BANK *of* UTAH **Memorandum**

To: James Anderson **Date:** Thursday, April 13, 2006
Office: President **Enc:**
From: Ronald A. Schulthies
Office: Executive Vice President Chief Lending Officer **cc:**
Subject: Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices FRB Docket No. OP-1248

The regulatory concern of Commercial Real Estate concentrations appears to be both intuitively reasonable but very vague and certainly short on specifics. The approach is broad and not specific as regards banks even though the anecdotal comments in the "Background" section refer to banks with high levels of CRE and minimum capital levels. One wonders why "new" guidance is necessary. And why regulators aren't dealing with specific institutions. Several broad assumptions become immediately apparent:

1. CRE is riskier than other types of loans
2. CRE is CRE
3. New Regulatory Guidance is required
4. Existing Regulatory capability is insufficient
5. Broad Regulatory Guidance is the answer as opposed to specific action by institution
6. Capital is an answer

CRE is Higher Risk than other Types of Loans

The Bank of Utah's experience since year 2000 in terms of incidence of risk – loss, is the opposite. The losses from CRE are dramatically lower than the losses from all other categories of lending. This certainly doesn't disprove your thesis that CRE is higher risk and may emphasize the cyclical element that well may not have completed its cycle. Nevertheless, the current data in our experience indicate the opposite in terms of which type of lending is higher risk.

CRE is CRE

All commercial real estate is the same. I have read both the Atlanta study and the 12th FRB study with interest as well as the guidelines on risk management. The Bank of Utah was the subject of a target exam in 2002 and I assume Bank of Utah was part of the 12th FRB study. This Bank certainly by the definitions being used has a high concentration of CRE. I have asked myself if this is sound and if so, why. The preponderance of CRE at Bank of Utah consists of two categories:

1) Residential Single Family Homes as the end product
2) Nonfarm Nonresidential Lending

Loans to developers and builders for single family homes, primarily entry level homes has to be in the broadest part of residential lending market and has the broadest government support for end loans. Furthermore, we focus on pre-sold ratios of 2:1 & 3:1 depending on the season when a loan is proposed. We by policy do not make loans for proposed purchasers who are not owner occupants i.e. no pre-sold loans for investors/speculators as end borrowers. We believe that is lower risk categorically than other types of CRE loans.

New Regulatory Guidance is Required

I would really like to see enforcement of existing regulations. With some frequency we see competitive violations or exceptions of FDICIA and FIRREA. Of particular irritation are loans in excess of supervisory limits. Certainly they can be done but there are **capital limits** and being skeptical I doubt they are being enforced

History of the Eighties, Lessons for the Future, Vol I, An Examination of the Banking Crises of the 1980s and Early 1990s, published by the Federal Deposit Insurance Corporation 1997. I lived through this period and I am reading this text with interest. Let me quote, "The period between 1980 and 1994 saw more legislative and regulatory change affecting the financial services industry than any other since the 1930s, pg. 87, op cit. I am sure regulation didn't begin nor end with this period but one might challenge the need for new regulation before embarking on the current proposal which I have no doubt will have a dramatic affect upon institutions like Bank of Utah. Do you really believe in the thesis and the solution you are proposing. I am not persuaded.

One other comment based on the findings in the text referenced above,

> "A pervasive relaxation of underwriting standards took place, unchecked either by the real estate appraisal system or by supervisory restraints. Overly optimistic appraisals, together with the relaxation of debt coverage, of maximum loan-to-value ratios, and of other underwriting constraints, meant that borrowers frequently had no equity at stake, and lenders bore all of the risk." op cit, pg. 26.

Forbearance programs were one of the categorical causes of the bank failures according to the text. Let me suggest to you in a homely fashion a current situation that is in some respects analogous to the effects of the forbearance factor and '**a lesson to be learned'** relative to underwriting and cause for concern in CRE.

> "Furthermore, applying forbearance to a group of banks may have adverse competitive effects on institutions outside the program. Unless restrained by the supervisory authorities, insolvent banks may offer above-market deposit rates and submarket loan rates, thereby weakening healthy competitors." pg 50 op cit.

The Bank of Utah is a community bank and at one time its loan portfolio was predominantly a consumer loan portfolio. Today the composition of the loan portfolio is 95% commercial loans and in the traditional call report sense, any commercial loan secured by real estate is CRE, it is predominantly a commercial loan portfolio secured by real estate. One might ask, how did this dramatic change occur? The answer is – **Credit Unions! Now relate to the comment on above market deposit rates and submarket loan rates, thereby weakening healthy competitors. This weakening does not come from insolvent competitors but rather from competitors who relative to this institution have a 39% advantage in being tax exempt. Allow me to make two points:**

1. The Credit Unions own the consumer loan market in Northern Utah
2. The Credit Unions have sought & are seeking expanded powers to make CRE loans

One cause of CRE loans and its concentration in community banks in this market is the inability to compete in the consumer market against the tax advantage of credit unions. Another effect is lax underwriting comes from the increasing competition for CRE loans from credit unions.

Now ask yourself where will community banks acquire loan assets if the proposals you are presenting are implemented? Yes, there are risks in CRE and concentrations relative to cycles are a risk.

This bank is examined by the State of Utah and the Federal Reserve Bank. The local FRB representative was recently quick to inform the management of this bank that the FRB takes no position relative to credit unions. There are lessons learned and not learned. A very responsible position!

Existing Regulatory Capability is Insufficient

I really haven't seen any presentation that suggests the massive regulatory activity of the 1980s and 1990s has left the regulatory agencies powerless to address CRE in all of its dimensions.

Broad Regulatory Guidance is the answer as opposed to specific action by institution

It seems it is human nature to not want to face problems/issues face to face where they exist as opposed to the seemingly easier approach of making broad statements to the universe.

Capital is the Answer

Community Banks are already at a disadvantage on the subject of capital. Big banks have all of the advantage through the machinations of risk adjusted capital resulting in them having less tangible capital because they have less risk(?) Of course the regulatory agencies acted upon the 'too big to fail' theory during the 1980s and 1990s and today community banks cannot compete on the basis of price relative to big banks for several reasons not the least of which are the leverage multipliers – higher capital requirement for community banks.

You may believe a bank can price for excess risk but that is a very risky proposition and has severe limitations. This leads us to your original assumption that there is excess risk in CRE. It is easy to say "risk" but very difficult to measure. How much risk? Can you quantify it? Just look at your fail risk definitions: Loans Otherwise Especially Mentioned, Substandard etc. Those definitions have existed since the 1930s which must to some degree indicate the difficulty in measuring risk. Safety and Soundness Examinations have been the answer for a long time i.e. individual examination of banks. I would certainly welcome a logical even if not scientific risk grading system for the loans in this bank. Please show me the way.

SUMMARY

I am very concerned about CRE exposures and concentrations but I am not persuaded your 100% and 300% solutions are the answer. If implemented they would have a significant effect on this bank. I do believe if we didn't have to compete with tax exempt institutions, underwriting standards and risk reward ratios (prices) would be sounder. It is hard to imagine that the regulatory agencies do not already possess the capability to help us protect the depositors.