NATIONAL ASSOCIATION OF REALTORS®

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April 13, 2006

Office of the Comptroller of the Currency
Attn: Public Information Room
250 E St. SW
Mail Stop 1-5
Washington, DC 20219
Docket # 06-01

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th St. and Constitution Ave. NW
Washington, DC 20551
Docket # OP-1248

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th St. NW
Washington, DC 20429

Regulation Comments
Chief Counsel's Office
Office of Thrift Supervision
1700 G St. NW
Washington, DC 20552
Attention: 2006-01

Comments of the National Association of REALTORS® on the Proposed Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices

Dear Sir or Madam:

On behalf of nearly 1.3 million members of the National Association of REALTORS® (NAR), I am pleased to provide comments to the Federal banking agencies regarding the proposed guidance on sound risk management practices for commercial real estate (CRE) lending published in the Federal Register on January 13, 2006.

The National Association of REALTORS®, "The Voice for Real Estate," is America's largest trade association, including NAR's five commercial real estate institutes and its societies and councils. REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,500 local associations or boards, and 54 state and territory associations of REALTORS®. Though the guidance pertains to the risk management practices of financial institutions, to the extent that the proposed guidance restricts the flow of capital to commercial real estate, NAR is concerned that an overly prescriptive risk management regimen may harm the nation's commercial real estate markets.

NAR favors the establishment of commercial real estate risk management guidelines that preserve and strengthen the safety and soundness of the banking system while not unduly harming the flow of capital to commercial real estate. At the same time, NAR is concerned that the combined impact of overly restrictive risk management practices with a revised regulatory capital regimen (Basel 1-A and Basel II) that does not fully recognize the unique character of commercial real estate lending could increase the cost of capital and dissuade financial institutions from making loans to sound commercial real estate ventures. This would decrease property values and hurt CRE markets.

Description of Proposed Guidance

The regulators have observed that some insured financial institutions have high and increasing concentrations of CRE loans on their balance sheets, and are concerned that these concentrations may make institutions more vulnerable to losses during commercial real estate cycles. While the regulators have previously issued regulations outlining supervisory expectations for a safe and sound CRE lending program, this proposed guidance is intended to reinforce existing guidance as it relates to institutions with elevated levels of concentration in CRE loans.

The guidance notes that in the past "weak CRE loan underwriting and depressed CRE markets have contributed to significant bank failures and instability in the banking system," and that "recent examinations have indicated that the risk management practices and capital levels of some institutions are not keeping pace with their CRE concentrations."[1] The regulators propose that financial institutions with CRE concentrations adopt additional risk management measures to provide an additional safeguard against market fluctuations.

The regulators propose to define CRE loans as exposures "secured by raw land, land development and construction (including 1-4 family residential construction), multifamily property, and non-farm non residential property where the primary or a significant source of repayment is derived from rental income associated with the property." The definition also includes loans to REITs and unsecured loans to developers that closely correlate to the risk in commercial real estate markets. Concentrations that warrant heightened risk management practices would be defined as:

- Total reported loans for construction, land development, and other land represent 100% or more of the institutions total capital; and
- Total reported loans secured by multifamily and non farm non residential properties and loans for construction, land development, and other land represent 300% of the institutions total capital[2].

According to the regulators, financial institutions meeting or exceeding these criteria should have heightened risk management practices. The following areas of the proposed guidance are of interest to NAR:

- <u>Risk Assessment and Monitoring of CRE Loans</u>: Financial institutions should maintain thoroughly articulated policies that specify criteria for risk rating CRE exposures. The risk ratings should take into account the property's sensitivity to changing market conditions.

