



April 13, 2006

Office of the Comptroller of the Currency  
Attention: Public Information Room  
250 E Street, SW  
Mail Stop 1-5  
Washington, DC 20219  
Docket No. 06-01

Robert E. Feldman, Executive Secretary  
Attention: Comments, Federal Deposit  
Insurance Corporation  
550 17<sup>th</sup> Street, NW  
Washington, DC 20429

Jennifer J. Johnson, Secretary  
Board of Governors of the  
Federal Reserve System  
20<sup>th</sup> Street and Constitution Avenue, NW  
Washington, DC 20551  
Docket No. OP-1248

Regulation Comments  
Chief Counsel's Office  
Office of Thrift Supervision  
1700 G Street, NW  
Washington, DC 20552  
Attention: No. 2006-01

Re: Proposed Guidance on Commercial Real Estate Lending

Ladies and Gentlemen:

Thank you for the opportunity to comment on the proposed guidance on commercial real estate (CRE) lending. For some background information, Indymac Bank is the largest savings and loan in Los Angeles County, and, nationwide, it is the ninth largest thrift based on assets and the tenth largest mortgage originator. All of our businesses revolve around homeownership, and as part of that basic philosophy, we work with developers and consumers to provide cost-efficient financing for the acquisition, development, and improvement of single-family homes.

For purposes of the proposed guidance, the agencies are including loans secured by raw land, land development, and construction (including 1-4 family residential construction) in the definition of CRE loans. Considering our significant activity in the origination/purchase, sale/securitization, and investment/servicing of these loans, we have carefully reviewed the agencies' proposal. As of December 31, 2005, Indymac reported total assets of \$20.3 billion, with construction, land development, and other land loans (as reflected in regulatory reports) totaling \$2.7 billion and representing 13% of total assets and 173% of total capital. Although the majority of these loans are reported in one line item on the Thrift Financial Report (TFR), they are comprised of two very distinct portfolios: 1) loans to individual consumers, which totaled \$1.6 billion and 2) loans to professional builders, which totaled \$1.1 billion. Nevertheless, all of these loans support the financing of 1-4 family residential properties: none provide for a commercial end use. The table on the following page provides further details regarding these portfolios as of December 31, 2005.

[www.indymacbank.com](http://www.indymacbank.com)

(\$ Thousands)	Loans to Consumers	Loans to Builders
Builder subdivision construction loans		609,962
Builder custom home ("single spec") construction loans		226,711
Consumer construction-to-permanent loans	1,477,828	
Consumer construction bridge loans	22,473	
<b>Subtotal - Construction</b>	<b>1,500,301</b>	<b>836,673</b>
Builder land loans		89,097
Builder acquisition and development loans		157,339
Consumer lot loans	103,824	
<b>Subtotal - Land</b>	<b>103,824</b>	<b>246,436</b>
<b>Total - Construction and Land</b>	<b>1,604,125</b>	<b>1,083,109</b>

For institutions with a concentration in CRE lending, the guidance requires heightened risk management practices and potentially higher capital levels. We support the majority of the risk management practices that are outlined in the proposal and have implemented them to the degree necessary to properly identify, monitor, and control risk in our consumer and builder construction portfolios. Nevertheless, we believe it is inappropriate to lump the majority of our construction, land development, and other land loans into the CRE category, since it appears inconsistent with the agencies' intent to target concentrations in those types of CRE loans that are particularly vulnerable to cyclical commercial real estate markets. It also appears inconsistent with other regulations and Interagency guidance, which clearly acknowledge the lower risk profile of these types of loans in comparison to other types of construction and commercial real estate loans.

Basically, we share some of the same concerns as expressed by the National Association of Home Builders (NAHB) in its January 2006 response to the agencies' Basel IA proposal. Specifically, we are concerned with the proposal's failure to make appropriate distinctions for the highly varied credit risk characteristics of the wide range of loans that are being included in the CRE category, and we believe the lack of distinctions mischaracterizes the risks associated with housing production, or residential land acquisition, development, and construction loans. As a result, we believe the definition of CRE loans and the methodology for identifying CRE concentrations should be revisited in regards to construction, land development, and other land loans that are secured by 1-4 family residential properties. In addition, we feel it is necessary to provide a couple of other comments to the agencies for their consideration. The following three points summarize our suggestions:

1. The agencies should exclude from the CRE category all land acquisition, development, and construction loans that support a residential end use. If the agencies decide to include these loans in the CRE category, then the agencies should at least exclude all consumer construction loans that are to individual borrowers for the construction of their own homes and all builder construction loans that are secured by homes that have been pre-sold to individuals who intend to occupy the properties.
2. Expectations regarding the appropriate level of capital should specifically consider key risk parameters and the actual historical performance of the various real estate loan products that are within the CRE category, and to this end, we believe the discussion of capital adequacy should reflect the principles that have already been outlined in the Basel II framework.
3. Expectations regarding the level of direct oversight and monitoring by the Board should not be the same for all institutions and should consider the size and financial condition of the institution, the quality of its management and internal controls, and the expertise of its lending and loan administration staffs.

