April 12, 2006

Comptroller of the Currency
250 E Street, SW
Mail Stop 1-5,
Washington, DC 20219
Re: Docket No. 06-01

Robert E. Feldman
Executive Secretary
Attention: Comments
FDIC
550 17th Street, NW
Washington, DC 20429

Jennifer J. Johnson, Secretary
Board of Governors
Federal Reserve System
20th & Constitution Ave., NW
Washington, DC 20551
Re: Docket No. OP-1248

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC, 20552
Attention: No. 2006-01

Dear Sir or Madam:

The Independent Community Bankers of America[1] (ICBA) welcomes the opportunity to comment on proposed guidance, *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices.* The Office of the Comptroller of the Currency, Board of the Governors of the Federal Reserve System, Federal Deposit Insurance Corporation and Office of Thrift Supervision have released proposed guidance that would require banks with concentrations in commercial real estate (CRE)[2] lending to tighten

[1] *The Independent Community Bankers of America represents the largest constituency of community banks of all sizes and charter types in the nation, and is dedicated exclusively to representing the interests of the community banking industry. ICBA aggregates the power of its members to provide a voice for community banking interests in Washington, resources to enhance community bank education and marketability, and profitability options to help community banks compete in an ever-changing marketplace.*

With nearly 5,000 members, representing more than 18,000 locations nationwide and employing over 265,000 Americans, ICBA members hold more than $876 billion in assets $692 billion in deposits, and more than $589 billion in loans to consumers, small businesses and the agricultural community. For more information, visit ICBA's website at www.icba.org.

[2] The proposed guidance defines CRE loans as exposures secured by raw land, land development and construction (including 1-4 family residential construction), multi-family property and non-farm nonresidential property where the primary or significant source of the repayment is derived from rental income associated with the property (that is, loans for which 50 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent

risk management practices and potentially increase capital. The proposal contains thresholds for determining whether or not an institution has a CRE concentration.

Summary of ICBA Views

ICBA strongly urges the banking agencies not to go forward with the proposed guidance in its current form. ICBA has received many communications from bankers about the proposed guidance and they are overwhelmingly negative. They view the proposal as overly broad, defining concentrations of risk in a manner that can not assess the true risk in a bank's CRE lending. Bankers are greatly concerned that they will need to rein in their CRE lending, if the guidance goes forward in its current form, though they do not believe that the risk in their portfolio warrants it. If they must decrease their CRE exposure, they will decrease their ability to meet the lending needs of their growing, thriving communities. The bank will suffer financially and so will their community.

Community banks question the need for this new guidance; they believe that the existing body of real estate lending standards, regulations and guidelines is sufficient to guide banks through any weakness in the CRE market. Examiners already have the necessary tools to enforce rules and regulations and address unsafe and unsound practices; thus community banks view the new guidance as unnecessary. They particularly object to the proposed concentration thresholds as they believe the thresholds can give a misleading picture of risk exposure. Banking regulators state that they have identified problems in "some" banks, yet they would apply this guidance in a broad brush approach across the entire industry, assuming many banks have problems. Instead, we believe that examiners should identify and address CRE lending and risk management problems, bank by bank.

While community banks are already employing many of the recommended risk management principles, they view the recommendations regarding stress testing and management information system (MIS) improvements as costly, burdensome and unnecessary for banks that already closely monitor their loans and customers.

For these reasons, ICBA strongly urges the banking regulators not to go forward with this flawed guidance as it was proposed.

Background

The banking agencies state they have observed that some institutions have high and increasing concentrations of commercial real estate loans on their balance sheets, potentially making them more vulnerable to cyclical commercial real estate markets. The regulators are particularly concerned about concentrations in CRE loans where the source of repayment is primarily dependent on rental income or the proceeds of the sale, refinancing or permanent financing of the property. These loans may expose institutions to unanticipated earnings and capital volatility due to adverse changes in the general commercial real estate market, the agencies state. The banking regulators say that recent examinations have indicated that risk management practices and capital levels of some institutions are not keeping pace with their increasing CRE concentrations.

