Housing Finance & Regulatory Affairs
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Legislative and Regulatory Activities Division
Office of Comptroller of the Currency
400 7th Street, SW
Suite 3E-218, Mail Stop 9W-11
Washington, DC 20219

Docket ID OCC-2017-0018
RIN 1557-AE10

Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave, NW
Washington, DC 20551

Docket No. R-1576
RIN 7100 AE-74

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

RIN 3064-AE59

Notice of Proposed Rulemaking:
Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996

Dear Sir or Madam:

The National Association of Home Builders (NAHB) is appreciative of the opportunity to submit comments on the Notice of Proposed Rulemaking (NPR) to simplify the capital rule in place since 2013 designed to strengthen capital requirements for banking organizations supervised by the Office of Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Federal Reserve) and the Federal Deposit Insurance Corporation (FDIC) (collectively, "the agencies"). Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996, which requires regulations prescribed by the agencies to be reviewed by them at least once every 10 years, NAHB welcomes the agencies' report this year in which they committed to "meaningfully reduce" regulatory burden, especially on community banking organizations.

NAHB is a Washington DC-based trade association representing more than 140,000 members involved in the development and construction of for-sale single family homes, including homes for first-time and low- and moderate-income homebuyers, as well as the construction, ownership and management of multifamily rental housing, including affordable rental housing. NAHB's members are predominately small to mid-sized home builders and developers who rely on their community banks as their primary source of acquisition, development and construction financing. Easing the regulatory burden faced by community banks has the potential to improve the ability of NAHB's members to address housing needs in their communities and contribute to economic growth.

Background

In June 2012, the agencies issued a proposed capital rule to apply Basel III international regulatory capital standards to U.S. banks. The proposed rule included three Notices of Proposed Rulemaking specific to Regulatory Capital: 1) Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action; 2) Advanced Approaches Risk-Based Capital Rule and Market Risk Capital Rule; and 3) Standardized Approach for Risk-weighted Assets and Market Discipline and Disclosure Requirements. The Advanced Approaches framework applies to large, internationally active banking organizations--generally those with at least $250 billion in total consolidated assets or at least $10 billion in total on-balance sheet foreign exposure--and includes the depository institution subsidiaries of those firms. All other financial institutions to which Basel III applies are mandated to use the Standardized Approach.

NAHB's members rely on community banks which generally fall within the parameters of financial institutions subject to the Standardized Approach for their acquisition, development and construction financing. In October 2012, NAHB submitted comments to the agencies on the capital rule specific to the Standardized Approach. NAHB's comments included concerns that the recommended capital requirements for the rule's proposed newly-created classification of commercial real estate loans called High Volatility Commercial Real Estate (HVCRE) for acquisition, development and construction (AD&C) financing would have negative consequences for community banks and their customers.

Since the final capital rule's Standardized Approach has been in effect, all AD&C loans determined to be HVCRE financings are required to be reported separately from other commercial real estate loans and assigned a risk weighting of 150 percent for risk-based capital purposes. Prior to creation of the HVCRE classification, most loans to finance AD&C would have been assigned a risk weighting of 100 percent. AD&C loans eligible for exemption from the HVCRE rules continue to be risk-weighted at 100 percent. These include AD&C loans on one-to-four family residential properties, certain community development projects and agricultural properties as well as commercial and multifamily projects that meet the following criteria:

1) The project's loan-to-value is less than or equal to the maximum supervisory loan-to-value limits set forth in applicable regulations (typically 80 percent); and,
2) The borrower(s) has contributed capital to the project prior to the advancement of funds in the form of cash, unencumbered readily marketable assets, land to be contributed to the project purchased with cash, or certain out-of-pocket development expenses, where the aggregate of such capital contributions is at least 15 percent of the real estate project's "as completed" appraised value; and,

3) Borrower-contributed capital is contractually required to remain throughout the life of the project, i.e., until the loan is converted to permanent financing or the debt is paid in full.

From the beginning, financial institutions found the definition of HVCRE loans hard to comprehend. In fact, loans to be classified as HVCRE loans are determined by eliminating those that are specifically exempted from the classification. Since the rules regarding the scope of loans to classify as HVCRE and those loans that could be exempted from the HVCRE classification have never been clear to the banking community, NAHB hears that banks either err on the side of caution and classify all commercial and multifamily AD&C loans as HVCRE and charge increased fees to cover the cost of holding the additional capital or they have pulled back from commercial real estate lending. From NAHB's perspective, both responses are harmful to builders and developers. Not only has the lack of clarity resulted in financial institutions applying the rules inconsistently, but it has added to the increased regulatory burden the capital rule has imposed on community banks, large financial institutions, real estate developers and builders. All have expressed concerns and have asked the agencies for clarification of numerous components of the HVCRE rule that may be deterring commercial real estate lending.

In acknowledgement of the difficulties and confusion, in March 2015 the agencies issued answers to Frequently Asked Questions regarding the capital rule. The document included 17 questions and answers specific to HVCRE. While helpful, many in the industry continued to press for additional guidance.