The following comments provide further support for our suggestions.

### **1. Construction, Land Development, and Other Land Loans Secured by 1-4 Family Residential Properties**

To define CRE loans, the proposal states, "For purposes of this Guidance, commercial real estate (CRE) loans are 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 the rental income associated with the property (that is, loans for which 50 percent 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."

Elsewhere, the proposal provides an exclusion from the CRE definition for loans secured by owner-occupied properties. The proposal states, "The Agencies have excluded loans secured by owner-occupied properties from the CRE definition because their risk profiles are less influenced by the condition of the general CRE market." We believe the owner-occupied exclusion is appropriate. However, as discussed further below, we believe the exclusion is ambiguous as it relates to construction loans, which could lead to inconsistencies in the application of the guidance by both bankers and examiners. We believe the owner-occupied exclusion is also ambiguous as it relates to second homes, which we believe (and the secondary market agrees) should be treated similarly to owner-occupied homes.

As a "preliminary step" to determine whether an institution has a concentration in CRE loans, the proposal instructs financial institutions to use regulatory reports to determine whether it meets one of the following two thresholds:

1. Total reported loans for construction, land development, and other land<sup>1</sup> represent one hundred percent (100%) or more of the institution's total capital; or
2. Total reported loans secured by multifamily and nonfarm nonresidential properties and loans for construction, land development, and other land represent three hundred percent (300%) or more of the institution's total capital.

While the use of regulatory reports is referred to merely as a "preliminary step," it appears that it is the only step for construction, land development, and other land loans, since the proposal states, "Institutions exceeding threshold (1) would be deemed to have a concentration in CRE construction and development loans.... If an institution exceeds threshold (2), the institution should further analyze its loans and quantify the dollar amount of those that meet the definition of a CRE loan contained in this Guidance."

Regulatory reports do not include sufficient granularity to identify actual risk exposure in a financial institution's loan portfolio. As just one example, in the TFR, all construction loans for 1-4 family residential properties are reported in one line item regardless of whether the loans are to individual consumers or builders, for non-speculative or speculative purposes, or supported by low or high LTV ratios. Clearly, the loans that are included in this one line item present differing degrees of

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<sup>1</sup> The guidance directs savings associations to use the following line items in Schedule SC of the TFR to determine the volume of construction, land development, and other land loans: line item SC230 (Construction Loans on 1-4 Family Dwelling Units), line item SC235 (Construction Loans on Multi-family Dwelling Units), line item SC240 (Construction Loans on Nonresidential Property), and line item SC265 (Permanent Mortgages on Land). As of December 31, 2005, we reported \$2.3 billion in line item SC230 and \$350.3 million in line item SC265.

credit risk. While we can segregate our loan portfolio differently in the public reports that we file with the Securities and Exchange Commission, the best source for investors and analysts to gather comparable information for savings associations is the TFR. As a result, we have separately requested that significant consideration be given to enhancing the TFR to allow for more stratification of the loan portfolio. If the TFR included more details regarding the loan portfolio, then investors and analysts, as well as the bank regulatory authorities, could draw more accurate and meaningful conclusions regarding an institution's overall level of credit risk.

Considering the lower-risk profile of construction loans that are secured by 1-4 family residential properties, as well as land development and other land loans that are secured by properties that are zoned for or ultimately intended to support 1-4 family properties, we believe these loans should not be included in the CRE category for purposes of this guidance. The following comments, which include additional specifics regarding our consumer and builder construction portfolios, provide further support for the lower-risk profile of these loans. As noted in the NAHB response, charge-off rates for residential housing production loans are dramatically lower than for nonresidential real estate loans, with the performance of single-family home construction loans tracking very closely to permanent home mortgages (based on data from TFRs).

