

November 19, 2019

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision

SUBJECT: Regulatory Capital Treatment for High Volatility Commercial Real Estate (“HVCRE”) Exposures

Summary: Section 214 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (“section 214”), which was enacted on May 24, 2018, amends the Federal Deposit Insurance Act (“FDI Act”) to provide a statutory definition of a high volatility commercial real estate acquisition, development, and construction (“HVCRE ADC”) loan. In accordance with section 214, staff are presenting for the approval of the Federal Deposit Insurance Corporation (“FDIC”) Board of Directors a request to publish the attached interagency final rule (“final rule”) that would revise the regulatory capital rule of the Office of the Comptroller of the Currency (“OCC”), the Board of Governors of the Federal Reserve System (“Board”), and the FDIC (collectively, the “agencies”) to conform the definition of high volatility commercial real estate (“HVCRE”) exposure with the statutory definition of HVCRE ADC loan. The preamble to the final rule includes interpretations for certain terms of the revised HVCRE exposure definition to facilitate uniform application of the revised definition, that are generally consistent with the instructions to the Consolidated Report of Condition and Income (“Call Report”). It also clarifies the capital treatment for loans that finance the development of land under the revised HVCRE exposure definition.

Concur:

Nicholas J. Podsiadly
General Counsel

Request: FDIC staff are requesting the FDIC Board of Directors approve the final rule and authorize its publication in the *Federal Register*, with an effective date of April 1, 2020.

Discussion:

I. Background

Section 214 adds a new section 51 to the FDI Act to define “HVCRE ADC loan.”

Pursuant to section 214, depository institutions should assign a heightened risk weight to an HVCRE exposure under the capital rule only if such exposure is an HVCRE ADC loan. The statutory HVCRE ADC loan definition excludes any loan made prior to January 1, 2015.

The agencies issued an interagency statement on July 6, 2018 (“interagency statement”)¹ that permits institutions to use available information to reasonably estimate and report HVCRE ADC loans in their Call Reports and refine these estimates as they obtain additional information. The interagency statement also provides that institutions will not be required to amend previously filed regulatory reports as these estimates are adjusted. As an alternative to reporting HVCRE ADC loans, the interagency statement indicated that an institution may continue to report and risk-weight HVCRE exposures in a manner consistent with the current instructions to the Call Report, until the agencies take further action.²

The effective date of the final rule is April 1, 2020. Prior to the effective date of the final rule, banking organizations should refer to the interagency statement. On and after April 1, 2020, the final rule will supersede the HVCRE exposure section of the interagency statement, as

¹ Board, FDIC, and OCC *Interagency statement regarding the impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)*, <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706a1.pdf>.

² Upon the effective date of the final rule, the HVCRE exposure section of the interagency statement related to EGRRCPA, is no longer applicable.

well as the set of FAQs issued by the agencies pertaining to HVCRE exposures.³ Accordingly, starting April 1, 2020, banking organizations subject to the capital rule must evaluate ADC credit facilities in accordance with the revised definition of HVCRE exposure in this final rule.

II. Summary of the Proposals and Comments

The agencies published a notice of proposed rulemaking (NPR or proposal) in the *Federal Register* in September 2018 to revise the HVCRE exposure definition in section 2 of the capital rule to conform to the statutory definition of an HVCRE ADC loan.⁴ To facilitate the consistent application of the revised HVCRE exposure definition, the proposal also included proposed interpretations for certain terms used in the revised HVCRE exposure definition. Under the proposal, the revised HVCRE exposure definition would have been applicable to all banking organizations that are subject to the capital rule. The proposal would have applied a 150 percent risk weight to loans that meet the revised definition of HVCRE exposure under the capital rule's standardized approach.⁵ Consistent with section 214, the agencies proposed to exclude from the statutory definition of HVCRE ADC loan any loan made prior to January 1, 2015.⁶

On July 23, 2019, the agencies sought to clarify a portion of the HVCRE proposal by publishing in the *Federal Register* a subsequent proposal (Land Development proposal) that

³ “Frequently Asked Questions on the Regulatory Capital Rule,” OCC Bulletin 2015–23 (April 6, 2016), available at: <https://www.occ.gov/news-issuances/bulletins/2015/bulletin-2015-23.html>. “SR 15–6: Interagency Frequently Asked Questions (FAQs) on the Regulatory Capital Rules” (April 5, 2015), available at:

<https://www.federalreserve.gov/supervisionreg/srletters/sr1506.htm>; FDIC FIL 16–2015, available at <https://www.fdic.gov/news/news/financial/2015/fil15016.html>.

