April 7, 2006

Office of the Comptroller of the Currency
250 E Street, SW
Public Information Room
Mail Stop 1-5
Washington, DC 20219
Attn.: Docket No. 05-21

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552
Attn.: Docket No. 2005-56

Robert E. Feldman
Executive Secretary
Attn: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Jennifer Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th St. and Constitution Ave, NW
Washington, DC 20551
Attn.: Docket No. OP-1246

Re: Proposed Guidance- Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices
71 FR 2302 (January 13, 2006)

Dear Sir or Madam:

America's Community Bankers (ACB)[1] appreciates the opportunity to comment on the Proposed Guidance – Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices[2] ("Proposed Guidance") issued by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision (collectively, the "Agencies").

ACB Position

Commercial real estate lending is an extremely important part of lending for community bankers. We understand the Agencies are concerned that "some institutions may have high and increasing concentrations of commercial real estate loans on their balance sheets

[1] America's Community Bankers is the member driven national trade association representing community banks that pursue progressive, entrepreneurial and service-oriented strategies to benefit their customers and communities. To learn more about ACB, visit www.AmericasCommunityBankers.com.
[2] 71 FR 2302 (January 13, 2006).

and are concerned that these concentrations may make the institutions more vulnerable to cyclical commercial real estate markets."

ACB supports the Agencies' position that "…institutions should have in place risk management practices and capital levels appropriate to the risk associated with these concentrations." We understand that the Proposed Guidance reiterates previously issued guidelines and regulations for safe and sound commercial real estate ("CRE") lending programs. We believe it is always prudent for the Agencies to remind lenders periodically of these elements of responsible lending practices. Generally, our members follow these principles in their commercial lending programs.

However, ACB believes it is extremely important for the Agencies to recognize the extensive burden that would be imposed on community banks by certain provisions in the proposal regarding risk management requirements for institutions engaged in CRE lending. To alleviate some of the burden, we recommend that, at a minimum, the Agencies' risk management examinations take into account the size and complexity of the institution and its CRE loan portfolio.

The Proposed Guidance contains an expansive definition of what constitutes CRE loans. CRE loans are defined to include exposures secured by raw land, land development and construction (including 1-4 family residential construction), multi-family property and non-farm nonresidential where the primary or a significant source of repayment is derived from rental income associated with the property or the proceeds of the sale refinancing or permanent financing of the property.

Following the expansive definition of CRE, the Proposed Guidance introduces rigid threshold tests by disparate types of loans for assessing whether an institution has a commercial real estate concentration that triggers heightened risk management practices and heightened regulatory scrutiny. We believe that the thresholds proposed by the Agencies are arbitrary and do not reflect the different types of lending. Further, we believe the thresholds will not accurately identify institutions that might be adversely affected by their commercial real estate portfolio in an economic downturn.

The proposal also calls for lenders with concentrations of CRE loans to increase their capital levels above regulatory minimums. ACB questions the inclusion of capital guidance in the Proposed Guidance. We recognize that discretion and judgment are part of how the Agencies' assess an institution, but we strongly believe that the application of discretion in this instance based on a faulty threshold test is inappropriate. Any requirement that an institution must raise extra capital should be imposed by regulation through the "risk based capital" rules currently being considered by the Agencies.[3]

Our explanation for these positions follows. In addressing the Proposed Guidance, we have segmented our comments into three areas: Concentration Tests, Risk Management Principles and Capital Adequacy.

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[3] 70 FR 61068 (October 20, 2005)

CRE Concentration Tests

ACB believes that the CRE concentration thresholds are inappropriate and that the proposed test formulas are severely flawed. The tests, as proposed, seem to be arbitrary and they ignore important differences in the compositions and characteristics of individual lenders' CRE portfolios.

The Agencies already have complete authority to implement additional oversight of any individual institution. Arbitrary thresholds that do not consider the specific circumstances of individual lending institutions may force some lenders out of the CRE market, creating an unnecessary and unintended shortage of credit. This could make it difficult for developers to fund their projects or force them to seek credit from non-federally regulated financial institutions.

