

September 7, 2018

**MEMORANDUM TO:** Board of Directors

**FROM:** Doreen R. Eberley, Director

**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 (“EGRRCPA”), 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 of EGRRCPA, staff is seeking the approval of the Federal Deposit Insurance Corporation (“FDIC”) Board of Directors to publish the attached interagency notice of proposed rulemaking (“proposed rule” or “proposal”) 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 to the statutory definition of HVCRE ADC loan. In addition, for purposes of facilitating the consistent application of the revised HVCRE exposure definition, the proposal also includes proposed interpretations for certain terms of the revised HVCRE exposure definition generally consistent with their usage in other relevant regulations or Call Report instructions, where applicable, and requests comment on

**Concur:**

Char  
General Counsel

those proposed interpretations and any other aspects of the revised definition warranting further clarification.

**Recommendation:** Staff recommends that the FDIC Board of Directors approve the proposed rule and authorize its publication in the *Federal Register* with a 60-day public comment period.

**Discussion:**

**I. Background**

In 2013, the agencies adopted a revised regulatory capital rule (“capital rule”) in response to the financial crisis of 2007-08.<sup>1</sup> The capital rule strengthened the capital requirements applicable to banking organizations supervised by the agencies by improving both the quality and quantity of banking organizations’ regulatory capital and increasing the risk-sensitivity of the capital rule. To better capture the risk of certain kinds of real estate exposures, the capital rule defined “high volatility commercial real estate” or “HVCRE” exposures, which consisted of certain acquisition, development, and construction (“ADC”) exposures shown to have increased risk characteristics relative to other ADC exposures.<sup>2</sup> Those exposures were assigned a heightened risk weight of 150 percent.

On May 24, 2018, EGRRCPA became law. Section 214 of EGRRCPA amends the FDI Act by adding a new section 51 to provide a statutory definition of an HVCRE ADC loan. Section 214 states the agencies may only require a depository institution to assign a heightened risk weight to an HVCRE exposure, as defined under the capital rule, if such exposure is an

---

<sup>1</sup> The agencies issued a joint final rule on October 11, 2013 (78 FR 62018) and the FDIC issued a substantially identical interim final rule on September 10, 2013 (78 FR 55340). In April 2014, the FDIC adopted the interim final rule as a final rule with no substantive changes. 78 FR 55340 (April 14, 2014).

<sup>2</sup> 12 CFR part 217 (Board); 12 CFR part 3 (OCC); 12 CFR part 324 (FDIC).

HVCRE ADC loan under EGRRCPA. The statutory HVCRE ADC loan definition excludes any loan made prior to January 1, 2015. Section 214 was effective upon enactment of EGRRCPA.

The agencies issued an interagency statement on July 6, 2018 (“interagency statement”).<sup>3</sup> With respect to section 214, the interagency statement states that institutions may use available information to reasonably estimate and report only HVCRE ADC loans in their Call Reports and may refine these estimates in good faith as they obtain additional information. The interagency statement also states 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 indicates 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.

## **II. Proposed Revisions to the Capital Rule**

In accordance with section 214 of EGRRCPA, the agencies propose to revise the HVCRE exposure definition in section 2 of the capital rule to conform to the statutory definition of an HVCRE ADC loan.<sup>4</sup> The revised HVCRE exposure definition would be applicable to the calculation of risk-weighted assets under both the standardized approach and the internal ratings-based (“advanced approaches”) approach.<sup>5</sup> Other than the definition change, no change to the calculation of risk-weighted assets under the advanced approaches is proposed. Similar to the

---

<sup>3</sup> 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>. (last visited August 21, 2018).

<sup>4</sup> See 12 CFR 217.2 (Board); 12 CFR 3.2 (OCC); 12 CFR 324.2 (FDIC).

<sup>5</sup> See 12 CFR 217 subparts D and E (Board); 12 CFR 3 subparts D and E (OCC); 12 CFR 324 subparts D and E (FDIC).

current risk weighting of HVCRE exposures, loans that meet the revised definition of an HVCRE exposure would receive a 150 percent risk weight under the capital rule's standardized approach.<sup>6</sup>

By its terms, the statutory definition of HVCRE ADC loan applies to depository institutions, which includes banks and savings associations. The proposed rule would apply the revised HVCRE exposure definition to depository institution holding companies in addition to depository institutions. The agencies would make conforming changes to the instructions for affected regulatory reports.