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financing of the property. Loans to REITs and unsecured loans to developers that closely correlate to the inherent risk in CRE markets would also be considered CRE loans for purposes of the guidance.

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The proposal is intended to reinforce existing guidance relating to institutions with CRE concentrations. The banking regulators state that this guidance is intended to focus on concentrations in CRE that are particularly vulnerable to cyclical commercial real estate markets.

Many community banks are likely to be effected by the proposal. The FDIC estimates CRE loans constitute 258% of capital of the 8,235 banks with less than $1 billion in assets. Many of these banks have relied on commercial real estate lending for growth and profitability and may not have as diverse a portfolio as banks with assets greater than $1 billion due to the more limited markets they serve. CRE lending has made up at least two-thirds of asset growth at community banks each year since 2001; a record 28% of total community bank assets were in CRE loans as of March 2005.

ICBA Views

The FDIC states in its just issued Spring 2006 *Regional Profile* that "the performance of C& D and CRE loans remains strong at present across virtually every region of the country." The report notes that many institutions in the West and South Atlantic divisions of the country are reporting rising concentrations of construction and development loans and CRE loans as a percent of Tier 1 capital, driven by population and employment growth. Though concentrations appear to vary significantly by region, the banking agencies would apply this latest guidance to every institution in the country.

Community bankers recognize that they should prepare for any significant downturns in the CRE market; they are very concerned that the proposed guidance will unnecessarily constrain their ability to meet the needs of their commercial real estate customers. Many view the proposal as a call to cut back on CRE lending. If a community bank must cut back, it means cutting back on one of its more profitable business lines. But it also means less money will be available to support community growth. This is a particular concern to community banks serving smaller communities and communities that have seen an influx of new businesses and residents. Community banks tell ICBA that they can and do manage their CRE portfolios in a safe and sound manner.

Community banks are also concerned that this latest proposal comes on top of other recent regulatory proposals aimed at the real estate sector. While the entire real estate sector has been very strong in recent years and historic cycles demonstrate that it can turn down, bankers are concerned that one message after another from the regulators could in itself set in motion a significant credit contraction that they believe is unwarranted. In their view rather than send broad industry wide messages, regulators should focus on individual institutions and address their specific weaknesses through the examination process.

We urge the regulators to abandon the proposed concentration thresholds and look at an institution's credit risk and risk management practices on a case by case basis. ICBA believes that the proposed threshold tests to determine whether or not an institution has a concentration in commercial real estate loans are seriously flawed and do not give a clear picture of risk. They do not take into account the lending and risk management practices of individual institutions. They do not recognize that different segments of the CRE markets have different levels of risk. Many community banks that exceed the threshold tests point out that they have gone through the difficult credit cycles in the 1980s and 1990s with less capital than they have now. They have learned from past mistakes and have more capital and stronger risk management systems than in the past and are now better equipped to handle future downturns.

Community banks underwrite and manage CRE loans in a conservative manner, requiring higher down payments or take other steps to offset credit risks and concentrations. They carefully inspect collateral and monitor loan performance and the borrower's financial condition. Community bankers lend in their communities and are close to their customers. Community banks believe they do a better job monitoring these loans than do large nationwide lenders because they are more likely to work one-on-one with the customer. They are positioned well to know the condition of their local economy and their borrowers.

While many community banks already have capital in excess of current minimum standards, they are concerned that the proposal calls for even higher levels simply because their CRE lending exceeds the proposed thresholds without any analysis of the actual risk. The proposed guidance is unfairly burdensome for community banks that do not have opportunities to raise capital or diversify their portfolio to the extent that larger regional banks can. The CRE portfolios of many community banks have grown in response to the needs of their communities. If community banks are pressured to lower their CRE exposures, their ability to generate income and more capital will be constrained and they will loose good loans to larger competitors.

