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March 14, 2006

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Regulation Comments

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Re: **FDIC** (No docket ID); **FRB** Docket No. OP-~~1246~~ 1248; **OCC** Docket No. 05-21; **OTS** Docket No. 2006-01; **Proposed Interagency Guidance on Concentrations in Commercial Real Estate**; 71 Federal Register 2302; January 13, 2006.

Ladies and Gentlemen:

The federal banking agencies (the Federal Deposit Insurance Corporation, Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Office of Thrift Supervision, hereafter designated "Agencies") have proposed an Interagency Guidance on Concentrations in Commercial Real Estate that raises the requirements for risk management by banks and savings associations ("Guidance") that are deemed to have a concentration in commercial real estate ("CRE"). While not all commercial banks or savings associations are significantly involved in commercial real estate lending, a number of them are. For the reasons outlined below, this Guidance may well have significant adverse impact upon the banking industry and local economies. Accordingly, we recommend that the Agencies not issue it in its current form.

ABA appreciates the opportunity provided by the Agencies to comment upon the proposed Guidance. The American Bankers Association, on behalf of the more than two million men and women who work in the nation's banks, brings together all categories of banking institutions to best represent the interests of this rapidly changing industry. Its membership--which includes community, regional and money center banks and holding companies, as well as savings associations, trust companies and savings banks--makes ABA the largest banking trade association in the country.

General Comments

ABA has been informed that Agency staff consider the Guidance as largely reflecting existing real estate lending guidance from the Agencies. However, ABA staff discussions with member bankers reveal that many of our bankers see the Guidance as imposing significant new requirements on them as they engage in CRE lending. These bankers see the Guidance as raising serious concerns, which may be summarized as follows:

1. The new definition of a concentration in CRE includes several different types of CRE lending without any attempt to distinguish the different levels of risk posed by each.

2. Bankers will need to invest significant time, money, and effort to counter the assumption that they have an unsafe "concentration" of real estate loans.

3. Community banks with large portfolios of CRE should not necessarily have significantly higher reserves for loan losses. Such increased reserves should follow only if a portfolio in fact presents a higher level of risk.

4. The Guidance strongly suggests that community banks deemed to have a concentration in CRE will be required to hold significantly higher levels of capital than other banks because of a conclusion that a large portfolio of CRE is inherently riskier.

5. The Guidance may significantly reduce community banks' ability to fund CRE in their communities, which will have negative impact on the banks and their communities.

Recommendations

The Agencies should not issue one-size-fits-all guidance. Rather, the Agencies should apply existing guidance on a case-by-case basis to address any problems in those banks not engaging in CRE lending responsibly.

If the Agencies do issue additional CRE guidance, then it needs to be greatly modified. First, it needs to focus on those institutions that are causing the Agencies concern. One way to achieve this is to exclude from the definition of a concentration in CRE property for which the contractor has a contract for the construction and purchase of the property. Second, the initial concentration limits are too low to justify the greater increased scrutiny. The initial screen should be raised to 200% of a bank's total capital.

With respect to the requirements for banks to monitor these CRE loans, the Guidance should make clearer how the specific requirements for management information systems and monitoring of the CRE portfolio may be scaled for smaller banks and/or banks with specific CRE portfolios, such as primary residential housing construction.

Finally, the proposed Guidance should be rewritten to more carefully state when and how higher levels of reserves and higher capital requirements would be determined by examiners. The Agencies should not impute higher risk levels just on the basis of a finding of a concentration (as it is newly defined in the Guidance) in CRE lending. The Agencies need to address the needs for larger reserves or more capital on a case-by-case basis as part of the supervisory examination process rather than through an overly broad approach to reigning in CRE lending.

Analysis

1. Concerns over the Agencies' definition of a "concentration in commercial real estate lending"

Central to the application of the proposed Guidance is the definition of a "concentration in commercial real estate." This raises two fundamental issues: First, what is a commercial real estate loan, and second, what level of CRE lending represents a "concentration."

