NBB
The National Bank

April 10, 2006

Robert E. Feldman
Executive Secretary
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Comments@FDIC.gov

Regulation Comments
Chief Counsel's Office
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1700 G Street, N.W.
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Attention: No. 2005-56
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Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
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Re: **FDIC** (No docket ID); **FRB** Docket No. OP-1246; **OCC** Docket No. 05-21; **OTS** Docket No. 2006-01; **Proposed Interagency Guidance on Concentrations in Commercial Real Estate**; 71 Federal Register 2302; January 13, 2006

Ladies and Gentlemen:

I am writing on behalf of National Bankshares, Inc. (NBI) to comment on the above proposal. NBI is the parent company to The National Bank, Bank of Tazewell County and National Bankshares Financial Services, Inc.

In March of 2004, former Federal Reserve Chairman Alan Greenspan noted in a speech in San Diego that the growth in commercial real estate lending by smaller banks was a "natural evolution of community banking and...quite profitable, helping to sustain both earnings and growing equity capital of community banks." He went on to state that "the evidence suggests that community banks have avoided the underwriting mistakes that led to so many problems ten to fifteen years ago."

The former Chairman's remarks underscore the importance of commercial real estate lending to community banks. Community banks rely heavily on commercial real estate lending to survive and make a profit. We do so because we have been squeezed out of so many other areas where we once did a significant business. For example, the car manufacturers now have captive finance companies that dominate care lending. Realtors now take advantage of their position as the first contact in the home-buying process to arrange mortgage financing for buyers through their mortgage company affiliates. Credit Unions use their tax-exempt status to aggressively compete against banks and gain an ever-increasing market share. Hence, commercial lending is perhaps now more than ever our "bread and butter."

Since commercial lending is so very critical to community banking, and since the proposed guidance would negatively impact smaller banks much more than larger banks, we are very concerned about what this proposal would mean for the very survival of community banks as ourselves. This is particularly true when, as former Chairman Greenspan observed, there is no evidence suggesting that there is a problem that needs fixing. Accordingly, we would urge the federal banking agencies to abandon or significantly modify the proposal.

We oppose the proposed guidance in its current form for the following specific reasons:

1. **The proposed guidance incorrectly assumes that all commercial loans secured by real estate constitute one "concentration" risk.**

The commercial real estate loans community banks make are not all alike. We make a variety of commercial loans secured by real estate in different geographic areas. We may have a line of credit to a law firm secured by the firm's office building, a construction loan to a home builder, a mortgage loan secured by a multi-unit apartment building, and so on. While all of the loans are secured by real estate, they are all different in terms of the risk of non-payment. The risk of loss depends much more on circumstances unique to each borrower than the fact that they are secured by real estate. Yet the proposed guidance assumes that all these loans represent the same kind of risk. We believe this is a mistaken assumption. It is inappropriate in our view to impose burdensome new requirements based on the premise that simply because loans are secured by real estate, they represent greater risk.

Moreover, we believe many loans should not be considered a commercial real estate loan in any event. Specifically, loans to finance 1-4 family residential construction where the contractor already has a contract for the house (a custom home contract as opposed to "spec housing") should be excluded. Likewise, loans made directly to consumers for the construction of a home should be excluded. There are minimal risks associated with such loans, and what risks exist are based on "consumer" rather than "commercial" reasons. In addition, we believe that the 100% capital threshold is much too low. It should be raised to 200% to the extent there is any threshold at all. Also, we believe that commercial real estate loans with a loan-to-value ratio of 65% or less should not be counted toward the thresholds, as the risk of loss on such loans is minimal or non-existent.

2. **The proposed guidance fails to recognize that commercial loans secured by real estate present less of a risk than loans not secured by real estate.**

One of the underlying premises of the proposed guidance is that commercial real estate loans pose greater risks than other loans. We disagree with this premise.

Would a bank be in a safer position with an unsecured line of credit as opposed to a line of credit secured by real estate? Of course not, but that is how the proposed guidance treats the two loans.

