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April 13, 2006

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G Street, NW
Washington, DC 20552

ATTN: Docket 2006-01

RE: Proposed Guidance; Concentrations in Commercial Real Estate Lending (January 13, 2006)

Dear Sir/Madam:

These comments respond to the above-referenced proposal published in the Federal Register on January 13, 2006 (the Proposal). I am writing as the CEO of an OTS regulated savings institution.

The Proposal appears ill conceived for a number of different reasons.

The attached spreadsheet shows the composition of the loan and lease portfolio assets of all FDIC insured depository institutions in the United States, both commercial banks and thrift institutions.[1] For convenience based upon readily available data from the FDIC, in addition to dividing these institutions between those with state and those with federal charters, they are separated between institutions having assets over $1 billion and those with assets not exceeding $1 billion.

While the larger institutions with over $1 billion in assets represent about 85% of all loan portfolio dollars, the smaller institutions represent about 93% by number of all FDIC insured institutions. As the data show, these smaller institutions are primarily commercial real estate lenders.[2] Commercial real estate loans (as defined in the Proposal) represents the largest component of the portfolio assets of these institutions, at about 41%. The only other asset category approaching the significance of commercial real estate lending for these institutions is single family mortgages, at about 31% of portfolio assets. The remaining portfolio asset categories are C&I loans (13%), consumer loans (7%), farmland and foreign real estate loans (3%), farm operating loans (3%), and government and other loans and leases (2%).

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[1] Source: FDIC Statistics on Depository Institutions, at *http://www2.fdic.gov/sdi/main.asp*. Data as of December 31, 2005. Underlying data in dollar amounts available upon request.

[2] For the entire industry segment of commercial bands and thrift institutions having assets not over $1 billion, commercial real estate loans represent 266% of equity capital and single family mortgages represent 198% of equity capital. For the 3,595 commercial banks in the asset size range of $100 million to $1 billion, total commercial real estate loans represent 315% of total equity capital.

If a significant portion of the community banking industry is to reduce its concentration of commercial real estate loans, then where is it to redeploy those assets? Based upon asset availability, the only option would appear to be to move in the direction of the "traditional thrift", but would that be an improvement? The banking industry has been evolving away from the traditional thrift business model for 25 years, and with good reason. With the advent of large scale securitization of home mortgages, resulting in increased market efficiencies for the consumer, home mortgage lending has ceased to provide adequate portfolio yield spreads to support the overhead of a community bank. While institutions specializing in mortgage banking can produce strong earnings from fee income and gains on sale, most community banks are not in a position to follow this business strategy. Home mortgages also represent a significant source of interest rate risk to traditional thrift lenders. In recent times, the credit risks associated with home mortgage lending have also increased, as the banking regulatory agencies have recognized in the recently proposed Interagency Guidance on Nontraditional Mortgage Products.

So, if increased emphasis on home mortgage lending by community banks is not a good solution, then what remains? Would the banking industry be better off if lenders substituted assets secured by accounts receivable, inventory and equipment for those previously secured by real estate? In any case, the C&I loan market is probably not big enough to absorb all the funds that would be shifted. It would take about a 75% increase in C&I lending by banking institutions of $1 billion asset size or less to reduce commercial real estate lending to the same portion of portfolio assets as single family mortgages now represent.

If a reduced reliance in commercial real estate lending is not to be redirected into single family mortgages or C&I loans, then no viable option remains. Consumer lending would need to more than double to accommodate the asset shift that would be caused by reducing commercial real estate loans to the level of single family mortgages for the up to $1 billion asset group. Consumer lending is generally unsecured and a market where inexperienced lenders can suffer significant losses, and it is a market generally dominated by larger specialized lenders. The only remaining asset categories are farm related loans, foreign loans, loans to governments and equipment leases. Most community banks have neither the market opportunity nor the expertise to originate significant volumes of these latter types of loans.