(a) The definition of CRE

CRE is defined by the Agencies as –

> exposures secured by raw land, land development and construction (including 1–4 family residential construction), multi-family property, and non-farm nonresidential property where the primary or a significant source of repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property.

CRE also includes loans to Real Estate Investment Trusts (REITs) and unsecured loans to developers that closely correlate to the inherent risk in CRE. The Agencies exclude loans secured by owner-occupied properties from the CRE definition as having a lower risk profile.

This definition melds various loans secured by commercial real estate into essentially one risk bucket, which ignores the very different risk profiles of some types of CRE-secured loans. First, there is no differentiation between retail and office commercial real estate loans and 1-4 family residential construction loans. This treatment does not consider the differences in risk of 1-4 family construction loans relative to construction loans for income property.[1] Second, there is no differentiation between 1-4 family residential construction that is built "on speculation" from 1-4 family residential construction where the contractor already has a contract for the house (a custom home contract). Losses on custom home contracts are very low and should not be in the same risk category as "spec housing."

The Guidance also inappropriately includes within the definition of CRE loans those loans that are made directly to consumers for construction of new housing. As we read the Guidance, the 100% threshold for a concentration of CRE does not treat these as owner-occupied. For some institutions, this type of lending is significant and its inclusion in regulatory guidance specific to CRE results in a significant distortion of the level of commercial construction risk relative to peer institutions. These direct-to-consumer construction loans are different from CRE because:

- These are really consumer real estate loans, not commercial real estate loans.
- These loans are generally originated for sale and underwritten to secondary market standards. The loans are classified as held for sale and generally sold to investors upon completion of construction.

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[1] ABA notes that the currently prescribed capital treatment of 1-4 family construction (50% vs. 100% risk weight of other loans) and the higher allowed supervisory loan to value limit (85% vs. 80%) is an acknowledgment by the Agencies of the lower relative risk of this type of lending. However, such recognition of this lower risk appears to be absent in the proposed Guidance. It would be appropriate to acknowledge this in whatever risk threshold is included in the final guidance. A failure to do so will distort risk level comparisons made between peer banks.

- While there is construction completion risk, there is virtually no real estate market risk. The owner-occupants are responsible for repayment, and the loans are underwritten to permanent financing standards.
- The agencies acknowledge the lower risk in this type of loan as the supervisory loan-to-value ratio limit for owner-occupied 1-4 family construction to permanent loans is 90%.

For all of these reasons, ABA recommends that the CRE definition be amended to distinguish clearly the risks between 1-4 family residential construction loans, particularly when they are "custom-built" loans or "owner-occupied" loans, and other commercial real estate loans. At a minimum, the Agencies should consider specifically excluding owner-occupied commercial real estate construction loans from the 100% threshold, in order to be consistent with the 300% threshold test for CRE, which acknowledges the fact that the risk profiles of these loans are less influenced by the condition of the general CRE market.[2]

(b) The appropriateness of the thresholds

After determining what is CRE, the Guidance sets forth the following two supervisory thresholds, either of which may trigger greater scrutiny, greater risk management requirements, greater loan loss reserves, and greater capital:

> (1) Total reported loans for construction, land development, and other land represent one hundred percent (100%) or more of the institution's total capital. Institutions exceeding threshold (1) would be deemed to have a concentration in CRE construction and development loans and should have heightened risk management practices appropriate to the degree of CRE concentration risk of these loans in their portfolios and consistent with the Guidance.[3]
>
> (2) Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land represent three hundred percent (300%) or more of the institution's total capital. Any institution exceeding threshold (2) should further analyze its loans and quantify the dollar amount of those that meet the definition of a CRE loan contained in this Guidance. If the institution has a level of CRE loans meeting the CRE definition of 300 percent or more of total capital, it should have heightened risk management practices that are consistent with the Guidance.

