The public is invited to make oral comments. Individual comments will be limited to 5 minutes. If you would like to have the TAP consider a written statement, please call 1–888–912–1227 or 206–220–6096, or write to Janice Spinks, TAP Office, 915 2nd Avenue, MS W–406, Seattle, WA 98174 or you can contact us at *http://www.improveirs.org.* Due to limited conference lines, notification of intent to participate in the telephone conference call meeting must be made with Janice Spinks. Miss Spinks can be reached at 1–888–912–1227 or 206–220–6096.

The agenda will include the following: Various IRS issues.

Dated: December 7, 2006.

John Fay,

Acting Director, Taxpayer Advocacy Panel.

[FR Doc. E6–21229 Filed 12–13–06; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

Open Meeting of the Area 3 Taxpayer Advocacy Panel (Including the States of Florida, Georgia, Alabama, Mississippi, Louisiana, Arkansas, and the Territory of Puerto Rico)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice.

SUMMARY: An open meeting of the Area 3 Taxpayer Advocacy Panel will be conducted (via teleconference). The Taxpayer Advocacy Panel is soliciting public comments, ideas, and suggestions on improving customer service at the Internal Revenue Service.

DATES: The meeting will be held Tuesday, January 16, 2007, from 11:30 a.m. ET.

FOR FURTHER INFORMATION CONTACT: Sallie Chavez at 1–888–912–1227, or 954–423–7979.

SUPPLEMENTARY INFORMATION: Notice is hereby given pursuant to section 10(a)(2) of the Federal Advisory Committee Act, 5 U.S.C. App. (1988) that an open meeting of the Area 3 Taxpayer Advocacy Panel will be held Tuesday, January 16, 2007, from 11:30 a.m. ET via a telephone conference call. If you would like to have the TAP consider a written statement, please call 1–888–912–1227 or 954–423–7979, or write Sallie Chavez, TAP Office, 1000 South Pine Island Rd., Suite 340, Plantation, FL 33324. Due to limited conference lines, notification of intent to participate in the telephone conference call meeting must be made with Sallie Chavez. Ms. Chavez can be reached at 1–888–912–1227 or 954–423–7979, or post comments to the Web site: *http://www.improveirs.org.* The agenda will include: Various IRS issues.

Dated: December 7, 2006.

John Fay,

Acting Director, Taxpayer Advocacy Panel.

[FR Doc. E6–21230 Filed 12–13–06; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

Open Meeting of the Area 4 Taxpayer Advocacy Panel (Including the States of Illinois, Indiana, Kentucky, Michigan, Ohio, Tennessee, and Wisconsin)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice.

SUMMARY: An open meeting of the Area 4 Taxpayer Advocacy Panel will be conducted (via teleconference). The Taxpayer Advocacy Panel is soliciting public comment, ideas, and suggestions on improving customer service at the Internal Revenue Service.

DATES: The meeting will be held Tuesday, January 16, 2007, at 10 a.m., Central Time.

FOR FURTHER INFORMATION CONTACT: Mary Ann Delzer at 1–888–912–1227, or (414) 231–2360.

SUPPLEMENTARY INFORMATION: Notice is hereby given pursuant to Section 10(a)(2) of the Federal Advisory Committee Act, 5 U.S.C. App. (1988) that a meeting of the Area 4 Taxpayer Advocacy Panel will be held Tuesday, January 16, 2007, at 10 a.m., Central Time via a telephone conference call. You can submit written comments to the panel by faxing the comments to (414) 231–2363, or by mail to Taxpayer Advocacy Panel, Stop 1006MIL, PO Box 3205, Milwaukee, WI 53201, or you can contact us at *www.improveirs.org.* This meeting is not required to be open to the public, but because we are always interested in community input we will accept public comments. Please contact Mary Ann Delzer at 1–888–912–1227 or (414) 231–2360 for dial-in information.

The agenda will include the following: Various IRS issues.

Dated: December 7, 2006.

John Fay,

Acting Director, Taxpayer Advocacy Panel.

[FR Doc. E6–21231 Filed 12–13–06; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Internal Revenue Service

Open Meeting of the Area 2 Taxpayer Advocacy Panel (Including the States of Delaware, North Carolina, South Carolina, New Jersey, Maryland, Pennsylvania, Virginia, West Virginia and the District of Columbia)

AGENCY: Internal Revenue Service (IRS), Treasury.

ACTION: Notice.

SUMMARY: An open meeting of the Area 2 Taxpayer Advocacy Panel will be conducted (via teleconference). The Taxpayer Advocacy Panel is soliciting public comments, ideas, and suggestions on improving customer service at the Internal Revenue Service.

DATES: The meeting will be held Wednesday, January 17, 2007, at 2:30 p.m. ET.

FOR FURTHER INFORMATION CONTACT: Inez E. De Jesus at 1–888–912–1227, or 954–423–7977.

SUPPLEMENTARY INFORMATION: Notice is hereby given pursuant to section 10(a)(2) of the Federal Advisory Committee Act, 5 U.S.C. App. (1988) that an open meeting of the Area 2 Taxpayer Advocacy Panel will be held Wednesday, January 17, 2007, at 2:30 p.m. ET via a telephone conference call. If you would like to have the TAP consider a written statement, please call 1–888–912–1227 or 954–423–7977, or write Inez E. De Jesus, TAP Office, 1000 South Pine Island Rd., Suite 340, Plantation, FL 33324. Due to limited conference lines, notification of intent to participate in the telephone conference call meeting must be made with Inez E. De Jesus. Ms. De Jesus can be reached at 1–888–912–1227 or 954–423–7977, or post comments to the Web site: *http://www.improveirs.org.*

The agenda will include the following: Various IRS issues.