Indeed, we believe that commercial loans secured by real estate typically pose less of a risk of loss than commercial loans secured by other sources of collateral, such as receivables, inventory or equipment. Covering losses by foreclosing on other forms of collateral is subject to all kinds of perils, such as bad behavior on the part of the borrower and a poor resale market for business inventory and equipment. Real estate, on the other hand, is a very reliable source of collateral - property values tend to increase over time, and even in times where values are stagnant, real estate as an asset is much more marketable than many other forms of collateral.

Furthermore, even if the value of real estate securing a commercial loan falls, it would have to fall significantly before the typical community bank loses any principal. This is because most such loans are made with a loan-to-value ratio of 80% or less. Add to that the fact that a borrower will likely have paid some principal before defaulting, and you can see that the real estate would have to drop substantially before the first dollar of loan principal is put at risk. For this reason, far from representing a "concentration" risk, commercial real estate loans are some of the safest loans on our books and thus should not be targeted for the kind of burdensome new requirements that have been proposed.

3. **The proposed guidance would impose significant new compliance burdens on community banks.**

Community banks are already struggling under a debilitating regulatory burden. The proposed guidance would add significantly to that burden.

In particular, while community banks should track their loan portfolios to guard against any legitimate concentrations of risk (and our bank does this), the extensive and difficult requirements set forth in the proposed guidance would simply overwhelm them (us). The proposed guidance provides for increased board oversight, new policies and procedures, strategic planning, new underwriting guidelines, contingency plans, new risk ratings, feasibility studies, sensitivity analysis, stress testing, monitoring and so on. Attempting to comply with all of these requirements will require a great deal of time and expense for a community bank, and, no matter how hard we might try, full compliance will all these complicated new requirements will be virtually impossible. Indeed, community banks struggle to understand what all of these provisions mean in terms of what would be required of us, much less how we could possibly manage to comply with them.

The burden associated with these requirements threatens the very future of community banking. Community banks, unlike larger banks, have limited resources to devote to new requirements such as these. And yet, perversely, it is the community bank that is most likely to meet the thresholds set forth in the proposed guidance triggering all the compliance burdens therein. This will put community banks at a competitive disadvantage relative to other financial institutions making commercial real estate loans that don't have to comply.

4. Requiring additional capital of community banks with higher levels of commercial real estate loans will hurt these banks competitively.

The proposed guidance indicated that banks meeting the thresholds for commercial real estate loan concentrations will be required to have higher capital levels. Again, this will hurt community banks, and, we believe, force many to sell to larger banks.

Quite simply, a community bank that is forced to hold a much higher lever of capital against its assets than a larger competitor bank will be forced to price much higher than its competitor or accept a lower return on shareholder equity. Neither approach would lead to growth, which is why, again, an increased capital requirement threatens the very survival of many community banks.

5. The proposed guidance adopts a "one-size-fits-all" approach when any concerns would be better addressed on an individual basis.

We believe the proposed guidance would unfairly punish all community banks for the problems (now or in the future) of a relative few. We urge the federal banking agencies to reconsider the approach of the proposed guidance.

In particular, we believe the agencies, and more importantly, community banking, would be much better served if the agencies applied existing guidance to problem banks rather than subjecting all banks (the vast majority of which pose no problem at all) to complicated and burdensome new requirements. In particular, we believe that fears associated with isolated geographic areas or a handful of banks are no justification for strangling an entire industry with new regulatory burdens. In short, the agencies can use existing law and their supervisory and examination authority to require those banks that pose unique risks to take the appropriate steps to address those risks. It is simply unnecessary to harm all banks in attempting to cure a few.

In conclusion, we emphasize that the proposed guidance would primarily impact community banks in a very negative and punitive manner. It will surely make it more difficult for us to compete in the safest and most profitable business left. If federal banking agencies care about the survival of community banking, they should not adopt this proposal.

Thank you for your consideration.

Sincerely,

F. Brad Denardo
Executive Vice President and
Chief Operating Officer

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