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CRE

Concentration Risk Management Plan

FISCAL YEAR ENDING MONTH DD, YYYY
PREPARED MONTH DD, YYYY

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A Strategic Framework for Banks

Many banks struggle to balance regulatory requirements with growth objectives when managing their CRE concentration risk. Traditional approaches to setting concentration limits often result in overly conservative thresholds that unnecessarily constrain lending, while others lack the quantitative rigor needed to withstand regulatory scrutiny.

At Invictus, we take a data-driven approach to concentration risk management, enabling banks to establish limits that are both supportable and strategically advantageous. Our methodology has helped banks expand their lending capacity, increase profitability, and navigate regulatory challenges with confidence. This plan provides a framework that incorporates these best practices, ensuring your bank has a roadmap for setting, monitoring, and optimizing CRE concentrations.

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Scope of Document

This section should define the purpose of the Concentration Risk Management Plan and provide a high-level overview of what it includes. The plan serves as the bank's framework for effectively identifying, measuring, and managing its concentrations to ensure sound risk management practices.

Briefly outline the key components covered in the document, including: Assessment, Policy Guidelines, Underwriting Analysis, CECL Considerations, Tools for Managing, Market Trends, Contingency Planning & Alignment with Strategic Objectives.

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Assessing Concentrations

This section should identify which concentrations exist within the bank's portfolio and determine whether they require enhanced risk management. Banks must assess their exposure to commercial real estate (CRE) and construction lending in alignment with regulatory thresholds and internal risk tolerance.

Key Considerations for Assessing Concentrations:

- **Regulatory Thresholds:**
  - 100% of risk-based capital for construction lending
  - 300% of risk-based capital for total CRE exposure
  - 36-Month Growth Rate – If growth exceeds 50% over 36 months, the bank should prioritize enhanced risk management.

- **Trend Analysis:**
  - Evaluate how the bank's CRE and construction loan exposure has evolved over time.
  - Identify any emerging risk patterns, such as accelerated growth in certain segments.

- **Strategic Alignment:**
  - Define how current concentrations fit into management's strategic plan for the next 1-3 years.
  - Determine whether the bank aims to increase, maintain, or reduce specific concentrations.
  - Assess potential capital implications and ensure alignment with risk appetite and growth objectives.

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CRE Portfolio Segmentation

This section should outline how the bank segments its Commercial Real Estate (CRE) and Construction portfolio to assess concentration risks effectively. Proper segmentation provides clarity on risk distribution and helps establish internal policy guidelines for managing exposure.

Key Segmentation Methods:

- **By Property Type:**
  - Retail, office, multifamily, industrial, hospitality, etc.
  - Helps identify which property types have higher exposure and potential risk.

- **By Geographic Market:**
  - Segmenting by location (e.g., NYC vs. NJ vs. PA) provides insight into regional economic factors and market-specific risks.
  - Consider local market conditions, economic trends, and regulatory environments.

- **By Loan Characteristics or Niche Segments:**
  - Identify specific high-risk sectors (e.g., land development, construction, owner-occupied vs. investor-owned).
  - Assess how different loan structures impact overall portfolio risk.

