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Robert E. Feldman, Executive Secretary
Federal Deposit Insurance Corporation
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Washington, DC 20429 E-Mail: Comments@FDIC.gov

Attention: Comments

RE: Office of the Comptroller of the Currency Docket # 06-01
Response to the Proposed Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices.

While the bank fully understands your concerns regarding current real estate lending practices, the guidance as proposed will add regulatory burden and increase the cost of compliance without addressing the source of the concerns: inadequate portfolio concentration management which leads to increased credit risk. In addition it will place certain institutions at a competitive disadvantage in relation to those institutions and lenders that are not covered by the guidance.

In many cases those institutions with the best systems, risk management and portfolio management systems are the ones that would be most severely affected by the guidance. This would lead the less experienced, less well managed institutions to fill-in the gap when the strong banks pull back in the market. The result could have a significant, negative impact on communities and the earnings/stability of the financial institutions.

Establishing real estate loan concentration limits, requiring additional capital and enhanced credit risk management practices may be prudent. However, defining the methodology will often add layers to the systems presently used by well managed banks with strong asset and risk management practices. This in turn may limit their ability, or promote a reluctance to meet the reasonable and necessary credit needs of the borrowers and communities which they serve.

For instance two of our major communities are growing at rates which exceed the national averages and are enjoying unemployment rates below both state and national averages. If the leading construction lenders cut back on residential construction and land development activities, the result would be seriously detrimental to those communities: increased prices would negatively impact affordability indexes that already are suffering from price pressures. Fewer people would be able to afford to purchase homes. Lot loan inventories represent less than a 45 day supply at existing growth rates. New residential inventories represent less than a 75 day supply at existing sales rates.

As noted within the proposal, most of the guidance is already included within the existing real estate lending guidelines and regulations. The additional guidelines do little to preclude bank failures and instability in the banking system. Stronger enforcement of the existing guidelines may do more to promote a stable banking system.

While many of the practices defined within the proposed guidelines are already adopted and in practice at our bank, a few of the additional requirements would require additional investment in sophisticated management information systems that are not presently available and could be expensive to develop. Additionally, some of the monitoring does not appear feasible under any MIS.

Comments on individual issues within the guidance are attached.

In summary, the implementation of the guidance requirements would create a significant impact for this community bank. It could limit our ability to serve our communities while not contributing to our ability to manage risk and profitability.

Sincerely,

Kathleen H. Dutro, Chief Credit Officer

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- Definition of COMMERCIAL REAL ESTATE (CRE) LOANS: Exposures secured by raw land, land development and construction (including 1 – 4 family residential construction), multi-family property and non-farm, non-residential property where the primary or a significant source of repayment is derived from rental income associated with the property (loans for which 50% or more of the source of repayment comes from third party, non-affiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. Loans to REIT's and unsecured loans to developers that closely correlate to the inherent risk in CRE markets would also be considered CRE loans.

  RESPONSE: As is acknowledged that prior to the 1990's weak CRE loan underwriting and depressed CRE markets contributed to significant bank failures and instability in the banking system. HOWEVER, underwriting standards have been strengthened and depressed CRE markets have not subsequently contributed to significant bank failures and instability. In some markets general economic declines due to loss of industry have caused system failures; however, those failures were the result of losses across the spectrum of loans and were not concentrated solely in CRE.

  COMMENT: Later the guidelines state: "The agencies have excluded loans secured by owner – occupied properties from the CRE definition because their risk profiles are less influenced by the condition of the general CRE market." It is suggested that this comment be moved into this section. It is also suggested that the measurement of "owner-occupied" be **50% or more is occupied by the owner**. This more closely matches the guidelines used by the SBA and other agencies. In many cases the business owner/occupant benefits from the rents paid on the property to minimize its occupancy costs.

  QUESTION: It appears from the definition that custom residential construction loans (the borrower will be the occupant of the home when completed) would be excluded from the CRE definition. However, how would loans to builders for homes that are "pre-sold" be treated? These are loans where the builder retains title and borrows for construction, but the home has been sold subject to completion. The buyer has provided proof of qualification for a long term loan, executed a purchase agreement and placed non-refundable earnest money in escrow. As a general rule, very few of these loans fail to close (less than 2%).

  QUESTION: Would (developed) lot loans to consumers be included in the definition of CRE?

  QUESTION: Would (developed) lot loans to operative builders (not developers) be included in the definition of CRE?

- 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.

  RESPONSE: Through the examination process and existing regulations, the Agencies have the authority to require the institutions to change/enhance their processes.

- The Agencies are also concerned when institutions with high CRE concentrations maintain capital levels near regulatory minimums. Minimum levels . . . are inconsistent with the Agencies' capital adequacy guidelines.

