TNW), injection capacity and liquidity position to demonstrate the ability to pay. • Evaluate guarantor and borrower relationship. • Re-evaluate when the terms and conditions are revised.
5.5 **Multi- and co-lender arrangements**	• Multi-lender and co-lending arrangements for CRE loans can pose additional risk due to legal, operational, and structural complexities. • Policy limits, underwriting, assessment, monitoring for quantifying and managing such risks.	• Insufficient policy, expertise, monitoring procedures for evaluating and managing the risks associated with multi-lender arrangements, including hidden leverage. • Inadequate legal, operational, and structural safeguards to protect its interests and rights in the event of default, distress, or dispute.	• Access and review on multi- and co-lender financial statement and risk profile over time.
5.6 **Borrower sensitivity analysis**	• FRFIs should conduct sensitivity analysis on individual accounts to assess the impact of economic trends and stress events. • FRFIs should match the thoroughness of sensitivity analysis with the exposure and vulnerability of the borrowers.	• Sensitivity analysis methodology and success criteria not sufficiently thorough in risk drivers and scenarios coverage; not sufficiently granular. • Lack of sensitivity to changes in the macroeconomic environment.	• Sensitivity calculations of different factors that can impact an obligor's performance including interest rate, vacancy level, rental rate, capitalization rate, and cost inflation sensitivities.
5.7 **Prudent account management**	• FRFIs should re-evaluate the borrower's capacity and risk rating when the original terms and conditions of CRE loans are revised. • FRFIs should have annual borrower review process, or more frequently if warranted.	• Inadequate review borrower's capacity and risk rating when CRE loans are revised (e.g., term renewal, new phase of interim loans).	• Obtaining the documentation necessary to verify its assessment of the borrower's financial condition, willingness to pay, guarantor's strength, and collateral value.

Portfolio management (section 6)

6.1 Effective portfolio and risk reporting systems

Key takeaways

- FRFIs should have robust portfolio data and risk reporting systems to effectively manage CRE risk.
- FRFIs need reliable and accurate information on CRE loan portfolio characteristics and credit metrics aligned with their lending strategy.

Common gaps

- Lack of reliable information on CRE loan portfolio characteristics and credit metrics.
- Inadequate portfolio data and risk reporting systems that hinder the identification and monitoring of CRE risks.
- Insufficient understanding of lending strategy, underwriting standards, and risk tolerances specific to CRE.

Key considerations

- Review and modernize portfolio data and risk reporting systems to ensure comprehensive coverage of CRE loan portfolios.
- Implement robust data collection and management processes to ensure reliability and accuracy of CRE loan portfolio information.

6.2 Diversification policy and concentration limits

Key takeaways

- FRFIs should have clear CRE loan diversification policies covering concentration limits based on property class, loan type, risk rating, segment, sub-segment, and location.
- FRFIs should identify correlated risk exposures and actively manage concentration levels within policy limits.

Common gaps

- Lack of defined of CRE loan diversification policies or lack of process to review and update those policies on a periodic basis.
- Inadequate process to clearly identify and mitigate correlated risk exposures.
- Inconsistent management and governance of concentration levels.

Key considerations

- Establish concentration limits aligned with risk appetite to integrate in loan diversification policies.
- Robust processes for the identification of correlated risk exposures.
- Regular reviews and stress testing to evaluate policy effectiveness and make adjustments.

6.3 Market monitoring analysis

Key takeaways

- FRFIs should thoroughly monitor CRE segments, geographies, and markets to identify areas of concern.
- Monitoring should include stress testing and sensitivity analysis and should be dynamic relative to macroeconomic trends and local market conditions.

Common gaps

- Insufficient granularity in monitoring CRE segments, geographies, and markets.
- Limited integration of market monitoring into portfolio stress testing and sensitivity analysis.
- Inadequate adjustment of monitoring intensity based on macroeconomic trends and local market conditions.

Key considerations

- Ensure availability of granular data to enable thorough monitoring.
- Implement dynamic monitoring that considers macroeconomic trends and localized market conditions.
- Ensure that portfolio stress testing and sensitivity analysis consider market monitoring outputs.

Portfolio management (section 6) – continued

	Key takeaways	Common gaps	Key considerations
6.4 **Portfolio stress testing**	• FRFIs should have robust stress testing frameworks that adapt to the evolving risk environment. • FRFIs are expected to implement robust data collection and management processes to ensure high-quality data inputs and early identification of risks.	• Inadequate stress testing frameworks that are not flexible enough to adapt to an evolving market. • Weak mechanisms for ensuring data quality inputs into stress testing processes. • No integration of market monitoring outputs.	• Review current stress testing frameworks to ensure flexibility and adaptability to current risk environment. • Integrate market monitoring outputs in the portfolio stress testing process. • Implement periodic review processes to improve the stress testing framework and data.
6.5 **Funding and liquidity**	• A comprehensive analysis of funding and liquidity risks associated with CRE lending should be undertaken. • Loan maturity risk, drawbacks on credit facilities, and securitization implications should be taken into consideration when assessing the potential stresses on the FRFIs' portfolio of CRE loan assets.	• Funding and liquidity risks with respect to CRE lending are not well understood and not quantified. • Even if these risks are quantified, specificities of the CRE portfolio or the broader impact of these risks on the FRFIs' operations are not well defined.	• Implement a robust funding and liquidity risk assessment process that considers potential secondary effects and stresses on the portfolio. • Regularly review and update the assessment process to reflect changes in the risk environment and portfolio dynamics.
6.6 **Adequacy of credit loss provisioning**	• FRFIs are expected to rigorously provision against CRE loan losses in a timely manner. • In the case of a SICR, a detailed assessment of the situation should be undertaken and documented. • For the SICR assessment under IFRS 9 guideline, forward-looking information should be considered.	• CRE loan losses are provisioned but not necessarily on a timely manner and not considering the evolving risk environment. • Absence of a clear process to assess and document SICR.	• Review the provisioning of CRE loan losses and ensure that the process is done on a timely basis. • Include forward-looking information, such as interest rate forecasts and vacancy expectations, when assessing SICR under the IFRS 9 guideline.

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