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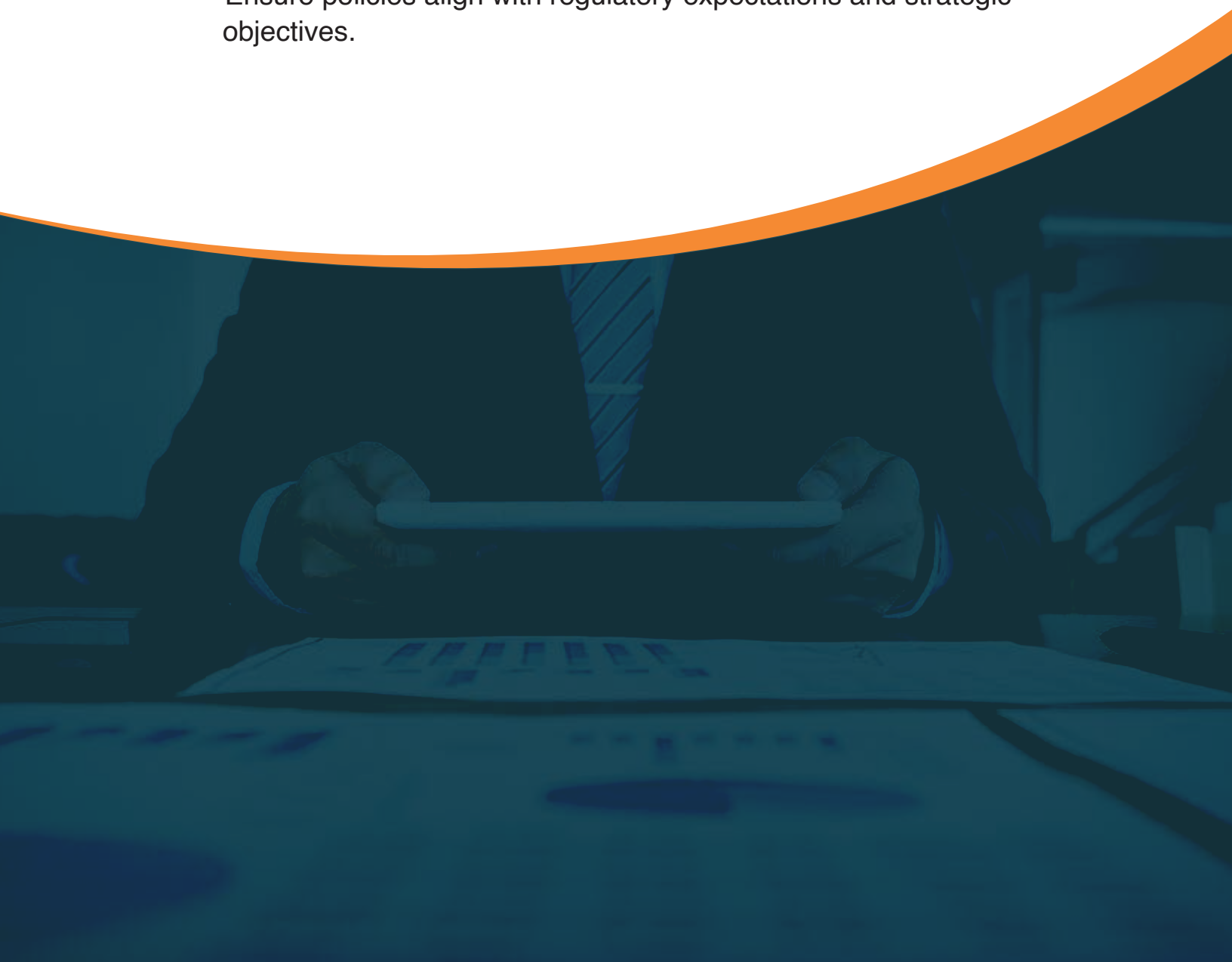
Establishing Internal Policy Guidelines:

- **Identify Higher-Risk Segments:**
  - Determine which portfolio segments have relatively higher concentrations relative to capital.
  - Example: A bank may decide to set internal guidelines if a CRE segment exceeds 50% of risk-based capital.

- **Trigger Risk Management Measures:**
  - Define when additional oversight or mitigation strategies are required.
  - Ensure policies align with regulatory expectations and strategic objectives.



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Concentration Policy Guidelines

Establishing clear concentration policy guidelines ensures that the bank maintains a well-managed and controlled CRE risk exposure. This section should define limits and triggers as a percentage of risk-based capital for each relevant segment of the CRE portfolio and outline a framework for forecasting future concentrations to support strategic decision-making.