Dated: December 7, 2006.

John Fay,

Acting Director, Taxpayer Advocacy Panel.

[FR Doc. E6–21233 Filed 12–13–06; 8:45 am]

BILLING CODE 4830–01–P

DEPARTMENT OF THE TREASURY

Office of Thrift Supervision

[No. 2006–50]

Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices

AGENCY: The Office of Thrift Supervision, Treasury (OTS).

ACTION: Final guidance.

SUMMARY: OTS is issuing final guidance: Concentrations in Commercial Real Estate (CRE) Lending, Sound Risk Management Practices (guidance). OTS developed this Guidance to clarify that institutions actively engaged in CRE lending should assess their concentration risk and implement appropriate risk management policies and procedures to identify, monitor, manage, and control their concentration risks.

EFFECTIVE DATE: The final Guidance is effective December 14, 2006.

FOR FURTHER INFORMATION CONTACT: *OTS:* William Magrini, Senior Project Manger, (202) 906–5744, or Fred Phillips-Patrick, Director, Credit Policy, (202) 906–7295.

SUPPLEMENTARY INFORMATION:

I. Background

OTS has observed that some institutions have high and increasing concentrations of CRE loans on their balance sheets and is concerned that these concentrations may cause some savings associations to be more vulnerable to cyclical CRE markets. In the past, concentrations in CRE lending coupled with weak loan underwriting and depressed CRE markets contributed to significant credit losses in the banking system. While underwriting standards are generally stronger than during previous CRE cycles, OTS has observed an increasing trend in the number of institutions with concentrations in CRE loans. These concentrations could cause institutions to be more vulnerable to cyclical CRE markets. Moreover, OTS believes an institution's risk management practices should be commensurate with its CRE concentrations.

In response to those concerns, OTS, together with the Office of the Comptroller of the Currency (OCC), The Federal Reserve Board (FRB), and the Federal Deposit Insurance Corporation (FDIC) (collectively ''Agencies'') published for notice and comment, proposed interagency guidance, ''Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices,'' 71 FR 2302 (January 13, 2006).

The Agencies sought public comment on all aspects of the proposed guidance. In particular, the Agencies requested comment on the scope of the definition of CRE and on the appropriateness of using thresholds for determining elevated concentration risk. For the purposes of the proposed guidance, the Agencies focused on concentrations in those types of CRE loans that are particularly vulnerable to cyclical CRE 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 have been considered CRE loans for purposes of the proposed guidance.

The proposed guidance set forth thresholds for assessing an institution's CRE concentrations that would require heightened risk management practices. The proposed Guidance also reminded institutions with CRE concentrations that they should hold capital higher than regulatory minimums and commensurate with the level of risk in their CRE lending portfolios. In assessing the adequacy of an institution's capital, the proposed Guidance stated that the Agencies would take into account the level of inherent risk in its CRE portfolio and the quality of its risk management practices.

Collectively, the Agencies received approximately 4,400 comment letters from financial institutions, their trade associations, state banking regulators, and other members of the public. OTS received approximately 1,300 comment letters. The vast majority of commenters were opposed to the Guidance as proposed.

II. Overview of Public Comments

The vast majority of commenters expressed strong opposition to the proposed CRE concentration Guidance and stated that the agencies should address the issue of concentration risk on a case-by-case basis as part of the examination process. Commenters stated that existing regulations and Guidance are sufficient to address the agencies' concerns regarding CRE concentration risk and the adequacy of an institution's risk management practices and capital. Many commenters asked that the Agencies either substantially revise the proposed Guidance or withdraw it.

Specifically, commenters expressed concern about the following areas of the proposal:

- That the definition of CRE inappropriately includes multifamily and one-to four-family construction loans;
- That the thresholds of 100 percent of the institution's capital for construction loans and 300 percent of capital for aggregate CRE loans would be viewed as limits; and
- That all institutions would be required to adopt intense risk management systems, regardless of their level of CRE lending.

Several commenters asserted that today's lending environment is significantly different than the late 1980s and early 1990s when banks and thrifts suffered losses from their real estate lending activities due to weak underwriting standards and risk management practices. Commenters stated that the underwriting practices of banks and thrifts are now much stronger, and capital levels are higher.

Comments from community banks raised serious opposition to the proposed Guidance and suggested that the proposed Guidance would discourage community banks from engaging in CRE. These commenters also noted that if community banks were forced to reduce their CRE lending, it could create a downturn in the economy and lead to systemic problems greater than any potential risks in CRE loans.

While smaller institutions acknowledge that many community banks and small thrifts have concentrations in CRE loans, they contend that there are few other lending opportunities in which community banks can successfully compete against larger financial institutions. Community banks commented that secured real estate lending has been their ''bread and butter'' business and, if required to reduce their CRE lending activity, they would have to look to other types of lending, which are historically more risky. Moreover, these commenters noted that community-based institutions have in depth knowledge of their local communities and markets, which affords them a significant advantage when competing for CRE loan business. Community banks also noted that their lending opportunities have diminished due to competition from other types of financial institutions, such as finance companies, Farm Credit banks, and credit unions.

