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August 1, 2006

The Honorable Susan Schmidt Bies
Governor
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, DC 20551

Re: Summary of Suggested Improvements to the Guidance on Concentrations in Commercial Real Estate (CRE), July 20 Meeting

Dear Governor Bies:

Thank you again for your participation in the recent meeting to discuss the proposed CRE guidance. Our members agreed with your assessments that the meeting was very productive, and we appreciate the opportunity to discuss the industry's concerns about the guidance. Following that meeting, we were offered the opportunity to summarize the suggestions offered at the meeting for ways to improve the guidance. Below is a summary of the major points advanced as well as other points that supplement the American Bankers Association's (ABA) comment letter dated March 30, 2006.

We note at the outset our continuing belief that it is more appropriate for the agencies to address problems with CRE concentrations on a bank-by-bank basis rather than issue a document that, because it applies industry-wide, necessarily risks being applied inappropriately at some institutions. If an examiner determines that a bank is failing to manage its CRE risks adequately, then clearly the agency should work with the bank to ensure that deficiencies are corrected. This is different, however, from suggesting (as guidance inevitably does) that there is a problem across the entire industry that the examiners must now fix. The latter approach risks inappropriately severe and procrustean responses by examiners to problems that do not exist.

If, however, the agencies conclude that guidance is necessary notwithstanding that risk, we offer the following suggestions for improvements to the guidance.

1. Of gravest concern to our bankers is the belief that the guidance may be interpreted as a direction to examiners, once a CRE concentration in the bank's portfolio of loans is found, to require a bank to take additional steps (perhaps including adding capital or refraining from making additional CRE loans), even if that portfolio is well managed. Subsequent discussions with the principals and senior staff of the Agencies reveal that this was not the intent of the Guidance. Our first suggestion, therefore, is to clarify in the guidance that CRE loans are not inherently

riskier than other types of loans and that, if prudently managed, a bank may continue to make CRE loans notwithstanding the fact that the bank has a CRE concentration.

2. Related to the first point is a concern about the guidance being applied in a way that would automatically result in the imposition of additional CRE risk-monitoring or risk-mitigation steps, including additional capital and/or reserves for loan or lease losses. As discussed at our meeting, our members strongly believe that no regulatory response should be forthcoming without an adequate understanding by the examiners of how well a particular bank is managing its CRE portfolio. To impose additional burden on a bank without first determining that the bank is not properly managing the CRE portfolio is to a troubling degree like shooting in the dark and could be unnecessary, counterproductive, and harmful to the bank and its community. Thus, the guidance must underscore that any supervisory response will be calibrated to the facts presented by a particular bank.

3. The guidance must also reflect the fact that different banks have different resources and that what will be appropriate for one bank may be inappropriate for another. A community bank cannot be expected to have the systems, people, and processes that a regional or multinational bank has and may not need them for its particular situation and conditions. We appreciate acknowledgement of this fact in recent speeches by the agency principals,[1] and we urge that the final guidance contain a comparable acknowledgment.

4. Specifically in the context of the discussion of capital and reserves, the guidance should state that capital and reserves are appropriate topics for discussion only after the following:

- A concentration is found;
- The risk of the CRE portfolio is determined;
- Examiners conclude that the risk is not adequately managed;
- Examiners inform management of the inadequacies;
- The bank does not take steps to improve risk management within a reasonable time; and
- Examiners then determine that current reserves and/or capital are inadequate for the risk.

Requiring a bank to add capital and reserves in the absence of a demonstrated need either will adversely and inappropriately affect return on equity or force the bank to take additional risks, perhaps outside its area of expertise, in order to make efficient use of the additional funds. This could lead to more risk being driven into the banking system by the very requirement (*i.e.*, additional capital) that is intended to strengthen the industry.

5. The definition of "commercial real estate" for purposes of any final guidance should be rewritten. Currently, out of 44 pages of the Call Report, two-thirds of a bank's assets are lumped together on one line on Schedule RC-C. As discussed below, this raises concerns about the utility of the current definition and the need to narrow the definition of CRE loans.

**Utility of the definition.** The proposed guidance includes so many different types of loans within the definition "CRE" lending that it undermines whatever utility there is to identifying a concentration. The current approach includes residential construction, office construction, business expansion, and small business loans secured by real estate, all of which may exhibit considerable

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[1] *See, e.g.*, Remarks by Governor Susan Schmidt Bies at the Mortgage Bankers Association Presidents Conference, June 14, 2006.

variability in risk, loan-to-value ("LTV") ratios, and market volatility. It is difficult to draw meaningful conclusions about the risks of a concentration when so many different types of loans – sharing only the common thread of being secured in whole or in part by commercial real estate – are lumped together. While the proposed changes to the Call Report[2] will partially help address this issue by providing additional granularity that may be used to identify problematic concentrations, until those changes are finalized the guidance is likely to create "false positives" where examiners conclude that a bank has greater risk from its CRE portfolio than the facts support.

**Scope of definition.** Even after the Call Report changes are finalized, the proposed definition of "CRE loan" inappropriately includes certain types of loans. This can be addressed only through changes to the definition. At a minimum, bankers believe that a definition of CRE for determining a concentration should exclude:

- Residential construction loans to consumers, which are risk-weighted at 50% for capital;
- Loans to builders on presold homes;
- Construction loans to entities that will occupy the building once it is completed;
- All 1-4 family residential rental property loans; and
- Loans with a low LTV ratio.