Two years later, Rep. Robert Pittenger (R-NC) and David Scott (D-GA) introduced H.R. 2148, *Clarifying Commercial Real Estate Loans*. The bill passed in the House of Representatives on November 7, 2017 and was sent to the Senate Committee on Banking, Housing and Urban Affairs on November 8, 2017. The bill would amend the Federal Deposit Insurance Act to change and/or clarify provisions regarding HVCRE loans that have generated the greatest uncertainty within the banking and real estate finance industries. Specifically, the bill would:

1. Clarify the definition of an “HVCRE ADC Loan” (i.e., secured real property AD&C loans where repayment is dependent upon future income/sale proceeds of such property);
2. Permit banks to count the value of appreciated property toward the borrower’s required 15 percent capital contribution;
3. Permit withdrawal of internally generated capital throughout the life of the project;
4. Permit withdrawal of contributed capital once the project meets underwriting requirements for permanent financing;
5. Permit withdrawal of HVCRE classification prior to the end of an AD&C Loan once project meets underwriting requirements for permanent financing; and
6. Exempt loans originated prior to January 1, 2015.

Proposed Simplifications to the Capital Rule

In March, the agencies submitted a report to Congress pursuant to their review of the capital rule under the Economic Growth and Regulatory Paperwork Reduction Act of 1996. In the report, the agencies indicated they found the capital rule unduly complex and burdensome and announced their intent to meaningfully reduce the regulatory burden on banks, in particular, the burden on community banking organizations. The resulting NPR recommends simplified regulatory capital treatment for mortgage servicing assets; certain deferred tax assets arising from temporary differences; investments in the capital of unconsolidated financial institutions; and capital issued by a consolidated subsidiary of a banking organization and held by third parties (minority interest). Of particular interest to NAHB, the NPR proposes significant revisions to the current definition and capital

treatment of HVCRE loans that the agencies hope will address the questions and ambiguity that have surrounded these loans. Changes affecting the HVCRE classification and other assets mentioned above would simplify compliance for banking institutions subject to the Standardized Approach capital calculation. Banking institutions subject to the Advanced Approaches regulatory treatment would follow their current regulatory capital regime.

Changes to the HVCRE classification

- The HVCRE classification would be changed to more accurately reflect the focus on AD&C financing. The new category would be called high volatility acquisition, development or construction or HVADC.

- The rule clarifies the definition and scope of HVADC, intending to make it easier to determine which loans would be captured under the new HVADC category of loans and which loans would be exempt.

  - A loan falls within the scope of the HVADC definition if it "primarily" finances or refinances: 1) the acquisition of vacant or developed land; 2) the development of land to prepare to erect new structures, including, but not limited to, the laying of sewers or water pipes and demolishing existing structures; or 3) the construction of buildings or dwellings, or other improvements including additions or alterations to existing structures. The loan is considered to "primarily" finance or refinance acquisition, development or construction activities if more than 50 percent of the funds are to be used for acquisition, development or construction activities.

  - The following loans are exempt from the HVADC classification:

    1) 1-4 family residential loans. The NPR clarifies that 1-4 family residential loans means loans that finance the acquisition, development or construction of 1-4 family residential properties and includes loans both to construct 1-4 family residential homes and loans that combine the land acquisition, development, or construction of 1-4 family homes either with or without a sales contract, including lot development loans. Per the proposal, a loan that finances the acquisition, development or construction of condominiums or cooperatives generally would not be classified as a 1-4 family residential property unless the project contains fewer than five dwelling units.

    2) Community development project loans.

    3) Loans that finance the purchase or development of agricultural land.

    4) Permanent loans.

- The proposed HVADC classification would eliminate the current exemption based on contributed capital.

- The proposed risk weight for HVADC exposures would be 130 percent, a reduction from the 150 percent risk weight that currently applies to HVCRE.

- Advanced Approaches institutions must calculate their capital requirements using both the requirements of the Standardized Approach and the Advanced Approaches and then hold the highest amount. To calculate their capital under the Standardized Approach they would use the new HVADC rules but continue to use the current HVCRE calculation for determining capital under their Advanced Approaches regime.

- A loan can be removed from classification as HVADC when it meets the definition of a permanent loan.

NAHB Comments

NAHB welcomes the agencies' efforts to ease the confusion and regulatory burden on financial institutions caused by HVCRE and to simplify compliance with the capital rules associated with HVCRE. Broadly, NAHB views the agencies' proposed changes to the capital rule as a step in the right direction. However, the proposed change to eliminate HVCRE and replace it with HVADC offers both improvements and drawbacks for financial institutions. Clarity and simplicity comes at the expense of capturing more loans within the bucket of loans that must be classified as "high volatility" and risk-weighted at 130 percent rather than 100 percent.

