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ARVEST BANK

April 10, 2006

Ms. Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

BY FAX TO: 202-452-3819

RE: PROPOSED INTERAGENCY GUIDANCE ON CONCENTRATIONS IN COMMERCIAL REAL ESTATE

FRB Docket No. OP-1248

Dear Sirs:

Arvest Bank is an Arkansas state-chartered commercial bank and a member of the Federal Reserve Bank of St. Louis. Arvest had consolidated banking assets of about $8.1 billion at December 31, 2005, including over $5.8 billion in loans. The trade territory of the bank stretches from north central Arkansas to southwest Oklahoma and from southwest Missouri to central Arkansas. The bank operates from over 200 branch locations in metropolitan areas including Little Rock, Oklahoma City and Tulsa; smaller metro areas such as Northwest Arkansas, Lawton, Oklahoma and Joplin, Missouri; and smaller cities such as Vinita, Oklahoma and Yellville, Arkansas. A wide variety of commercial real estate loans, both in size and type, are made in markets throughout the trade area.

We have read and studied the proposal and considered the proposed provisions in light of our trade areas, nature of loan opportunities, competitive factors and other matters. Numerous Arvest lenders and members of executive management have direct experience in dealing with the real estate difficulties of the 1980s and later years and have experience in a variety of business cycles.

In addition, we have read the comment letter dated March 30, 2006 submitted by the American Bankers Association, of which we are an active member. The ABA's letter provides a very thorough description of the concerns expressed by many bankers and we share the ABA's concern in most respects. We will not repeat the ABA's comments but rather express our support of the gist of their comments and attempt to provide an Arvest perspective on the proposal.

Our comments are grouped into three sections. The first set of comments relate to broader concepts and the approach to the issue of commercial real estate lending concentrations. The second section focuses on practical concerns. The third section addresses technical observations and comments.

502 South Main Mall • Tulsa, OK 74103-4425 • (918) 631-1000

CONCEPTS AND OVERALL APPROACH

Concentrations of assets, including loans, present an investor or asset manager an exposure to value declines in the asset classes in which the concentrations exist. Investment managers often choose to concentrate in asset classes where there is a reasonable belief that the financial reward more than offsets any increased risks. While such a strategy may be appropriate in an investment fund, the nature of lending by federally insured depository institutions should, on average, be more conservative and judicious in the acceptance of risks. We appreciate, and share, the regulatory interests in ensuring that concentration risk is appropriately managed.

Since the Thrift Debacle of the 1980s and early 1990s much has changed in the safety and soundness of the bank supervision system. Capital standards have been upgraded and the Basel "1.5" proposal is a continuing effort to manage capital adequacy. Much work has been done in the ALLL area and risk management concepts are more fully integrated in loan portfolio management. Real estate lending standards are more well-defined.

In developing a concept and approach to managing commercial real estate concentration risk, we offer the following ideas for consideration:

- The definition of concentration is crucial and different types of credits are not necessarily additive;
- Realistic and informed underwriting and quality documentation are essential precursors to managing credit risks of all kinds;
- Geographic and specific borrower concentrations remain most bank's primary concentrations;
- Simple measures allow for examiner latitude and resulting inconsistent application; and
- Capital and ALLL provides a cushion to absorb risk.

Definition of Concentration. **The proposal would establish a definition of concentration as the ratio of certain types of loans as compared to the bank's capital. In particular, two thresholds would be established at 100% of capital and 300% of capital.**

This concept of concentration presumes that loans of different types can be added together to arrive at some composite level. This is a questionable concept that can be misleading. Although a simple measure of concentration risk would be desirable, we are doubtful that the proposal has solved the puzzle.

Recognition that concentration is a risk that deserves effective management does not logically lead to a conclusion that concentration risk is the most important risk to manage or that concentration risk can be aggregated in a simple manner. For example, a bank with a very low level of concentration risk can still be a high-risk bank if underwriting standards are weak. Likewise, an apartment loan in Lawton, Oklahoma is not additive with a physician's clinic loan in Mountain Home, Arkansas and a distributor's warehouse loan in Webb City, Missouri. Even if all the loans above were to finance physician clinics, they are still not logically added to arrive at a composite risk as they involve different borrowers and different markets.

While we agree that concentration risk is worthy of good risk management practices, we would suggest that broad, aggregate measures are not very useful in efficient management of the risk. In short, a broad definition forces the bank to overstate its "real" risk and to likely devote resources in terms of manpower and operating expenses to what the proposal calls "heightened risk management" rather than to areas that the lender may consider more worthy of the resource. To the extent that overstatement of risk leads to more stringent underwriting, or to a scaling back of investment in certain loan types, then not only does the bank lose lending (and profit) opportunities but the market loses a competitor for loans that can adversely affect the liquidity in the market and lead to downward pressure on asset values. Lack of market liquidity is the stuff of which recessions and depressions are made.

Definitions of concentrations need to be more robust and sophisticated in order to be most meaningful.

