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## REGULATORY GUIDANCE ON CONCENTRATIONS IN COMMERCIAL REAL ESTATE LENDING

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On January 13, 2006, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency (OCC), the Federal Deposit Insurance Corporation (FDIC), and the Office of Thrift Supervision (OTS) (Agencies) published for comment in the *Federal Register* proposed guidance entitled “Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices” (Guidance).<sup>3</sup> Eleven months, one congressional hearing, and over 5,700 comment letters later, the Guidance was issued in final.<sup>4</sup> This Article summarizes what transpired during these eleven months, including the Agencies’ reasons for issuing the Guidance, the industry’s concerns over the content of the Guidance, and the transformation of the Guidance from its initial form to its final form. The Article concludes with some suggestions to facilitate compliance with the requirements mandated by the Guidance.

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\* The authors acknowledge with appreciation the thoughtful and helpful comments of Professor Lissa Broome, Publication Editor Kimberly J. Tacy, and Dr. Alan Kingsley, a student at the University of Virginia School of Law.

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3. See Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. 2302 (proposed Jan. 13, 2006).

4. See Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. 74,580 (Dec. 12, 2006) (OCC, Fed and FDIC version); see also Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. 75,294 (Dec. 14, 2006) (OTS version).

I. REGULATORY CONCERNS RELATING TO COMMERCIAL REAL ESTATE  
CONCENTRATIONS

The Agencies' stated purpose for issuing the Guidance was to "address the increasing concentrations of commercial real estate (CRE) loans at many institutions."<sup>5</sup> The Agencies were concerned that these concentrations might make banks "more vulnerable to cyclical CRE markets."<sup>6</sup> The Agencies were also concerned, based on results from recent examinations, that some banks were growing their CRE portfolios at a rapid pace without having prudent risk management practices in place.<sup>7</sup> Another concern was that some banks were entering new markets without first conducting appropriate market analyses and "establishing adequate control and reporting processes."<sup>8</sup>

The Agencies' view of the risk associated with CRE loans is heavily influenced by the events that occurred in the late 1980s and early 1990s in the CRE industry. As the agency commentary to the proposed Guidance noted, "[i]n the past, weak CRE loan underwriting and depressed CRE markets have contributed to significant bank failures and instability in the banking system."<sup>9</sup> These concerns over the CRE industry on the surface appear legitimate, but they do not take into account the evolution of banking practices over the past fifteen years.

The FDIC publication, *History of the Eighties – Lessons For the Future*, explains the role CRE lending played in the problems the banking industry experienced in the late 1980s and early 1990s.<sup>10</sup>

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5. Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. at 2304.

6. *Id.* Also, recent data reflects that between June 2000 and June 2006 there was a significant increase in the number of FDIC-supervised institutions whose ratio of CRE loans to Total Capital exceeded 300%. Marianne Lester et al., *Examiners Report on Commercial Real Estate Underwriting Practices*, SUPERVISORY INSIGHTS (Div. of Supervision and Consumer Protection of the Fed. Deposit Ins. Corp., Wash., D.C.), Winter 2006, at 28 tbl.1 [hereinafter *Examiners Report*], available at <http://www.fdic.gov/regulations/examinations/supervisory/insights/siwin06/siwin06.pdf>.

7. Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. at 2304.

8. *Id.*

9. *Id.*

10. See 1 DIV. OF RESEARCH AND STATISTICS, FED. DEPOSIT INS. CORP., HISTORY OF THE EIGHTIES – LESSONS FOR THE FUTURE 138 (1997) [hereinafter HISTORY OF THE 80S], available at <http://www.fdic.gov/bank/historical/history/vol1.html>.

Beginning in the early 1980s, banks began to increase their exposure to CRE loans.<sup>11</sup> Demand for CRE was stimulated by a number of factors, including provisions contained in the Economic Recovery Tax Act of 1981 (the 1981 Act)<sup>12</sup> that provided favorable tax treatment to CRE projects.<sup>13</sup> The 1981 Act changed the depreciation rules for CRE and allowed for accelerated depreciation, increasing the tax deductions associated with CRE and increasing the after-tax return on a CRE investment.<sup>14</sup> In addition, around this same time, thrifts were given expanded authority to make CRE loans.<sup>15</sup> This increased competition from thrifts led many banks to lower their underwriting standards for CRE loans, which in turn helped fuel the overbuilding cycle of the 1980s.<sup>16</sup>

The enactment of the Tax Reform Act of 1986 had a negative effect on the demand for CRE by eliminating (1) the provision of the 1981 Act that allowed for accelerated depreciation for CRE, and (2) the provision of the Internal Revenue Code that allowed taxpayers to offset ordinary income with passive losses.<sup>17</sup> This decreased demand had the effect of softening real estate prices.<sup>18</sup>

The decline in demand and the overbuilding that occurred during the 1980s led to an unprecedented increase in vacancy rates for office properties in major markets from 4.9% in 1980 to a peak of 18.9% in 1991.<sup>19</sup> Similarly, vacancy rates for retail properties rose from 4.9% in 1983 to 10.8% in 1991.<sup>20</sup>

Beginning in the late 1980s and persisting into the early 1990s, the CRE market went from a boom cycle to a bust cycle.<sup>21</sup> The effect on the banking industry was severe. In 1991, the proportion of nonperforming CRE loans to total CRE loans was 8.2%, and the

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11. *Id.* at 137.

12. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172.