The following summarizes the final Guidance and how OTS addressed specific aspects of commenter concerns about the proposed Guidance.

III. Final Guidance

Significant comments on the specific provisions of the proposed guidance, OTS's responses, and changes to the proposed guidance are discussed as follows.

Scope of the Guidance

The proposed guidance set forth two benchmarks for identifying institutions with CRE loan concentrations that may warrant greater supervisory scrutiny. Specifically, if loans for construction, land development, and other land exceed 100 percent of total capital, the institution would be considered to have a CRE concentration. Also, if loans secured by multi-family and non-farm nonresidential property, where the primary source of repayment is derived from rental income or the proceeds of the sale, refinancing, or permanent financing, combined with construction, development, and land loans, exceed 300 percent of total capital, the institution would be considered to have a CRE concentration. Institutions with concentrations would be expected to employ heightened risk management practices.

General Comments on the Benchmarks

Most commenters disagreed with the establishment of these benchmarks. Many of the commenters questioned the basis for the benchmarks and asserted that a rigid, arbitrary concentration test should be eliminated. By establishing CRE concentration benchmarks, many commenters noted that examiners would perceive such benchmarks as *de facto* limits on an institution's CRE lending activity.

Commenters noted that the proposed benchmarks did not recognize the different segments in an institution's CRE portfolio and treated all CRE loans as having equal risk. A commenter noted that a concentration test cannot reflect the distinct risk profile within an institution's loan portfolio and that the risk profile is a function of many intangibles, including the institution's risk tolerance, portfolio diversification, the prevalence of guarantees and secondary collateral, and the condition of the regional economy.

Commenters noted that the benchmarks would not accurately identify banks and thrifts that might be adversely affected by their CRE portfolio in an economic downturn. One commenter noted that proposed benchmarks mixed together real estate loans with vastly different potential for loss and, therefore, would fail to accomplish the Agencies' goal of identifying institutions that might be affected by a downturn.

Several commenters noted that the benchmarks did not consider the loan-to-value (LTV) ratio of a CRE loan as an indication of risk and that interagency real estate lending standards exist that limit high LTV loans.[1] A commenter noted that there is a vast difference in risk between a loan conservatively underwritten where the borrower has a large investment at stake and a loan offering overly generous terms where the borrower has little to lose if the project should fail. One commenter stated that a bank or thrift with no high LTV CRE loans but with a concentration in CRE loans would be presumed to have a higher risk CRE portfolio than a bank or thrift with a lower concentration but with a significant number of high LTV CRE loans.

Commenters stated that, if the agencies were to adopt the guidance with benchmarks, the concentration test should consider the institution's asset size, geographic dispersion of its loans, CRE product concentrations, its underwriting standards, and lending experience. Further, a commenter stated that the guidance should be focused on those types of speculative CRE loans that are most susceptible to economic downturn.

The 100 percent Construction Benchmark: Those commenters expressing an opinion on the 100 percent construction benchmark found the benchmark too low, and several suggested that it should be at least 200 percent. Several commenters recommended that presold one-to four-family residential construction loans, commercial construction loans for owner-occupied businesses, and commercial construction loans with firm takeouts should be specifically excluded as such loans are significantly less risky. One commenter noted that construction loans on presold versus speculative residential properties should be treated differently as presold properties have construction risk but not real estate market risk, which was the concern of the Agencies.

The 300 percent CRE Benchmark: Commenters asserted that 300 percent aggregate concentration benchmark was too low and that a benchmark in the range of 400 to 600 percent of capital would be more appropriate. Commenters also noted that the benchmark mixed together all types of CRE loans that have vastly different potential for loss, and that an assessment of concentration risk based on the Agencies' benchmark did not consider the risk characteristics of the subcategories of CRE loans. One commenter noted that the proposal did not differentiate the risks posed by a loan on a speculative office building versus a fully occupied apartment building.

To address commenter concerns, OTS revised the focus of this final guidance. Instead of using numerical thresholds to identify institutions with CRE concentrations, the Guidance now states that all institutions actively engaged in CRE lending should assess their own CRE concentration risk. Accordingly, institutions should implement sound risk management procedures commensurate with the size and risks of their CRE portfolios and also establish internal concentration thresholds for internal reporting and monitoring.

For the reasons described herein, there are no numerical thresholds or screens in this Guidance. OTS monitors compliance with statutory lending limits, CRE, and other lending activity in off-site analyses of Thrift Financial Reports as well as in the scope of OTS's risk-focused examinations. Institutions that have recently experienced rapid growth in CRE lending or have a notable exposure to a specific type of CRE may be identified for closer review. Examiners will determine whether savings associations actively engaged in CRE lending have performed an assessment of their CRE credit and concentration risks and have implemented appropriate risk management systems and controls to mitigate such risks.