We believe the soundness of an institution's CRE portfolio depends on individual characteristics of the portfolio and the institution's CRE underwriting capabilities and experience. Accordingly, each institution should continue to be evaluated on a case-by-case basis as part of the ongoing safety and soundness examination. This evaluation should be based on the overall capital structure of the institution, delinquency trends and historical losses, composition of the CRE portfolio, performance of that portfolio and the quality of underwriting including classified loans, delinquency trends and losses, demographics of the market served and the level of management controls in place at each institution.

Further, it is a mistake to combine all types of CRE loans into a single risk classification for purposes of setting thresholds. Different types of commercial real estate have very different risk profiles. For example, it is important to differentiate speculative CRE loans for raw land, land development, contractor spec home construction, and commercial construction and development from non-speculative CRE loans that either have firm takeouts or established cash flow patterns.

Home construction and multifamily mortgages with firm takeouts or established rent rolls, for example, have much less risk than CRE loans that have no firm takeout or established cash flow history. The Agencies' have the ability to look at loss histories, which would confirm this assessment. Home construction loans that are matched to pre-qualified takeout buyers who are contractually bound to close the loans upon completion also have low risk.

Completed multifamily properties, including apartments, rental complexes, assisted living complexes, etc., with established performance for occupancy, rent rolls and operating expenses have significantly less risk than non-multifamily CRE loans that have no such history. Multifamily mortgages historically have had much lower loss ratios than certain other loan classifications included in the tests. In an economic downturn, multifamily loan performance tends to run counter-cyclically to other types of real estate, such as single-family mortgages, because potential homebuyers are more likely to rent than to purchase a home.

The proposed tests mix together real estate loans with vastly different potential for loss, and therefore fail to accomplish the Agencies' goal of identifying institutions that might be adversely affected by their commercial real estate portfolio in an economic downturn. Therefore, we do not believe that either of the threshold tests is appropriate or accurate.

However, if the Agencies deem it necessary to impose threshold tests, the tests should be modified to correspond to the actual risk inherent in the portfolio. ACB believes that multifamily loans, pre-sold residential construction and construction/permanent financing with either firm takeouts or established cash flows that provide sufficient debt service coverage should be excluded from the definition of CRE loans. This change will allow the Proposed Guidance to focus on those types of speculative loans that are most susceptible to economic downturns.

In order for the final guidance to exclude the aforementioned types of CRE loans or to make the tests correspond to distinct loan risk profiles, we understand that certain refinements would be required in the Call Reports and Thrift Financial Reports to enable an accurate breakout of different loan classifications, and we support such changes. Also the Call Reports and Thrift Financial Reports currently do not break out CRE for owner-occupied properties, which are excluded from the CRE definition in the Proposed Guidance. However, we understand that the Agencies will modify the reports in 2007 to address this problem.

CRE Risk Management Principles

The Proposed Guidance outlines the Agencies' view of what constitutes a "sound commercial real estate lending program." These regulatory guidelines cover the following areas: board and management oversight of CRE lending; the incorporation of a section on CRE lending in each institution's strategic plan; underwriting guidelines for CRE loans; risk assessment and monitoring of CRE loans; CRE portfolio risk management practices; the need for management information systems that can produce "meaningful information on CRE loan portfolio characteristics," policies for identifying and classifying CRE loan concentrations; the need for market analysis; portfolio stress testing; and developing an adequate allowance for CRE loan losses.

ACB recognizes that most of these "risk management principles" have been in effect for some time and are generally acknowledged by the industry as prudent standards that should be used by any institution engaged in CRE lending. However, ABC strongly believes that an institution's risk management practices should be appropriate for the size and complexity of the individual institution. The risk management examination for a small institution should not be the same as for a large, complex institution.

It would be extremely difficult for many community institutions to routinely "stress test" their entire CRE portfolios. Community banks engaged in CRE lending routinely "stress test" each CRE loan at the time of origination as a part of their normal credit underwriting loan approval process and, also, on a periodic basis as part of an ongoing portfolio concentration review process. Few community banks today, however, have the financial software and sophisticated data bases to periodically stress test their entire CRE loan portfolios. Thus, adoption of the Agencies' proposal would impose a significant new regulatory burden and cost on these institutions.