13. HISTORY OF THE 80S, *supra* note 10, at 140-41.

14. *Id.*; *see also* Economic Recovery Tax Act, 95 Stat. 172.

15. *See* HISTORY OF THE 80S, *supra* note 10, at 154.

16. *Id.* at 153-56.

17. *Id.* at 140-41; *see also* Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085.

18. HISTORY OF THE 80S, *supra* note 10, at 141.

19. *Id.* at 146.

20. *Id.* at 148.

21. *Id.*

proportion of charge-offs on CRE loans to total CRE loans was 2.0%.<sup>22</sup> Compounding the problem was the decline in the value of the collateral that secured most CRE loans. Appraisal standards during the 1980s were non-existent, resulting in overinflated and sometimes fraudulent appraisals.<sup>23</sup> In addition, many banks had relaxed their underwriting standards, including raising their maximum loan-to-value (LTV) ratios.<sup>24</sup> Thus, when a loan defaulted, the collateral securing the loan was not valuable enough to repay the loan in full, leaving the lending bank with a loss.<sup>25</sup>

Evidence suggests that concentrations in CRE loans contributed to many bank failures. Indeed, “in all years between 1980 and 1993, the concentrations of CRE loans relative to total assets were higher for banks that subsequently failed than for nonfailed banks.”<sup>26</sup> In 1980, CRE loans of subsequently failed banks represented approximately 6% of total assets, while in 1993, this figure rose to almost 30%.<sup>27</sup> Among nonfailed banks, CRE loans also represented approximately 6% of total assets in 1980, but the figure increased to only 11% in 1993.<sup>28</sup>

Based on the evidence from the 1980s and early 1990s, the Agencies’ concerns over increased CRE concentrations appear to have a solid foundation. Many high-level officials within the Agencies lived through the boom-bust cycle of this period and, as they watched CRE concentrations increase, did not want to see history repeat itself. However, these concerns do not take into account a number of factors including:

- the development of syndicated lending practices which diffuse credit risk over a large number of bank and nonbank providers of capital;<sup>29</sup>
- the availability of better information on the health of CRE markets resulting from the development of the Commercial Mortgage Backed Securities (CMBS) market and Real Estate

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22. *Id.* at 153 tbl.3.3.

23. *Id.* at 156-57.

24. HISTORY OF THE 80S, *supra* note 10, at 155.

25. *Id.*

26. *Id.* at 158-59.

27. *Id.* at 159.

28. *Id.*

29. This is particularly true for large real estate investment and real estate construction projects, typically in excess of \$50 million.

- Investment Trusts (REIT) market;
- the demand for housing, office space, shopping centers, and warehouses for the more than 100 million increase in population in the Sunbelt and Pacific states over the past two decades;
  - the large amount of foreign investment in real estate experienced over the past decade, particularly in South Florida, California, Washington and New York City; and
  - the development of much more stringent appraisal standards that are diligently enforced by the regulatory agencies.

## II. BRIEF SUMMARY OF THE GUIDANCE IN ITS INITIAL FORM

The Guidance, as originally proposed, defined 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 a significant source of repayment is derived from rental income associated with the property (that is, loans for which 50[%] or more of the source of repayment comes from third party, non-affiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property.<sup>30</sup>

Loans to REITs and unsecured loans to developers that are subject to the risks inherent in the CRE market were also included in the definition of a CRE loan.<sup>31</sup> The proposed Guidance expressly excluded loans secured by owner-occupied properties from the definition of CRE, explaining that “their risk profiles are less influenced by the condition of the general CRE market.”<sup>32</sup>

The proposed Guidance provided for two supervisory thresholds. A bank that exceeded either threshold would be deemed to have a concentration in CRE and would be required to have heightened risk management practices consistent with the standards set forth in the

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30. Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. 2302, 2304 (proposed Jan. 13, 2006).

31. *Id.*

32. *Id.*

proposed Guidance.<sup>33</sup> A bank crossed the first threshold when its total loans for construction and land development were equal to or exceeded its total risk-based capital.<sup>34</sup> A bank crossed the second threshold when its total loans for construction and land development, multifamily, and non-farm nonresidential real estate were equal to or exceeded 300% of its total risk-based capital.<sup>35</sup>

The proposed Guidance also set forth a number of risk management principles that a bank with a CRE concentration would be expected to follow. The principles set forth in the proposed Guidance were intended to reinforce already existing supervisory expectations for a “safe and sound” lending program.<sup>36</sup> The risk management principles are described below:

- *Board and Management Oversight:* A bank’s board of directors should approve its overall CRE lending strategy and policies.<sup>37</sup> The board should receive reports on changes in CRE market conditions and the bank’s CRE lending activity; the reports should identify the size, significance, and risks related to the bank’s CRE concentration.<sup>38</sup> “The board should periodically review and approve CRE aggregate risk exposure limits and appropriate sublimits (for example, by property type and geographic area) . . . .”<sup>39</sup> Further, “management is responsible for implementing the CRE strategy in a manner that is consistent with the bank’s stated risk tolerance,” as well as developing and implementing policies and procedures for identifying, measuring, and monitoring CRE risks.<sup>40</sup>
- *Strategic Planning:* A bank should address its CRE concentration as part of its strategic planning process and “perform an analysis of the potential effect of a downturn in real

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33. *Id.* at 2305.

34. *Id.* This threshold will hereinafter be referred to as the “100% threshold.”