The Definition of CRE Loans

For the purposes of the proposed guidance, the Agencies focused on CRE loans that may expose an institution to unanticipated earnings and capital volatility due to adverse changes in the general CRE market. This includes CRE exposures where the primary source of repayment is derived from rental income associated with the property or the proceeds of 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 the CRE market would also be considered CRE loans for purposes of the proposed guidance. However, loans secured by owner-occupied properties where less than 50 percent of the source of repayment comes from third party, non-affiliated, rental income were excluded from the CRE definition as the risk profile of these loans is less influenced by the condition of the general CRE market.

Commenters asked for clarification on the scope of the definition of CRE loans. Several commenters noted that the proposed definition combined several different types of CRE loans and ignored the very different risk profiles of these loans. Many of the commenters found

[1] Interagency Guidelines for Real Estate Lending Policies (Appendix to OTS 12 CFR 560.100–101) state that the aggregate amount of commercial, agricultural, multifamily, or other non-one- to four-family loans should not exceed 30 percent of an institution's total capital if they exceed supervisory loan-to-value limits.

the proposed definition too broad and grouped together loans on stabilized properties with those under development into the same risk category.

Commenters raised questions as to whether the agencies intended to include in the CRE loan definition loans secured by motels, hotels, mini-storage warehouse facilities, and apartment complexes where the primary source of repayment is rental or lease income. One commenter asked for clarification as to whether the CRE loan definition included loans on small-to medium-sized business properties where the borrower leased the property to a business entity in which the borrower held an ownership interest. The commenter noted that a narrow interpretation of the definition of owner-occupied would include these types of loans in the scope of the CRE definition even though such loans exhibit the same risk profile as an owner-occupied property.

A number of commenters contended that loans on certain types of CRE properties should not be considered CRE loans for purposes of the proposed guidance, including:

Presold One- to Four-Family Residential Construction Loans: Commenters recommended that the proposed guidance should not cover residential construction loans where homes have been sold to qualified borrowers prior to the start of the construction. These commenters argued that presold one- to four-family residential construction loans carry far less risk than speculative home construction loans as the homeowners are known and have had their credit evaluated as being satisfactory prior to the commencement of construction. Commenters noted that their rationale for excluding presold one- to four-family residential construction is consistent with the proposal's exclusion of CRE loans on owner-occupied properties. As another indicator of risk, commenters noted that presold one- to four-family residential construction loans were subject to only a 50 percent risk weight under the current risk-based capital rules.

Multifamily Residential Loans: Commenters recommended that multifamily construction loans with firm takeouts or loans on completed multifamily properties, including assisted living complexes, with established rent rolls be excluded from the proposed CRE definition. In making this recommendation, commenters contend that multifamily residential loans have much less risk than CRE loans that have no firm takeout or established cash flow history. One commenter noted that in an economic downturn, multifamily loan performance tends to move counter-cyclically to other types of real estate, such as single-family mortgages, because potential homebuyers are more likely to rent than to purchase a home. Another commenter noted that over the last 20 years, institutions have incurred minimal losses on multifamily loans and attributed this performance to strong underwriting and stability in rental properties.

Treatment of REITs: The commenter, representing REITS, sought clarification as to whether the proposed guidance would apply to both secured and unsecured loans to REITs. This commenter asserted that unsecured loans to REITs should not be considered a CRE loan for purposes of the proposed guidance as the risk of an unsecured loan to a REIT is mitigated by diversified sources of repayment because the rental income from one property or even a collection of properties is not the only source of revenue available to a REIT to repay the unsecured loan. Further, the commenter argued that, in general, a loan to a large, well-diversified equity REIT (whether secured or unsecured) does not carry the same credit risk as a secured loan on a single asset and that the proposed guidance should allow a lending institution to consider the REIT's property diversification and overall financial strength. Therefore, the commenter sought clarification that a bank or thrift need not treat a REIT as merely a collection of single properties, but rather a geographically and product diverse operating company with a diversified revenue stream.

Reliance on the Call and Thrift Financial Reports: Commenters noted that the identification of CRE loans in the current Call Reports and Thrift Financial Reports did not correspond to the scope of the CRE definition in the proposed guidance and did not constitute an accurate measurement of the volume of an institution's CRE loans that would be vulnerable to cyclical CRE markets. Commenters did acknowledge that the revisions to the Call Reports and Thrift Financial Reports, effective March 2007, would address the separation of CRE loans for owner-occupied properties.

While OTS agrees that risks vary among the various CRE property types, geographical area, and lending standards, it is important to note that the definition only serves as a high level indicator of possible concentration risk. Moreover, because OTS removed the proposed thresholds and numerical screens that would have mandated institutions to adopt more stringent risk management practices, maintaining the proposed definition will not trigger additional or unwarranted risk management if concentration risk is minimal.

Appropriateness of the Risk Management Practices

The proposed guidance reinforces sound risk management practices for a bank or thrift with a concentration in CRE lending. The proposal reminds an institution's board of directors and management of their ultimate responsibility for the level of risk undertaken by their institution and reinforces and builds upon existing real estate lending standards, regulations, and guidelines. The proposed guidance describes key risk management elements for an institution's CRE lending activity with a particular emphasis on those components of the risk management process that are more generally applicable to an institution with a CRE concentration. The proposed risk management expectations are discussed along the following frameworks: board and management oversight, strategic planning, underwriting, risk assessment, monitoring of CRE loans, portfolio risk management, management information systems, market analysis, and stress testing. In the proposal, the agencies acknowledged that the sophistication of risk management practices should be consistent with the size and complexity of the institution's CRE portfolio.

