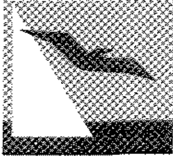

Bay Cities National Bank

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February 6, 2006

Regulation Comments, Chief Counsel's Office
Office of Thrift Supervision
1700 G. Street, NW.
Washington, DC 20552

RE: REQUEST FOR COMMENT on Concentrations in CRE loans, Sound Risk Management OCC BULLETIN 2006-2

Dear National Bank Examiner:

I feel it is necessary for me to comment on the agencies proposal for Sound Risk Management for banks, thrifts and credit unions when it comes to an institutions high concentrations in commercial real estate loans.

First of all, let me begin by stating I have been a commercial banker for more than 38 years. The bulk of that time has been spent working for national banks. However, I have also worked for two state banks as well as one credit union. Therefore, I feel qualified to address this issue with some understanding as to how each regulatory agency supervises their institutions.

Let me also say that in the many years I have been in banking, I have spent more than 35% of my time working on the special asset side of the desk. The other 65% of my time has been spent as the institution's chief credit officer. In the past, I have been responsible for organizing and managing groups of collection people, charged with resolving more than a billion dollars worth of distressed loans in the states of Alaska, California, Arizona, Oklahoma and Texas. And, I was heavily involved in this endeavor in the late 80s and early 90s during a time when real estate values suffered severely, causing many financial institutions to fail nation wide.

Given this experience, I think it is safe to say that I likely have as much, or more experience with resolving problem loan portfolios in down economic times than many other bankers. I have seen real estate values drop more than 35% during a 6 to 9 month period, and with that, so did the borrowers ability to pay or even be able to liquidate their properties for enough to come close to paying off their loans. However, what needs to be recognized by all of the Agencies when trying to assess the risk in their supervised institution's portfolios, is what causes a severe decline in CRE values in the first place. When real estate values drop significantly, it is because of serious economic problems elsewhere, such as mass business failures and employee layoffs.

Business failures and unemployment are the primary reason that real estate values decline significantly, not overbuilding, product saturation or high CRE portfolio concentrations.

By the time real estate values decline precipitously, all financial institutions with high concentrations in traditional business loans and lines of credit should be far more concerned than institutions with portfolios consisting primarily of real estate collateral, even if that collateral has declined from their original appraised value. As commercial loans and lines of credit that are secured by traditional collateral such as, accounts receivable, inventories, furniture, fixtures and other miscellaneous assets, are virtually valueless once a lender is aware the business is in trouble. That is because the company has likely already liquidated most of its current assets, just trying to stay in business.

Therefore, institutions that are highly leveraged with CRE loans may have a problem when real estate values decline, but they do at least still have something to liquidate, even if it is at a reduced amount, where those institutions with more basic commercial business loan portfolios may have no collateral at all, and guarantors with no sources of repayment.

In my opinion, if an institution is conservative in the good times, and maintains good loan to value ratios on each new CRE loan relationship, if the economy does drop real estate values by 25% to 30%, that institution might suffer some loss, but not nearly the high amount that an institution would experience who has a high concentration of traditional commercial loans and lines of credit.

The major exception to this is when institutions have high concentrations of junior real estate lien loans and/or home equity lines of credit. These loans are always subject to running out of equity when real estate values drop, especially if an institution is too aggressive at the on-set, with high loan to value ratios. And, when problems do occur, the institution must either walk away from their loan or face the necessity of assuming the liens from the senior lien holders, if there is any equity worth protecting. However, by the time a problem occurs, the first line holder is often reduced in equity themselves, which causes the secondary lien holder to abandon their debt, especially if they have no capacity to payoff a senior lien holder, due to lending limit constraints.

In my opinion, these loans are the ones that the regulatory agencies should concentrate on and be trying to monitor. This is especially the case in states like California, where an institution cannot go after a borrower for a deficiency on a real estate loan, unless it is done on a Judicial Foreclosure basis. This is a process that takes 12 months and the borrower has a 1 year right of redemption. In this case, an institution is at a total loss for a long period of time while the property (collateral) remains as Other Real Estate Owned, because the institution cannot sell it for a minimum of 1 year.

I hope these comments are useful and I would be happy to discuss this letter at any time if additional input is desired.

Sincerely,

Ron Schmidt
Chief Credit Officer