The proposal's recommendations regarding management information system reports will be particularly costly and burdensome to community banks; the costs will most likely out weigh the benefits for smaller banks. They find the guidance regarding stress testing of the portfolio and changes to the management information systems called for by the guidance to be particularly burdensome.

Comments on Aspects of the Proposal

Thresholds for Assessing "Concentration"

In proposing the guidance, the banking agencies are focusing on concentrations in those types of CRE loans that are particularly vulnerable to cyclical commercial real estate markets. These include CRE exposures where the source of repayment primarily depends upon rental income or the sale, refinancing, or permanent financing of the property. Loans to REITs and unsecured loans to developers that closely correlate to the inherent risk in CRE markets would also be considered CRE loans for purposes of the proposed guidance.

The banking regulators propose thresholds for assessing whether an institution has a CRE concentration and should employ heightened risk management practices. According to the proposal, if an institution exceeds or is rapidly approaching the following thresholds, it has a concentration in CRE loans:

1. Total reported loans for construction, land development, and other land[3] representing 100% or more of total capital;[4]

   OR

2. Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land[5] represent 300% or more of total capital.

If the bank exceeds threshold (1), it should have heightened risk management practices appropriate to the degree of CRE concentration. If the bank exceeds threshold (2), it should further analyze its loans and quantify the dollar amount of those that meet the definition of a CRE loan. If the institution has a level of CRE loans meeting the CRE definition of 300 percent or more of total capital, it should have heightened risk management practices described in the guidance. The guidance may also be applied on a case-by-case basis to any bank that has had a sharp increase in CRE lending over a short period of time or has a significant concentration in CRE loans secured by a particular property type.

Owner occupied loans are excluded from this guidance because their risk profiles are less influenced by fluctuations in the market. ICBA agrees that owner occupied loans should be excluded from the calculations as they pose less risk, but we also believe that loans made for the construction of 1-4 family homes should be excluded since they will be owner-occupied, and thus less influenced by market fluctuations. We also urge the banking agencies to clarify the meaning of "owner-occupied" since it is not currently defined and is unclear, such as when a loan is for a mixed use property when only a portion is owner occupied. In our view when an owner occupies at least a portion of the building, the risk profile is lowered.

While the use of such thresholds could facilitate the monitoring of a particular bank's level of CRE lending and the level of CRE lending in the industry overall, we do not believe that their use will give a reliable picture of the true level of risk in a particular institution or the industry. The proposed thresholds can not capture true risk because they can not take into account underwriting standards and risk management practices. The thresholds treat all loans within the calculation as having equal risk. For example, the second threshold test assumes loans secured by multifamily properties to have the

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[3] For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC-C item 1a. For Savings associations as reported in the Thrift Financial Report, schedule SC lines SC230, SC235, SC240, and SC265.

[4] Total capital is the total risk-based capital as reported in Call Report (FFIEC 031 and 041 schedule RC-R-Regulatory Capital, line 21). For savings associations as reported in the Thrift Financial Report, CCR, Line CCR39.

[5] For commercial banks as reported in the Call Report FFIEC 031 and 041 schedule RC-C items 1a, 1d, and 1e. For savings associations as reported in the Thrift Financial Report Schedule SC lines SC230, SC235, SC240, SC256, SC260 and SC265.

same risk as land development loans, yet multifamily properties have historically preformed far better.

Further, the proposed thresholds can not truly identify a concentration. For example, a community bank with $100 million in assets with $80 million in loans and 8 percent capital could reach the first threshold with just $8 million in loans and the second threshold with $24 million in loans. This would represent only 10 percent and 30 percent of the entire portfolio, respectively, and does not truly imply a concentration.

Banking is about making judgments and managing risk. We are concerned that the proposal would inappropriately replace judgments with “pass/fail” tests. Community banks are concerned that the proposed thresholds will be arbitrarily used by examiners to assess risk: exceed them and the bank is automatically a high risk institution and should raise more capital, without sufficient regard to risk mitigating factors.