Commenters noted that the proposed risk management principles have been in effect for some time and are generally acknowledged as prudent industry standards that should be used by an institution engaged in CRE lending. While there was general agreement with the appropriateness of the risk management principles, commenters noted that the agencies should consider an institution's size and complexity of its lending activity in assessing the adequacy of its risk management practices. The majority of commenters noted that the recommended practices, particularly with regard to the management information systems and portfolio stress testing, would place a great deal of additional burden on smaller institutions at a time when they are already faced with Bank Secrecy Act and information security compliance requirements.

To address commenter concern, OTS clarified that after performing their own self-assessment of CRE concentration risk, institutions would be expected to implement risk management policies and procedures appropriate for the size, complexity, and risk of their CRE exposure.

Capital Adequacy and ALLL

The proposed guidance noted that institutions should hold capital commensurate with the level and nature of the risks to which they are exposed and that institutions with high CRE concentrations would be expected to operate well above regulatory capital minimums. Further, as part of internal capital analysis, the proposed guidance reminded institutions that the results of any stress testing and quantitative and qualitative analysis should be used to assess the adequacy of capital. The proposed guidance also reminded institutions that they should consider CRE concentrations in their assessment of the adequacy of allowance for loan and lease losses (ALLL), consistent with existing interagency guidance.

Overall, commenters found the proposed capital discussion too restrictive and that it did not take into account the institution's lending and risk management practices. Moreover, commenters asserted that many institutions already hold capital at levels above minimum standards and should not be required to raise additional capital simply because their CRE concentrations exceed a threshold. There was also concern expressed that the proposal would give examiners the ability to arbitrarily assess additional capital requirements solely due to a high concentration. Comments from smaller institutions noted that the proposal would unfairly burden them as they do not have the opportunity to raise capital or diversify their portfolio to the extent to that large regional banks or thrifts are able.

Commenters called into question the consistency of the proposed guidance with current risk-based capital requirements that assess capital adequacy based on the risk inherent in an asset class and tie capital requirements to loan-to-value ratios. Several commenters suggested that any discussion on capital adequacy issues arising from CRE lending should be best addressed within the context of the Agencies' risk-based capital framework, which several commenters noted is currently being revised by the agencies.

Commenters noted that allowance for loan and lease losses is another means of protection for an institution and, therefore, should be considered in determining the effects of potential concentrations on the adequacy of capital. Further, commenters viewed the proposed guidance as imposing arbitrary tests to determine reserves that, based on the amount of CRE loans in an institution's CRE portfolio, may not be a true indicator of risk.

As provided in the proposed guidance, the final Guidance states that such institutions should also have in place capital levels appropriate to the risk associated with CRE concentrations. To address commenter concerns, OTS revised the capital section of the guidance to make it clear that most institutions with CRE meet current capital expectations so additional capital will not be expected. In assessing the adequacy of an institution's capital, the Guidance states that OTS will take into account the level of inherent risk in its CRE portfolio and the quality of its risk management practices.

The final Guidance does not have a separate section concerning ALLL. The language in the Guidance, however, serves as a reminder that ALLL levels for CRE loans should reflect the collectability of loans in the CRE portfolio. This is a requirement under generally accepted accounting principles and interagency ALLL policy.

The Agencies worked together to develop the final guidance and made a number of changes to the proposed guidance to respond to commenters' concerns and provide additional clarity to address commenter concerns. The OCC, FRB, and FDIC are concurrently issuing separate guidance for banks. OTS is issuing separate guidance for savings associations that is similar to the guidance issued for banks. The primary focus of this guidance is to remind savings associations of the importance of performing an assessment of their CRE concentration risk and the need to implement appropriate risk management procedures to monitor and control such risks.

Unlike statutory investment requirements for other federal financial institutions, the Home Owner's Loan Act sets various limits on certain loans and investments made by savings associations [12 U.S.C. 1464 (5)(c)(2)(B)]. This includes a 400 percent of capital statutory investment limit on loans secured by nonresidential real estate. As a result, OTS engages in extensive monitoring to determine when savings associations approach the legal lending limit for these and other loans subject to HOLA investment limits. Accordingly, given the statutory investment limit applicable to savings associations, and the significantly different risk characteristics of various types of CRE, OTS's guidance does not include numerical or supervisory screens.

V. Text of Final Guidance

The text of the OTS Guidance on Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices follows:

Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices

Purpose

The Office of Thrift Supervision (OTS) is issuing this Guidance to address concentrations of commercial real estate (CRE) loans in savings associations. Concentrations of credit can add a dimension of risk that compounds the risk inherent in individual loans.

The Guidance reminds savings associations that strong risk management practices and appropriate levels of capital are essential elements of a sound CRE lending program, particularly when an institution maintains a concentration in CRE loans. The Guidance reinforces and enhances OTS's existing regulations and guidelines for real estate lending [2] and loan portfolio management. The Guidance does not establish specific CRE lending limits; rather, it seeks to promote sound risk management practices that will enable savings associations to continue to pursue CRE lending in a safe and sound manner.

