



भारतीय रिज़र्व बैंक
RESERVE BANK OF INDIA
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DBOD.BP.No. 502 / 08.12.015/ 2008-09

July 7, 2009

All Commercial Banks
(excluding RRBs)

Dear Sir,

**Revised draft guidelines on
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.

2. 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 Exposure, as also in the light of switching over to Basel-II Framework which has specific provisions relating to such exposures, it was decided to review the definition of CRE Exposure. Draft guidelines were placed on the RBI website vide our circular No. DBOD.BP.No. 11021/08.12.015/2008-09 dated January 7, 2009 for comments of banks and general public.

3. In the light of the comments and suggestions received the proposed definition has been revised. In view of the modifications, it is considered appropriate to seek comments of banks and public again. Accordingly, revised draft of the guidelines is annexed 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 by **July 16, 2009**. The comments may also be sent [through e-mail](#) .

Yours faithfully

(B. Mahapatra)
Chief General Manager

Annex

Guidelines on Commercial Real Estate (CRE) Exposure

1. Definition of CRE Exposure

1.1 Real Estate is generally defined as an immovable asset- land (earth space) and the permanently attached improvements to it. Income-producing real estate (IPRE) has been defined in para 226 of the Basel-II 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 (Special Purpose Entity), 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".

1.2 From the definition of IPRE given above it may be seen that for an exposure to be classified as IPRE/CRE, the essential feature would be that the funding will result in the creation / acquisition of real estate (*such as, office buildings to let, retail space, multifamily residential buildings, industrial or warehouse space, and hotels*) where the prospects for repayment would depend primarily on the cash flows generated by the asset. Additionally, the prospect of recovery in the event of default would also depend primarily on the cash flows generated from such funded asset which is taken as security, as would generally be the case. The primary source of cash flow (i.e. more than 50% of cash flows) for both repayment and recovery would generally be lease or rental payments or the sale of the assets.

1.3. The approach followed by RBI

The approach followed is closely aligned to Basel II definition and Commercial Real Estate exposure would accordingly be defined as at para 1.2 above. It follows that if the repayment primarily 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.

1.4 The CRE exposures collateralized by eligible credit risk mitigants would be reduced to the extent of risk mitigating effects of the collateral as per the provisions of para 7.3.4 of [Master Circular RBI/2009-10/43. DBOD.No.BP.BC.21/21.06.001/2009-10](#) dated July 1, 2009 – Prudential Guidelines on Capital Adequacy and Market Discipline- Implementation of the New Capital Adequacy Framework (NCAF). CRE exposures to the extent secured by Commercial Real Estate would attract a risk weight of 100 percent. In cases where a part of the CRE exposure is not covered by the security of commercial real estate, that part would attract a risk weight for CRE exposure or as warranted by the external rating of the borrower, whichever is higher.

1.5. These guidelines will also be applicable to certain cases where the exposure may not be directly linked to the creation or acquisition of CRE, but the repayment would come from the cash flows generated by Commercial Real Estate. Illustratively, such cases may include: extension of guarantees on behalf of companies engaged in commercial real estate activities, exposures on account of derivative transactions undertaken with real estate companies, corporate loans extended to real estate companies and investment made in the equity and debt instruments of real estate companies.

2. Simultaneous classification of CRE into other regulatory categories

It is possible for an exposure to get classified simultaneously into more than one category, as different classifications are driven by different considerations. In such cases, the exposure would be reckoned for regulatory/ prudential exposure limit, if any, fixed by RBI or by the bank itself, for all the categories to which the exposure is assigned. For the purpose of capital adequacy, the largest of the risk weights applicable among all the categories would be applicable for the exposure. The rationale for such an approach is that, while at times certain classifications/categorizations could be driven by socio-economic considerations and may be aimed at encouraging flow of credit towards certain activities, these exposures should be subjected to appropriate risk management/prudential/capital adequacy norms so as to address the risk inherent in them. Similarly, if an exposure has sensitivity to more than one risk factor it should be subjected to the risk management framework applicable to all the relevant risk factors.

For instance, in terms of our [Master Circular RBI/2009-10/69 DBOD No. Dir. BC 13/13.03.00/2009-10](#) dated July 1, 2009 {para 2.3.7.3 (vi)}, lending in respect of Special Economic Zones (SEZs) has been defined as one of the categories eligible

for classification as ‘Infrastructure Lending’. Detailed definition of “Infrastructure Lending” as contained in this circular is reproduced in **Appendix 1**. Since certain types of exposures in respect of SEZs (please see item No. 4 in **Appendix 2**) would have the characteristics of CRE Exposure as per the approach outlined above, these would simultaneously be classified as both CRE Exposure and “Infrastructure Lending”. In such cases, the risk weight applicable would be that for CRE exposure even when the borrower may be AAA rated. However, the exposure would be eligible for all the regulatory concessions available to “Infrastructure Lending” as per extant RBI guidelines.