### ***Consumer Construction Portfolio***

As mentioned previously, the outstanding balance of our consumer construction and land loans totaled \$1.6 billion as of December 31, 2005. These loans do not have a commercial end use and are not to commercial entities. These loans are to individual consumers. We believe the risk characteristics of these loans much more closely resemble the risk characteristics of homogenous, permanent single-family residential mortgage loans than heterogeneous CRE loans. As of December 31, 2005, our consumer construction portfolio includes 7,684 loans with a weighted average loan-to-value ratio of 71% and a weighted average FICO score of 717. Similar to a homogeneous permanent single-family residential mortgage portfolio, the risk of default in the consumer construction portfolio is spread over numerous small-to-moderately sized loans, rather than a few large loans, with the weighted average commitment amount of these loans totaling \$434 thousand.

As of December 31, 2005, 92% of our consumer construction and land loans consist of combination construction-to-permanent (CTP) loans that are being made to individuals for the construction of their homes. For CTP loans, both the construction and permanent financing are committed on the same day, and the individual borrowers are qualified using conventional, single-family residential mortgage loan underwriting standards that support the borrower's ability to repay the permanent loan. As a result, while repayment is dependent upon the completion of construction, it is not dependent upon the proceeds of the sale, refinancing, or permanent financing of the property, since the permanent financing already exists at the origination of the CTP loan. The lower-risk profile of this portfolio is also supported by its historical performance, which has been characterized by lower rates of non-performing loans and loan losses than in our permanent single-family residential mortgage portfolio. From 1995 through 2005, non-performing loan and charge-off rates for our CTP loans have, on average, been 33% and 27% lower than for our permanent single-family residential mortgage loans, respectively. In fact, the 10-year average annual charge-off rate for this portfolio is a respectable 0.11%.

While lot loans only represent 6% of our consumer construction and land loans as of December 31, 2005, this significantly understates our experience with this product, since we regularly securitize and sell these loans. As of March 31, 2006, our lot loan servicing portfolio, which includes our own lot loan portfolio, totals \$1.2 billion and is characterized by an average loan-to-value ratio of 80%,

an average FICO score of 725, and an average loan size of \$173 thousand. We have experienced minimal losses on our lot loans, with charge-offs since 2002 totaling only \$567.7 thousand.

### ***Builder Construction Portfolio***

As of December 31, 2005, the outstanding balance of our builder construction and land loans totaled \$1.1 billion. While these loans are to commercial entities, they do not have a commercial end use. These loans are to finance the construction of single-family residences, the majority of which will be sold (or already have been sold) to individual consumers who intend to occupy the properties. In fact, in 2005, sold units have represented, on average, 61% of the total units that are under construction or complete, and this average increases to 68% when excluding condominium units. Furthermore, the majority, or 75% of these loans, are represented by loans to finance the construction of entry-level or first-time move up homes, which are less vulnerable to cyclical real estate markets.

While the primary source of repayment for our builder loans is derived from the sale of the single-family residences, the use of stringent underwriting requirements, such as those regarding loan-to-value ratios, pre-sale and phasing requirements, and guarantees, considerably limits our exposure to declining or softening real estate market conditions. We acknowledge that our builder construction loans present more credit risk than our consumer construction loans. However, it should be noted that these loans, due to their floating rates, present minimal interest rate risk, which is an equally important (but often underemphasized) risk that we must manage. We understand the risks inherent in our builder loans and have created a risk management framework that enables us to mitigate the risks and ultimately reduce the potential for losses. In fact, as of December 31, 2005, the 10-year average annual charge-off rate for our builder construction loans is a reasonable 0.17%.

If the agencies decide to include construction, land development, and other land loans that are secured by 1-4 family residential properties in the definition of CRE loans, then we believe the agencies should at least exclude all consumer construction loans that are to individual borrowers for the construction of their own homes and all builder construction loans that are secured by homes that have been pre-sold to individuals who intend to occupy the properties. This treatment would be consistent with the owner-occupied exclusion that is provided in the proposal for permanent mortgages. It would also be consistent with existing regulations and Interagency guidance, which clearly acknowledge the lower risk profile of these loans. For savings associations, the pertinent regulations and Interagency guidance are found in 12 CFR Part 567, Capital, and the Appendix to 12 CFR 560.101, Interagency Guidelines for Real Estate Lending Policies. The capital regulations and Interagency guidelines include the following considerations in relation to 1-4 family residential construction loans:

- The capital regulations allow a lower 50% risk weighting for "qualifying mortgage loans<sup>2</sup>," which include certain loans to individual borrowers for the construction of their homes, as well as "qualifying residential construction loans," which include certain 1-4 family residential construction loans to builders that have substantial project equity and are secured by homes that have been pre-sold to individuals who intend to occupy the properties.
- The Interagency Guidelines for Real Estate Lending Policies allow the aggregate amount of loans in excess of supervisory loan-to-value limits to reach 100% of capital, with a more

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<sup>2</sup> Per the capital regulations, "qualifying mortgage loans" generally include loans that are: 1) secured by a first lien on a 1-4 family residential property; 2) underwritten in accordance with prudent underwriting standards, including LTV standards; 3) performing and not more than 90 days past due.

restrictive 30% sub-limit placed on the aggregate amount of these loans that are comprised of higher-risk commercial, agricultural, multifamily, and other non 1-4 family residential properties.<sup>3</sup>

## **2. Capital Adequacy**

We agree that banks should hold capital commensurate with the level and nature of risks to which they are exposed. The guidance reiterates this principle, but it also suggests that additional capital should be held for CRE concentrations. The guidance provides no methodology for determining the additional amount of capital that may be necessary, however, which could lead to the inconsistent and inequitable application of the guidance across institutions.

The proposal's suggestion that additional capital is necessary for CRE concentrations does not adequately address the numerous risk mitigation techniques that are used by financial institutions today to reduce exposure to credit risk including, but not limited to, the following: portfolio limitations regarding property type, geographic location, and loans to one borrower; underwriting standards regarding loan-to-value and loan-to-cost ratios, pre-sale and phasing requirements, and guarantees; and guidelines for risk-based pricing. Moreover, the proposal's inference does not adequately address the significance of the allowance for loan losses for CRE loans on the additional capital levels that must be maintained.

We believe the internal-ratings-based approaches to capital allocation, which are outlined in proposed supervisory guidelines relating to Basel II, provide for a more appropriate consideration of key risk parameters and their relationship to required capital levels. As a result, we believe that a more sufficient discussion of capital adequacy would reference the principles that are outlined in the Basel II framework.

## **3. Risk Management Principles / Board Oversight**

As previously stated, we are supportive of the risk management principles that are outlined in the proposal and have implemented them to the degree necessary to properly identify, monitor, and control risk. Having said that, however, we believe the agencies should not expect or require the same level of direct oversight and monitoring by the boards of directors of all financial institutions. When considering the appropriate level of direct oversight and monitoring that should be expected at the board level, we believe the agencies should consider the institution's size and financial condition, the quality of its management and internal controls, and the expertise and size of its lending and loan administration staffs.

The following bullet points demonstrate a few of the board-level responsibilities that have been specified in the proposal:

- Directors, or a committee thereof, should explicitly approve the overall CRE lending strategy and policies of the institution.
- The board should periodically review and approve CRE aggregate risk exposure limits and appropriate sublimits (for example, by property type and geographic area) to conform to any changes in the institution's strategies and to respond to changes in market conditions.
- 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

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<sup>3</sup> Per OTS staff, land development loans and lot loans that are for 1-4 family properties are considered secured by 1-4 family properties for the purposes of this guidance and are not subject to the 30% sub-limit.

management approvals, and provide reports to the board of directors detailing the number, nature, justifications, and trends for exceptions in a timely manner.

For a large and sophisticated institution, we believe oversight of this magnitude is the primary responsibility of fully accountable executives/senior managers and senior management committees. We also believe that board members can lose their independence and hinder their ability to express unbiased opinions, if they become too involved in day-to-day management activities. The delegation of certain oversight responsibilities by the board is warranted as long as the lending activities conform to the broad objectives and aggregate risk exposure limits that have been established by the board and the executives/senior managers and senior management committees are responsible for the timely reporting of significant problems to the chief executive officer and the board.

We would also like to point out that the proposed level of board reporting in regards to exceptions is inconsistent with the Interagency Guidelines for Real Estate Lending Policies, which only require institutions to individually report exception loans of a significant size to its board of directors. It is also inconsistent with the guidelines outlined in Section 212 of the OTS Examination Handbook, which only require institutions to report aggregate exception levels to the board.

To conclude, we would like to reiterate our appreciation for the opportunity to comment on the Agencies' CRE proposal, and we hope our comments have been useful in your considerations. If you have any questions regarding our comments, please do not hesitate to contact me at (626) 535-8139.

Sincerely,



Ruthann Melbourne  
Executive Vice President and Chief Risk Officer