Background

OTS recognizes that savings associations play a vital role in providing credit for business and real estate development. In the past, concentrations in CRE lending coupled with weak loan underwriting and depressed CRE markets contributed to significant credit losses in the banking system. While underwriting standards are generally stronger than during previous CRE cycles, there has been an increasing trend in the number of institutions with concentrations in CRE loans. These concentrations may make such institutions more vulnerable to cyclical CRE markets. Moreover, some institutions' risk management practices are not evolving with their increasing CRE concentrations. Therefore, this Guidance reminds savings associations with concentrations in CRE loans that their risk management practices and capital levels should be commensurate with the level and nature of the risks that concentrations pose.

[2] Refer to OTS's regulations on real estate lending standards and the *Interagency Guidelines for Real Estate Lending Policies:* 12 CFR 560.100–101 and the *Interagency Guidelines Establishing Standards for Safety and Soundness:* 12 CFR 570, appendix A.

Scope

In developing this Guidance, OTS 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. As discussed under ''CRE Concentration Assessments,'' institutions are encouraged to segment their CRE portfolios to acknowledge these distinctions for risk management purposes.

This Guidance focuses on those CRE loans for which the cash flow from the real estate is the primary source of repayment rather than loans to a borrower for which real estate collateral is taken as a secondary source of repayment or through an abundance of caution. Thus, for purposes of this Guidance, CRE loans are those loans with risk profiles sensitive to the condition of the general CRE market (e.g., market demand, changes in capitalization rates, vacancy rates, or rents). CRE loans include land development and construction loans (including one-to four-family residential and commercial construction) and loans secured by raw land, multifamily property, and nonfarm 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 percent or more of the source of repayment comes from third party, nonaffiliated, rental income) or the proceeds of the sale, refinancing, or permanent financing of the property. Loans secured by owner-occupied nonfarm nonresidential properties where the primary or significant source of repayment is the cash flow from the ongoing operations and activities conducted by the party, or affiliate of the party, who owns the property are excluded from the scope of this Guidance. Loans to Real Estate Investment Trusts (REITs) and unsecured loans to developers should also be considered CRE loans for purposes of this Guidance if their performance is closely linked to performance of CRE markets.

CRE Concentration Assessments

Credit concentrations are groups or classes of credit exposures that share common risk characteristics or sensitivities to economic, financial, or business developments. Therefore, savings associations with an accumulation of such exposures should be able to quantify the additional risk such credit concentrations may pose. Savings associations actively involved in CRE lending should also perform ongoing risk assessments to identify any changes in the risk of their CRE portfolios resulting from growth in the amount of their exposures or changes in underwriting standards or the economic environment. The risk assessment should identify potential concentration risk by stratifying the CRE portfolio into segments that have common risk characteristics or would be affected by similar external events. An institution's CRE portfolio stratification should be reasonable and supportable. The CRE portfolio should not be divided into multiple segments simply to avoid the appearance of concentration risk.

OTS recognizes that risk characteristics differ among property types of CRE loans. A manageable level of CRE concentration risk will vary by institution depending on the portfolio risk characteristics, the quality of risk management processes, and capital levels. Therefore, the Guidance does not establish a CRE concentration limit or an implication that any particular level is undesirable. Rather, the Guidance encourages savings associations to: identify and monitor credit concentrations and the additional risk that they may pose, establish internal concentration limits, and report all concentration risks to management and the board of directors on a periodic basis. Depending on the results of its internal risk assessment, the institution may need to enhance its risk management systems as described below.

Risk Management

The sophistication of a savings association's 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. Savings associations should address the following key elements in establishing a risk management framework that effectively identifies, monitors, and controls CRE concentration risk:

- Board and management oversight
- Portfolio management
- Management information systems
- Market analysis
- Credit underwriting standards
- Portfolio stress testing and sensitivity analysis
- Credit risk review function

Board and Management Oversight

An institution's board of directors has ultimate responsibility for the level of risk assumed by the institution, including both its credit and concentration risks. An institution's strategic plan should address the rationale for any CRE concentration in relation to its overall growth objectives, financial targets, and capital plan. In addition, OTS's real estate lending regulations require that each institution adopt and maintain a written policy that establishes appropriate limits and standards for all extensions of credit that are secured by liens on or interests in real estate, including CRE loans. Therefore, the board of directors or a designated committee thereof should:

- Establish policy guidelines and approve an overall CRE lending strategy regarding the level and nature of CRE concentration risk acceptable to the institution, including any binding commitments to particular borrowers or CRE property types.
- Ensure that management implements procedures and controls to effectively adhere to and monitor compliance with the institution's lending policies and strategies.
- Receive information that identifies and quantifies the nature and level of risk presented by the CRE concentration, including reports that describe changes in CRE market conditions in which the institution lends.
- Periodically review and approve CRE risk exposure limits and appropriate sublimits (for example, by nature of concentration) to conform to any changes in the institution's strategies and to respond to changes in market conditions.

Portfolio Management

Savings associations with CRE concentrations need to manage not only the risk of individual loans but also the additional portfolio risk that may arise from an overall exposure to a single economic risk factor. Even when individual CRE loans are prudently underwritten, concentrations of loans that are similarly affected by cyclical changes in the CRE market can expose an institution to an unacceptable level of risk if not properly managed. Management should regularly evaluate the degree of correlation between related real estate sectors and establish internal lending guidelines and concentration limits that control the institution's overall risk exposure.

