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Statement of

Daniel T. McKee, Central Regional Director
Office of Thrift Supervision

concerning

Commercial Real Estate: A Chicago Perspective on Current Market Challenges and Possible Responses

before the

Financial Services Subcommittee on Oversight and Investigations
United States House of Representatives

May 17, 2010

Office of Thrift Supervision
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Testimony on

Commercial Real Estate: A Chicago Perspective on Current Market Challenges and Possible Responses

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I. Introduction

Good afternoon Chairman Moore, Ranking Member Biggert and members of the Subcommittee. I am Daniel McKee, Regional Director for the Central Region of the Office of Thrift Supervision (OTS). I appreciate the opportunity to testify on behalf of the OTS on the topic of Commercial Real Estate (CRE) in the Chicago area and throughout the nation.

I have been with the OTS since it was created in 1989. I currently serve as the Regional Director for 10 states in the Midwestern United States, including Illinois. Our regional headquarters office is located in Chicago. The region has many small community banks whose business models center on home mortgages, auto loans, agriculture and, to a lesser extent, CRE loans. OTS supervises 27 savings institutions with home offices in the Chicago metropolitan area that range in asset size from $3.6 million to $1.6 billion As of year-end 2009, these 27 institutions held total assets of $7.1 billion and approximately 23 percent of these assets – or $1.6 billion – consisted of CRE.

It is important to understand that OTS-regulated institutions (commonly called "thrifts") have limited participation in the CRE market. Thrifts primarily serve the financial services needs of their communities by extending credit for home mortgages and other consumer loans. There are statutory constraints on OTS-regulated institutions that limit their participation in CRE lending. The Home Owners' Loan Act (HOLA) caps the aggregate amount that thrifts can lend for commercial real estate loans at 400 percent of the thrift's total capital. In addition, HOLA restricts thrifts from investing more than 20 percent of their assets in commercial business loans. [1] Loans secured by residential properties, such as loans for multifamily housing and development of single family homes, are not subject to statutory limits.

[1] 12 USC 1464(c)(2)(A).

Today's testimony will present the views of the OTS on the condition of the CRE lending market and conditions currently creating obstacles to credit availability in the Chicago area and nationwide. It will also explain the actions the OTS has taken to encourage prudent extensions of CRE credit. Finally, it will recommend increasing the availability of CRE credit from OTS-regulated institutions by modifying statutory constraints that inhibit commercial lending.

II. Impediments to CRE Lending

The same factors that have tightened credit for home mortgages and small businesses also have constrained the extension of credit for CRE. The recession has constricted lending across the financial services industry from its peak before the crisis. This constriction is due in large part to the proliferation of loan defaults and losses in the commercial, mortgage and consumer lending sectors. These defaults and losses necessitate a heightened sensitivity to the risk that each institution is able to bear.

Defaults in CRE loans for OTS-regulated thrifts in the Chicago Metropolitan Statistical Area (MSA) increased steadily and dramatically over the past five years. From year-end 2005 to year-end 2009, CRE defaults jumped more than five percent from 1.8 percent to 7.0 percent. The Chicago MSA's default rate for CRE of 7.0 percent at year-end 2009 was above the national average of 5.8 percent.

In light of elevated delinquency rates for all types of loans, thrifts and banks are understandably more careful in extending credit than they were during the height of the real estate boom a few years ago. Sound underwriting is based on each borrower's ability to repay the loan and not primarily on the value of the collateral, which as we have seen, can drop precipitously, causing upheaval in the real estate market and the economy overall. There is a balance to be sought, and a point of appropriate equilibrium to be reached, by the financial industry as encouraged and overseen by the industry's regulators. As regulators, we must ensure that the trend toward restoring sound underwriting does not move too far and restrict credit for creditworthy borrowers. In the OTS Central Region, I have observed that federal savings institutions have a strong desire to make CRE loans to solid businesses whose recent financial statements and tax returns demonstrate good cash flows, good business plans and good collateral.

III. Actions to Expand CRE Lending

The OTS has always held the position that thrifts should never turn away a good customer. We have encouraged OTS-regulated institutions to make all types of loans allowed by statute, provided they are prudently underwritten to creditworthy borrowers. OTS emphasizes that thrift managers must find a proper balance between fulfilling the credit needs of their communities and ensuring safety-and-soundness of their institutions.

To support this position, the OTS and other federal banking agencies issued a "Policy Statement on Prudent Commercial Real Estate Loan Workouts" on October 29, 2009. This interagency statement was designed to promote supervisory consistency, enhance the transparency of CRE workout transactions, and ensure that supervisory policies and actions do not inadvertently curtail the availability of credit to sound borrowers. It states that examiners will take a balanced approach when reviewing an institution's CRE loans and workouts.

The OTS believes this statement sends a clear message to financial institutions that they will not be criticized for making prudent CRE loans or for working with existing CRE borrowers who need to refinance or restructure their loans, as long as they do so in a prudent manner.

Research by a California-based research-and-consulting firm[2] suggests that this message is being heard. The research shows that lenders have granted extensions on about 60 percent of the commercial real estate loans that have matured since the beginning of 2009. The firm estimates that in the Chicago area, commercial property loans totaling $22.2 billion will mature over the next three years. Prudently extending loan due dates, as the interagency statement urged, could reap benefits if borrowers can refinance a year or two later after the economy improves and property values continue to rise.

IV. Legislative Recommendations

As I mentioned earlier in this testimony, the OTS supports a legislative proposal that would further encourage thrift institutions to make more loans for CRE and small businesses. HOLA restricts the volume of CRE, commercial and small business loans that thrift institutions are allowed to make. Currently, HOLA caps the aggregate amount of credit thrifts can lend for commercial purposes at 20 percent of a savings institution's assets. Any commercial loans in excess of 10 percent of assets must be small business loans.[3] In addition, HOLA caps a thrift's level of CRE loans at 400 percent of the institution's capital. The proposal would remove the statutory limit for small business lending and increase the cap on other commercial lending from 10 to 20 percent of assets. Due to the current limits, some thrifts may be discouraged from entering this line of business altogether because they believe they will be unable to achieve sufficient economies of scale.

The existing ceiling on commercial lending limits the pool of credit available for CRE and limits the ability of thrifts to provide credit to serve the important commercial needs of their communities.

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[2] Foresight Analytics LLC, Oakland, California

[3] 12 USC 1464(c)(2)(A).

A statutory change included in previous legislation and supported by the OTS, which passed the House Financial Services Committee in the 108th, 109th and 110th Congresses and passed the full House of Representatives twice, would have increased credit for CRE lending by increasing the cap on commercial lending from 10 percent to 20 percent of an institution's assets and by entirely lifting the limits on small business lending.

In a hearing on February 26, 2010, before the House Committee on Financial Services on the "Condition of Small Business and Commercial Real Estate Lending in Local Markets," Chairman Frank and Ranking Member Bachus agreed that lifting these caps is an important and desirable goal. We appreciate Chairman Frank's leadership in this effort and hope that this change will be included in future legislation.

V. Conclusion

I have tried to put the current broad credit issues in some perspective and to make suggestions to hasten the return of adequate credit to the CRE market. However, although the economy is starting to show some positive signs and pockets of recovery, full recovery and a full flow of credit through the economy will take more time.

I appreciate the opportunity to testify today on behalf of the OTS and would be happy to answer any questions you may have.