Underwriting and Documentation. The most fundamental aspect of credit risk management is the adoption of sound underwriting standards implemented by experienced, well-trained and properly supervised lenders and properly documented to protect the bank's interest. A bank with strong underwriting and documentation can carry the same or higher level of concentration risk as another bank with weak underwriting yet be lower risk. While this may be the essence of the proposal's "heightened risk management" practices, we see this element as fundamental and not something that is part of a "heightened" regimen.

Geographic and Specific Concentrations. The proposal makes an underlying presumption that commercial real estate is particularly risky and deserving of some specialized attention. However, exposure to local or regional economies is virtually always a higher risk just as does exposure to a specific borrower. While lending limit rules curb the exposure to specific borrower risk, the geography risk generally is a component of every community and regional bank.

We are disappointed that the proposal does not offer ample evidence of the level of risk associated with commercial real estate lending as compared to other types of loans in support of such a presumption.

Examiner Latitude. The proposed 100% and 300% thresholds are simple enough as to how to compute. The issue of concern is how examiners will use the rule. It is not clear as to what the consequences are if the thresholds are exceeded. We believe there is much room for inconsistencies in how examiners from various agencies will apply the rule and that disparate impact will occur among competitors in the same market. It is not uncommon for different banks in the same market to be held to different standards in what constitutes sound underwriting based on our experiences, especially in markets where de novo banks are present and growth in loans is an extreme priority. It is not at all clear how the agencies will apply the rule in a reasonably consistent manner to all banks. While there are many worthy suggestions in the proposal as to what constitutes good practices in managing concentration risk, surely a bank would not be expected to enact all of the suggestions but rather those bank management found helpful and necessary. The provisions in the proposal for examiners to apply the guidance where there has been a "sharp increase" or a "significant concentration" only points out the high degree of subjectivity that can be expected. The current situation where the existing Supervisory Loan to Value Guidelines are not applied consistently to lenders in the same market exemplifies the problem.

Capital and ALLL to Absorb Risk. **The ultimate role of reserves and capital in a bank are to absorb losses. Those losses are absorbed first by reserves such as the ALLL and secondarily by shareholders' equity. The proposal, in its threshold ratio calculations, utilizes a capital adequacy concept of risk-based capital, a narrower view of capital.**

The more poignant issue is that risk-based capital is an inappropriate base for measuring concentration risk. Risk-based capital is computed for a specific purpose in measuring one of several views of capital adequacy and was not intended to be a broad measure of capital available to absorb losses. We believe the appropriate base is total shareholder's equity plus the entire ALLL.

It could be tempting to argue that shareholder's equity should be haircut for goodwill and intangible assets. However, these assets are already subject to quarterly impairment analysis and adjustment. Therefore, as shareholder's equity is already reduced through those mechanisms, there is no need for a haircut.

PRACTICAL CONCERNS

These comments include both general observations and specific issues of interest:

1. The proposal seems to address many of the similar issues being discussed in the Basel "1.5" discussions and the new ALLL documentation proposal. Each of these proposals generally deals with credit risk management. It would seem there is more than a little potential for conflict or inconsistent rules to be established;

2. The proposal does not seem to apply to credit unions. Credit Unions continue to enter the commercial loan business and need to be held to the same standards in such an important area;

3. The proposal states on page 5 that when the threshold ratios are exceeded, the bank should have capital "... higher than the regulatory minimum and appropriate to the risk in their CRE lending portfolio". Furthermore, on page 12 the proposal refers to the existing risk-based capital rules noting in Footnote 7 that some CRE exposures are weighted at less than 100% under current capital rules. This proposed seemingly is in conflict with capital rules. The capital rules treat residential as 50% risk-weighted, yet the 100% threshold-ratio in the proposal makes no adjustment for such loans.

   In addition, Footnote 8 on page 12 states that capital may be required at levels exceeding the "well capitalized" standard. This is based on the apparent premise that capital rules never contemplated concentrations as a risk to be covered by minimum capital levels. This seems somewhat at odds with "adequate" capital being 8% of risk-based assets while "well capitalized" requires 10%. Such a premium surely was to provide for higher than average risk.

   Interestingly, on April 6, 2006 Comptroller of the Currency John C. Dugan in a speech to the New York Bankers Association stated:

   "But the simple fact is that the overwhelming majority of such institutions already hold capital cushions that exceed regulatory minimums by more than two hundred basis points, and, as a result, these institutions generally would not be affected by the capital adequacy part of the guidance."

This observation by Mr. Dugan supports the proposition that banks are already adequately capitalized for concentration risk except for those banks who choose not to be well-capitalized.