Each institution, its community, and thus its business, is different. Banking regulators send examination teams on site because that is the best way to ensure that they have a true picture of an institution’s financial condition and risk management. We do not think arbitrary thresholds can replace this close up perspective. But, should the banking agencies decide to go forward with the concept of thresholds, those that are proposed are too low and we would urge you to double the percentages for each to more narrowly target institutions with concentration risk.

Risk Management Principles
The agencies propose several risk management principles to reinforce a safe and sound real estate lending program.

Board Oversight
The proposal points out that the board of directors has the ultimate responsibility for the level of risk taken by the institution. Therefore, the board or a board committee should approve the overall CRE lending strategy and policies and receive reports on the CRE market and lending activities. The board should periodically review and approve CRE aggregate risk exposure limits and appropriate sublimits to correspond with changes in strategies or market conditions. The board should also ensure that management compensation policies are compatable with the institution’s strategy and do not create incentives to assume unintended risks. Community banks tell ICBA that this is the approach already in place in their institutions.

Strategic Plans
The bank must include the rationale for its CRE levels in its strategic plan, analyze the effect of a downturn on earnings and capital, and have a contingency plan. The agencies require that each bank adopt and maintain a separate written policy that establishes appropriate limits and standards for all loans secured by real estate. Loans exceeding the interagency loan-to-value (LTV) guidelines should be recorded and reported to the Board. Examiners will review these reports to determine if they are adequately documented. Community banks tell ICBA that they do not view this as a change from their current practices.

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Secondary Market Underwriting

According to the proposal, when a bank's underwriting standards are substantially more lenient than the secondary market standards, management should justify the reasons why the risk criteria deviate from those of the secondary market. Community banks have great difficulty in underwriting their CRE loans to secondary market standards. For many of the CRE loans that community banks make, there isn't a ready secondary market—certainly not like that which exists for residential mortgages. Many of the loans are for projects that are too small or that have characteristics that make them unsuitable for securitization. Many community banks still hold residential mortgages in portfolio because they do not meet secondary market underwriting standards, but that does not make them inherently riskier. In our view, the same can be said for CRE loans. Thus, this portion of the guidance is not practical for community banks and many of the CRE loans they make.

The regulators also suggest that banks use secondary market sales or securitizations to manage concentration levels. This is not a realistic option for many community banks. While they may be considered to have a concentration of CRE loans, due to their size, it does not equate to a large volume of loans. Secondary markets and securitizations depend on volume and community banks often are frustrated because they do not have sufficient volume for these to be viable options.

Risk Assessment

According to the proposal, banks must measure and control commercial real estate risk at the portfolio level by identifying and managing concentrations, performing market analysis, and stress testing. The proposed guidance states that a bank's management information system (MIS) should provide meaningful information on CRE portfolio characteristics that are relevant to the institution's lending strategy, underwriting standards and risk tolerances. Banks are encouraged to analyze the portfolio by property type, geographic area, tenant concentrations, tenant industries, developer concentrations, and risk rating. The system should maintain the appraised value at origination and subsequent valuations. Other measurements should include loan structure, loan type, loan-to-value limits, debt service coverage, and policy exemptions.

Banks are encouraged to stress test the CRE portfolio against changing economic conditions. The agencies state they realize stress testing is an evolving process and encourage banks to consider its use as a risk management tool and to periodically review the adequacy of stress testing practices relative to CRE risk exposures. The complexity of a bank's stress testing practices should be consistent with the size and complexity of its CRE loan portfolio.

Community banks believe that the proposal's recommendations regarding MIS enhancements and stress testing are particularly costly and burdensome to community banks; the costs will most likely out weigh the benefits for smaller banks, with the result being an unwarranted and unnecessary contraction in CRE lending. While by the proposed thresholds a community bank may be deemed to have a concentration in CRE loans, it may not equate to a large number of loans due to the bank's size. Community

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banks typically operate in a limited geographic area, enabling them to closely monitor the economic status of individual borrowers, the industry and the community. Thus, we do not believe that the regulators should put out a general call for increased MIS systems and stress testing. Rather they should look at the particular needs of an institution during the examination process and urge enhancements when they find that existing systems and are lacking.