35. *Id.*

36. Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. at 2305.

37. *Id.*

38. *Id.*

39. *Id.*

40. *Id.*

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estate markets on both earnings and capital.”<sup>41</sup> Further, its strategy should include a contingency plan that responds to adverse market conditions and addresses possible ways to mitigate CRE concentration risk, such as selling CRE loans on the secondary market.<sup>42</sup> If selling loans on the secondary market is part of the contingency plan, then a bank should assess the marketability of its portfolio, including comparing its underwriting standards with those of the secondary market.

- *Underwriting*: A bank should have lending policies that clearly define the risk tolerance acceptable to the bank and provide measurable underwriting standards consistent with agency guidance.<sup>43</sup> Loan policies should address standards for, among other things, LTV limits by property type and minimum requirements for borrower equity.<sup>44</sup> Also, for development and construction loans, a bank “should have sound policies and procedures governing loan disbursements.”<sup>45</sup> Moreover, “management should compare [its] underwriting standards . . . with those that exist in the secondary market,” and should justify reasons for deviation if it finds that its standards are “substantially more lenient.”<sup>46</sup> Finally, a bank should permit exceptions to its underwriting standards only on a limited basis and should document any exceptions, obtain appropriate approvals, and report them to the Board of Directors.<sup>47</sup>
- *Risk Assessment and Monitoring of CRE Loans*: A bank “should establish and maintain thoroughly articulated policies” and procedures for risk rating its CRE exposures, monitoring its CRE loans, and identifying loan impairment.<sup>48</sup>
- *Portfolio Risk Management*: A bank “should measure and control CRE credit risk on a portfolio basis, [and not just on an

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41. *Id.*

42. Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. at 2305.

43. *Id.* at 2305.

44. *Id.* at 2305-06.

45. *Id.* at 2306.

46. *Id.*

47. *Id.*

48. Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. at 2306.

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individual loan basis], by identifying and managing [loan concentrations . . . .”<sup>49</sup>

- *Management Information Systems*: A bank’s management information system (MIS) “should provide meaningful information on CRE portfolio characteristics that are relevant to the [bank’s] lending strategy, underwriting standards, and risk tolerances.”<sup>50</sup> Banks should stratify their CRE portfolio by such categories as property type and geographic area.<sup>51</sup>
- *Identifying and Managing Concentrations*: “Management should continually evaluate the degree of potential correlation between related sectors and establish internal lending guidelines and limits that control the [bank’s] overall risk exposure.”<sup>52</sup> Management should also develop strategies for managing concentration levels, such as the use of secondary market sales, in order to reduce concentrations in certain property types or geographic areas.<sup>53</sup>
- *Market Analysis*: A bank should perform ongoing evaluations of market conditions and integrate its findings into its CRE lending strategy.<sup>54</sup> Market analysis is particularly important when expanding into new markets. Further, a bank should “utilize multiple sources for obtaining market information such as published research data, monitoring new building permits, and maintaining contacts with local contractors, builders, real estate agents, and community development groups.”<sup>55</sup>
- *Portfolio Stress Testing*: Banks are encouraged to utilize portfolio stress testing, understanding that this is an “evolving process.”<sup>56</sup> The level of sophistication of the stress portfolio model need only “be consistent with the size and complexity of the [bank’s] CRE portfolio.”<sup>57</sup>

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49. *Id.*

50. *Id.*

51. *Id.*

52. *Id.*

53. *See id.*

54. Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. at 2307.

55. *Id.*

56. *Id.*

57. *Id.*



In addition to the requirement of heightened risk management practices, the proposed Guidance also stated that “an institution 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.”<sup>58</sup> It further stated that “[i]n assessing the adequacy of an institution’s capital, the Agencies [would] take into account . . . an evaluation of the level of inherent risk in the CRE portfolio and the quality of [the institution’s] risk management” practices.<sup>59</sup> The proposed Guidance concludes by stating that “an institution that is unable to adequately assess and meet its capital needs may be required to develop a plan for reducing its concentrations or for achieving higher capital ratios.”<sup>60</sup>

### III. INDUSTRY’S RESPONSE TO THE GUIDANCE

The significance of the Guidance is illustrated by the industry’s interest in it. Out of approximately 9,000 depository institutions in the United States, the Agencies collectively received over 5,700 comment letters on the proposed Guidance.<sup>61</sup> In fact, the Agencies decided to extend the public comment period on the Guidance for an additional thirty days due to the “wide public interest in the proposal.”<sup>62</sup> The interest generated was influenced by the universe of banks potentially impacted by the Guidance. Early industry estimates indicated that nearly a third of all banks would exceed at least one of the two numerical thresholds, although these estimates did not account for the mitigating effect of owner-occupied loans.<sup>63</sup>

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58. *Id.*

59. Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. at 2307.

60. *Id.*

61. Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. 74,580, 74,581 (Dec. 12, 2006) (OCC, Fed. and FDIC version); Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. 75,294, 75,295 (Dec. 14, 2006) (OTS version).

62. Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, Extension of Comment Period, 71 Fed. Reg. 13,215, 13,216-17 (Mar. 14, 2006).