RESPONSE: As stated, this is inconsistent with existing guidelines. New guidelines are not necessary to enforce changes at individual institutions.

- (1) Total reported loans for construction, land development, and other land (Schedule RC-C item 1a) represent 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 (Schedule RC-C items a1, ad, and 1e) represent 300% or more of the institution's total capital.

  RESPONSE: These two rules are confusing and inconsistent. It is suggested that they be eliminated. In their place define the loans that are included in the CRE definition and use that total to measure the 300% of capital. In addition to the targeted loan types, the schedules mentioned include owner-occupied commercial loans, custom residential and commercial construction and lot loans to consumers. Using the schedules to trigger the 100% or 300% rule is misleading.

- Board and Management Oversight.

  RESPONSE: With the possible exception of the compensation sentence (Directors should also ensure that management compensation policies are compatible with the institution's strategy and do not create incentives to assume unintended risks.), these guidelines are integral to other guidance and regulations which have previously been issued.

- Strategic Planning.

  RESPONSE: With the possible exception of the marketability of the portfolio into the secondary market, these points are addressed in less detail in the FDIC letter dated March 4, 2005. Since the plans must necessarily be unique to each bank, detailing the requirements of the plan is not productive.

  If stress testing is required in the final guidelines, provide either historical information or sources of data upon which the institutions may base their stress tests: What happened in the last two to four downturns in residential and commercial real estate? Requiring each institution to go looking for the data with the many faulty sources will waste time and resources. The Agencies have usually identified good sources of data that the institutions may use.

- Underwriting.

  RESPONSE: The Agencies review the underwriting standards of each institution. The failure to provide adequate standards should be addressed individually based on the situation at each institution. As stated in the guidance, adequate standards exist in other regulations/guidance to support those activities.

- . . . provide reports to the board of directors detailing the number, nature, justifications, and trends for exceptions in a timely manner. . . .

  RESPONSE: This statement is simultaneously too broad and too restrictive. Tracking exceptions is onerous and most MIS cannot handle more than one or two exceptions. Tracking exceptions that are not mitigated by other factors is the critical risk management element. In many institutions exceptions are tracked on a statistical basis - not on a loan by loan basis. The thought is good; the application would be a nightmare.

  Exceptions to underwriting standards are made on virtually every loan. Our quality control examinations provide this information on key exceptions on an on-going basis. Our originators report and obtain approval for exceptions each time a loan is approved. For instance an exception may be granted on the debt to income ratio because the borrower has no other debts and cash and investments sufficient to retire 500% of the debt. Although this is an exception, it is completely mitigated and to report it as an exception would be to create unnecessary work with no appreciable benefit.

- Risk Assessment and Monitoring of CRE Loans.

  RESPONSE: Most of this is a re-statement of existing regulations and guidance. Two sentences could sum-up the situations that require special treatment for CRE:

  “When assigning risk ratings to CRE loans, an institution should consider the property’s sensitivity to changes in macro and project-specific factors including variations in vacancy and rental rates, interest rates, and inflation rates. Policies should address the ongoing monitoring of individual loans, including the frequency of account reviews **(income and expenses vs. debt service requirements**), updating borrower credit information, **property inspections** and status of leasing.”

  The dual risk rating system described here is a repeat of the system that was recently rejected by the regulators and the industry.

- Portfolio Risk Management.

  RESPONSE: Nothing new or different from existing regulations/guidance.

- Management Information System.

  RESPONSE: The sophistication of the MIS should be appropriate to concentrations and levels of risk in the portfolio and the size of the institution. For instance if there is no concentration in non-owner-occupied commercial real estate, the ability to analyze tenant concentrations and tenant industries is unnecessary.

Identifying and Managing Concentrations.

RESPONSE: From the way they are written, the first two paragraphs appear to refer to non-owner occupied commercial real estate. This is part of the stress testing and could be eliminated.

- Portfolio Stess Testing and
- Allowance for Loan Losses
- Capital Adequacy.

SUGGESTION: Many institutions have enjoyed very limited losses and non-performing loans. In some cases this is because they are less than 15 years old, in other cases they are located in areas that have enjoyed long term economic growth. The result is that they have limited loss or non-performing asset experience. It would be very helpful if the Agencies could cite sources for statistics and analyses regarding losses and non-performing assets. This along with the impacts on the balance sheets and income statements of the affected lending institutions would help today's institutions be more thorough and proactive in the design of stress tests and strategic planning. E.g. unemployment levels vs. default rates on HELOC's and residential loans, loss rates on those loans, the effect on earnings, the average period the loans were in default before the lender was able to obtain title to the property, the average liquidation period. For those same economies, how long before the unemployment condition began to affect the commercial real estate and apartment markets?