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April 27, 2005

Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA)
Comment Letter – Real Estate Lending Standards

In December 1992 the Office of the Comptroller Currency (OCC), the Federal Reserve, FDIC, and Office of Thrift Supervision issued real estate lending standards [12 CFR 34, Subpart D, Appendix A] as required by Federal Deposit Insurance Corporation Improvement Act of 1991.

These original standards adopted in 1992 established supervisory loan-to-value (LTV) limits for all types of real estate lending (raw land, land development, construction, commercial and residential). Banks were permitted to make exceptions to the supervisory LTV limits but were required to track and measure these exceptions against their capital. Furthermore, the aggregate amount of these exceptions could not exceed 100 percent of their capital. Also, within the aggregate amount, all loans for commercial, agricultural, and multi-family residential could not exceed 30 percent of capital.

Since the real estate lending standards were adopted in 1992, banks have measured and reported their exceptions to the supervisory LTV limits by tracking only the amount that the loan exceeds the appraisal value of the real estate securing the loan. For example, residential property with an appraised value of $100,000 has a supervisory LTV limit of 90 percent or $90,000. If a bank makes a loan against this property for $92,000, then the $2,000 would become part of the aggregate amount to be measured against capital.

In August 2003, the OCC issued new guidance on real estate lending standards. This new guidance requires the entire amount of a high-loan-to-value loan be included in the aggregate amount to be measured against capital, not just the portion exceeding the supervisory LTV limit. This new method of calculation greatly increased the total amount to be measured against a bank's capital. However, the total amount does not appropriately measure risk and is therefore meaningless.

To illustrate from the previous example, the new guidance requires that the entire $92,000 loan balance versus just the $2,000 excess be measured against capital. If the same borrower were to borrow $89,999.99 using the same real estate as collateral, then no reporting or tracking is required. Prior to the August 2003 guidance, banks tracked the $2,000 difference, as this is the real risk. Under the new guidance issued by the OCC, the measurement of risk is illogical.

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A similarly illogical result arises when you compare the potential risk of loss in typical large commercial real estate loan and a home mortgage loan. Assume that a bank made an $8,525,000 loan on a parcel of improved commercial real estate with an appraisal value of $10 Million. Under the guidelines, this loan would exceed the 85% supervisory LTV by $25,000, thereby requiring tracking the entire amount against capital. If the same bank makes a $200,000 home loan against real estate worth $100,000, the bank will be $110,000 over the 90% supervisory guidelines and will also track this loan against capital. The greater risk exists in the home loan ($110,000), not the commercial real estate loan ($25,000), yet the entire principal amount of both loans must be tracked against capital.

Finally, the new guidance severely limits the ability of small community banks to compete in the market place. Large banks have a larger capital base and can therefore track more non-conforming loans than small banks can. As a result, large banks have the ability and opportunity to market special loan products (e.g. 100% LTV home equity loans) to strong, creditworthy customers more often than community banks do. In this way, the guidance places a community bank at a competitive disadvantage without effectively addressing the actual risk involved in a nonconforming loan.

Sincerely,

H. Charles Maddy
President and CEO