In the presence of concentration risk, management should develop appropriate strategies for managing concentration levels, including a contingency plan to reduce concentrations or mitigate concentration risk in the event of adverse market conditions. Loan participations, whole loan sales, and securitizations are a few examples of strategies for actively managing concentration levels without curtailing new originations. If the contingency plan includes selling or securitizing CRE loans, management should assess the marketability of the portfolio. This should include an evaluation of the institution's ability to access the secondary market and a comparison of its underwriting standards with those that exist in the secondary market.

Management Information Systems

A strong management information system (MIS) is key to effective portfolio management. The sophistication of MIS will necessarily vary with the risk associated with concentrations and the complexity of the institution. MIS should provide management with sufficient information to identify, measure, monitor, and manage CRE concentration risk. This includes meaningful information on CRE portfolio characteristics that is relevant to the institution's lending strategy, underwriting standards, and risk tolerances. An institution should periodically assess the adequacy of MIS in light of growth in CRE loans and changes in its risk profile.

Savings associations are encouraged to stratify the CRE portfolio by property type, geographic market, tenant concentrations, tenant industries, developer concentrations, and risk rating. Other useful stratifications may include loan structure (for example, fixed rate or adjustable), loan purpose (for example, construction, short-term, or permanent), loan-to-value limits, debt service coverage, policy exceptions on newly underwritten credit facilities, and affiliated loans (for example, loans to tenants). Another useful stratification may be a determination if property is considered owner-occupied. If 50 percent or more of the property's rental income comes from third party, non-affiliated, rental income, the property would not be considered owner-occupied.[3] An institution should also be able to identify and aggregate exposures to a borrower, including its credit exposure relating to derivatives.

Management reporting should be timely and in a format that clearly indicates changes in the portfolio's risk profile, including risk-rating migrations. In addition, management reporting should include a well-defined process through which management reviews and evaluates concentration and risk management reports, as well as special ad hoc analyses in response to potential market events that could affect the CRE loan portfolio.

Market Analysis

Market analysis should provide the institution's management and the board of directors with information to assess whether its CRE lending strategy and policies continue to be appropriate in light of changes in CRE market conditions. An institution should perform periodic market analyses for the various property types and geographic markets represented in its portfolio.

Market analysis is particularly important as an institution considers decisions about entering new markets, pursuing new lending activities or expanding in existing markets. Market information may also be useful for developing sensitivity analysis or stress tests to assess portfolio risk.

Sources of market information may include published research data, real estate appraisers and agents, information maintained by the property taxing authority, local contractors, builders, investors, and community development groups. The sophistication of an institution's analysis will vary by its market share and exposure as well as the availability of market data. While an institution operating in non-metropolitan markets may have access to fewer sources of detailed market data than an institution operating in large, metropolitan markets, an institution should be able to demonstrate that it has an understanding of the economic and business factors influencing its lending markets.

Credit Underwriting Standards

An institution's lending policies should reflect the level of risk that is acceptable to its board of directors and should provide clear and measurable underwriting standards that enable the institution's lending staff to evaluate all relevant credit factors. When an institution has a CRE concentration, the importance of sound lending policies becomes even more critical and should consider both internal and external factors, such as its market position, historical experience, present and prospective trade area, probable future loan and funding trends, staff capabilities, and technology resources. Consistent with interagency real estate lending guidelines, CRE lending policies should address the following underwriting standards:

- Maximum loan amount by type of property
- Loan terms
- Pricing structures
- Collateral valuation[4]
- LTV limits by property type
- Requirements for feasibility studies and sensitivity analysis or stress testing
- Minimum requirements for initial investment and maintenance of hard equity by the borrower
- Minimum standards for borrower net worth, property cash flow, and debt service coverage for the property

An institution's lending policies should permit exceptions to underwriting standards only on a limited basis. When an institution does permit an exception, it should document how the transaction does not conform to the institution's policy or underwriting standards, obtain appropriate management approvals, and provide reports to the board of directors or designated committee detailing the number, nature, justifications, and trends for exceptions. Exceptions to both the institution's internal lending standards and interagency supervisory LTV limits[5] should be monitored and reported on a regular basis. Further, savings associations should analyze trends in exceptions to ensure that risk remains within the institution's established risk tolerance limits.

Credit analysis should reflect both the borrower's overall creditworthiness and project specific considerations as appropriate. In addition, for development and construction loans, the institution should have policies and procedures governing loan disbursements to ensure that the institution's minimum equity requirements by the borrower are maintained throughout the development and construction periods. Prudent controls should include an inspection process, documentation on construction progress, tracking pre-sold units, pre-leasing activity, and exception monitoring and reporting.

Portfolio Stress Testing and Sensitivity Analysis

An institution with CRE concentration risk should perform portfolio level stress tests or sensitivity analysis to quantify the impact of changing economic conditions on asset quality, earnings, and capital. Further, an institution should consider the

[3] The determination as to whether a property is considered ''owner-occupied'' should be made upon origination or purchase of the loan. This is consistent with the new reporting items adopted by OTS in the revisions to the Thrift Financial Report published December 1, 2006, 71 FR 69619.

[4] Refer to OTS's appraisal regulations: 12 CFR part 564.