In fact, many community banks have no practical alternative but to focus on commercial real estate lending, broadly defined, in order to produce an adequate return on equity. Unfortunately, the Proposal fails to adequately distinguish between high risk and low risk commercial real estate lending. Multifamily lending, historically, has been the lowest risk type of all lending for OTS regulated institutions.[3] On the other hand, non-real estate secured commercial lending and UCC-secured manufactured housing loans have the highest recent charge-off rates among all loan types for OTS regulated institutions.[4] It makes no sense for the regulatory agencies to be pushing banking institutions in the direction of making more of these higher risk loans. It could make sense to focus more regulatory attention on the specific types of commercial real estate lending that have historically involved the

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[3] According to the OTS report, "Thrift Industry Charge-Off Rates by Asset Types" for the period 2001 through 2005, multifamily loans had an average annual charge-off rate of 0.003% of average assets, lower than any other loan category, including single family mortgages.

[4] Ibid. The 2001 through 2005 average annual charge-off rates for non-real estate secured loans by OTS regulated institutions were 1.519% for commercial loans and 1.571% for manufactured housing loans, higher than for any category of real estate secured lending, including commercial real estate lending.

highest degree of risk, generally speculative construction lending both for single family dwellings and non-residential commercial property, and speculative land loans.[5]

Specifically with regard to the carve out in the Proposal for owner-occupied commercial real estate, this approach, although perhaps representing conventional wisdom in some quarters, may not necessarily be advisable. Owner occupied commercial real estate property often has a single tenant and may even be be a special purpose property. Dependence on the owner of the property for loan repayment has some of the same risks as non-real estate secured commercial lending, which experience shows is relatively high in risk. A well managed multi-tenant commercial property in a non-rural market that is not overbuilt has the advantage of diversification in the tenant base and the opportunity for the property manager to benefit from a relatively liquid market for commercial tenants to replace tenants who vacate, before there are loan performance problems.

The Management Information System, Economic Analysis, and Portfolio Stress Testing requirements of the Proposal may impose the most difficult burdens on the community banking institutions that would likely come under the requirements of the Proposal. Obviously these smaller institutions specializing in commercial real estate lending often would not have the resources to support the kind of infrastructure that the Proposal seems to envision.

The Capital Adequacy provision of the proposal appears to be an end run around the uniform system of capital regulation adopted by Congress in 1989 and internationally recognized in the Basel accords. The area of risk-based capital regulation is obviously complex, requiring sophisticated analysis. This is sufficiently true that the same regulatory agencies that have promulgated the Proposal found it appropriate on October 20, 2005, to publish an Advance Notice of Proposed Rulemaking that may potentially lead to a more refined, carefully considered, and objective risk-based capital regulatory scheme, which meanwhile could have been short-circuited by subjective and conceivably arbitrary determinations of lower level regulatory staff, as contemplated in the institution-by-institution capital requirements outlined in the Proposal. This capital provision should definitely be removed from any future versions of the Proposal. The October 20, 2005, proposal provides a vehicle for giving much more careful and broadly based consideration to the capital adequacy issues involved in commercial real estate lending.

Thank you for your consideration of these comments.

Sincerely,

A. Bruce Cleveland
President and CEO

[5] Ibid. For the 2001 through 2005 period, average annual charge-off rates for OTS regulated institutions were 0.122% for non-residential construction landing and 0.113% for single family construction lending, higher than for any of the other real estate lending categories.

LOAN PORTFOLIO COMPOSITION of ALL FDIC INSURED INSTITUTIONS

Data as of December 31, 2005

	All Institutions	All Institutions - Federally chartered	All Institutions - State chartered	All Institutions Over $1B	All Institutions $1B or Less
Construction, CRE, Multifamily	21.74%	15.35%	35.15%	18.40%	41.42%
Single Family Loans	38.41%	43.16%	28.43%	39.71%	30.72%
Commercial and Industrial Loans	16.16%	15.90%	16.70%	16.64%	13.36%
Consumer Loans	14.11%	15.47%	11.25%	15.39%	6.59%
Farmland and Foreign Real Estate	1.50%	1.35%	1.81%	1.19%	3.28%
Farm Operating Loans	0.77%	0.49%	1.36%	0.37%	3.13%
Government, Other Misc. Loans & Leases	7.32%	8.29%	5.30%	8.31%	1.50%
All Loans and Leases - Gross	100.00%	100.00%	100.00%	100.00%	100.00%
Percent of All Institutions by Number	100.00%	29.33%	70.67%	7.13%	92.87%
Percent of Gross Loan and Lease Assets	100.00%	67.71%	32.29%	85.47%	14.53%

Source: FDIC Statistics on Depository Institutions, at *http://www2.fdic.gov/sdi/main.asp*