Key Components of Concentration Policy Guidelines

Defining Limits & Triggers:

- Set specific thresholds for each CRE segment (e.g., Multifamily, Office, Retail, Construction & Land Development).
- The sum of segment-level limits should define the overall CRE portfolio limit.
- Limits should be based on quantitative analysis, including stress testing, rather than arbitrary benchmarks.

Comparing Current Concentrations to Policy Limits:

- Evaluate existing concentration levels against established limits and triggers.
- Identify segments approaching or exceeding risk thresholds.

Forecasting Future Concentrations:

- Align with the bank's strategic plan to anticipate future risk levels.
- Provide the Board of Directors with a clear view of expected concentration trends.
- If forecasts indicate a breach of policy limits, banks should:
  - Adjust the strategic plan accordingly.
  - Develop a mitigation strategy (e.g., loan sales, participations, underwriting adjustments).

Quantifying CRE Limits:

Rather than setting arbitrary concentration limits, banks should leverage a data-driven approach to determine the highest sustainable limits that align with their risk appetite, capital position, and growth objectives. Best practices are as follows:

- Assessing the bank's ability to absorb CRE losses through capital stress testing
- Perform reverse stress tests to quantify maximum concentration levels
- Benchmarking against peer institutions to ensure competitive positioning
- Identifying opportunities to safely expand exposure in underutilized segments

This approach ensures that limits are not only defensible in regulatory discussions but also maximize lending capacity without exposing the bank to undue risk.

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Portfolio Underwriting Analysis

A comprehensive underwriting analysis is essential to ensuring that the bank's CRE portfolio maintains strong credit quality and aligns with risk management policies. This review should be conducted annually at a minimum and focus on key underwriting trends at the segment level, especially for segments that have concentration policy limits and triggers.

Key Areas of Underwriting Analysis

Loan-to-Value (LTV) & Loan-to-Cost (LTC) Trends

- Are LTVs or LTCs creeping up over time?
- How do current levels compare to underwriting standards?

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Debt Service Coverage Ratio (DSCR) Trends

- Is the percentage of DSCRs falling below underwriting standards increasing or decreasing?
- Are there more loans with high LTV and low DSCR combinations, indicating increased risk?

Underwriting Exceptions

- Are exceptions to underwriting guidelines becoming more frequent?
- Are there more loans with multiple underwriting exceptions, which may indicate a weakening of credit discipline?

Risk Rating Migration & Loan Review Findings

- Are criticized or classified loans increasing in the portfolio?
- Has there been an increase in collateral-dependent loans?
- Are loan reviews supporting existing risk ratings, or are more loans being challenged and downgraded?

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CECL & Concentration Risk Management

The Current Expected Credit Loss (CECL) framework requires banks to ensure that concentration risk is accurately reflected in the Allowance for Credit Losses (ACL). This section should document how concentration risk is incorporated into the ACL calculation and the methodology used to quantify its impact.

Key Considerations for CECL & Concentration Risk

Methodology for Capturing Concentration Risk in the ACL

- How is concentration risk being factored into ongoing ACL calculations?
- Are qualitative factors (Q-factors) being used, or is the model capturing risk quantitatively?

Considerations for Simpler, Q-Factor-Heavy Approaches (e.g., WARM)

- If using the Weighted Average Remaining Maturity (WARM) method, banks must establish a robust framework for deriving and justifying the concentration Q-factor.
- This should include clear documentation of how specific CRE segments, market conditions, and economic forecasts influence concentration-related Q-factor adjustments.

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Considerations for Loan-Level, PD/LGD-Based Models

- Banks using Probability of Default (PD) / Loss Given Default (LGD) models should document:
  - How concentration risk is captured quantitatively within the model.
  - Whether stress testing or scenario analysis is used to forecast concentration risk impact on expected credit losses.
  - How historical loss experience, economic conditions, and portfolio segmentation inform concentration risk estimates.