The Guidance is unclear on the effective differences between these two thresholds. Under threshold (1), an institution "should have heightened risk management practices appropriate to the degree of CRE concentration risk of these loans in their portfolios and consistent with the Guidance." Under threshold (2), an institution "should have heightened risk management practices that are consistent with the Guidance." The key appears to be that under threshold (1), an institution must determine its degree of CRE concentration risk and then apply appropriate risk management practices. This may allow institutions to determine that they have a lower risk rate in their portfolios of 1-4 family residential construction loans or in direct-to-consumer loans than if they have a concentration in office construction. However, the Guidance is not clear that banks may do this. This may lead to a heightened but uneven examiner scrutiny of banks' risk management practices, as different examiners

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[2] ABA notes that there are pending Call Report changes to schedule RC-C, line 1.e. that would facilitate the exclusion of owner-occupied commercial real estate loans form this calculation. If the Agencies continue with any Guidance, then ABA encourages the Agencies to use the new Call Report line item that excludes these loans when it becomes available.

[3] As noted above, this is an imprecise definition of CRE that does not distinguish between levels of risk of different types of lending identified as CRE by the Call Reports. If the Agencies decide to issue a revised Guidance, then bankers suggest that there be changes to the Call Report that allow better differentiation before defining such a threshold.

arrive at different judgments of an institution's "degree of CRE concentration risk" and require significantly different levels of risk management risk practices to similarly situated institutions.

Additionally, bankers are concerned at the relatively low threshold for determining when CRE concentrations present a higher risk. The Guidance sets an initial threshold of 100% of total capital for CRE. Previous limits on real estate lending set a threshold of 100% of total capital for loans secured by real estate **that were in excess of the supervisory loan-to-value ratio**. Total loans in excess of the supervisory LTV limits "for all commercial, agricultural, multifamily or other non-1-to-4 family residential properties" were also limited to no more than 30 percent of total capital.[4] As we understand the proposed Guidance, it is now possible for an institution to have **no** real estate loans over their appropriate LTV, yet trigger a presumed level of higher risk in CRE lending. This appears to be a significant shift in supervisory concern not clearly justified by the Agencies.

<u>2. Concerns over the burden required to counter the assumption of an unsafe concentration of CRE.</u> After determining that the bank has a concentration of CRE under the new definitions, the bank must ensure that it has "heightened risk management practices that are consistent with the Guidance." As noted above, all of the bankers we have consulted agree that high levels of CRE require heightened risk management, and they believe that they do in fact have such risk management. However, few community banks have all of the recommended risk management practices in place, and none believe that all of the practices set forth in the Guidance are justified for the CRE lending that they are doing.[5] These banks are following existing real estate lending guidance that provides a more detailed listing of risk management practices and is aimed at institutions that actually pose higher risks in their CRE lending. There appears to be no attempt in the proposed Guidance to scale the regulatory response to the size of the bank or the particular composition of its

4 See FDIC regulations at Appendix A to 12 CFR Part 365: Interagency Guidelines for Real Estate Lending Policies.
5 The complete list of recommended risk management practices is extensive. It includes:
(1) Board and management oversight of the level of acceptable CRE exposures and implementation of a CRE strategy consistent with risk tolerance. "Directors, or a committee thereof, should explicitly approve the overall CRE lending strategy and policies of the institution. They should receive reports on changes in CRE market conditions and the institution's CRE lending activity that identify the size, significance, and risks related to CRE concentrations. Directors should use this information to provide clear guidance to management regarding the level of CRE exposures acceptable to the institution."
(2) Addressing the CRE strategy in the institution's strategic plan. Strategic planning should include "an analysis of the potential effect of a downturn in real estate markets on both earnings and capital and a contingency plan for responding to adverse market conditions."
(3) Instituting clear and measurable underwriting standards in its lending policy with only limited, documented, exceptions. Underwriting standards should include:
- Maximum loan amount by type of property,
- Loan terms,
- Pricing structures,
- LTV limits by property type,
- Requirements for feasibility studies and sensitivity analysis or stress-testing,
- Minimum requirements for initial investment and maintenance of hard equity by the borrower, and
- Minimum standards for borrower net worth, property cash flow, and debt service coverage for the property.