Section 214 of EGRRCPA excludes from the statutory definition of HVCRE ADC loan any loan made prior to January 1, 2015. Unless a lower risk weight would apply, banking organizations may apply a 100 percent risk weight to ADC loans originated prior to January 1, 2015 that were classified as an HVCRE exposure and are not past due. For ADC exposures issued on or after January 1, 2015 banking organizations would follow the interagency statement that permits them to either apply the statute on a best efforts basis or classify HVCRE exposures according to the superseded definition until the final rule is effective. The proposal seeks comment as to whether ADC loans originated on or after January 1, 2015 should be reevaluated to determine if such loans should be classified under the revised HVCRE exposure definition, the advantages and disadvantages of such an approach, and whether there are alternative treatments that the agencies should consider.

### **III. Proposed Interpretations of the Revised HVCRE Exposure Definition**

To facilitate the consistent application of the revised HVCRE exposure definition, the proposal also includes proposed interpretations for certain terms used in the revised HVCRE

---

<sup>6</sup> See 12 CFR 217.32(j) (Board); 12 CFR 3.32(j) (OCC); 12 CFR 324.32(j) (FDIC).

exposure definition. The agencies would generally look to substantially similar terms in relevant regulations or Call Report instructions for the interpretation of undefined terms. The proposal seeks comment on those proposed interpretations and any other terms in the revised definition warranting further clarification. The proposal also seeks comment on the potential advantages and disadvantages of incorporating the agencies' interpretations of the terms used in the revised HVCRE exposure definition into the rule text or similar publication.

#### **A. Revised Scope of an HVCRE Exposure**

Section 214 of EGRRCPA defines an HVCRE ADC loan as “a credit facility secured by land or improved real property.” While the statute does not define “a credit facility secured by land or improved real property,” the Call Report instructions provide a definition for a “loan secured by real estate.” To ensure consistent reporting and because the two terms appear substantially similar, the agencies propose to interpret the term “a credit facility secured by land or improved real property” for the purpose of the revised HVCRE exposure definition to be consistent with the Call Report definition for “a loan secured by real estate.” The Call Report instructions indicate that a loan is “secured by real estate” where the estimated value of the real estate collateral at origination (after deducting all senior liens held by others) is greater than 50 percent of the principal amount of the loan at origination. As a result, under the proposal, HVCRE exposures would consist solely of loans that met this collateral criteria.

Section 214 of EGRRCPA provides that a credit facility that is secured by land or improved real property is required 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. Finally, the repayment of the credit facility must depend upon future income or sales proceeds from, or refinancing of, such real property. The determination of whether or not a loan is considered an HVCRE exposure under the revised definition would be made once, at the loan's origination.

Further, the agencies are proposing that other land loans (generally loans secured by vacant land except land known to be used for agricultural purposes) would be included in the scope of the revised HVCRE exposure definition, consistent with the Call Report's inclusion of other land loans with construction and development loans.

## **B. Exclusions from HVCRE ADC Loan**

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 revised definition of an HVCRE exposure includes an exclusion for one- to four-family residential properties. The agencies propose to generally align the scope of exposures included in this exclusion with the definition of a one- to four-family residential property provided in the codified interagency real estate lending standards.<sup>7</sup> The interagency real estate lending standards define a one- to four-family residential property as a property containing fewer than five individual dwelling units, including manufactured homes permanently affixed to the underlying property (when deemed to be real property under state

---

<sup>7</sup> See Interagency Guidelines For Real Estate Lending Policies, 12 CFR Part 208 Appendix C (Board); 12 CFR part 34 Appendix A (OCC); 12 CFR part 365 Appendix A (FDIC).

law). The interagency real estate lending standards further state that the construction of condominiums and cooperatives are multifamily construction. Accordingly, loans to finance the construction of condominiums and cooperatives would generally not be included in the one- to four-family residential property exclusion under the revised HVCRE exposure definition. Additionally, the agencies are proposing that the one- to four-family residential property exclusion would include both loans to construct one- to four-family residential structures and loans that combine the land acquisition, development, or construction of one- to four-family structures, including lot development loans. Finally, loans used solely to acquire undeveloped land would not qualify for the one- to four-family residential property exclusion, regardless of how the land is zoned.

## **2. Community Development Investment**

The statutory HVCRE ADC loan definition under EGRRCPA excludes loans financing the acquisition, development, or construction of real property that would qualify as an investment in community development. The agencies propose to look to their Community Reinvestment Act (“CRA”) regulations in determining an investment in community development.<sup>8</sup> Therefore, this exclusion would apply to 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’ CRA regulations. Under the agencies’ CRA regulations, loans have to be evaluated to determine whether they meet the criteria for community development. For example, ADC loans that are conditionally repaid with the U.S. Small Business Administration’s section 504 financing would have to be evaluated against the

---

<sup>8</sup> 12 CFR Part 228 (Board); 12 CFR Part 24 (OCC); 12 CFR Part 345 (FDIC).

criteria for community development in order to determine whether the loan would qualify for this exclusion.