Ongoing Monitoring & Documentation

- How often is concentration risk assessed within the ACL framework?
- Are periodic adjustments to Q-factors or model parameters being made based on portfolio trends?
- How is management ensuring consistency between CECL, stress testing, and broader risk management policies?

Aligning Concentration Risk with CECL Modeling

Banks that accurately quantify their CRE concentration risk can better align their CECL modeling to reflect real exposure rather than relying on broad assumptions. The Bank's approach should incorporate:

- Segment-specific loss projections tied to concentration risk levels
- Dynamic Q-factor adjustments based on real-time market and portfolio conditions
- Forward-looking risk analysis that supports regulatory justification for reserve levels

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Stress Testing & Capital Resilience

Purpose:

This section should outline the **frequency, methodology, and results of stress testing,** ensuring that concentration risks are evaluated at both the **portfolio level (CRE/Construction)** and the **bank-wide level (capital stress testing).**

It is absolutely critical that your stress test on your CRE loans impacts institution's capital adequacy. Do not make the mistake of thinking all you need to do is a CRE loan-only stress test! This can only be done with a loan-level stress test that rolls into a broader capital stress test that captures the impact on the entire
bank.

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Key Components of an Effective Stress Testing Framework

Comprehensive Stress Testing Approach

Your stress tests should have all of these capabilities synced together; these are not three separate / mutually exclusive analyses:

- **Loan-Level, Bottom-Up Analysis:**
  - Stress testing should be conducted at the loan level, driven by individual loan characteristics (LTV, DSCR, property type, geography, etc.).
  - Avoid top-down stress testing, which lacks granular insights.

- **Economic Scenario-Based Testing:**
  - Stress tests should model realistic economic downturn scenarios, such as a severe recession, to assess the true impact on capital.
  - Scenarios should incorporate rising vacancies, falling rents, and declining property values in CRE portfolios.
  - Scenarios should also be highly relevant to current market conditions. For example, banks must be running stress tests against a recession potentially triggered by tariff policies and a looming global trade war.

- **Capital Stress Testing:**
  - A bank-wide capital stress test should assess the impact of portfolio risk on the bank's capital adequacy and resilience.

Frequency of Stress Testing

- Conducted at least annually, but ideally semi-annually or quarterly to capture evolving risks.
- Results should be analyzed over time to detect trends and identify deteriorating conditions.

Interpreting Stress Test Results

- Establish Key Performance Indicators (KPIs) to track stress test results over time.
  - Are stress test results improving or worsening?
  - What factors are driving changes in results?

- Compare stress test results against internal capital and concentration limits (as outlined in Section 4).
- Identify CRE loans most vulnerable under stress scenarios and develop action plans for high-risk exposures.

Stress Testing Multiple Iterations of the Bank

At minimum, you should have the capability of stress testing each of the following versions of the Bank:

- No-Growth iteration which assumed a static balance sheet and assumes no Management changes. This gives you a baseline analysis before consideration of Management actions.

- Strategic Plan or Budget which likely includes asset growth, loan growth (especially growth in areas of concentration), capital actions, and growth in expenses. A stress test of your plan is a highly theoretical, but can help you quantify the amount of capital required to fund the plan by comparing to the No-Growth scenario.

- Concentration Limit Stress Test which simulates growth in CRE or construction lending until the Bank no longer passes the stress test. An alternative version includes a stress test of existing limits.

- Contingency Plan Stress Test. This should simulate how Management would likely respond to stress. Could include the positive impact to capital from de-leveraging, reducing capital actions, cutting expenses, pushing down capital from the holding company, etc.

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Capital at Risk & Loan-Level Action Plans

- Sort stress test results by "Capital at Risk"—loans with the highest risk of loss should be prioritized for proactive management.
- Management should develop individualized plans for high-risk loans to mitigate potential losses before issues materialize.

Common Misconception: Stress Tests vs. Sensitivity Tests

- Stress Tests: Assess how a portfolio performs under a severe economic downturn scenario.
- Sensitivity Tests (See Next Section): Analyze how individual factors (e.g., NOI decline, LTV shocks) impact risk levels.