Capital Adequacy

The proposal states that minimum levels of regulatory capital do not provide banks with a sufficient buffer to absorb unexpected losses arising from loan concentrations. A bank with a CRE concentration should recognize the need for additional capital support for CRE concentrations in its strategic, financial, and capital planning, including an assessment of the potential for future losses on CRE exposures, the guidance says. Institutions with high or inordinate risk are expected to operate well above minimum capital requirements. In assessing capital adequacy, regulators will consider the bank's analysis, the level of risk in the portfolio and the quality of the bank's risk management practices.

Most community banks already hold capital levels well above regulatory minimums and are concerned that the proposed guidance could require them to hold even more. They question whether the proposed guidance regarding capital levels is consistent with risk based capital requirements currently in place that assess capital adequacy based on risk inherent to an asset class and consistent with existing regulatory requirements that tie capital requirements to loan-to-value ratios.

We urge the banking regulators to not arbitrarily require banks to hold more capital (or require them to decrease CRE lending) simply because they pass certain thresholds of CRE loans to capital. Community banks believe the suggestion that they would need more capital if they are identified as having a CRE concentration does not recognize the fact that risk-based capital standards can and should address risk based on asset risk. Guidance pertaining to capital should be consistent with existing capital rules and guidance.

The allowance for loan losses is another means of protecting an institution that should be a consideration in determining the effects of potential concentrations on capital adequacy. However, banks should not be required by their regulators to increase their reserves based on arbitrary tests for the amount of CRE loans, a measure that may or may not be a true indicator of loan losses.

Hurricane and Other Disaster Areas

The proposed guidance is particularly troublesome for community banks located in areas affected by Hurricanes Katarina and Rita and other disaster areas where rebuilding efforts are very likely to cause them to have CRE concentrations. If the regulators go forward with this guidance, we urge them to either exempt community banks operating in these locations from the guidance or provide them maximum flexibility to continue their support of rebuilding efforts.

Summary
ICBA strongly urges the banking regulators not to go forward with the guidance as proposed. Regulators should instead rely on existing rules, regulations and guides for management of risks in CRE lending to ensure banks take appropriate steps to protect their safety and soundness when they are experiencing high levels of lending growth, particularly in industries such as CRE where history demonstrates that significant downturns can occur.

Community banks object strongly to the proposed thresholds for determining CRE concentrations as they do not believe that they are reliable measures of the true risk in an institution. Community banks have taken significant steps since previous CRE downturns; they underwrite loans conservatively, have better staff resources and higher capital and thus are in a better position to withstand weakness. Because they lend in limited geographic areas and typically have a close customer relationship, they are in a good position to closely monitor their CRE loans and economic factors impacting them.

The banking regulators should address problems on an individual bank basis, rather than issue broad "one size fits all" guidance that may cause community banks to curtail their CRE lending when it is not necessary for safety and soundness. If a broad message is sent across the banking industry that absolute levels of CRE lending are inherently unsafe and unsound, banks will respond and cut back on CRE lending, which will unnecessarily curtail their earnings ability and the growth of their communities.

We urge the regulators not to go forward with the guidance as proposed and instead send a clear message to banks and their examiners that growth in CRE lending can occur, consistent with safety and soundness, when banks take the steps to manage it properly.

We appreciate the opportunity to comment on the proposed guidance. If you wish to discuss our comments further, please contact the undersigned or Ann M. Grochala at 202-659-8111 or email karen.thomas@icba.org or ann.grochala@icba.org.

Sincerely,

Karen M. Thomas

Karen M. Thomas
Executive Vice President
Director, Government Relations Group

INDEPENDENT COMMUNITY BANKERS *of* AMERICA *The Nation's Voice for Community Banks*℠
One Thomas Circle, NW Suite 400 Washington, DC 20005 ▪ (800)422-8439 ▪ FAX: (202)659-1413 ▪ Email:info@icba.org ▪ Web site:www.icba.org