

January 7, 2009

All Commercial Banks
(excluding RRBs & LABs)

Dear Sir,

**Draft Guidelines on Classification of Exposures as
Commercial Real Estate (CRE) Exposures**

Please refer to our circular DBS.CO.PP.BC.21/11.01.005/2004-05 dated June 29, 2005 on the captioned subject, inter alia, defining CRE Exposures (Please see Annex).

In view of a number of queries received from banks and other quarters as to whether or not certain exposures should be treated as CRE Exposures, as also in the light of switching over to Basel-II Framework which has specific provisions relating to such exposures, it has been decided to review the definition of CRE Exposure. Draft proposals in this regard are contained in Annex for comments of banks and general public.

The comments may be sent to Chief General Manager-in-Charge, Department of Banking Operations and Development, 12th Floor, Central Office, Reserve Bank of India, Fort, Mumbai-400 001 before **January 31, 2009**. The comments may also be sent through e-mail.

Yours faithfully,

(Prashant Saran)
Chief General Manager-in-Charge

**Draft Guidelines on Classification of Exposures as
Commercial Real Estate (CRE) Exposures**

In terms of Basel -II Framework, CRE Exposures are of two types, (i) income producing real estates (IPRE) (ii) High volatility commercial real estate (HVCRE). These terms have been elaborated in the Framework in the context of advanced approaches for credit risk. It would be appropriate to follow the same approach for classification of exposures as CRE Exposures by banks which follow the Standardized Approach.

2. Basel-II Framework regarding CRE Exposures

2.1 Real Estate is generally defined as an immovable asset- land (earth space) and the permanently attached improvements to it. Under Basel-II, IPRE has been defined (para 226) of the Framework which is reproduced below:

"Income-producing real estate (IPRE) refers to a method of providing funding to real estate (such as, office buildings to let, retail space, multifamily residential buildings, industrial or warehouse space, and hotels) where the prospects for repayment and recovery on the exposure depend primarily on the cash flows generated by the asset. The primary source of these cash flows would generally be lease or rental payments or the sale of the asset. The borrower may be, but is not required to be, an SPE, an operating company focused on real estate construction or holdings, or an operating company with sources of revenue other than real estate. The distinguishing characteristic of IPRE versus other corporate exposures that are collateralised by real estate is the strong positive correlation between the prospects for repayment of the exposure and the prospects for recovery in the event of default, with both depending primarily on the cash flows generated by a property".

2.2 From the definition of IPRE given above it may be seen that for an exposure to be classified as IPRE/CRE, **both repayment and recovery** of the exposure should depend upon the real estate asset. In other words, if **either** the repayment (the identified source of repayment of principal and interest in normal course) **or** the recovery (the identified source of repayment of principal and interest in the event of default) does not depend upon the real estate, the exposure need not be defined as IPRE/CRE. However, in cases where the exposure is unsecured and the source of repayment is sensitive to change in real estate prices, the exposures would be classified as commercial real estate exposures.

2.3 Besides Basel II Framework, Federal Reserve System, USA have also defined Commercial Real Estate Lending as "income producing commercial property loans and commercial or residential developmental loans. (Para 2090.1 of Commercial Banks Examiners Manual). HVCRE need not to be elaborated at this stage, as we do not have any documented history of real estate cycles in India.

3. The approach proposed to be followed by RBI

The approach proposed to be followed is closely aligned to Basel II definition. If both the repayment and recovery of loan is primarily dependent upon either the level of real estate rentals or the real estate prices, it will be classified as Commercial Real Estate Exposure. On the other hand, if the repayment depends on other factors such as operating profit from business operations, quality of goods and services, tourist arrivals etc., the exposure would not be counted as Commercial Real Estate even if the land and building are taken as collateral and might be used in the recovery of the loan. However, unsecured exposures where the prime source of repayment has direct correlation with the level of real estate prices and rentals will also be classified as CRE.

4. Illustrations

In the following examples, we have applied the above principles to illustrate the point. Banks should keep these illustrations in mind while classifying their exposures and should record a reasoned note justifying the classification.

i) Loans extended to builders towards construction of housing buildings, hotels, hospitals, condominiums, shopping malls, office blocks etc. meant for sale/leasing.

In such cases, the source of repayment in normal course would be the cash flows generated by the sale/lease rentals of the houses/hotel/hospital/condominium etc. In case of default of the loan, the recovery will also be effected by sale of houses /hotel/hospitals. **Therefore, these exposures will be classified as CRE Exposures.**

ii) Loans extended for construction of hotels and hospitals to those entrepreneurs who themselves run these ventures.