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Sensitivity Testing

Purpose:

This section should outline the methodology, frequency, and results of sensitivity testing, which assesses how changes in key risk factors impact the CRE portfolio. Unlike stress testing, which evaluates economic downturn scenarios, sensitivity testing isolates specific risk variables such as Net Operating Income (NOI), interest rates, and property valuations to measure their impact on loan performance.

Key Components of Sensitivity Testing

Comprehensive Sensitivity Analysis

- **NOI Stress Testing:**
  - Evaluate how loans perform under decreasing NOI scenarios (e.g., 20% decline).
  - Break down NOI into rental rates, occupancy rates, and operating expenses to assess how each factor contributes to risk.

- **Property Valuation Shocks:**
  - Test the impact of declining property values by increasing cap rates (e.g., +200 basis points).
  - Identify loans where LTV exceeds 100% under these conditions.

- **Interest Rate Sensitivity:**
  - Determine which loans would see their DSCR fall below 1.0x if interest rates rise upon repricing.
  - Assess the impact of potential future rate hikes on floating rate loans and loan renewals.

Frequency & Trend Analysis

- Sensitivity testing should be conducted at least annually, but ideally quarterly to capture market fluctuations.
- Compare results to previous sensitivity tests to identify emerging risks and track deterioration over time.

Identifying High-Risk Loans

- Loans that fail multiple sensitivity tests (e.g., falling NOI, rising rates, and declining values) should be flagged for immediate review.
- Cross-reference with stress test results—loans that fail both tests should be prioritized for further analysis, especially if they are still pass-rated (not yet criticized/classified).

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Market Analysis

Purpose:

This section should provide a summary of market trends affecting the CRE sectors in which the bank has exposure. The goal is to identify emerging risks and opportunities by analyzing transaction activity, cap rates, and relevant market indices.

Key Components of Market Analysis

CRE Market Trends

- **Transaction Volume:**
  - Are property sales increasing or slowing down?
  - Which property types (e.g., multifamily, office, industrial, retail) are experiencing higher/lower transaction activity?

- **Cap Rate Trends:**
  - Are cap rates expanding or compressing for key property types?
  - How do current cap rates compare to historical averages?
  - Loan Demand & Credit Conditions:
  - Are lending standards tightening or loosening?
  - How is loan origination volume trending across different CRE sectors?

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Sector-Specific Analysis

- Break down market trends by relevant property type and geography.
- If the bank has significant exposure to a particular niche (e.g., Class B Office in secondary markets), provide insight on vacancy rates, rental trends, and investment activity.
- Include local economic drivers (e.g., job growth, infrastructure projects) that may impact portfolio risk.

Market Data & Research Sources

- **Summarize insights from reputable data sources such as:**
  - CoStar, REIS, Green Street, CBRE, Moody's, or Trepp.
  - Federal Reserve economic reports or industry white papers.
  - Local real estate board reports or surveys.

- **DO NOT simply copy and paste data**—translate findings into relevant takeaways for the bank's portfolio.

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Contingency Planning

Purpose:

This section should outline Management's plan of action if the bank breaches policy limits related to CRE concentration risk. The plan should cover both strategic and tactical responses to mitigate risk and realign with policy guidelines.

Key Components of Contingency Planning

Triggers for Contingency Actions

- Clearly define what constitutes a breach of policy limits (e.g., CRE expo sure exceeding internal risk thresholds set in Section 4).
- Identify early warning indicators that suggest concentrations may soon exceed acceptable levels.

Strategic Contingency Measures

- **Capital Plan Reference:**
  - If policy limits are breached, the bank should assess the need to raise additional capital to support higher CRE concentrations.
  - Link contingency planning to the Bank's Capital Plan, which outlines longer-term strategic actions.

