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FINANCIAL GROUP

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April 27, 2005

Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA)
Comment Letter – Real Estate Lending Standards

In December 1992 the Office of the Comptroller Currency (OCC), the Federal Reserve, FDIC, and Office of Thrift Supervision issued real estate lending standards [12 CFR 34, Subpart D, Appendix A] as required by Federal Deposit Insurance Corporation Improvement Act of 1991.

These original standards adopted in 1992 established supervisory loan-to-value (LTV) limits for all types of real estate lending (raw land, land development, construction, commercial and residential). Banks were permitted to make exceptions to the supervisory LTV limits but were required to track and measure these exceptions against their capital. Furthermore, the aggregate amount of these exceptions could not exceed 100 percent of their capital. Also, within the aggregate amount, all loans for commercial, agricultural, and multi-family residential could not exceed 30 percent of capital.

Since the real estate lending standards were adopted in 1992, banks have measured and reported their exceptions to the supervisory LTV limits by tracking only the amount that the loan exceeds the appraisal value of the real estate securing the loan. For example, residential property with an appraised value of $100,000 has a supervisory LTV limit of 90 percent or $90,000. If a bank makes a loan against this property for $92,000, then the $2,000 would become part of the aggregate amount to be measured against capital.

In August 2003, the OCC issued new guidance on real estate lending standards. This new guidance requires the entire amount of a high-loan-to-value loan be included in the aggregate amount to be measured against capital, not just the portion exceeding the supervisory LTV limit. This new method of calculation greatly increased the total amount to be measured against a bank's capital. However, the total amount does not appropriately measure risk and is therefore meaningless.

To illustrate from the previous example, the new guidance requires that the entire $92,000 loan balance versus just the $2,000 excess be measured against capital. If the same borrower were to borrow $89,999.99 using the same real estate as collateral, then no reporting or tracking is required. Prior to the August 2003 guidance, banks tracked the $2,000 difference, as this is the real risk. Under the new guidance issued by the OCC, the measurement of risk is illogical.

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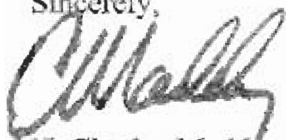
A similarly illogical result arises when you compare the potential risk of loss in typical large commercial real estate loan and a home mortgage loan. Assume that a bank made an $8,525,000 loan on a parcel of improved commercial real estate with an appraisal value of $10 Million. Under the guidelines, this loan would exceed the 85% supervisory LTV by $25,000, thereby requiring tracking the entire amount against capital. If the same bank makes a $200,000 home loan against real estate worth $100,000, the bank will be $110,000 over the 90% supervisory guidelines and will also track this loan against capital. The greater risk exists in the home loan ($110,000), not the commercial real estate loan ($25,000), yet the entire principal amount of both loans must be tracked against capital.

Finally, the new guidance severely limits the ability of small community banks to compete in the market place. Large banks have a larger capital base and can therefore track more non-conforming loans than small banks can. As a result, large banks have the ability and opportunity to market special loan products (e.g. 100% LTV home equity loans) to strong, creditworthy customers more often than community banks do. In this way, the guidance places a community bank at a competitive disadvantage without effectively addressing the actual risk involved in a nonconforming loan.

Sincerely,



H. Charles Maddy
President and CEO

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Economic Growth and Regulatory Paperwork Reduction Act of 1996 (EGRPRA)
Comment Letter – Appraisal Standards

Title XI of the Financial Institutions Reform, Recover, and Enforcement Act of 1989 (FIRREA) requires the supervising agencies to adopt regulations on the preparation and use of appraisals by federally regulated financial institutions. Such real estate appraisals are to be in writing and performed in accordance with uniform standards by an individual whose competency has been demonstrated and whose professional conduct is subject to effective state supervision.

The agencies adopted regulations in August 1990 and defined transactions that require an appraisal by a state licensed or certified appraiser. The regulations allow for less formal evaluations of the real estate for exempt transactions. Exempt transactions are when the transaction value is less than $250,000 or a business loan of $1,000,000 or less, and the transaction is not dependent on the sale of, or rental income derived from, real estate as the primary source of repayment.

The exempt transaction level was established on August 24, 1990 and has not been adjusted or indexed to reflect the current value of residential or commercial real estate. Fifteen years later the regulations needs to be amended to raise the exempt transaction level to at least $500,000 for a residential loan and $2,000,000 for a business loan.

The regulation also defines minimum appraisal standards. The agencies appraisal regulations include five minimum standards for the preparation of an appraisal. The appraiser must:

1. Conform to generally accepted appraisal standards as evidenced by the Uniform Standard of Professional Appraisal Practice (USPAP) by the Appraisal Standards Board (ASB).
2. Be written and contain sufficient information and analysis to support the institutions decision to engage in the transaction.
3. Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units.
4. Be based upon the definition of market value, as defined by the agencies appraisal regulations.

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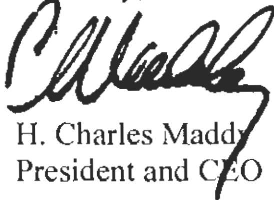
5. Be performed by state licensed or certified appraiser in accordance with requirements set forth in the regulation.

As set forth above, the minimum standard requires the appraiser to report deductions and discounts on tract developments. Tract developments are defined as a project of five units or more that is constructed or is to be constructed as a single development. A problem arises under this regulation because tract development can be speculative in nature or a project can be "pre-sold" where all units are under retail contract to be built. The agencies need to redefine and expand the minimum standard for tract developments to include loan type and structure.

Example:

A developer/builder has purchased a large tract of land and completes the infrastructure for single family homes and townhouses. The developer/builder has six single family models and five townhouse models and requests a $2,000,000 revolving line of credit to construct pre-sold units, no speculative building. Currently he has sixteen pre-sold townhouses and wishes to construct two eight-plexs. The common sense approach would be to have the five model townhouses appraised and extrapolate those into the sixteen. However, since there are more than five units this falls under the definition of tract development and requires the two eight-plexs be appraised with reductions and discounts as if this was a speculative project.

Sincerely,



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