⁴ See 83 FR 48,990 (Sept. 28, 2018); see also 12 CFR 217.2 (Board); 12 CFR 3.2 (OCC); 12 CFR 324.2 (FDIC).

⁵ See 12 CFR 217.32(j) (Board); 12 CFR 3.32(j) (OCC); 12 CFR 324.32(j) (FDIC).

⁶ Under the capital rule, on January 1, 2015, the heightened risk weight for HVCRE exposures became effective for all banking organizations.

would have provided that the exclusion for one- to four-family residential properties from the definition of HVCRE exposure does not include credit facilities that solely finance land development activities, such as the laying of sewers, water pipes, and similar improvements to land, without any construction of one- to four-family residential structures.⁷

In response to the proposal, the agencies received 54 comment letters, and, in response to the Land Development proposal, the agencies received 9 comment letters. Numerous commenters supported the proposal to revise the definition of HVCRE exposure in accordance with section 214, although commenters were less supportive of the Land Development proposal. Many commenters offered suggestions on how the agencies should interpret several of the terms used in section 214 and in the revised definition of HVCRE exposure in the proposal. Several commenters observed that the revised HVCRE exposure definition would be narrower than the previous regulatory definition of HVCRE exposure, and, that the revised definition would apply only to a relatively small number of exposures. These commenters suggested that the agencies should therefore remove the distinction between HVCRE and other ADC exposures under the capital rule's standardized approach and apply a flat 100 percent risk weight to all ADC loans. One commenter recommended eliminating the distinction between HVCRE and other ADC exposures only for banking organizations with less than \$50 billion in total assets. One commenter, by contrast, opposed the proposal and indicated that it could lead to increased risk taking by banking organizations.

III. The Final Rule

The final rule would combine the proposal and the Land Development proposal into a consolidated final rule.

⁷ See 84 FR 35344 (July 23, 2019).

A. Evaluation of ADC Loans Originated After January 1, 2015

In response to comments, the final rule would provide banking organizations with the option to maintain their current capital treatment for, or reevaluate any or all of its ADC loans originated between January 1, 2015 and the effective date of this final rule (April 1, 2020) using the revised HVCRE exposure definition. Loans originated after the effective date of this final rule could not use the capital rule's prior HVCRE exposure definition.

B. Revised Scope of an HVCRE Exposure

Consistent with section 214, the final rule also requires a credit facility to meet three criteria before being classified as an HVCRE ADC loan. First, the credit facility must primarily finance or refinance the acquisition, development, or construction of real property. Second, the purpose of the credit facility must be to provide financing to acquire, develop, or improve such real property into income-producing real property. Third, the repayment of the credit facility must depend upon future income or sales proceeds from, or refinancing of, such real property.

The final rule would also define an HVCRE exposure as a credit facility secured by land or improved real property. The preamble to the final rule would interpret the term "a credit facility secured by land or improved real property" to be consistent with the Call Report definition for "a loan secured by real estate." This interpretation is generally supported by commenters.

The preamble to the final rule would clarify that loans secured by owner-occupied properties generally are not dependent upon future income or sales proceeds from, or refinancing of, the real property being financed for the repayment of such credit facility, and are therefore not part of HVCRE. Finally, the preamble of the final rule would clarify that "other land loans" (generally loans secured by vacant land except land known to be used for agricultural purposes)

are typically within the scope of the revised HVCRE exposure definition. Several commenters expressed concerns stating that loans to purchase vacant land should not automatically be considered HVCRE exposures. In response, the agencies are clarifying that a loan would have to meet the three criteria in order to be an HVCRE exposure.

C. Exclusions from HVCRE ADC Loan

Under the final rule, a loan secured by land or improved real property that meets the three criteria for the revised HVCRE exposure categorization may be excluded from the higher risk weight if it meets one or more of the following HVCRE exposure exclusions.

1. One- to Four-Family Residential Properties

Consistent with section 214, the proposal would have excluded credit facilities that finance the acquisition, development, or construction of one- to four-family residential properties from the definition of HVCRE exposure. The proposal would have generally aligned the scope of exposures that finance acquisition, development, or construction of one- to four-family residential properties with the definition of one- to four-family residential property set forth in the agencies' real estate lending standards.⁸ The interagency real estate lending standards define a one- to four-family residential property as a property containing fewer than five individual dwelling units. The interagency real estate lending standards further state that the construction of condominiums and cooperatives are multifamily construction, and, therefore, would not be eligible for the one- to four-family exclusion from HVCRE.