- **Portfolio Diversification Strategy:**
  - Evaluate whether the bank should shift its lending focus to diversify risk across other asset classes or regions.

Tactical Risk Mitigation Actions

- **Tightening Underwriting Standards:**
  - Increase minimum DSCR, lower maximum LTVs, or adjust risk-based pricing.
  - Reduce exposure to higher-risk segments by implementing stricter approval processes.
- **Increasing Loan Participations & Syndications:**
  - Sell participations in CRE loans to reduce exposure while maintaining customer relationships.
  - Explore syndication opportunities with other banks or financial institutions.
- **Loan Sales & Portfolio Rebalancing:**
  - Identify loans or segments that can be sold to de-risk the portfolio.
  - Consider secondary market conditions and potential impact on earnings.
- **Modifying the Allowance for Credit Losses (ACL):**
  - Reassess CECL models and ensure the bank's ACL reflects heightened concentration risks.
  - Adjust economic forecasts and Q-factors in response to CRE market conditions.

Monitoring & Execution

- Assign responsibilities to specific Management & Board committees for implementing contingency measures.
- Define a timeline for executing risk mitigation strategies once a breach occurs.
- Establish reporting protocols to ensure stakeholders remain informed on the effectiveness of contingency actions.

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Capital Planning

Purpose:

This section should emphasize the critical connection between the bank's Capital Plan and its Concentration Risk Management Plan. While the Capital Plan is a separate document, it plays a key role in determining how the bank can support its CRE and Construction lending concentrations.

Key Components of Capital Planning in Relation to CRE Concentration Risk

Reference to the Bank's Capital Plan

- The Capital Plan should outline the bank's overall capital adequacy strategy, including how much capital is needed to support current and projected CRE concentrations.
- Banks should ensure that their capital planning aligns with concentration risk limits established in Section 4 (Concentration Policy Guidelines).

How the Capital Plan and Concentration Risk Management Interact

- **Stress Testing Integration:**
  - CRE concentration risk stress tests (discussed in Section 7) should directly inform the capital adequacy assessment.
  - If stress testing results indicate a potential capital shortfall, the Capital Plan should outline how the bank will address this (e.g., raising capital, reducing risk exposure).

- **Future Growth & Strategic Objectives:**
  - If the bank's strategic plan includes increasing CRE concentrations, the Capital Plan should reflect whether existing capital levels can support this growth.
  - If concentrations exceed internal risk-based capital thresholds, capital management strategies should be triggered (e.g., issuing subordinated debt, retaining earnings, or adjusting loan growth plans).

- **Regulatory & Risk-Based Capital Considerations:**
  - The Capital Plan should ensure compliance with regulatory capital requirements under Basel III and other applicable guidelines.
  - Capital adequacy should be reviewed in conjunction with regulatory expectations for CRE risk management.

Contingency Planning & Capital Adjustments

- **If stress test results show a need for additional capital, the Capital Plan should outline contingency actions, including:**
  - Issuing new capital (subordinated debt, preferred equity, etc.).
  - Adjusting dividend policies to preserve retained earnings.
  - Reducing high-risk concentrations through loan sales or participations.
  - Strengthening ACL reserves in alignment with CECL considerations.

Monitoring & Reporting

- The Board and Senior Management should regularly review capital adequacy in relation to CRE concentrations.
- A dashboard or quarterly report should track key metrics, such as:
  - Risk-Based Capital Ratios vs. CRE exposure.
  - Projected capital needs based on growth and stress testing outcomes.
  - Regulatory capital buffers and sensitivity analysis results.