63. Ben Jackson, *Small Banks’ Dim View of CRE Proposal*, AM. BANKER, Mar. 3, 2006, § Community Banking, at 1.

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The majority of the comment letters were from financial institutions and their trade associations. The vast majority of commenters expressed strong opposition to the proposed Guidance. For purposes of this Article, we have chosen to highlight the views found in the comment letters of two industry trade associations, the American Bankers Association (ABA) and the Independent Community Bankers of America (ICBA), as well as a comment letter submitted by the Conference of State Bank Supervisors (CSBS). These comment letters are representative of the views of the banking industry as a whole.

Prior to analyzing the comment letters, it is important to understand how the financial markets have changed over the past two decades. Community banks have, in large part, been eliminated from large segments of the consumer lending market. Automobile financing has become highly concentrated in the automobile companies' captive finance companies and credit unions. The credit card market has been highly concentrated with ten banks controlling over 80% of the receivables, and a major portion of the residential mortgage market has been captured by nonbank providers. Technological advances coupled with securitization have facilitated this evolution. As a consequence, smaller commercial banks have been finding that their major lending markets reside in the small business and commercial real estate areas.

#### A. *CSBS Comment Letter*

Not all of the bank regulatory agencies thought it necessary to issue the Guidance. CSBS is the association that represents the interests of the various state banking supervisory authorities. CSBS made it very clear in its comment letter that it believes the Guidance is unwarranted based on the health of today's CRE market, and based on its view that supervisory tools are already available to regulators to allow them to deal effectively with unsafe and unsound CRE lending practices.<sup>64</sup> CSBS stated that recent joint examinations with the federal regulatory agencies indicated that most banks were prudently managing their CRE

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64. Letter from Neil Milner, President and CEO, Conference of State Bank Supervisors, to Robert E. Feldman, Executive Sec'y, Fed. Deposit Ins. Corp, Jennifer J. Johnson, Sec'y, Bd. of Governors of the Fed. Reserve Sys., Office of the Comptroller of the Currency, and Office of Thrift Supervision 3 (Mar. 24, 2006), <http://www.fdic.gov/regulations/laws/federal/2006/06c549crelending.pdf>.

concentrations.<sup>65</sup> It expressed the view that awareness over the potential risks associated with a CRE concentration is prudent, but that the proposed Guidance went too far and was too prescriptive.<sup>66</sup>

Several concerns about the form of the Guidance were expressed by CSBS. One concern was that “[t]he proposed Guidance [did] not recognize that risk varies among CRE sub-markets.”<sup>67</sup> Another concern was that the Guidance would place a heavy burden on community banks, which could result in smaller banks diverting their resources away from CRE lending, an area in which they have great expertise, and into other areas in which they do not have expertise.<sup>68</sup> For example, CSBS was concerned that certain requirements, such as requiring a bank to perform stress testing and other similar types of analysis, would impose significant expense on smaller banks while creating little value for the bank.<sup>69</sup> In the view of CSBS, the proposed Guidance failed to recognize “the greatest risk mitigation tool available to community banks – the proximity of the lender to the borrower.”<sup>70</sup>

#### B. *ABA and ICBA Comment Letters*

One of the primary concerns of the banking industry was the fear that the 100% and 300% thresholds would turn into hard caps on the amount of CRE loans a bank could hold in its portfolio when implemented by the Agencies’ examiners. This concern is based on the theory that there is a tendency on the part of examiners to err on the side of caution and, as a result, the burden of proof placed on banks by examiners to justify their CRE concentration would be so great that it could never be met. The ABA, in its comment letter, stated that “of gravest concern to our bankers is the belief that the guidance may be interpreted as a direction to examiners, once a CRE concentration in the bank’s portfolio of loans is found, to require a bank to take additional steps (perhaps including adding capital or refraining from making

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65. *Id.*

66. *Id.*

67. *Id.* at 1.

68. *Id.* at 1-2.

69. *Id.* at 2.

70. Letter from Neil Milner to Robert E. Feldman, Jennifer J. Johnson, Office of the Comptroller of the Currency, and Office of Thrift Supervision, *supra* note 64, at 2.

additional CRE loans), even if that portfolio is well managed.”<sup>71</sup>

The ABA and ICBA also expressed concern over the manner in which CRE was defined for purposes of the Guidance. For example, the ABA noted that the definition in the proposed Guidance “melds various loans secured by [CRE] into essentially one risk bucket” and ignores “the very different risk profiles” of the various types of CRE-secured loans.<sup>72</sup> It pointed out that there is no differentiation in the proposed Guidance between loans secured by office and retail properties (which carry more risk) and construction loans on one-to-four family homes.<sup>73</sup> Further, it pointed out that “there is no differentiation between 1-4 family residential construction that is built ‘on speculation’ from a 1-4 family residential construction where the contractor already has a contract for the house.”<sup>74</sup> The ABA’s concern was that by lumping in low-risk residential home construction loans with traditionally higher-risk CRE loans, a bank’s CRE loan totals might inflate and subject a bank to unwarranted supervisory scrutiny.<sup>75</sup>

The industry also held the view that the Guidance was unnecessary and that its “one-size-fits-all approach” would have a negative impact on banks that are prudently managing their CRE portfolio by increasing their burden and expense while not offering any additional benefits.<sup>76</sup> For example, the ABA recommended in its comment letter that “instead of imposing these new costs on the industry in general, the Agencies [should] apply existing guidance on a case-by-case basis to address any problems in those banks not engaging in CRE lending responsibly.”<sup>77</sup> The ABA further stated that it “believe[s] that the application of the Guidance to all banks is excessive and that the full array of measures it requires should be reserved for

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71. Letter from Mark Tenhundfeld, Director, Office of Regulatory Policy, Am. Bankers Ass’n., to Susan Schmidt Bies, Governor, Bd. of Governors of the Fed. Reserve Sys. 1 (Aug. 1, 2006), [http://www.federalreserve.gov/SECRS/2006/August/20060808/OP-1248/OP-1248\\_1698\\_1.pdf](http://www.federalreserve.gov/SECRS/2006/August/20060808/OP-1248/OP-1248_1698_1.pdf).