Similarly, an investment in the equity of a real estate company or a Mutual Fund/Venture Capital Fund (VCF) / Private Equity Fund (PEF) which invests in the equity of real estate companies, would be sensitive to the movement in prices of real estate, in addition to having a correlation with the general equity market. Therefore, these would be reckoned both as ‘capital market exposure’ (for the purpose of compliance with the regulatory ceiling fixed by RBI) and the internal ceiling for ‘real estate exposure’ fixed by the bank itself, as required in terms of extant RBI guidelines. At present, such exposures would attract a risk weight of 125% (as applicable to equity exposures) /150% (as applicable to exposure to VCFs), as the case may be as these risk weights are higher than that applicable to CRE at 100 percent. The exposure should also be reported to RBI under both the classifications with an appropriate foot note to avoid double counting. Banks could deal with any other instances of dual classification of exposures involving exposure to CRE, based on these principles.

3. In order to assist banks in determining as to whether a particular exposure should be classified as CRE or not, some examples based on the principles described above are given in **Appendix 2**. Based on the above principles and illustrations given in **Appendix 2** banks should be able to determine, whether an exposure not included in **Appendix 2** is a CRE or not and should record a reasoned note justifying the classification. In case banks have difficulty in making such determination, reference may be made to the Department of Banking Operations and Development with full particulars.

4. These guidelines supercede all previous circulars issued by RBI in so far as these relate to classification of exposures as CRE Exposures. The regulatory instructions

governing other aspects of real estate exposure including those contained in DBS circular dated June 29, 2005 would remain unchanged.

Definition of 'infrastructure lending'

Any credit facility in whatever form extended by lenders (i.e. banks, FIs or NBFCs) to an infrastructure facility as specified below falls within the definition of "infrastructure lending". In other words, a credit facility provided to a borrower company engaged in

- developing or
- operating and maintaining, or
- developing, operating and maintaining any infrastructure facility that is a project in any of the following sectors, or any infrastructure facility of a similar nature:
 - i. a road, including toll road, a bridge or a rail system;
 - ii. a highway project including other activities being an integral part of the highway project;
 - iii. a port, airport, inland waterway or inland port;
 - iv. a water supply project, irrigation project, water treatment system, sanitation and sewerage system or solid waste management system;
 - v. telecommunication services whether basic or cellular, including radio paging, domestic satellite service (i.e., a satellite owned and operated by an Indian company for providing telecommunication service), network of trunking, broadband network and internet services;
 - vi. An industrial park or Special Economic Zone;
 - vii. generation or generation and distribution of power;
 - viii. transmission or distribution of power by laying a network of new transmission or distribution lines;
 - ix. construction relating to projects involving agro-processing and supply of inputs to agriculture;
 - x. construction for preservation and storage of processed agro-products, perishable goods such as fruits, vegetables and flowers including testing facilities for quality;
 - xi. construction of educational institutions and hospitals;
 - xii. laying down and/or maintenance of gas, crude oil and petroleum pipelines.
 - xiii. any other infrastructure facility of similar nature.

Illustrative Examples

A. Exposures which should be classified as CRE.

1. Loans extended to builders towards construction of any property which is intended to be sold or given on lease (e.g. loans extended to builders for housing buildings, hotels, restaurants, gymnasiums, hospitals, condominiums, shopping malls, office blocks, theatres, amusement parks, cold storages, warehouses, educational institutions, industrial parks, warehouses)

In such cases, the source of repayment in normal course would be the cash flows generated by the sale/lease rentals of the property. In case of default of the loan, the recovery will also be made from sale of the property if the exposure is secured by these assets as would generally be the case.

2. 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. Even though such exposures do not result in funding/acquisition of commercial real estates, the repayment will be sensitive to fall in real estate rentals. Such finance may or may not be secured by the mortgage of the underlying properties.

3. Loans for multiple houses intended to be rented out

The housing loans extended in cases where houses are 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 and 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, if the total number of such units is more than two, the exposure for the third unit onwards may be treated as CRE Exposure as the borrower may be renting these housing units and the rental income would be the primary source of repayment.