Financial Institution Capital Adequacy

ACB also acknowledges that financial institutions engaged in CRE lending should be capitalized adequately and that the capital levels should be based on the inherent levels of risk being taken by the financial institution in their various loan portfolios. We also firmly believe that the appropriate place for the capital guidance in the risk based capital rules—not in this guidance.

To determine the appropriate capital level for an institution engaged in making CRE loans, ACB believes that the regulators should take into consideration the following factors:

- The experience and past performance of the institution in making specific types of CRE loans;
- The inherent risk of each product type of CRE loan (e.g., multifamily, office, retail, warehouse, hotel, acquisition and development, new construction, special purpose, etc.);
- The dynamics of the geographic markets being served by the financial institution and
- The quality of the institution's risk management practices.

We believe that the appropriate mechanism by which the Agencies should impose such a mandate for extra capital, based on the factors listed above, is by regulation in the "risk based capital" rules currently being considered by the Agencies.[4] In fact, in our comment letter to the Agencies' on the Basel 1a proposal, we specifically suggested the following as it relates to CRE:

- The risk criteria that should be taken into account to differentiate multifamily residential mortgages should be LTV ratios and number of units. A similar approach to the buckets for single-family residential mortgage loans should be used to stratify these mortgages based on risk.

- We support the approach in the proposal that would provide lower risk weights for commercial real estate loans that meet certain conditions, such as compliance with appropriate underwriting standards and the presence of an appropriate amount of long-term borrower equity. In order to ensure that Basel I banks are not put at a competitive disadvantage with regard to Basel II banks for the treatment of commercial real estate, we believe institutions should be provided an option to risk-weight these loans in additional buckets using LTV ratios and loan terms as risk drivers.

[4] 70 FR 61068 (October 20, 2005)

- While we support the use of credit ratings as a factor in determining the risk of commercial loans, we also urge the Agencies to allow banks to use additional types of collateral and LTV ratios when no credit rating exists. Many community banks make both large and small commercial loans to borrowers that do not have a credit rating. We believe the permitted use of additional non-rated collateral LTVs will help keep capital requirements fairly simple, encourage lending to creditworthy and unrated businesses, and avoid any potential competitive disadvantages.

- We believe that any expansion of the types of eligible collateral or guarantees that can be used to mitigate risk should be optional for the institution. Institutions that want to keep capital requirements simple and do not want the added burden of continually tracking collateral should have that option.

We strongly oppose any requirement that an institution increase its capital levels based only on the fact that the institution may have a concentration of CRE loans.

Conclusion

Not only is commercial real estate critical to the lending programs of many community bankers, it is essential to the health of the American economy. Any guidance that imposes additional requirements in a mechanical or arbitrary manner could lead to policy shifts in the lending practices of community banks that could discourage CRE lending. Diminished CRE lending could also have a negative impact on our economy in general and contribute to an economic downturn. It is important to note that one of the only remaining lending categories with which community banks can compete and serve their communities effectively is CRE lending.

For the reasons described above, we strongly recommend that this guidance be redrafted and made workable. ACB urges the Agencies to avoid imposing regulatory burdens in the risk management area that are disproportionate to the size and complexity of an individual institution.

ACB also recommends that the Agencies eliminate rigid, arbitrary threshold tests that ignore the actual risk factors associated with a particular loan or portfolio. If the threshold tests must be used and are to be useful tools at all, they should be flexible and much more refined, and should not to combine together CRE loans with vastly different potential for losses.

The Agencies also should not require an institution to increase its capital levels simply because the institution has a concentration of CRE loans. Appropriate capital levels should be determined based on a thorough analysis of the individual institution and any requirement for an institution to hold extra capital should be imposed by regulation in the "risk based capital" rules and not by this proposed Agency guidance.

ACB appreciates the opportunity to comment on this important matter. If you have any questions, please contact the undersigned at 202-857-3129 or jfrank@acbankers.org.

Sincerely,

Janet Frank

Janet Frank
Director, Mortgage Finance