72. Letter from Paul Smith, Senior Counsel, Am. Bankers Ass’n, to Robert E. Feldman, Executive Sec’y, Fed. Deposit Ins. Corp, Jennifer J. Johnson, Sec’y, Bd. of Governors of the Fed. Reserve Sys., Office of the Comptroller of the Currency, and Office of Thrift Supervision 3 (Mar. 30, 2006), <http://www.fdic.gov/regulations/laws/federal/2006/06c619crelending.pdf>.

73. *Id.*

74. *Id.* at 3-4.

75. *See id.* at 2.

76. *Id.*

77. *Id.*

those few banks that have problems in the risk management of their portfolios . . . .”<sup>78</sup> The ICBA comment letter echoed this concern in stating that “[c]ommunity 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.”<sup>79</sup> The ICBA further stated that “[e]xaminers 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.”<sup>80</sup>

Along these same lines, there was concern that an examiner might interpret the Guidance as requiring a bank to adopt all of the risk management measures referenced in the Guidance, regardless of the size and complexity of the bank’s CRE portfolio. The ABA noted that “[t]here appears to be no attempt in the proposed Guidance to scale the regulatory response to the size of the bank or the particular composition of its portfolio.”<sup>81</sup> There was also concern that the risk management requirements set forth in the proposed Guidance “may be overwhelming to a community bank” and will place an excessive and unnecessary burden on community banks.<sup>82</sup> The ICBA comment letter noted that “the proposal’s recommendations regarding MIS enhancements and stress testing [will be] particularly costly and burdensome to community banks; the costs will most likely outweigh the benefits for smaller banks, with the result being an unwarranted and unnecessary contraction in CRE lending.”<sup>83</sup> The ICBA further noted that community banks “typically operate in a limited geographic area” and this enables them to “closely monitor the economic status” of their borrowers and their local community, thus decreasing their need for complex stress

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78. Letter from Paul Smith to Robert E. Feldman, Jennifer J. Johnson, Office of the Comptroller of the Currency, and Office of Thrift Supervision, *supra* note 72, at 6.

79. Letter from Karen M. Thomas, Executive Vice President, Indep. Cmty. Bankers of Am., to Robert E. Feldman, Executive Sec’y, Fed. Deposit Ins. Corp, Jennifer J. Johnson, Sec’y, Bd. of Governors of the Fed. Reserve Sys., Office of the Comptroller of the Currency, and Office of Thrift Supervision 2 (Apr. 12, 2006), <http://www.fdic.gov/regulations/laws/federal/2006/06c789crelending.pdf>.

80. *Id.*

81. Letter from Paul Smith to Robert E. Feldman, Jennifer J. Johnson, Office of the Comptroller of the Currency, and Office of Thrift Supervision, *supra* note 72, at 6

82. *Id.* at 6-7.

83. Letter from Karen M. Thomas to Robert E. Feldman, Jennifer J. Johnson, Office of the Comptroller of the Currency, and Office of Thrift Supervision, *supra* note 79, at 7.

testing and MIS systems.<sup>84</sup> It argued that examiners should look at the particular needs of each institution during the examination process and encourage enhancements to these systems as needed.<sup>85</sup>

Both the ABA and ICBA also expressed concern that language contained in the proposed Guidance regarding capital could lead examiners to arbitrarily demand higher capital for any bank with a concentration, regardless of the actual risk contained in the CRE portfolio.<sup>86</sup> They urged the Agencies to eliminate the discussion on the need for additional capital if a concentration is present and rely instead on existing authority as the basis for a case-by-case determination of any need for additional capital.<sup>87</sup>

The ABA and ICBA were also concerned about the impact the proposed Guidance would have on small community banks and their communities. The ABA noted that community banks are finding it hard to compete in various types of consumer lending businesses, such as credit card lending, auto lending, and residential mortgage lending.<sup>88</sup> One area in which small community banks have been able to remain competitive is CRE lending. Their knowledge of their communities and markets provides them with a considerable advantage when competing against larger banks for CRE loans.<sup>89</sup> Their “willingness to support business expansion in their communities has been crucial to economic recovery over the last few years.”<sup>90</sup>

The industry also took issue with the Agencies’ premise for issuing the Guidance. As mentioned above, the Agencies made it clear that their concern over CRE concentrations stems from the bust cycle that occurred during the 1980s and early 1990s. As summarized in the ABA comment letter, the industry believes that “banking today is different from what it was in the mid-eighties. We now have new

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84. *Id.* at 7-8.

85. *Id.* at 8.

86. *Id.* at 4, 8; Letter from Paul Smith to Robert E. Feldman, Jennifer J. Johnson, Office of the Comptroller of the Currency, and Office of Thrift Supervision, *supra* note 72, at 7-9.

