Regulatory notice

Title	Commercial Real Estate risk management
Category	Sound Business and Financial Practices

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1. Background

Commercial real estate (CRE) is highly cyclical with the potential for significant losses, especially when risks are not effectively managed. In the current rapidly evolving risk environment, high inflation and rising interest rates have increased the potential for a rise in the number of borrower defaults. As discussed in OSFI's 2023-24 Annual Risk Outlook, we are conducting enhanced monitoring of CRE lending at federally regulated financial institutions (FRFIs), and this Regulatory Notice is intended to both respond to and provide support for this ongoing supervisory work.

2. Purpose and scope

This Regulatory Notice applies to all FRFIs active in CRE lending in Canada. It is interim regulatory guidance that responds to the heightened risk environment by reinforcing and clarifying expectations regarding sound risk management of CRE lending, including governance, underwriting, account management, and portfolio management. This interim guidance highlights key areas of focus for OSFI that have been identified through ongoing supervisory work and does not provide an exhaustive list of our expectations.

3. Definition

For the purposes of interpreting this Notice, CRE lending encompasses a broad asset class including but not limited to loans secured by income-producing real estate used for business purposes (e.g., shopping malls, office buildings), loans provided for the acquisition, development and construction (ADC) of such real estate, loans for residential real estate with 5 or more units where repayment depends on sale or rental income (e.g., apartment buildings), real estate held for lease to third parties, and non-residential real estate occupied by its owner or a related party.

4. Governance and risk management

The FRFI's risk appetite framework should establish limits regarding the level and type of risk the FRFI is willing to accept to achieve its business objectives with respect to CRE. It should be forward-looking and consider both normal and stressed scenarios. The risk appetite framework should form the basis of the FRFI's policies and procedures for CRE lending and portfolio management.

> Please refer to OSFI's Corporate Governance Guideline for expectations of FRFI boards of directors regarding the business plan, strategy, risk appetite, culture, and the oversight of senior management and internal controls.

Senior management is responsible for developing, implementing, and sustaining the FRFI's policies and procedures for CRE. These policies and procedures should reflect the size, scope, nature, and complexity of the FRFI's CRE portfolio and lending activity, and they should address the key principles of effective risk management, which are covered in more detail below (e.g., underwriting criteria, account management processes, economic monitoring, stress testing and sensitivity analysis, and data management and reporting systems).

The FRFI's CRE lending policies and procedures should be aligned with its enterprise-wide strategy and, in turn, linked to the enterprise risk management program. The FRFI should be able to identify, measure, monitor, and manage the risks connected to its CRE lending activity and its portfolio of CRE loan assets. On an ongoing basis, the FRFI should review its CRE lending policies and procedures to ensure they remain appropriate relative to its risk profile, long-term strategic plan, and the evolution of the risk environment.

5. Prudent underwriting and account management

5.1 Detailed underwriting criteria and exception processes

The FRFI should have documented and detailed underwriting criteria with clear, prudent, and measurable limits for the approval of individual CRE loans, based on the type of loan or property, including the maximum loan amount, term length, amortization schedules, and loan-to-value (LTV) ratios. These limits should be accompanied by processes for identifying, escalating, approving and reporting exceptions.

5.2 Debt service capacity (DSC) assessments

OSFI expects the FRFI to have processes to rigorously assess the borrower's ability and demonstrated willingness to service debt obligations, including the evaluation of the borrower's net operating income (NOI), global financial condition (e.g., material long-term expenses, debt obligations to other lenders), equity at risk (e.g., unencumbered investment in the underlying collateral) and track record operating similar properties or completing similar projects.

These assessments should reflect both the current and future capacity of the borrower to service debt obligations. Forward-looking assessments should consider significant year-to-year variations of NOI. Any adjustments made to future earnings (e.g., "add backs") should be carefully evaluated using the FRFI's documented underwriting criteria.

5.3 Borrower collateral valuations

Rigorous initial and ongoing valuation risk assessments of the underlying collateral are crucial for prudent CRE lending. Ongoing reviews should ensure that the FRFI critically assesses the borrower's current circumstances (e.g., capitalization rates, lease rates, tenancy, revenue and expenses), the status of projects (e.g., land development, building construction), and prevailing economic conditions (e.g., rates of employment, consumer spending, demographics and household formation). Collateral provides a source of recourse in the event the borrower and guarantor are unable to meet their obligations. As a result, where current information implies a meaningful decline in property valuation, adjustments to the collateral value and LTV ratio should be made as part of the ongoing credit risk assessment.

5.4 Sponsor and guarantor assessments

The FRFI should have an established process to review a loan sponsor or guarantor's financial strength and level of commitment, including the assessment of liquidity, net worth, contingent liabilities and support for other projects. It is also important to evaluate the demonstrated willingness of the guarantor to provide support based on an evaluation of their track record supporting other loans. In general, the thoroughness of the FRFI's assessment should be commensurate with the level of reliance placed on the guarantor.