(4) Instituting policies specifying requirements and criteria for risk rating CRE exposures, ongoing account monitoring, identifying loan impairment, and recognizing losses. Risk ratings should be risk sensitive, objective, and tailored to the CRE exposure types underwritten by the institution.
(5) Identifying and managing concentrations, performing market analysis, and stress testing CRE credit risk on a portfolio basis.
(6) Maintaining MIS systems that are adequate go provide, on either an automated or manual basis, stratification of the "portfolio by property type, geographic area, tenant concentrations, tenant industries, developer concentrations, and risk rating. Institutions should be able to aggregate total exposure to a borrower including their credit exposure related to derivatives, such as interest rate swaps. MIS should maintain the appraised value at origination and subsequent valuations."

portfolio, creating a "one-size fits all' approach inconsistent with recent regulatory initiatives in examination and supervision. For example, in the recent ANPR on Modifications to Domestic Capital Standards (Basel IA), the Agencies suggest that it would be appropriate to further lower the risk weight of home mortgage lending while including direct-to-consumer mortgage construction lending as higher risk CRE.

The Agencies state in the preamble to the Guidance that

> Recent examinations have indicated that the risk management practices and capital levels of **some** institutions are not keeping pace with their increasing CRE concentrations. In some cases, the Agencies have observed that institutions have rapidly expanded their CRE lending operations into new markets without establishing adequate control and reporting processes, including the preparation of market analyses.[6]

One of the problems with new Guidance that has as its focus a few institutions is that examiners and bankers assume that the Guidance will be applied with greater rigor to **all** institutions, not just the **some** that prompted the Agencies to propose the Guidance. We in fact already see this happening, as two of the bankers providing comment to ABA noted that their recent examinations involved much greater levels of scrutiny of the CRE and considerably more criticism of their risk management, even though neither felt that there had been significant changes in either their portfolios or their risk management practices since their last examinations.[7]

The extensive requirements set forth in the Guidance may be overwhelming for a community bank. Examiners will be asking for the bank's reports on market conditions, evidence of increased board oversight, production of new policies, more detailed strategic planning, quantifiable limits, contingency plans, feasibility studies, sensitivity analysis, stress-testing, tracking presales and more. Examiners clearly may use this Guidance to substantially increase the regulatory burden on community banks with limited staffs, and they may well feel that they are required to do so by the terms of the Guidance. ABA and our bankers believe this to be excessive, and should be reserved for those few banks that have problems in the risk management of their portfolios, whether it be CRE or any other concentration of lending.

<u>3. Concerns that the Agencies have made a *per se* assumption that CRE necessarily is riskier and warrants higher levels of reserves for loan losses</u>

The Guidance appears to create a *per se* assumption that banks with large portfolios of CRE should have significantly higher reserves for loan losses because of a presumed greater level of risk presented by the CRE. However, many banks report little or no loss in their CRE portfolios, and they question the validity of singling out CRE for additional reserves. The Agencies, in the preamble to the Guidance, state that "[i]n the past, weak CRE loan underwriting and depressed CRE markets have contributed to significant bank failures and instability in the banking system." But a point made repeated by bankers with whom we've communicated (and a point with which the Agencies apparently agree) is that banking today is different than it was in the mid-eighties. We now have new capital requirements and examinations are better. As the Agencies note in the preamble, overall underwriting is better, largely due to the existing Agency guidance on real estate lending and the application of supervisory loan-to-value (LTV) ratios and limits on loans in excess of those ratios.

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[6] 71 FR 2304 (emphasis added).

[7] One of the bankers stated, after reading the proposed Guidance, that he now understood what had happened to him in his recently concluded exam: the examiners were applying the draft Guidance to his institution before it had even been published.

Therefore, to blanket all banks with these requirements based on a newly crafted ratio, when there is no other evidence of weakness in capital or management, seems unjustified.