87. Letter from Karen M. Thomas to Robert E. Feldman, Jennifer J. Johnson, Office of the Comptroller of the Currency, and Office of Thrift Supervision, *supra* note 79, at 8; Letter from Paul Smith to Robert E. Feldman, Jennifer J. Johnson, Office of the Comptroller of the Currency, and Office of Thrift Supervision, *supra* note 72, at 9.

88. Letter from Paul Smith to Robert E. Feldman, Jennifer J. Johnson, Office of the Comptroller of the Currency, and Office of Thrift Supervision, *supra* note 72, at 9-10.

89. *Id.* at 10.

90. *Id.*

capital requirements, more stringent real estate lending and appraisal requirements, express limits on high LTV real estate loans, and better supervisory examinations.”<sup>91</sup> In addition, it was pointed out that better information on the condition of the CRE market is available today due to the growth of REITs and the creation of the CMBS market.<sup>92</sup> This information was virtually nonexistent during the 1980s and early 1990s.

### C. Other Concerns

An additional concern for counsel for financial institutions is the types of enforcement actions the Agencies could employ to require adherence to the regulatory thresholds. The Agencies followed traditional administrative law standards which underpin agency enforcement powers in issuing the Guidance. The Guidance was issued initially with Notice of Comment provisions in January 2006. By utilizing this administrative process the Agencies may well have produced a *de facto* regulation at the time the Guidance was issued in final form. In the event the Agencies wish to enforce the Guidance through provisions of the Financial Institutions Supervisory Act (cease and desist powers) or the Financial Institutions Regulatory Act (civil money penalty powers), a reviewing court may be compelled to uphold the agency authority pursuant to the *Chevron Doctrine*<sup>93</sup> as it is incorporated in the Supreme Court decisions in *U.S.N.B. v. IIAA*, 508 U.S. 439 (1993), *NationsBank v. VALIC*, 513 U.S. 251 (1995), *Barnett Bank v. Nelson*, 517 U.S. 25 (1996), and *Smiley v. Citibank*, 517 U.S. 735 (1996).

On the one hand, the Agencies in their press releases stressed the informal nature of the Guidance and the amount of discretion which remains with the individual examiner, while on the other hand, the Agencies have utilized a procedure for its issuance which transforms the Guidance into a regulation. This problem is addressed by the Office of

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91. *Id.* at 9.

92. *Review of Proposed Financial Services Regulations: Hearing Before the H. Subcomm. on Financial Institutions and Consumer Credit of the H. Comm. on Financial Service*, 110th Cong. (2006) [hereinafter *Hearing*] (testimony by Glenn R. Mueller, Ph.D Professor, University of Denver).

93. *Chevron U.S.A. Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) (holding that reviewing courts must follow any reasonable agency interpretation of an “ambiguous” statute).

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Management and Budget's Good Guidance Practice Bulletin issued on November 23, 2005,<sup>94</sup> which to-date has not been issued in final form. There is no effort to harmonize the Guidance with the proposed Office of Management and Budget issuance. However, a literal reading of the proposed Office of Management and Budget issuance may lead to the conclusion that the Guidance is a regulation.

*D. Congressional Hearing*

Based on the amount of public interest generated by the proposed Guidance, the House Subcommittee on Financial Institutions and Consumer Credit held a hearing on September 14, 2006.<sup>95</sup> The hearing included a panel of regulators and industry representatives and allowed each side to express their views on the necessity and content of the Guidance. The panel of regulators included representatives of the Federal Reserve, FDIC, OCC, OTS, and CSBS. The panel of industry representatives included representatives of the ABA, ICBA, America's Community Bankers, and others.

Most of the testimony rehashed the views previously discussed, with one major exception. During his testimony, OTS Director John Reich expressed his view, for the first time publicly, that he felt that the 100% and 300% thresholds should be eliminated from the Guidance.<sup>96</sup> His view concerning the thresholds was a major sticking point with the other agencies.

Additionally, CSBS raised an issue at the hearing not found in its comment letter. In its testimony, CSBS expressed concern that the thresholds could be interpreted by examiners in the field as limits, and therefore effectively serve as a cap on an institution's ability to exceed them, even if the portfolio is prudently underwritten and well managed.<sup>97</sup> As previously discussed, this was also a chief concern of the banking industry.

The members of the Subcommittee attending the hearing

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94. EXECUTIVE OFFICE OF THE PRESIDENT, OFFICE OF MGMT. AND BUDGET, OMB RELEASES DRAFT BULLETIN FOR GOOD GUIDANCE PRACTICES, 2005-30 (2005), available at <http://www.whitehouse.gov/omb/pubpress/2005/2005-30.pdf>

95. See *Hearing*, *supra* note 92.

96. *Id.* (statement of John M. Reich, Director, Office of Thrift Supervision).

97. *Id.* (statement of Steven L. Antonakes, Massachusetts Commissioner of Banks, on behalf of the Conference of State Bank Supervisors).



expressed major concern over the proposed Guidance, particularly Ranking Member Barney Frank. Mr. Frank was concerned about the message the Guidance would send to the industry and examiners. He said, “[t]he very fact that you single something out has a great impact.”<sup>98</sup> He was particularly concerned about the impact the Guidance would have on multifamily housing, noting the outstanding track record of multifamily portfolios over the last several years.<sup>99</sup>

#### IV. FINAL GUIDANCE

On December 6, 2006, the Guidance was issued in its final form.<sup>100</sup> The final Guidance had some noticeable changes from its initial form. Most notably, the OTS decided to issue its own version of the Guidance without the numerical thresholds. In the weeks leading up to the issuance of the final Guidance, OTS Director Reich made it clear that he believed the Guidance should not contain numerical thresholds.<sup>101</sup> After the final Guidance was issued, Director Reich explained his reasoning for not including the numerical thresholds in the OTS version of the Guidance. Echoing the sentiments of the banking industry, he stated that he thought the Guidance was “too prescriptive, that the numbers would be interpreted by bank examiners across the country as ceilings, not screens or thresholds for further examination.”<sup>102</sup> He further stated that he was “fearful as to how the guidance will be administered.”<sup>103</sup> Apart from the elimination of the numerical thresholds, the OTS version of the Guidance is very similar in most other respects to the version issued by the other three banking agencies.

