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Statement of the Shadow Financial Regulatory Committee on the Interagency Policy Statement on Commercial Real Estate Loans

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Bank examiners have been much criticized in recent years for excessively harsh evaluations of bank loan portfolios. Administration officials, some members of Congress, and would-be borrowers have argued that these actions have contributed to a "credit crunch." (See the Committee's Statement No. 67, February 11, 1991.)

These concerns have focused particularly on commercial real estate loans. Commercial real estate markets in most parts of the country are suffering severe economic problems -- excessive supply and weak absorption rates -- combined with heavy debt burdens based on overly optimistic past estimates of value. The result is that cash flows in many instances are inadequate to support existing loans.

The four federal banking regulatory agencies recently issued a joint statement on the review and classification of commercial real estate loans. This week, a meeting of field bank examiners is being held to address these issues in more detail. While the Administration has characterized this action as part of its efforts to promote economic growth, the regulatory agencies present their announcement as a clarification and restatement of existing policy.

Besides describing general approaches to loan markets, administrative procedures, and valuations, the statement contains language that may be construed as dictating more leniency in bank examinations.[1] While each of the points cited in the footnote contains qualifications or exceptions, the Committee has several concerns about the overall tone and content of the regulators' statement. The Committee's reservations derive as much from the fact that the statement was issued in response to political pressures as its specific language.

First and most important, we object to attempts to use bank supervisory policy as a means of influencing macroeconomic activity. This issue has arisen in the past and has usually been resisted by the agencies. It appears that the recent policy statement reflects a weakening of the agencies' resolve to oppose such pressures. It should be emphasized that independence of examiner judgment is key to the integrity of the examination process.

Second, lenient regulatory policies cannot eliminate the substantial oversupply of commercial structures. Third, even though cash payments continue to be made on some real estate obligations, changes in the borrower's cash flow position or the market value

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[1] Here are four examples: First, assumptions about appraisals of real estate "should not be based solely on current conditions that ignore the stabilized income-producing capacity of the property." Specifically, while acknowledging that discounted cash flow is an appropriate valuation methodology, according to the regulators such procedure should take into account "the ability of real estate to generate <u>over time</u> (emphasis added) income based on reasonable and supportable assumptions." Second, assumptions made recently by qualified appraisers "should be given a reasonable amount of deference" by examiners. Third, for a so-called performing real estate loan, increases in loan-loss allowances are not required "automatically" if the value of collateral has declined to an amount less than the loan balance. Finally, when management has maintained effective loan systems and controls dealing with quality problems and analyzed "all" significant factors affecting portfolio collectability, "considerable weight" should be accorded management's estimates of the adequacy of loan-loss allowances.

of the collateral itself will affect the value of a lender's claim. The carrying value of a loan should reflect changes in the probability of loss, just as the values of marketable debt reflect changes in credit quality even in the absence of a default. In this connection, the Committee supports the concept of loan-splitting (reflected in general terms in the statement), but only as a step toward the current-valuation technique that the Committee has long espoused. Fourth, deference to management assumptions and valuations based on other than current conditions has in the past increased the amounts of loss ultimately borne by the insurance funds or the public generally. This risk remains.

Examiners have been more critical of commercial real estate loans in recent years than many bankers believe is reasonable. While some examiners may have made mistakes, the facts are that the "unduly harsh" judgments of the examiners have proven to be more correct than the estimates made by bankers and assented to by their auditors.