As community banks have been forced to consolidate lending due to national competition (in credit cards, mortgage lending and auto lending), local commercial real estate has been one of the strongest products for community banks. Their knowledge of their communities and markets affords community banks a significant advantage when competing for CRE loans. To now have stricter guidelines regarding commercial real estate imposed on all of them appears to increase the costs to all community banks doing CRE while only peripherally addressing any problem banks.

The assumption that there is a higher risk in a CRE portfolio ignores the risk presented by lending alternatives. Unsecured C&I loans, inventory financing, credit card lines, loans for consumer chattels -- none of these appear to be inherently less risky than CRE lending. Unlike these other types of loans, loans secured by mortgages on real estate, will still have value in the property upon recovery even if the property deteriorates or the appraiser made an overestimation of the property value. In even the worst case, only part of the principal will be lost.

Review of the Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions ("Policy Statement") reveals little additional information about concentration other than that factors to be considered in developing loss measurements include as one of a list of eight, "Effects of changes in credit concentrations," and that institutions should consider "(1) A review of trends in loan volume, delinquencies, restructurings, and concentrations" when considering validation of their loan loss methodology. [PAUL: I moved this text here from the following section b/c it addresses ALL. However, it will need some sort of punch line – perhaps something along the lines of "The Policy Statement has proven effective in focusing banks' attention on the risks presented by concentrations and the need to consider them when establishing reserves. We believe that there is insufficient evidence that additional burdens are appropriate at this point. In short, the Guidance perhaps is a solution in search of a problem."

By highlighting CRE and newly defining concentrations in CRE, the Agencies seem to be urging a higher reserving that previous guidance and policy do not necessarily support. Worse, it may be at odds with recent guidance on reserving from the AICPA, which places the community bank squarely between its regulator and its auditors. At a minimum, this part of the Guidance needs to be clarified by better explanation of the connection of the Guidance to the above-mentioned Policy Statement and Guidelines

<u>4. Concerns that the Agencies have concluded that banks with a focus on CRE should be required to hold higher levels of capital than other banks simply CRE lending is riskier.</u>

As noted above, CRE is not inherently riskier. Clearly, any high level of lending requires better risk management of that lending line and, therefore, there should be greater risk management as the concentration in any line of lending increases. However, community bankers tend to focus on one or two major lines of lending, in order to be sure that they have the expertise on hand to manage the risk in that lending. Higher levels of CRE lending appear to be a logical evolution for community banks. As former Federal Reserve Board Chairman Alan Greenspan said in a speech in early 2004,

> Particularly noteworthy is the longer-term trend at community banks that seems to have accelerated in the past three years--the increasing share of asset growth accounted for by nonresidential real estate finance, particularly construction and land development loans and commercial and industrial real estate financing. Last year these categories accounted for more than 90 percent of the net asset growth of banks with

> less than $1 billion in assets; multifamily real estate and farmland finance would bring the total to more than 100 percent, offsetting the declines in other categories.
>
> Such credit exposures are a natural evolution of community banking and are quite profitable, helping to sustain both the earnings and growing equity capital of community banks. Moreover, the evidence suggests that community banks have avoided the underwriting mistakes that led to so many problems ten to fifteen years ago. Borrower equity is much higher and credit criteria are much stricter. In the last recession and during the early weak recovery, we saw very few delinquencies in these credits. Nonetheless, bankers need to be aware of the historical real estate cycle that, in the past, placed such exposures under severe stress. One hopes these improvements in underwriting standards are lasting. But the painful lessons of banking history underscore the ever-present need for vigilance in managing geographic and business line concentrations.[8]

Community bankers do not argue against the need for vigilance in managing geographic and business line concentrations. But they do argue against the arbitrary demand for additional capital apparently found in the Guidance. The Interagency Guidelines Establishing Standards for Safety and Soundness ("Guidelines"), under the topic *Credit Underwriting*, state that institutions should establish and maintain prudent credit underwriting practices that "(5) take adequate account of concentration of credit risk; and (6) are appropriate to the size of the institution and the nature and scope of its activities." Regardless of the intent of the Guidance, the risk is that the Guidance will lead to inappropriately higher capital levels .The Guidance states that –