The agencies received several comments on the scope of the proposed one- to four-family residential properties exclusion from the HVCRE exposure definition. Many commenters stated that the HVCRE exposure definition should exclude loans to finance any development of

⁸ 12 CFR part 208, subpart E (Board); 12 CFR part 34, subpart D (OCC); 12 CFR part 365, subpart A (FDIC).

condominiums or cooperatives. Several commenters requested that the agencies align the one- to four-family residential properties exclusion with the reporting instructions for one- to four-family residential construction loans. After considering the comments, the agencies have modified the proposal to align the exclusion for loans that finance one- to four-family residential properties consistent with the definition and reporting of one- to four-family residential properties set forth in the Call Report and FR Y-9C. Therefore, under the final rule, one- to four-family residential construction loans would include construction loans secured by single-family dwelling units, duplex units, townhouses, condominiums or cooperatives reported in the Call Report and FR Y-9C on line 1.a.(1) of Schedules RC-C and HC-R.⁹

In the proposal, the agencies invited comment on whether it would be appropriate to include one-to four-family lot development loans within the scope of the one- to four-family residential properties exclusion from the definition of HVCRE exposure. Commenters on the proposal indicated that it remained unclear whether a facility that finances the purchase of land to be developed into lots, but does not finance the construction of dwellings, still would be considered one- to four-family residential property financing. After reviewing the comments, the agencies issued the Land Development proposal, which provided that the exclusion for one- to four-family residential properties would not include credit facilities that solely finance land development activities, without any construction of one- to four-family residential structures. In order for a loan to be eligible for this exclusion, the Land Development proposal provided that the credit facility would be required to include financing for construction of one- to four-family residential structures. Commenters were generally not supportive of the Land Development

⁹ See Federal Financial Institutions Examination Council, Instructions for Preparation of Consolidated Reports of Condition and Income: FFIEC 031 and FFIEC 041, RC-C-4 (2018); and FFIEC 051, RC-C-6 (2018).

proposal. However, the agencies believe that the proposed treatment of lot development loans is risk sensitive, appropriate, and consistent with the statutory definition of HVCRE exposure and are finalizing the Land Development proposal, as proposed.

2. Community Development Investment

The proposal would have excluded from the HVCRE exposure definition, credit facilities that finance the acquisition, development, or construction of real property projects for which the primary purpose is community development, as defined by the agencies' Community Reinvestment Act ("CRA") regulations.¹⁰ Generally, this includes affordable housing, community services targeted to low- and moderate-income individuals, economic development through the financing of small farms and small businesses that meet a size and purpose test, and activities that revitalize and stabilize certain designated geographies.

The agencies received numerous comments on operational concerns regarding the community development exclusion. In particular commenters stated that all Small Business Administration section 504 loans should be exempt from the definition of HVCRE exposure, regardless of whether they qualify as community development investments under the agencies' CRA regulations. The agencies are finalizing the community development exclusion as proposed. Referring to the CRA regulations to determine whether an exposure is consistent with the agencies' practice of looking to the same or substantially similar terms in other regulations or the Call Report to clarify the interpretation of the statutory definition of HVCRE ADC loan.

3. Agricultural Land

Consistent with section 214, the proposal would exclude from the definition of HVCRE exposure, credit facilities financing the acquisition, development, or construction of agricultural

¹⁰ 12 CFR part 24 (OCC); 12 CFR part 345 (FDIC); 12 CFR part 228 (Board).

land which is interpreted to, have the same meaning as “farmland,” as used in the Call Report instructions.¹¹ Commenters found this interpretation of this exclusion to be sufficiently clear and the agencies are finalizing this section of the proposal without change.

4. Loans on Existing Income-Producing Properties that Qualify as Permanent Financings

Consistent with section 214, the revised definition of HVCRE exposure in the proposal would have excluded credit facilities that finance the acquisition or refinancing of existing income-producing real property secured by a mortgage on such property, so long as the cash flow generated by the real property covers the debt service and expenses of the property in accordance with the lender’s underwriting criteria for permanent loans. The agencies also proposed to exclude credit facilities financing improvements to existing real property secured by a mortgage on such property. Commenters generally supported this aspect of the proposal and the agencies are adopting this exclusion from the proposed definition of HVCRE exposure without modification.