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

Exposures towards purchase of land will be repaid from the sale proceeds/rental of the plots given on lease 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 the repayment and recovery of loan even if it is not mortgaged would depend on the cash flow from sale price/rentals, these exposures would be classified as CRE Exposures. (Banks can finance land only in case where it is permitted as per existing instructions). The exposure towards meeting the cost of development will be classified as CRE for the reason that the source of repayment would be the rentals or sale proceeds of the developed plots. Since these would be generally secured by the land and the

developed structure the recovery would be sensitive to the movement in real estate prices.

However, banks should keep in mind the substance of the transaction rather than the form. For example, it is possible that a SEZ may be developed by a single company entirely or mainly for its own use. In such cases the repayment will depend on the cash flows generated by the economic activities of the units in the SEZ and the general cash flow of the company rather than the level of real estate prices. **It should not then be classified as CRE.**

Similarly there can be co-developers in an SEZ who undertake a specific job such as provision of sewerage, electrical lines etc. If their repayment are not dependent on the cash flows generated by the CRE asset, **such exposures would not be classified as CRE.** This illustratively would be the case where the co-developer is paid by the main developer based on progress in work.

5. Loans for integrated township projects

Where the CRE is part of a big project which has small non-CRE component, it will be classified as CRE exposure since the primary source of repayment for such exposures would be the sale proceeds of buildings meant for sale.

6. Exposures to real estate companies

In some cases exposure to real estate companies is not directly linked to the creation or acquisition of CRE, but the repayment would come from the cash flows generated by Commercial Real Estate. Such exposures illustratively could be:

- Corporate loans extended to these companies
- Investments made in the equity/units/debt instruments of these companies
- Extension of guarantees on behalf of these companies
- Derivatives transactions entered into with these companies.

7. Exposures to MFs/VCFs/PEFs investing primarily in the real estate companies

Exposure to MFs/VCFs/PEFs investing primarily in the real estate companies would be classified as CRE exposure though the exposure would not be directly linked to the creation or acquisition of CRE, because the repayment would come from the cash flows generated by Commercial Real Estate.

8. General purpose loans where repayment is dependent on real estate prices

Exposures intended to be repaid out of rentals/ sale proceeds generated by the existing CRE owned by the borrower, where the finance may have been extended for a general purpose.

B. Exposures which may not be classified as CRE

1. Exposures to entrepreneurs for acquiring real estate for the purpose of their carrying on business activities, which would be serviced out of the cash flows generated by those business activities. The exposure could be secured by the real estate where the activity is carried out, as would generally be the case, or could even be unsecured.

a) Loans extended for construction of a cinema theatre, establishment of an amusement park, hotels and hospitals, cold storages, educational institutions, running haircutting saloons and beauty parlours, restaurant, gymnasium etc. to those entrepreneurs who themselves run these ventures would fall in this category. Such loans would generally be secured by these properties.

For instance, in the case of hotels and hospitals, 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 to some extent 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 cases, however, the recovery in case of default, if the exposure is secured by the Commercial Real Estate, would depend upon the sale price of the hotel/hospital as well as upon the maintenance and quality of equipment and furnishings.

b) Loans extended to entrepreneurs, for setting up industrial units will also fall in this category. 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 if secured by these assets. Thus, it may be seen that in these cases the real estate prices do not affect repayment though recovery of the loan could partly be from sale of real estate.

2. Loans extended to a company for a specific purpose, not linked to a real estate activity, which is engaged in mixed activities including real estate activity.

A company has two divisions. One division is engaged in real estate activity, and other division is engaged in power production. An infrastructure loan, for setting up of a power plant extended to such a company, to be repaid by the sale of electricity would not be classified as CRE. The exposure may or may not be secured by plant and machinery.

3. Credit facilities provided to construction companies which work as contractors

The working capital facilities extended to construction companies working as contractors, rather than builders, will not be treated as CRE exposures because the repayment would depend upon the contractual payments received in accordance with the progress in completion of work.

4. Financing of renovation of self-owned company premises

Such exposures will not be treated as CRE exposures because the repayment will come from company revenues.

5. Exposures towards acquisition of units in SEZ

Such loans were specifically included in the definition of CRE vide our [circular No. DBOD.BP.BC 30/21.01.002/2006-07](#) 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 should be more like financing of industrial units or the projects and if such is the case, these may not be treated as CRE Exposures.

6. Exposures to industrial units set up in SEZs

The exposures to industrial units towards purchase of plant and machinery, and working capital requirement etc. may not be treated as CRE Exposures.