<u>Definition of HVADC</u>

The HVCRE classification has been a difficult process for many banks, in particular community banks. The proposed definition of HVADC much more clearly defines the specific financing purpose that will require a loan to be classified as HVADC than the current HVCRE rule does. This should eliminate one of the most confusing aspects of HVCRE. Further, specifying that the HVADC classification only will apply if more than 50 percent of the funds are to be used for the specified acquisition, development or construction activities will help lenders determine which loans must be captured and also ensure the classification applies to loans that are clearly focused on AD&C. NAHB believes this enhanced definition is a positive change and probably would reduce the number of loans banks would classify in the higher risk weight category.

<u>Eliminating the Capital Contribution Exemption</u>

One of biggest problems associated with HVCRE from the beginning has been understanding and complying with the conditions to qualify a loan for exemption from the HVCRE classification if the borrower has contributed capital of at least 15 percent of the real estate project's "as completed" appraised value prior to the advancement of funds. The current rule says contributed capital to the project must be in the form of cash or unencumbered readily marketable assets or development expenses paid out-of-pocket. Further, the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project. The life of a project concludes only when the credit facility is converted to permanent financing or is sold or paid in full. Borrowers and lenders continue to seek clarification on meeting the requirements of this exemption. Confusion has surrounded the allowable sources of contributed capital and there is frustration regarding the requirement to use the "as completed" appraised value to calculate the contributed capital.

Rather than attempting to more clearly define the capital contribution exemption the agencies have instead eliminated it. Per the NPR, regardless of how much equity or contributed capital is in the project, all loans that primarily finance or refinance the defined AD&C activities for multifamily and commercial projects must be classified as HVADC unless they are eligible for one of the other exemptions. NAHB believes this revision to the capital rule would increase the number of loans that would require the higher risk weight and consequently discourage the origination of AD&C loans by some financial institutions.

NAHB considers eliminating this exemption contrary to the intent of the HVADC proposal and the original HVCRE rule. The increased capital requirements under Basel III were a direct response to the crisis in the financial markets and enhanced capital for certain commercial real estate loans was intended to reduce institutions' risk on such holdings. Eliminating the HVADC exemption for loans to borrowers with significant "skin in the game"

and applying the 130 percent risk weight to all eligible HVADC loans would appear also to eliminate the incentive to manage risk on individual loans.

Permanent Loan Exemption

The NPR confirms that a permanent loan is exempt from HVADC classification. The current HVCRE rule exempts permanent loans from the HVCRE classification but only once the life of the AD&C project has concluded and the loan is converted to permanent financing in accordance with the financial institution's normal lending terms. The proposed rule offers a clarified and expanded definition of permanent loan. The proposed rule defines a permanent loan as "a prudently underwritten loan that has a clearly identified ongoing source of repayment sufficient to service amortizing principal and interest payments aside from the sale of the property." The agencies recognize that borrowers may have means of repayment of an AD&C loan without relying on the repayment from the sale or lease of the property. In this case, the AD&C loan would be considered permanent financing and exempt from classification as HVADC. NAHB appreciates this clarification and believes lenders and borrowers will benefit.

NAHB Recommendations

The capital rule should allow financial institutions discretion to judge the risk of some multifamily and commercial AD&C loans based on prudential underwriting standards. If a loan meets the supervisory standards for prudently underwritten loans, it should have a risk weight of 100 percent. To classify all multifamily and commercial AD&C loans as equally risky and require the 130 percent risk weight will require banks to hold excessive capital. For some banks, the cost will prove prohibitive and they will cease making HVADC loans. Others will pass the cost on to borrowers, making some viable projects not economically feasible. If the proposed capital rule is finalized with no changes, it will continue to hamper the ability and willingness of some financial institutions to make AD&C loans.

NAHB believes the agencies should retain the exemption from the HVADC classification and higher risk weight requirement when a certain amount of capital has been contributed to the project. Banks should not be penalized for financing AD&C projects that are adequately structured with sufficient equity. This only will end up penalizing borrowers. Rather than eliminate the exemption altogether because the agencies could not find a simplified way to thoroughly explain the contributed capital exemption, the agencies should find a way to do so.

NAHB believes H.R. 2148, *Clarifying Commercial Real Estate Loans* offers a good model for the agencies to follow. In particular, the appreciated value of land should be counted toward the contributed capital and the scope of limitation on withdrawals of contributed capital should be adjusted. An exemption based on contributed capital should not be calculated based on the "as completed" value of the project. Not only does this inflate the required amount of contributed capital required, but the contributed capital is then based on the estimate of an appraiser and is somewhat arbitrary based on factors that vary across the country and with economic conditions.

While NAHB believes the proposed rule has offered some constructive fixes to the flawed HVCRE requirements, we believe a better approach is to modify the current HVCRE rule to incorporate the positive changes, including enhancements to the definition of an AD&C loan subject to increased capital and the permanent loan exemption. We believe the contributed capital exemption with the suggested modifications, using H.R. 2148, *Clarifying Commercial Real Estate Loans* as a model should be maintained.

Conclusion

Please contact Becky Froass, Director, Financial Institutions and Capital Markets, at rfroass@nahb.org 202-266-8529 if you have any questions about our comments this issue.

Sincerely,

David L. Ledford