5. Certain Commercial Real Property Projects

The proposal, consistent with section 214, would have excluded from the definition of HVCRE exposure certain commercial real property projects, underwritten in accordance with supervisory underwriting standards, where the borrower contributed a specified amount of capital to the project. The proposal provided that a credit facility financing a commercial real property project would have to meet four distinct criteria to qualify for this exclusion from the revised HVCRE exposure definition. First, the loan-to-value ratio would have to be less than or equal to the applicable supervisory maximum. Second, the borrower would have to have

¹¹ See Call Report Instructions for Schedule RC-C, Part I, Item 1.b (defining loans secured by farmland).

contributed capital of at least 15 percent of the real property's appraised "as completed" value to the project. Third, the 15 percent amount would have to be contributed prior to the institution's advance of funds, except for nominal sums meant to secure the depository institution's lien on the real property. Fourth, the 15 percent amount of contributed capital would have to be contractually required to remain in the project until the loan can be reclassified as a non-HVCRE exposure.

a. Contributed Capital

Under the proposal, cash, unencumbered readily marketable assets, paid development expenses out-of-pocket, and contributed real property or improvements would have counted as forms of contributed capital for purpose of the exemption criteria. The proposal also provided that a banking organization could consider costs incurred by the project and paid by the borrower prior to the advance of funds as paid development expenses out-of-pocket. The proposal provided that the value of contributed real property means the appraised value of real property contributed by the borrower as determined under the standards prescribed by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (12 U.S.C. 3339). The proposal further stated that the value of the real property that could count toward the 15 percent contributed capital requirement would be reduced by the aggregate amount of any liens on the real property securing the HVCRE exposure.

In response to the comments, the preamble to the final rule makes several clarifications. The agencies expect that any borrowed funds should not be derived, related to, or encumber the project that the credit facility is financing or encumber any collateral that has been contributed to the project, contributed real property or improvements must be directly related to the project to be eligible to count toward the 15 percent contributed capital requirement, and the term

“unencumbered readily marketable assets” should be interpreted consistent with the agencies’ codified real estate lending standards. With these clarifications, the final rule would finalize this aspect of the proposal without change.

b. “As Completed” Value Appraisal

The HVCRE proposal would have required that the 15 percent capital contribution be calculated using the real property’s appraised “as completed” value. In the proposal, the agencies stated that they would permit the use of an “as is” appraisal in instances where an “as completed” value appraisal was not available, such as in the case of purchasing raw land without plans for development in the near term. In addition, the agencies stated they would allow the use of an evaluation of the real property instead of an appraisal to determine the “as completed” appraised value, for purposes of the revised HVCRE exposure definition, where the agencies’ appraisal regulations¹² permit evaluations to be used in lieu of appraisals.

A few commenters asked the agencies to allow greater flexibility in the appraisal requirement. However, section 214 specifically requires an appraised, “as completed” value for the contributed capital exemption from the definition of HVCRE exposure. Therefore, the final rule would finalize this aspect of the proposal without change.

c. Project

In the HVCRE proposal, the agencies stated that the 15 percent capital contribution calculation and the “as completed” value appraisal would be measured in relation to a “project” And, in the case of a project with multiple phases, each phase must have its own appraised “as completed” value/ appropriate evaluation in order for it to be deemed a separate “project” for the

¹² See OCC: 12 CFR 34; Board: 12 CFR 225; FDIC: 12 CFR 323.

purpose of the 15 percent capital contribution calculation. The agencies would finalize this aspect of the rule as proposed.

D. Reclassification as a Non-HVCRE Exposure

Consistent with section 214, the HVCRE proposal provided that a banking organization may reclassify an HVCRE exposure as a non-HVCRE exposure when the substantial completion of the development or construction on the real property has occurred and the cash flow generated by the property covered the debt service and expenses on the property in accordance with the organization's loan underwriting standards for permanent financings. The preamble indicates that the agencies expect banking organization to have prudent, clear, and measurable underwriting standards that may be reviewed through the regular supervisory process. The agencies are finalizing this aspect of the proposal without change.

E. Rescission of Frequently Asked Questions (FAQs)

After reviewing the comments received, staff believe it is appropriate to rescind all outstanding HVCRE exposure-related FAQs. FAQs related to topics other than the superseded definition of HVCRE exposure will remain.

Conclusion:

FDIC staff are requesting the FDIC Board of Directors approve the attached final rule and authorize its publication in the *Federal Register*, with an effective date of April 1, 2020.

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