[1] Federal Register Vol. 71, No. 9 Friday, January 13, 2006, Notices page 2304.
[2] Ibid, p. 2305

- Portfolio Risk Management: Institutions should measure and control CRE credit risk on a portfolio basis by identifying and managing concentrations, performing market analysis, and stress testing. Risk management practices should include:

  - Management Information Systems: Institutions should stratify the portfolio by property type, geographic area, tenant concentrations, tenant industries, developer concentrations, and risk rating.
  - Market Analysis: Institutions should perform on going evaluations of the market conditions for the various property types and geographic areas or markets represented in their portfolio.
  - Portfolio Stress Testing: Institutions should consider performing portfolio level stress tests of their CRE exposures to quantify the impact of changing economic scenarios.

- Capital Adequacy: Financial institutions with CRE concentrations should recognize the need for additional capital support, beyond what is regulatorily required, for CRE concentrations in its strategic, financial and capital planning[3].

The proposed guidance provides recommendations for financial institutions to strengthen their risk management practices should they develop concentrations in CRE lending. It is our understanding that numerous financial institutions have similar risk management programs in place, and generally adhere to the FDIC's rules on real estate lending standards. This proposed guidance seems to be intended to address institutions who may be tempted by overheated local markets to increase exposure to certain classes of real estate lending.

NAR Recommendation

NAR supports agency efforts to ensure that institutions provide CRE loans based on sound underwriting principles with the finance charges priced appropriately to reflect the economic risk of each loan. We are, however, concerned that an overly stringent or inconsistent application of the guidelines may cause financial institutions not to lend to worthy projects, and as a consequence, harm the commercial real estate markets and depress property values.

The regulators appear to be addressing the soundness of CRE lending on two fronts: through the implementation of the Basel II and Basel I-A accords, which would revise the methodologies by which financial institutions determine regulatory capital, and through the proposed guidance.

On the proposed Basel I-A framework, NAR provided the following comments on CRE lending:

- Multifamily Residential Mortgages: NAR urged the regulators to treat multifamily mortgages within the Income Producing Real Estate category set in Basel II, and thus afford those properties with a consistent and strong revenue history a lower risk weighting than loans secured by other types of real estate.

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[3] ibid, p. 2306-2307

- Commercial Real Estate: NAR noted that several studies by the FDIC and the Federal Reserve indicated that underwriting and internal risk management procedures improved markedly. These improvements were a factor in Basel II's establishment of the IPRE category and the HVCRE category. NAR urged that Basel I A also treat commercial lending in two categories as Basel II does[4].

Consistent with our comments that regulators should treat different classes of real estate lending separately under Basel 1-A, NAR believes that the proposed guidance should emphasize that portfolio diversity can be achieved through different types of CRE loans with varying degrees of risk. NAR recommends that regulators encourage diversity of CRE exposures across classes of commercial real estate and markets. Commercial real estate is often divided into the following classes: office, industrial, retail, multifamily condo, multifamily rental, and hospitality, each with unique performance characteristics. Though each class is tied to the overall health of the economy, some classes are more susceptible to market fluctuations than others. As part of a financial institution's portfolio risk management, NAR believes that financial institutions should be able to effectively manage risk through creating CRE portfolios that are diverse in exposures to different classes of commercial real estate in different regional markets.

Conclusion:

The regulators should carefully consider the effects of a revised risk-based capital regimen combined with increased risk management safeguards on the commercial real estate markets. Financial institutions may be dissuaded from making loans to, or unnecessarily raise the cost of capital for sound commercial real estate ventures. This could hurt commercial real estate markets and depress property values. NAR asks that the regulators carefully evaluate the potential impact the proposed guidance could have on the real estate markets before finalizing the proposed guidance.

We hope that you find these comments helpful. If you have any questions, please feel free to call Tom Heinemann at (202) 383-1090.

Sincerely yours,

David A. Lereah
Senior Vice President, Chief Economist

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[4] NAR comments re: Risk-Based Capital Guidelines, Capital Adequacy Guidelines, Capital Maintenance, Domestic Capital Modifications OCC Docket # 05-16, OTS No. 2005-40, Federal Reserve Docket # R-1238, FDIC Comments 3064-AC-96.