### **3. Agricultural Land**

Consistent with section 214, the revised HVCRE exposure definition includes an exclusion for agricultural land. The Call Report instructions include a definition for “farmland,” which excludes loans for farm property construction and land development purposes. The term “farmland” used in the Call Report instructions includes all land known to be used or usable for agricultural purposes. To ensure consistent reporting, the agencies propose that “agricultural land” for the purpose of the revised HVCRE exposure definition would have the same meaning as “farmland,” as used in the Call Report instructions.

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

Consistent with section 214, the revised HVCRE exposure definition excludes credit facilities for the acquisition or refinance 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 a depository institution’s underwriting criteria for permanent loans. The revised HVCRE exposure definition similarly excludes credit facilities financing improvements to existing income-producing real property secured by a mortgage on such property.

### **5. Certain Commercial Real Property Projects**

The HVCRE ADC loan definition under the statute excludes a loan: (1) that finances a commercial real property project in which the loan-to-value ratio is less than or equal to the



applicable supervisory maximum; (2) where the borrower has contributed capital of at least 15 percent of the real property's appraised "as completed" value to the project; (3) where the 15 percent amount is contributed prior to the depository institution's advance of funds other than a nominal sum to secure the depository institution's lien on the real property; and (4) where the 15 percent amount of contributed capital is contractually required to remain in the project until the loan can be reclassified as a non-HVCRE exposure.

**a. Contributed Capital**

Under section 214, for purposes of the 15 percent contributed capital exclusion criteria for commercial real property projects, cash, unencumbered readily marketable assets, paid development expenses out-of-pocket, and contributed real property or improvements count towards the capital contribution. For paid development expenses out-of-pocket, the agencies propose to include costs both incurred by the project and already paid by the borrower prior to the advance of funds by the banking organization. Section 214 provides 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 agencies propose further to reduce the value of the real property that would count towards the 15 percent contributed capital requirement by the aggregate amount of any liens on the real property securing the HVCRE exposure.

**b. "As Completed" Value Appraisal**

Under the revised HVCRE exposure definition and consistent with section 214, the 15 percent capital contribution will be required to be calculated using the real property's appraised "as completed" value to the project. However, an "as completed" value appraisal may not

always be available, such as in the case of purchasing raw land without plans for development in the near term, which would typically have an “as is” value appraisal. Therefore, the agencies would permit the use of an “as is” appraisal, where applicable, for purposes of the 15 percent capital contribution. In addition, the agencies’ regulations permit the use of an evaluation in place of an “as completed” value appraisal for a commercial real estate transaction under \$500,000 that is not secured by a single one-to four-family residential property. The agencies note that section 214 does not distinguish between credit exposures based on size; however, the agencies’ appraisal regulations permit the use of evaluations under certain circumstances. The agencies thus propose to allow the use of an evaluation for transactions under \$500,000 that are not secured by a single one- to four-family residential property and for certain transactions with values of less than \$400,000 involving real property or an interest in real property that is located in a rural area.

**c. Project**

Under the revised HVCRE exposure definition and consistent with section 214, when considering whether a credit facility is excluded as a “certain commercial real property project,” the 15 percent capital contribution calculation and the “as completed” value appraisal are measured in relation to a “project.” The agencies recognize that some credit facilities for the acquisition, development, or construction of real property may have multiple phases as part of a larger construction or development project. The agencies are proposing that in the case of a project with multiple phases or stages, in order for a loan financing a phase or stage to be eligible for the contributed capital exemption, the phase or stage must have its own appraised “as completed” value or an appropriate evaluation in order for it to be deemed a separate “project” for purposes of the 15 percent capital contribution calculation.

## **6. Reclassification as a Non-HVCRE Exposure**

Consistent with section 214, under the revised HVCRE exposure definition, 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 covers the debt service and expenses on that property in accordance with the banking organization's loan underwriting standards for permanent financings.

### **Conclusion:**

FDIC staff recommends that the FDIC Board of Directors approve the attached proposed interagency rule and authorize its publication in the *Federal Register* with a 60-day public comment period.

### **Staff Contacts:**

#### **RMS/Capital Markets**

Ben Bosco, Chief, Capital Policy Section (ext. 8-6853)

David Riley, Senior Policy Analyst (ext. 8-3728)

Michael Maloney, Policy Analyst (ext. 8-6516)

#### **Legal**

Michael Phillips, Acting Supervisory Counsel (ext. 8-3581)

Catherine Wood, Counsel (ext. 8-3788)

Alec Bonander, Attorney (ext. 8-3621)