While the other three banking agencies did not eliminate the

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98. Steven Sloan, *Legislators Press Agencies On Basel, CRE Guidelines*, AM. BANKER, Sept. 15, 2006, § Washington, at 1-2.

99. *Id.*

100. See Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. 74,580 (Dec. 12, 2006) (OCC, Fed and FDIC version); see also Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. 75,294 (Dec. 14, 2006) (OTS version).

101. John M. Reich, Dir., Office of Thrift Supervision, Remarks at Annual Conference of America’s Community Bankers (Oct. 15, 2006).

102. Barbara A. Rehm, *OTS Sells Thrift Charter in Pursuit of Start-ups*, AM. BANKER, Dec. 15, 2006, § Washington, at 1.

103. *Id.*

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numerical thresholds, they did add an additional screen for the 300% threshold. In addition to a bank's total CRE loans equaling or exceeding 300% of its total risk-based capital, the bank's CRE portfolio must also have increased by 50% or more over the prior thirty-six months in order for the 300% threshold to become applicable.<sup>104</sup> The addition of the 50% screen was in response to the industry's concern that the concentration thresholds did not take into account an institution's experience in managing CRE concentrations.<sup>105</sup> This additional screen places more of a focus on banks that have rapidly grown their CRE portfolio. It should be noted that the 50% growth rate screen does not apply to the 100% threshold.

The agencies also added language to reduce the likelihood that examiners would view the numerical thresholds as limits. In the second paragraph of the Guidance, the following sentence was added: "The Guidance does not establish specific CRE lending limits; rather, it promotes sound risk management practices and appropriate levels of capital that will enable institutions to continue to pursue CRE lending in a safe and sound manner."<sup>106</sup> Additionally, in the section of the Guidance that outlines the two numerical thresholds, a section was added stating:

The Agencies will use the criteria as a preliminary step to identify institutions that may have CRE concentration risk. Because regulatory reports capture a broad range of CRE loans with varying risk characteristics, the supervisory monitoring criteria do not constitute limits on an institution's lending activity but rather serve as high-level indicators to identify institutions potentially exposed to CRE concentration risk.<sup>107</sup>

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104. Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. at 74,587.

105. *Id.* at 74,584.

106. *Id.* at 74,585.

107. *Id.* at 74,587.

The Agencies<sup>108</sup> also took steps to address other concerns raised by the industry during the comment period. Many commenters were concerned over the broadness of the definition of CRE for purposes of the Guidance and the lack of recognition in the proposed Guidance of potential for diversification by property type and geography.<sup>109</sup> The Agencies responded by noting that “because the Guidance does not impose lending limits, its scope is purposely broad so that it includes those CRE loans, including multifamily loans, with risk profiles sensitive to the condition of the general CRE markets, such as market demand, changes in capitalization rates, vacancy rates and rents.”<sup>110</sup> The final Guidance includes a section discussing certain factors that will mitigate the risk associated with a CRE concentration, including portfolio diversification, geographic dispersion, underwriting standards, level of presold buildings, and portfolio liquidity.<sup>111</sup> This provides bankers and examiners with more guidance as to risk mitigation factors. Additionally, a sentence was added which states that “the Agencies recognized that different types of CRE lending present different levels of risk, and that consideration should be given to the lower risk profiles and historically superior performance of certain types of CRE, such as well-structured multifamily housing finance, when compared to others, such as speculative office space construction.”<sup>112</sup>

Another concern raised by the industry during the comment period was the expense associated with upgrading their MIS systems and portfolio stress testing. The Agencies included language in the final Guidance acknowledging that “[t]he sophistication of [an institution’s] MIS will necessarily vary with the size and complexity of the CRE portfolio and level and nature of concentration risk.”<sup>113</sup> Further, the final Guidance notes that portfolio stress testing may not require the use of sophisticated portfolio models, and the sophistication of stress testing practices “should be consistent with the size, complexity and risk

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108. Because of the substantial similarity between the OTS’s Final Guidance and the other three banking agencies’ Final Guidance, the remainder of this Article, for purposes of simplicity, will reference only the latter, and “Agencies” will hereinafter refer to the Bd. of Governors of the Fed. Reserve System, the FDIC, and the OCC.

109. Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. at 74,582.

110. *Id.*

111. *Id.* at 74,587.

112. *Id.* at 74,585.

113. *Id.* at 74,586.