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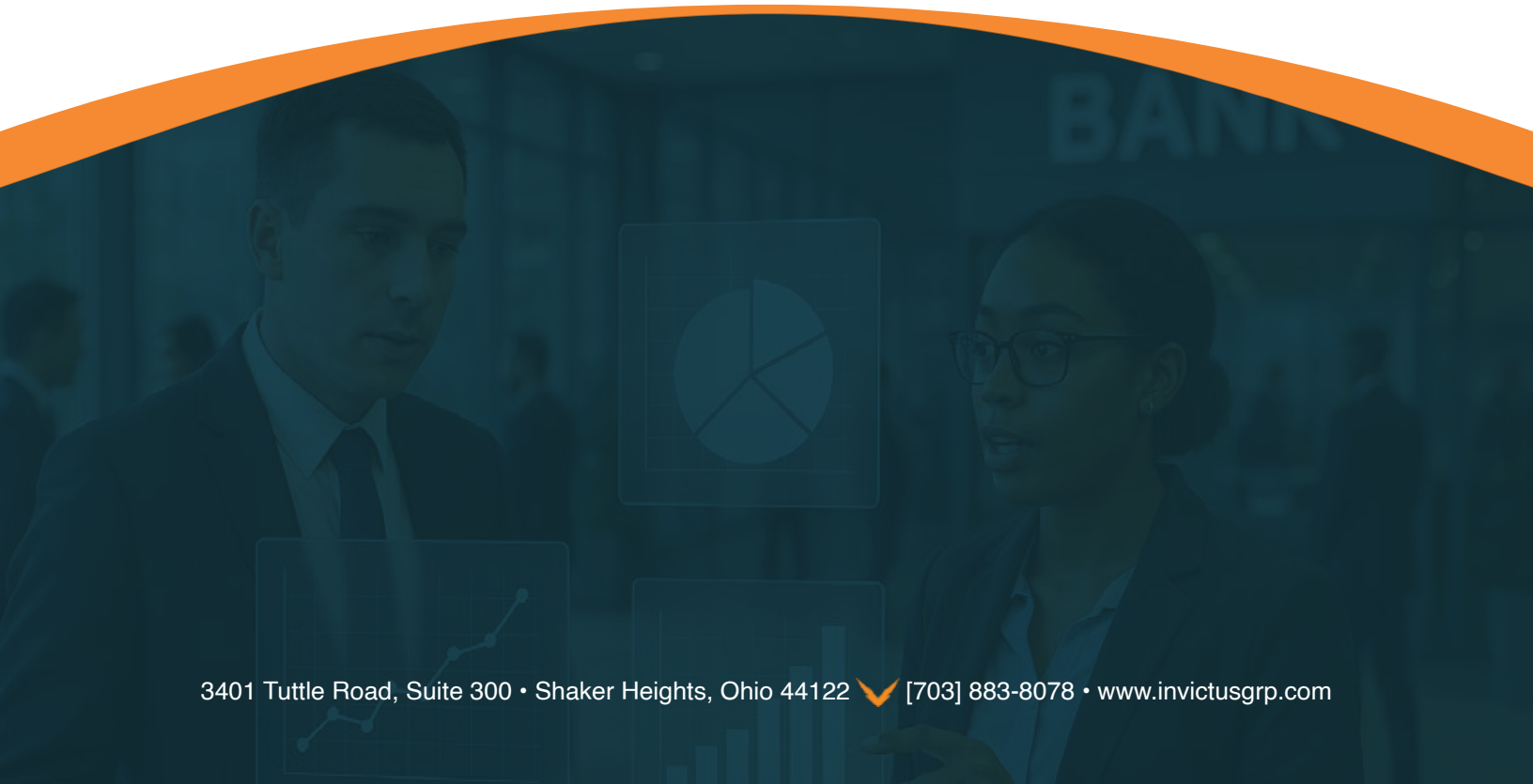
Conclusion

Effective CRE concentration risk management is not just about setting limits, it's about optimizing them. Invictus' approach allows banks to maximize their lending potential while maintaining capital strength and regulatory alignment. By leveraging advanced analytics and stress testing, banks can ensure that their concentration policies are not only defensible but also strategically advantageous. This plan provides the foundation for achieving that balance, ensuring that risk management supports, not hinders, growth.



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