> Minimum levels of regulatory capital do not provide institutions with sufficient buffer to absorb unexpected losses arising from loan concentrations. Failure to maintain an appropriate cushion for concentrations is inconsistent with the Agencies' capital adequacy guidelines. Moreover, an institution with a CRE concentration should recognize the need for additional capital support for CRE concentrations in its strategic, financial, and capital planning, including an assessment of the potential for future losses on CRE exposures.[9]

Our bankers unanimously read this as an instruction to examiners to demand more capital in the event that the examiner determines that there is a concentration in CRE. They see this as unrelated to how well the institution is managing its CRE portfolio, how low losses have been, what reserves have already been taken, and all of the other factors that should weigh on a determination of the need for additional capital. True, at the end of the discussion on capital adequacy, the Agencies state "In assessing the adequacy of an institution's capital, the Agencies will take into account analysis provided by the institution as well as an evaluation of the level of inherent risk in the CRE portfolio and the quality of risk management based on the sound practices set forth in this Guidance." However, community bankers wonder if they can provide the kind of risk analysis that examiners will accept as mitigating this perceived higher risk. In short, bankers see this Guidance as a demand for higher capital at concentration levels that are really designed for triggering heightened risk management review rather than higher levels of capital.

The Agencies already have authority to demand higher levels of capital from any institution, if they determine that the institution has accumulated significantly higher risks than its peers. Here the Guidance appears to move past that authority into creating an inherent need for additional capital for

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[8] Remarks by Federal Reserve Board Chairman Alan Greenspan before the Independent Community Bankers of America Convention; San Diego, California; March 17, 2004.
[9] 71 FR 2307.

any concentration of CRE. Bankers believe that this sets far too low a trigger for requiring additional capital and ignores their current risk management practices. They urge that the Agencies drop this discussion of the need for additional capital and rely instead on existing authority, guidance and policies as the basis for a case-by-case determination of any need for additional capital.

5. Concerns that the effects of this Guidance will be to significantly reduce their ability to fund CRE in their communities, which will have negative impact on them and their communities.

Community bankers already find themselves unable to be competitive in various consumer lending businesses, lacking the scale to make credit card or auto lending profitable and sometimes unable to compete against the largest national mortgage lenders. Many have become larger lenders in the CRE market as a natural evolution of the banking market, as former Chairman Greenspan observed. This willingness to support business expansion in their communities has been crucial to economic recovery over the last few years in a number of communities. The implication that there will be major increases in capital requirements and loan loss reserves, as well as major additional demands on banks' officers and lending personnel to provide in-depth market analysis, stress testing analysis, and other analyses relating to possible negative effects of CRE concentrations, leads many banks to believe that they may well have to significantly curtail their CRE lending. As CRE lending has been one of few remaining major profit lines for community banks, they are deeply concerned about the negative impact of this Guidance on them and, consequentially, on their communities.

Conclusion

Our discussions with staff of the Agencies lead us to believe that those consequences are not the intent of the Agencies, but it is the nature of lending Guidance such as this to result in a period of constriction while examiners and bankers work out new understandings of regulatory instructions from on high. Such a result will not be of benefit to community banks or their communities, and apparently will not be what the Agencies intended either. ABA recommends that the Agencies carefully reconsider issuing this Guidance and instead rely upon current guidance and policies during examinations to rein in those few banks that are causing the Agencies' concerns about CRE.

If the Agencies continue with issuing this Guidance, ABA strongly urges the Agencies to thoroughly revise the Guidance to eliminate the areas of confusion and concern that it has created for community banks. Failing to do so would be a disservice to the Agencies' regulated institutions and to the communities these banks serve. If you have any questions about these comments, please call the undersigned.

We at Clearfield Bank & Trust Company support ABA's position.

Sincerely,

WEWood

William E. Wood
Chairman, President & CEO