It may be possible to use a broad definition of CRE while taking the above CRE distinctions better into account in the risk assessment of the portfolio. That is, rather than exclude these types of CRE from the definition, simply provide guidance to examiners that these types of CRE may pose considerably less risk and will require less rigorous "risk management" because of the lower risk inherent in them. This appears to be particularly true of loans to consumers for 1-4 family residential construction, presold residential construction, and loans with LTV ratios of 50% or less. Indeed, as noted above, 1-4 family residential construction loans are viewed as such low-risk investments that they are risk-weighted under Basel I Capital Accord at only 50% and may be rated even lower in Basel II revisions to the Capital Accord.

6. The proposed guidance excludes "owner-occupied" property, but bankers found the definition of "owner-occupied" to be unclear. We note that the recent FDIC FIL-7-2006 contains a test for determining whether a property is "owner-occupied."[3] At a minimum, this explanation should be included in the guidance.

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[2] Several proposed changes to the Call Reports have been adopted, but on a staggered, delayed system, some in 2006, some in 2007, and some in 2008, largely dependent upon the size of the bank and the degree of concentration in CRE. The changes are as follows:

- Splitting "Construction, land development, and other land loans" (CLD&OL loans) into separate categories for 1–4 family residential CLD&OL loans and all other CLD&OL loans (Schedule RC–C, part I, item 1.a; Schedule RC–N, item 1.a; Schedule RI–B, part I, item 1.a; and Schedule RC–L, item 1.c.1);
- Splitting loans "Secured by nonfarm nonresidential properties" (commercial real estate loans) into separate categories for owner-occupied and other commercial real estate (Schedule RC–C, part I, item 1.e; Schedule RC–N, item 1.e; Schedule RI–B, part I, item 1.e); and
- Replacing the breakdown of "Lease financing receivables" between leases from U.S. and non-U.S. addressees with a breakdown of leases between retail (consumer) leases and commercial leases for banks with foreign offices or with domestic offices only and $300 million or more in total assets (Schedule RC–C, part I, items 10.a and 10.b; Schedule RC–N, items 8.a and 8.b on the FFIEC 031 and Memorandum item 3.d on the FFIEC 041; and Schedule RI– B, part I, items 8.a and 8.b on the FFIEC 031 and Memorandum item 2.d on the FFIEC 041).

[3] "'Loans secured by other nonfarm nonresidential properties'" are those loans that are currently reported in Schedule RC-C, item 1.e, where the primary or a significant source of repayment is derived from rental income

7. The guidance also needs to provide a clearer discussion of what agricultural loans are included within its scope. The proposed guidance has two concentration tests:

> (1) Total reported loans for construction, land development, and other land represent one hundred percent (100%) or more of the institution's total capital; or
> (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.

The proposed guidance states in the footnotes that item (1) above is "For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC–C item 1a." The Call Report instructions state that:

> Schedule 1.a Construction, land development, and other land loans. Report in column B loans secured by real estate made to finance land development (i.e., the process of improving land -- laying sewers, water pipes, etc.) <u>preparatory to erecting new structures or the on-site construction of industrial, commercial, residential, or farm buildings.</u> For this item, "construction" includes not only construction of new structures, but also additions or alterations to existing structures and the demolition of existing structures to make way for new structures.
> Also include in this item:
> (1) Loans secured by vacant land, <u>except land known to be used or usable for agricultural purposes, such as crop and livestock production (which should be reported in Schedule RC-C, part I, item 1.b, below, as loans secured by farmland)….</u>
> (Emphasis added.)

For the second test of a CRE concentration, the proposed guidance includes nonfarm nonresidential properties, as reported in the Call Report. This point is explained in footnote 4 of the proposed guidance as follows: "For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC–C items 1a, 1d, and 1e." 1b is loans secured by farmland and 1c is loans secured by 1-4 family residential properties.

The guidance leaves open questions such as whether a loan secured by land on which a farm building is constructed is included within within the definition of "CRE loan" and, if so, whether it is included for purposes of both concentration thresholds. In order to achieve the agencies' goal of providing clarity about what is a CRE concentration, and in order to avoid any unintended

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associated with the property (i.e., 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. <u>Thus, the primary or a significant source of repayment for 'Loans secured by owner-occupied nonfarm nonresidential properties' is the cash flow from the ongoing operations and activities conducted by the party, or an affiliate of the party, who owns the property, rather than from third party, nonaffiliated, rental income or the proceeds of the sale, refinancing, or permanent financing of the property.</u> 'The determination as to whether a property is considered 'owner-occupied' should be made upon acquisition (origination or purchase) of the loan. However, for purposes of determining whether existing nonfarm nonresidential real estate loans should be reported as 'owner-occupied' beginning March 31, 2007, or 2008, banks may consider the source of repayment either when the loan was acquired or based on the most recent available information. <u>Once a bank determines whether a loan should be reported as 'owner-occupied' or not, this determination need not be reviewed thereafter.</u>" (Emphasis added.)

consequences of discouraging farmland lending, the guidance must be clearer in its discussion of when farmland will be deemed to be within the scope of the guidance.

* * *

As noted at our meeting, we very much appreciate the agencies' willingness to discuss the concerns of the industry and to make appropriate adjustments to the guidance to reflect those concerns. If the agencies decide that guidance is necessary (as opposed to dealing with problems on a case-by-case basis), then, given the substantial changes to the guidance that we recommend be made, we suggest the agencies republish the guidance in proposed form again so that the final product is likelier to strike the appropriate balance between benefit and burden. If, however, the agencies decide to publish a final guidance document as the next step, we suggest at a minimum, given the nonbinding, informal nature of guidance, that the agencies continue their dialogue with the industry about how the guidance is being applied and ways it may be improved going forward.

Sincerely,

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