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characteristics of its CRE loan portfolio.”<sup>114</sup>

The Agencies also took action to address the concern raised during the comment period that an examiner might interpret the Guidance as requiring a bank to adopt all of the risk management measures referenced in the Guidance, regardless of the size and complexity of the bank’s CRE portfolio. The Agencies included a sentence at the beginning of the Risk Management section stating that “[t]he sophistication of an institution’s CRE risk management processes should be appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risk to the institution.”<sup>115</sup>

The final Guidance also clarified the circumstances under which a bank should compare its underwriting standards to those of the secondary market, and it included language acknowledging that an institution’s market analysis will vary based upon the availability of market data.<sup>116</sup>

#### V. POTENTIAL STRATEGIES FOR COMMUNITY BANKS TO COPE WITH THE NEW REGIME

It will be interesting to see what impact the Guidance has on the CRE portfolios of banks. Will the numerical thresholds simply serve as screens in order to focus examiners on institutions with concentrations, or will the thresholds turn into caps as many bankers fear? Are there realistic strategies that banks can employ to relieve regulatory concerns expressed by the Guidance?

Clearly, many community banks will be required to upgrade their internal control and monitoring procedures to provide greater detail on loan concentrations. The Guidance specifies a number of control measures which appear to have been developed by large banks in implementing BASEL II requirements. These measures will require expenditures for both software and staff.

It will be important for a bank to work closely with its regulator in developing its strategy for managing its CRE portfolio. Prior to spending money to upgrade its systems and controls, a bank should

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114. *Id.* at 74,587.

115. Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices, 71 Fed. Reg. at 74,585.

116. *Id.* at 74,583.

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develop a plan outlining any changes it deems necessary and meet with its regulator to ensure that the proposed steps are sufficient. The following actions appear to be minimal steps required to meet the expectations of the regulators:

- A bank will need to develop a CRE Lending Strategy Statement to be approved by its Board of Directors. At a minimum, the statement should set forth: (i) the acceptable level of risk within the bank's CRE portfolio; (ii) acceptable levels of concentration for the various types of CRE loans; and (iii) the responsibilities of bank management for establishing procedures to identify, measure, monitor and prepare reports for the Board on the CRE portfolio and the risks contained therein. As part of its CRE lending strategy, it will be prudent for banks to include strategies for managing CRE concentrations once they are identified. This could include taking such actions as identifying loans within its portfolio that are eligible for sale on the secondary market.
- The most important step that a bank will need to take is to develop a complete understanding of the make-up of its CRE portfolio. In order to accomplish this, a bank will need to stratify its CRE portfolio. It will be the responsibility of the Board of Directors and senior management to determine the various categories for the stratification. It may be as simple as stratifying by CRE loan type (office, retail, industrial, apartments, hotel) or the categories may be broken down even further to include specific types of properties within each category.
- The Board of Directors will need to establish appropriate limits and sub-limits for each exposure type (for example, a limit on loans made on retail shopping centers in a certain geographic area).<sup>117</sup> Once these limits are established, the Board should periodically receive reports comparing the bank's CRE portfolio to the limits set forth in the bank's loan policy.
- It will also be important for bank personnel to properly code each CRE loan in order to ensure proper identification for

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117. See *Examiner's Report*, supra note 6, at 30.

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internal reporting purposes, and to ensure that any owner-occupied loan is properly accounted for.

- A bank will need to develop minimal standards for CRE loan applications and files and develop an exception report tracking system for exceptions granted in the loan applications. The Board of Directors should receive reports on a periodic basis listing each exception to the bank's CRE Loan Policy. Along with this list of exceptions should be a thorough explanation as to why each exception was granted (for example, what mitigating factors were taken into consideration in approving the loan).
- The Board of Directors, as well as management, should closely monitor the conditions of the various markets in which the bank makes CRE loans. The type of information analyzed will vary depending upon the bank's market. For banks located in non-metropolitan areas, it may be difficult to obtain research reports on the bank's market. However, a bank in such a market should establish contacts with local developers, builders and real estate agents to gain an understanding of the direction the market is heading, and then take any necessary action based upon this information.<sup>118</sup> For example, if the market analysis indicates that vacancy rates for office properties are increasing significantly, the bank should reevaluate its strategy in making future loans to this market segment. This may necessitate revising the bank's portfolio limits.
- A bank will need to closely examine its appraisal process to ensure that it is compliant with industry standards. It will be prudent for banks to establish strong internal appraisal review programs that provide an independent analysis of appraisals prior to funding.<sup>119</sup> A bank should also review the qualifications of its appraisers on an ongoing basis and remove those that do not provide appraisals that comply with the relevant regulatory requirements for appraisals.<sup>120</sup>

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118. See Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices; 71 Fed. Reg. at 74,586, see also *Examiners Report*, supra note 6, at 30.

119. See *Examiners Report*, supra note 6, at 31.

120. *Id.*

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These are just some of the immediate steps a bank will need to consider initiating. In dealing with the long term implications of the Guidance, community banks may be compelled to revise their strategic planning to develop alternative lines of business or increase capital to accommodate the new regulatory requirements.

Diversification of credit risk by (i) geographic region, (ii) asset composition, (iii) CRE product type, and (iv) source of repayment will be the mantra for long term compliance. Many community banks may benefit from purchasing loan participations from correspondent banks. There has been increased interest in utilizing this alternative as a method to diversify the risk in a bank's portfolio of loans.

The Board of Directors and senior management will play a crucial role in determining the real impact that the Guidance has on their bank. If the Board of Directors and senior management are proactive in managing their bank's CRE portfolio and take the steps necessary to understand and mitigate the risks within the portfolio, their bank should be able to withstand any heightened regulatory scrutiny resulting from the Guidance.