[5] The Interagency Guidelines for Real Estate Lending (12 CFR 560.100–101) state that loans exceeding the supervisory loan-to-value (LTV) guidelines should be recorded in the institution's records and reported to the board at least quarterly.

sensitivity of portfolio segments with common risk characteristics to potential market conditions. The sophistication of stress testing practices and sensitivity analysis should be consistent with the complexity of the institution and risk characteristics of its CRE loan portfolio. For example, well-margined and seasoned performing loans on multifamily housing normally would require significantly less robust stress testing than most acquisition, development, and construction loans.

Portfolio stress testing and sensitivity analysis may not necessarily require the use of a sophisticated portfolio model. Depending on the risk characteristics of the CRE portfolio, stress testing may be as simple as analyzing the potential effect of stressed loss rates on the CRE portfolio, capital, and earnings. The analysis should focus on the more vulnerable segments of an institution's CRE portfolio, taking into consideration the prevailing market environment and the institution's business strategy.

Credit Risk Review Function

A strong credit risk review function is critical for an institution's self-assessment of emerging risks. An effective, accurate, and timely risk-rating system provides a foundation for the institution's credit risk review function to assess credit quality and, ultimately, to identify problem loans. Risk ratings should also be risk sensitive, objective, and appropriate for the types of CRE loans underwritten by the institution. Further, risk ratings should be regularly reviewed for appropriateness.

Supervisory Oversight

As part of its ongoing supervisory monitoring processes, OTS uses certain criteria to identify savings associations that may have CRE concentration risk. These include savings associations that:

- Are approaching their HOLA investment limits.
- Have experienced rapid growth in CRE lending.
- Have notable exposure to a specific type of or high-risk CRE.
- Were subject to supervisory concern over CRE lending during preceding examinations.
- Have experienced significant levels of delinquencies or charge-offs in their CRE portfolio.

A savings association that exhibits any of the risk elements described above may receive further supervisory analysis to ascertain whether its internal concentration risk assessment and resulting risk management practices are commensurate with of the level and nature of its CRE exposure.

OTS will use the above criteria as a preliminary step to identify savings associations that may have CRE concentration risk.[6] Because regulatory reports capture a broad range of CRE loans with varying risk characteristics, the supervisory monitoring criteria are intended to serve as high-level indicators to identify savings associations potentially exposed to CRE concentration risk.

For some types of CRE exposures, concentration risk may be present well before the statutory limit is reached. The statutory investment limit of 400 percent of total capital for non-residential real estate should not be considered a ''safe harbor'' for savings associations with smaller commercial real estate exposures. OTS expects all savings associations that are actively engaged in CRE lending to assess their concentration risk and maintain adequate risk management policies and procedures to control such risks.

Evaluation of CRE Concentration Risk

The effectiveness of an institution's risk management practices will be a key component of the supervisory evaluation of its CRE concentration risk. Examiners will evaluate an institution's internal CRE analysis and engage in a dialogue with the institution's management to assess CRE exposure levels and risk management practices. Savings associations that have experienced recent, significant growth in CRE lending will receive closer supervisory review than those that have demonstrated a successful track record of managing the risks in CRE concentrations.

In evaluating the level of risk, OTS will consider the institution's own analysis of its CRE portfolio including the presence of mitigating factors, such as:

- Portfolio diversification across property types
- Geographic dispersion of CRE loans
- Portfolio performance
- Underwriting standards
- Level of pre-sold units or other types of take-out commitments on construction loans
- Portfolio liquidity (ability to sell or securitize exposures on the secondary market)

Assessment of Capital Adequacy

OTS's existing capital adequacy guidelines note that an institution should hold capital commensurate with the level and nature of the risks to which it is exposed. Accordingly, savings associations with CRE concentration risks are reminded that their capital levels should be commensurate with the risk profile of their CRE portfolios that includes both credit and concentration risks. In assessing the adequacy of an institution's capital, OTS will consider the level and nature of inherent risk in the CRE portfolio as well as management expertise, historical performance, underwriting standards, risk management practices, and market conditions. Most savings associations currently meet this expectation and will not be expected to increase their capital levels. However, an institution with inadequate capital to serve as a buffer against unexpected losses from a CRE concentration should develop a plan for reducing its CRE concentrations or for maintaining capital appropriate for the level and nature of its CRE concentration risk.

This concludes the text of the Guidance entitled, Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices.

Dated: December 7, 2006.

By the Office of Thrift Supervision.

John M. Reich,

Director.

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DEPARTMENT OF VETERANS AFFAIRS

Health Services Research and Development Service Merit Review Board; Notice of Meeting

The Department of Veterans Affairs (VA) gives notice under Public Law 92–463, Federal Advisory Committee Act, that a meeting of the Health Services Research and Development Service Merit Review Board will be held march 6–8, 2007, at the Sir Francis Drake Hotel, 450 Powell Street, San Francisco, CA. Various subcommittees of the Board will meet during that period. Each subcommittee meeting of the Merit Review Board will be open to the public the first day for approximately one half-hour from 8 a.m. until 8:30 a.m. to cover administrative matters and to discuss the general status of the program. The remaining portion of each meeting will be closed. The closed portion of each meeting will involve discussion, examination, reference to, and oral review of the research proposals and critiques.

[6] Savings associations are reminded that this guidance does not affect the existing statutory investment limitations as set forth in 12 CFR 560.30. The statutory investment limit for loans secured by nonresidential properties is 400 percent of total capital.