In such cases, the source of repayment in normal course would be the cash flows generated by the services rendered by the hotel and hospital. In the case of a hotel, the cash flows would be mainly sensitive to the factors influencing the flow of tourism, not directly to the fluctuations in the real estate prices. In the case of a hospital, the cash flows in normal course would be sensitive to the quality of doctors and other diagnostic services provided by the hospital. In these cases, the source of repayment might also depend upon the real estate prices to the extent the fluctuation in prices influence the room rents, but it will be a minor factor in determining the overall cash flows. In these two cases, the recovery in case of default may partly depend upon the sale price of the hotel/hospital. Thus it may be seen that in these cases while repayment is not dependent on real estate prices, recovery is only partly dependent on the real estate prices/rentals. **Accordingly, such exposures need not be classified as CRE Exposures.**

iii) The loans extended to entrepreneurs, against the security of factory land and building, for purchase of the plant and machinery and raw material.

In such cases, the repayment would be made from the cash flows generated by the industrial unit from sale of the material produced which would mainly depend upon demand and supply factors. The recovery in case of default may partly depend upon the sale of land and building. Thus, it may be seen that in these cases the real estate prices do not affect repayment though recovery of the loan is partly from sale of real estate. **Accordingly, such exposure need not be classified as CRE Exposures.**

iv) Loans extended against the security of future rent receivables generated by CRE Exposure.

A few banks have formulated schemes where the owners of existing real estate such as shopping malls, office premises have been offered finance to be repaid out of the rentals generated by these properties. Such finance may or may not be secured by the mortgage of the underlying properties. In case it is unsecured, the repayment will be sensitive to fall in real estate rentals and there would be no source of recovery in case of default. In case the loan is secured by mortgage of the underlying property, both the repayment and recovery would depend upon property prices. Thus, these exposures would need to be classified as CRE Exposures.

v) Loans for purchasing plant and machinery

Working Capital Loan and Term Loan to acquire machinery to an industrial unit where the land and building is taken as collateral will not be classified as CRE Exposures because the repayment primarily depends on the operating profit of the unit.

vi) Loans for multiple houses intended to be rented out

While the above examples illustrate the approach intended to be followed, the housing loans extended in cases where the individual borrower declares that the house would be rented out need to be treated differently. As per Basel II Framework, loans secured by a single or small number of condominium or co-operative residential housing units in a single building or complex also fall within the scope of the residential mortgage category. National supervisors may set limits on the maximum number of housing units per exposure. Therefore, such loans need not necessarily be classified as CRE Exposures. However, it may be more appropriate to treat such loans as CRE Exposures if the borrower is in the business of renting housing units and if the total number of such units is more than two.

5. Exposure to SEZs

Drawing upon the above principles, our approach towards classification of exposures to SEZs would be as under:

5.1 Exposures towards purchase of land for setting up SEZs and development thereof

Exposures towards purchase of land and development thereof will be repaid from the sale proceeds/rental of the plots sold/leased to the units in the SEZs. The cost of plots would include the cost of land acquisition as well as the cost of land development. As both the repayment and recovery of loan depend on the same source of cash flow i.e. sale price/rentals, these exposures would be classified as CRE Exposures. (This is also the present position).

5.2 Exposures towards acquisition of units in SEZ.

Such loans were specifically included in the definition of CRE vide circular dated September 20, 2006 in order to prevent speculative dealings in such units. However, since there are restrictions on transfer of such units and require Government permission, the speculative activity in sale and re-sale of units is unlikely to be there. Therefore, such cases are more like financing of industrial units or the projects such as those mentioned at para 4(ii) above, and may not be treated as CRE Exposures.

5.3 Exposures to industrial units set-up in SEZs

The exposures to industrial units towards purchase of plant and machinery, and working capital requirement etc. will **not** be treated as CRE Exposures. (This is also the present position).

5.4 Classification of Exposures to SEZ as “Infrastructure Lending”

In terms of Para(vi) of Annex to Circular DBOD No.BP.BC. 52/21.04.048/2007-08 dated November 30, 2007 on 'Financing of Infrastructure by the Banks and Financial Institutions- Definition of Infrastructure Lending', exposure to SEZ is treated as “Infrastructure Lending”. For the purpose of these guidelines, only the exposure to SEZ indicated at Para 5.1 above will be treated as “Infrastructure Lending”.