This entire section illustrates the dangers of modifying capital requirements through the back door. The Basel "1.5" proposal contains an interesting discussion (Federal Register, Vol. 70, No. 202, October 20, 2005, page 61076) on CRE exposures for ADC loans which seems to recognize that ADC loans come in different flavors of risk and while certain ADC loans may necessitate higher levels of capital, others would not. The proposed Basel "1.5" would actually not over-weight ADC loans in the capital standards that meet the Interagency Real Estate Lending Standards thus recognizing the risk-lowering effect of properly underwritten loans;

4. Page 8 of the proposal describes the strategic planning issues and would establish a requirement for a new contingency plan if a "concentration" arises to address actions to take should adverse market conditions occur. The proposal should make clear the evaluation of actions to take should only be to reduce the "concentration" level below the threshold calculations;

5. It is not uncommon that banks will ask for collateral out of an abundance of caution and after the collateral is real estate that would meet the CRE definition in this proposal. This proposal would have the unintended consequences of providing an incentive to banks to not ask for the collateral;

6. Certain loans, such as SBA Loans, may have agency guarantees yet be collateralized by real estate meeting the CRE definition. Such guarantees are taken into account in loan classifications, in the supervisory loan-to-value rules and in risk-based capital calculations. As written, the proposal could lead to a loan being treated in a favorable manner as a lower risk category for some purposes but high risk CRE for this proposal; and

7. Section II of the Supplementary Information in the proposal ("Principal Elements of the Guidance") states that:

   "Loans to REITs and unsecured loans to developers that closely correlate to the inherent risk in CRE markets would also be considered CRE loans for purposes of the proposed Guidance."

   First, there needs to be a clear safe harbor definition of a "developer" so that banks are not inconsistently applying this part of the rule. It is also not clear what "inherent risks" are contemplated and how "correlation" would be determined. This could become very burdensome in assessing loans to individuals and

   businesses who may be involved in development activities on a less than full-time basis. Many "developers" are LLPs and similar entities organized for the express purpose of developing land and the LLP partners usually have other sources of income on which the lender relies in whole or in part for repayment (such as the medical practice income of a physician who is an LLP partner and who provides a personal guarantee).

   Being able to make a determination of what borrowers are "developers" would require a new coding scheme in loan data systems.

TECHNICAL COMMENTS

Several technical corrections are offered, as summarized below:

1. The 300% threshold calculation allows an offset for owner occupied properties included in commercial real estate loans but it is not clear whether owner-occupied is similarly offset in the 100% threshold calculation. Further, it is not clear how custom homes (i.e., homes being constructed with an underlying signed sales contract from the eventual owner) are treated in the 100% and 300% calculations. We have heard conflicting interpretations of the proposal in this regard, including comments from regulators, that indicate a need for greater clarity;

2. The definition of CRE takes into account both consideration of the collateral (e.g., raw land or multi-family) as well as repayment source where rental income from a third party is the primary source. Since the repayment source percentage can change over time, it needs to be clear that the determination of whether or not the loan is CRE under this rule is to be made at date of origination or renewal only. Alternatively, a bank could be allowed to establish its policy as either (a) designating at origination or renewal or (b) tracking changes during the term of the loan and modifying the designation accordingly; and

3. Call reports would need to be modified to collect data on loans for properties that are owner-occupied or non-owner occupied.

SUGGESTIONS

While we appreciate the regulatory desire to institute a common measure of commercial real estate concentrations for use in regulatory monitoring, we believe this proposal should be withdrawn and reworked. We believe there are serious problems both with the mechanics of the threshold ratios and with the sanctions regimen. At a minimum, we make the following suggestions as ways to address the more major deficiencies:

1. In the threshold calculations, use shareholder's equity plus the ALLL rather than risk-based capital as the denominator of the ratio;

2. Consider how to refine the definition of CRE to better identify higher risk types of lending and avoid the adding together of a wide range of risk to arrive at an

3. overall level of risk. It would seem that dispersion of CRE over a variety of geographic markets is an effective mitigation of much of the CRE concentration risk addressed in this proposal;

4. Make clear that owner-occupied (including custom home construction) and all 1-4 family residential are excluded from CRE in both the 100% and 300% threshold calculation;

5. Provide an adjustment for "abundance of caution" collateral;

6. Extend the proposal to cover all insured depository institutions, including credit unions;

7. Limit the sanctions resulting from exceeding the threshold limits to implementing additional risk management procedures as considered appropriate by the bank. Capital requirements should be addressed through the capital standards. At most, the proposed rule should only provide for as capital sanctions the requirement for a bank to achieve "well capitalized" status under the capital adequacy standards;

8. Make clear that any "contingency plans" in the event of severe and prolonged adverse market conditions need only address mitigating the risk to levels which would not exceed the threshold calculation limits;

9. Provide for an adjustment to reflect government guaranteed loans;

10. Make clear the determination of owner-occupied (including the 50% or more repayment source) is determined only at the time of origination or renewal or allow the bank to opt-in to tracking changes; and

11. Provide a workable and practical definition of "developer" for use in determining when unsecured lending is to be included as CRE loans, including more specific guidance as to how correlation would be defined and measured.

Please do not hesitate to contact me should you have any questions regarding our response.

Sincerely,

Donald E. Walker
President & CEO
Arvest Bank