February 24, 2006

To: Federal Deposit Insurance Corporation

From: Greene County Bank
Jim Dalton, SVP
Steve Droke, SVP
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Subject: Comment on Proposed Real Estate Lending Interagency Guidance FIL-4-2006.

We do not disagree with the risk management practices outlined in the regulation and believe that most of the practices already exist at well run banks; we do however have several comments to make that, in our view, will embrace the intent of the proposal while offering clarity in expectations of both the bankers and the agencies and serve to better define higher risks in CRE lending.

1) It is our position that if the proposal is implemented as written, the Agencies run the risk of precipitating further disintermediation in the commercial real estate competitive environment. Smaller commercial banks are actively involved in their contiguous CRE markets and are indeed a primary mechanism of supporting such activity in these markets. In fact these banks are expected to be actively involved in this type lending under the Community Reinvestment Act and are in fact in part measured by such activity.

The proposal as written places a burden on an entire industry, a burden which is perhaps over reaching. It is our opinion that banks that are well run (as shown in reports of examination) that have adequate reporting, monitoring and control systems and reasonable capital levels in place should not be subject to somewhat arbitrary standards and measures.

The regulatory examination system as it exists today serves to identify individual Bank's at risk. Such banks should be dealt with on an individual basis; however, we do agree that some mechanism of <u>objective</u> measurement must be in place in support of this view.

2) One of our key concerns with the proposal as written is the vague definitions and inferences as to what "high or inordinate levels of risk" are and further what "appropriate cushions" might mean concerning capital levels. Both of these topics must be further defined and refined and perhaps codified.

We feel that an excellent foundation exists from which to base an <u>objective</u> assessment of capital. Specifically the basis we refer to is the FDIC Examination Manual which includes specifics on Risk Based Capital calculations (see instructions in manual). If such a calculation were <u>adopted and uniformly applied by all agencies</u> to banks not subject to BASEL, with modification as outlined in items A - C below, the agencies would achieve a level of balance, fairness, clarity, objectiveness and definition of CRE risk for purposes of this proposal.

Consequently, utilizing the existing Risk Based Capital framework with the proposed revisions as discussed below, defines in quantitative/objective terms the level of "cushion" institutions are required to maintain relative to CRE loans.

<u>Modifications</u>:

A. Our first recommended modification concerns the definition of Commercial Real Estate (CRE) as contained in the proposal. It is our position that the definition of CRE should be limited to Raw Land, Development Loans, *speculative* construction of 1 – 4 family homes and non-owner occupied commercial facilities. We do feel that the existing definition of non-owner occupied real estate is adequate and that such properties justly do not belong in the definition. However, we strongly feel that inclusion of construction of all 1 – 4 family units is un-necessary and over reaching. Homes built by contractors on a custom basis should clearly be excluded. Further, it is our position that multifamily projects (other than construction phase which would be included in call report code 1A) that have reached stabilized occupancy should not be included. Although these properties are reliant upon rental income for repayment (through appropriate assignment of rents and leases), these type properties are subject to down turns in the broader economy rather than commercial real estate specific down turns and the rental flows necessary for repayment are generated by a sufficiently diverse group of residents that the risk does not reach that of CRE for purposes of this proposal. The risk exists during the construction and stabilization phase and we do not object to including these properties during that time only. If these multi-family units are excluded we believe some definition of stabilized occupancy should be drafted. As an example, a multi-family unit could be considered as having reached stabilized occupancy after producing a full calendar year of what is traditionally considered net operating income. This would exclude the "construction" phase of perhaps twelve to eighteen months.

We are opposed to the definition of CRE as contained in its present form in the proposal.

B. The proposed guidance states "institutions with high or inordinate levels of risk are expected to operate well above minimum regulatory capital levels" and further, that institutions are expected to maintain an "appropriate cushion." It is our opinion that the proposed guidance should unquestionably define from a quantitative approach what constitutes a "high or inordinate risk," in that this term can not be one open to subjectivity. Further, the proposed guidance suggests that affected institutions maintain an "appropriate cushion." The term "appropriate cushion" is also much too vague. The Agencies need to specify what capital "cushion" is adequate.

Once defined, it is our opinion that an acceptable mechanism of quantitatively approaching the capital determination is expanding and refining the weighted percentages applied in the "risk based capital" calculation found in the FDIC examination manual. By this we intend to propose that all CRE risk is not equal, nor should the risk based weighting be equal.

The current weighting applied to commercial real estate is 100%. We recommend the agencies reconsider that risk based weighting in that there is significant underlying value of these assets and the weighting is perhaps heavy. A refined risk based adequacy model should include some level of asset disposal value and this factor should be factored into the risk based capital weighting and more importantly stratifications under a CRE category; e.g. speculative office building construction is perhaps riskier than subdivision development depending on the market.

Some consideration should be given to differing CRE market risk conditions by Metropolitan Statistical Areas. The risk of one MSA is significantly different from another MSA. The key concern being that what might be considered a "high or inordinate risk" in one MSA is simply not in another MSA. Although markets are in a constant state of flux and transformation, the agencies should be able to adequately quantify risks in individual markets, defined by MSA for purposes of this proposal.

Further, the risk based capital calculation currently gives some level of capital consideration to the ALLL. Many banks employ the use of sophisticated quantitative economic capital models that are statistically based. These models measure not only expected loss, but unexpected loss (as referenced in the proposal) to confidence levels approaching 99.98%, equivalent to the insolvency rate expected for an AA or Aa credit rating. This is consistent with information presented in the FDIC Supervisory Insights Winter 2004 issue entitled, “Economic Capital and the Assessment of Capital Adequacy.” To the extent such models are being utilized by bank’s in the analysis of the Allowance for Loan and Lease Loss adequacy and more particularly by bank’s with “concentrations” in commercial real estate as defined in the proposed guidance, it is our opinion that the amount allocated to the “commercial real estate” exposure above the expected loss (mean) should be treated as “capital” and more importantly as an adequate “cushion.”

C. The proposal suggests identifying institutions with CRE concentrations using two hurdle targets. Hurdle (1) is the “total reported loans for construction, land development, and other land represent one hundred percent (100%) or more of the institution’s total capital’; and (2) ‘total reported loans secured by multifamily and non-farm nonresidential properties and loans for construction, land development, and other land represent three hundred percent (300%) or more of the institution’s total capital.”

As previously stated in “B” above we feel the definition of CRE should be modified to exclude multifamily properties and 1 – 4 family construction other than “spec.”

However, should the agencies proceed under the proposed definition the agencies should consider expanding the categories of determining concentrations. The agencies should consider three capital thresholds. 100% as defined under hurdle (1), hurdle (2) at 300% excluding multifamily and then perhaps adding a third hurdle (3) at 500% of capital which would include multifamily. This approach recognizes differences in CRE risk.

Again, some method of measuring and incorporating risk of differing Metropolitan Statistical Areas is warranted when considering these “hurdles.” CRE risk in one MSA is simply not equal to that of other MSAs. The agencies and in particular the FRB has the data available to make such differentiation available.