May 21, 2019

MEMORANDUM TO: Board of Directors

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

SUBJECT: Regulatory Capital Treatment of Certain Land Development Loans for the Definition of High Volatility Commercial Real Estate 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. On September 28, 2018, 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") published a notice of proposed rulemaking in the Federal Register ("HVCRE NPR") to revise the HVCRE exposure definition in section 2 of the capital rule to conform to the statutory definition of an HVCRE ADC loan. After reviewing comments received to the HVCRE NPR, staff is seeking the approval of the FDIC Board to publish a notice of proposed rulemaking, which expands upon the HVCRE NPR, to seek comment on the treatment of loans that finance the development of land for purposes of the one- to four-family residential properties exclusion in the revised HVCRE exposure definition ("HVCRE Land Development NPR").

Recommendation: Staff recommends that the FDIC Board approve the HVCRE Land Development NPR and authorize its publication in the *Federal Register*, with a thirty day comment period.

Concur:

Nicholas J. Podsiadly
General Counsel

Discussion:

I. Background

On September 28, 2018, the agencies published the HVCRE NPR to revise the HVCRE exposure definition in section 2 of the capital rule[1] to conform to the statutory definition of an HVCRE ADC loan.[2] Consistent with section 214, the agencies proposed in the HVCRE NPR to exclude credit facilities that finance the acquisition, development, or construction of one- to four-family residential properties from the definition of HVCRE exposure.

In the HVCRE NPR, the agencies also 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. Some commenters to the HVCRE NPR supported aligning the one- to four-family residential properties exclusion with the treatment of one- to four-family residential construction loans as reported in the Call Report and FR Y-9C. Other commenters to the HVCRE NPR supported the exclusion of lot development loans from the definition of HVCRE exposure.

After reviewing the comments related to lot development loans, staff of the agencies believe that the regulatory capital treatment of such loans warrants further consideration and clarification before finalizing the definition of an HVCRE exposure. Staff of the agencies have considered the use of the term "lot development loan" or "land development loan" for purposes of the one-to-four-family residential properties exclusion to the definition of HVCRE exposure, and are proposing to use the term "land development," which is described in the instructions to the Call Report and FR Y-9C as a loan that finances the process of improving land, such as

[1] 12 CFR part 3 (OCC); 12 CFR part 217 (Board); and 12 CFR part 324 (FDIC).

[2] See 12 CFR 217.2 (Board); 12 CFR 3.2 (OCC); 12 CFR 324.2 (FDIC).

laying sewers, water pipes, and similar improvements to prepare the land for erecting new structures. Accordingly, staff of the agencies are recommending that the agencies issue this HVCRE Land Development NPR, which expands upon the HVCRE NPR, to seek comment on the treatment of land development loans for the purpose of the one- to four-family residential properties exclusion in the revised HVCRE exposure definition.

Section 214 became effective upon enactment of the EGRRCPA. Accordingly, on July 6, 2018, the agencies issued a statement (interagency statement), advising banking organizations that, when determining which loans should be subject to a heightened risk weight, they may choose to continue to apply the current regulatory definition of HVCRE exposure, or they may choose to apply the heightened risk weight only to those loans they reasonably believe meet the definition of "HVCRE ADC loan" set forth in section 214 of the EGRRCPA.[3] Until the agencies take further action, banking organizations are advised to reference the interagency statement for purposes of the HVCRE exposure definition and regulatory reporting.

II. Summary of HVCRE Land Development NPR

The HVCRE Land Development NPR would expand upon the HVCRE NPR to revise the definition of HVCRE exposure in the capital rule by adding a new paragraph that provides that the exclusion for one- to four-family residential properties would 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. In order for a loan to be eligible for this exclusion, the credit facility would be required to include financing for construction of one- to four-family residential structures. This revision would

[3] Board, FDIC, and OCC, *Interagency statement regarding the impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)*, https://www.fdic.gov/news/news/press/2018/pr18044a.pdf.

generally align with the instructions set forth in the Call Report and FR Y-9C on line 1.a.(1) of Schedules RC-C and HC-R.

Allowing banking organizations to apply a consistent definition of one- to four-family residential property and land development in this manner would simplify reporting requirements, reduce burden, and promote uniform application of the capital rule. Additionally, supervisory experience has demonstrated that certain acquisition, development, and construction loan exposures present risks for which the staff believe banking organizations should hold additional capital. Staff generally consider land development loans to present elevated risk as compared to construction loans. For example, while the loan-to-value ratio is only one of several pertinent credit factors to be considered when underwriting a real estate loan, the agencies have established in their real estate lending standards more stringent supervisory loan-to-value ratios for land development loans (75 percent) than for construction loans (80 or 85 percent depending on property type) because of the elevated credit risk in land development loans.[4] Furthermore, in some cases, land development loans may be made for speculative purposes, generate no cash flow, and require other sources of cash to service the debt. Based on risks arising from land development loans, staff do not believe that loans that solely finance land development preparatory to erecting new structures should be included as part of the one- to four-family residential properties exclusion of the HVCRE exposure definition and receive a lower risk weight.

[4] See Board, OCC, and FDIC, *Interagency Guidelines For Real Estate Lending Policies* (real estate lending standards), 12 CFR Part 208 Appendix C (Board); 12 CFR part 34 Appendix A (OCC); 12 CFR part 365 Appendix A (FDIC).

Conclusion:

Staff recommends that the FDIC Board approve the attached HVCRE Land Development NPR and authorize its publication in the *Federal Register* with a thirty day comment period.

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