5.5 Multi- and co-lender arrangements

Multi-lender and other co-lending arrangements for CRE loans (e.g., participation agreements) can present additional risk based on legal, operational, and structural complexities (e.g., non-standardized contracts, layering of subordinated debt arrangements). OSFI expects the FRFI to undertake its own due diligence and to have sound underwriting criteria, policy limits, risk management expertise, monitoring, and processes for evaluating and managing the risks associated with such arrangements, including hidden leverage.

5.6 Borrower sensitivity analysis

Through the annual borrower review process, or more frequently if warranted, the FRFI should conduct sensitivity analysis on individual accounts to assess how cyclical economic trends and severe but plausible stress events may impact loan performance and borrower risk. In general, the thoroughness of sensitivity analysis should be commensurate with the FRFI's exposure and the vulnerability of borrowers to market conditions.

5.7 Prudent account management

Documentation should be kept current through an annual borrower review process, or more frequently if warranted. OSFI expects the FRFI to have processes for obtaining the documentation necessary to verify its assessment of the borrower's financial condition, willingness to pay, guarantor's strength, and collateral value. The FRFI should regularly obtain relevant, current and up-to-date documentation about the financial condition of borrowers (e.g., NOI, tenancy, rent rolls, sustainability of cash flow); the liquidity, contingent liabilities and net worth of guarantors; the status of projects; multi-lender arrangements; and the value of underlying collateral.

OSFI recognizes the importance of the FRFI working constructively with CRE borrowers during more challenging periods of the cycle. However, the FRFI should maintain prudent underwriting criteria and CRE loan policy limits when taking actions to manage the accounts of distressed borrowers, such as forbearance, re-amortization, and other forms of loan accommodation or workout arrangements. For example, when the FRFI takes action to provide forbearance it should ensure the appropriate realignment of the borrower's ability to pay to avoid masking financial distress. In addition, when the original terms and conditions of CRE loans are revised (e.g., re-amortization) the FRFI should re-evaluate the borrower's capacity and risk rating.

6. Portfolio management

6.1 Effective portfolio and risk reporting systems

OSFI expects the FRFI to have portfolio data and risk reporting systems that are sufficient to identify, measure, monitor, report, and manage CRE risk. This includes reliable, accurate, and meaningful information on CRE loan portfolio characteristics and credit metrics relevant to the FRFI's lending strategy, underwriting standards, and risk tolerances.

6.2 Diversification policy and concentration limits

FRFIs with concentrations of CRE loans can suffer considerable distress during challenging market conditions. As such, CRE loan diversification policies are critical for effective portfolio management. It should include concentration limits across CRE loan assets that share similar characteristics or sensitivities to economic trends, such as the class of property, type of loan, risk rating, segment and sub-segment, and geographic location. OSFI expects the FRFI to identify correlated risk exposures and to mitigate the potential impact by proactively managing levels of concentration within policy limits.

6.3 Market monitoring and analysis

OSFI expects CRE segments, geographies, and markets to be monitored with sufficient granularity to permit identifying areas of concern. Monitoring market developments is a critical element of portfolio management. This monitoring should also inform portfolio stress testing and sensitivity analysis. The level of monitoring should be appropriate to the FRFI's exposure to loan product type, property type or geographic area. Monitoring intensity should be dynamic relative to macroeconomic trends and local market conditions (e.g., heightened monitoring of the office segment in certain geographies may be warranted in the current risk environment).

6.4 Portfolio stress testing

Stress testing is important for understanding how market conditions may impact CRE loans, particularly sub-segments of elevated risk or portfolio concentrations. OSFI expects the FRFI to have stress testing frameworks that are robust and fit for purpose, given the evolving risk environment. This includes having robust mechanisms for ensuring high-quality data inputs, appropriate postures of conservatism, and early identification of risks.

6.5 Funding and liquidity

The FRFI should comprehensively analyze funding and liquidity risks with respect to CRE lending, including the potential for secondary effects. Considerations should reflect the current risk environment and potential stresses on the FRFI's portfolio of CRE loan assets (e.g., loan maturity risk, drawbacks on credit facilities, and securitization implications).

6.6 Adequacy of credit loss provisioning

OSFI expects the FRFI to provision with rigour, including timely recognition and adequate provisioning against CRE loan losses. This should also include a detailed assessment of the evidence for a significant increase in credit risk (SICR) if warranted by the risk environment. In assessing SICR under the IFRS 9 Standard and OSFI's IFRS 9 Guideline, the FRFI should use reasonable and supportable forward-looking information available without undue cost, such as interest rate forecasts and vacancy expectations.