*Via Electronic Submission*

December 26, 2017

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**Re: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996; Regulation Q; Notice of Proposed Rulemaking (Docket No. R–1576; RIN 7100-AE74)**

To Whom It May Concern:

The Financial Services Roundtable[1] (the "FSR") appreciates the opportunity to submit this letter to the Office of the Comptroller of the Currency (the "OCC"), the Federal Deposit Insurance Corporation (the "FDIC") and the Board of Governors of the Federal Reserve System (the "FRB") (collectively, the "Agencies") in connection with the Agencies' notice of proposed rulemaking to modify certain aspects of their regulatory capital rules following the report issued earlier this year under the Economic Growth and Regulatory Paperwork Reduction Act of 1996 ("EGRPRA").[2]

Overall, FSR supports the Agencies' goal to reduce unnecessary regulatory burdens and simplify their regulatory capital rules. In particular, we fully support the Agencies' proposed revisions to the deduction thresholds for mortgage servicing assets ("MSAs"), deferred tax assets ("DTAs"), and significant investments in the capital of unconsolidated financial institutions,

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[1] FSR represents the largest integrated financial services companies providing banking, insurance, payment, investment and finance products and services to the American consumer. FSR member companies provide fuel for America's economic engine, accounting directly for $54 trillion in managed assets, $1.1 trillion in revenue, and 2.1 million jobs.

[2] FRB, OCC, FDIC, Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996; Regulation Q, 82 Fed. Reg. 49984 (Oct. 27, 2017) (the "Proposing Release").

although we believe these changes should apply to all banking organizations not just non-advanced approaches organizations.

However, we have significant concerns about various aspects of the proposal, most notably the proposal to replace the standardized approach's treatment of high-volatility commercial real estate ("HVCRE") with a new treatment for high-volatility acquisition, development or construction ("HVADC") exposure subject to a 130% risk-weight. While we support the Agencies' overall aim to simplify the treatment of HVCRE exposures, we are concerned that the new HVADC definition is both overly reductionist in removing the HVCRE exclusion for contributed capital (as described below) and overly complicated by requiring advanced approaches banking organizations to implement two sets of classification methodologies (one for grandfathered HVCRE exposures and one for HVADC exposures).

**Executive Summary**

- The HVADC definition should clarify that HVADC exposures are limited to loans secured by real estate that is the primary repayment source for the loan.
- The Contributed Capital Exception should be restored to the proposed HVADC definition, and should clarify that:
    - Only a minimum of 15% contributed capital must remain in the project in order to qualify for the exception and that appreciated land value can be counted towards that amount;
    - Appreciated land value pursuant to a Financial Institutions Reform, Recovery, and Enforcement Act of 1989 ("FIRREA")-compliant appraisal may be counted towards the minimum of 15% contributed capital; and
    - 15 percent contributed capital requirement be evaluated against the total cost of the project, rather than against the appraised "as completed" value.
- The Agencies should retain a single treatment for HVCRE and HVADC (with the revisions suggested herein) in order to prevent unnecessary complexity and to prevent regulatory arbitrage.
- The Agencies should provide a justification for the 130% risk weight for HVADC exposures.
- The Agencies should allow banking organizations to choose to apply the HVCRE or HVADC definition to legacy exposures (provided it does not adopt the single treatment recommended above), as long as it does so in a consistent way across all its exposures.
- The Agencies should extend the simplified framework for MSAs, DTAs, etc. to all banking organizations, not just non-advanced approaches banking organizations.

- The Agencies should reduce the risk weight for MSAs not deducted from capital to 100%.

## I. Clarify HVADC Definition

The proposed rule introduces a new definition of HVADC exposure, which effectively is based on the HVCRE definition with certain modifications. In particular, the definition would clarify acquisition, development or construction ("ADC") activities by limiting the definition of HVADC to credit facilities that primarily[3] finance or refinance the: (1) acquisition of vacant or developed land; (2) 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) construction of buildings, dwellings or other improvements including additions or alterations to existing structures.

FSR recommend that the proposed definition clarify the scope of credit facilities that would be subject to the HVADC exposure rules. In particular, we request that the Agencies clarify that HVADC exposures are limited to those ADC exposures that are secured by real estate that is the primary source of repayment for the exposure. Clarifying the definition of HVADC in this manner would eliminate much of the inherent ambiguity resulting from the purpose-based nature of the definition as currently formulated. The clarification also would make classifying exposures a much more "bright-line" test that is easier to administer and validate, while capturing the types of exposures meant to be covered by the current HVCRE definition.

## II. Reinstate the Contributed Capital Exception

The HVCRE definition included an exception for commercial real estate projects that meet a three-part test based on (1) the loan-to-value ratio; (2) the amount of borrower contributed capital; and (3) the timing and the committed status of the borrower contributed capital (the "Contributed Capital Exemption"). The proposed HVADC definition does not contain a similar concept. In deciding not to include such a definition, the Agencies cited concerns about the exception's complexity and potential inconsistent application. Furthermore, the Agencies stated they considered alternative approaches, but concluded those approaches were similarly complex and inconsistent with the goal of simplifying the capital rule.

FSR believes the elimination of the Contributed Capital Exception is a disproportionate response to the complexity of the exception because an exception for exposures for which a borrower has contributed sufficient amounts of capital is fundamentally sound. Such exposures are demonstrably less volatile than other types of commercial real estate exposures. Instead of removing the Contributed Capital Exception, we recommend the Agencies modify and simplify the exception as described below.

FSR recommends that the Contributed Capital Exception should be retained, and also recommends the following modifications and clarifications to the Contributed Capital Exception.

[3] More than 50% of the proceeds must be used for acquisition, development or construction activities.

**First**, we request that the Agencies clarify that only a minimum of 15% contributed capital must remain in the project in order to qualify for the Contributed Capital Exception, and not any amounts contributed by a borrower to a project in excess of the required 15% minimum.

**Second**, we request that the Agencies confirm that, with respect to cash paid for land contributed by a borrower, the full appreciated land value pursuant to a FIRREA-compliance appraise may be counted towards the 15% contributed capital requirement, given that appraised value often reflects a much more current and accurate view of value than historical cost, particularly when land is purchased a long period of time before development.

**Third**, we suggest that the 15 percent contributed capital requirement should be evaluated against the total cost of the project, as it provides a more meaningful measurement than when it is measured against value. When comparing two projects of equal cost and equal contributed capital, the current methodology would imply that the project with the higher appraised value would carry more risk. The current methodology provides an incentive to lower the amount of the loan for properties with higher values (as compared to the cost of the project) and increase the amount of the loan for properties with lower values (as compared to the cost of the project).

## III. Retain a Single Treatment for HVCRE and HVADC

As proposed, advanced approaches banking organizations would continue to use the HVCRE exposure definition to calculate their risk-weighted assets under the advanced approaches, while using the HVADC definition for the purpose of calculating their risk-weighted assets under the standardized approach. In proposing to retain the HVCRE definition under the advanced approaches, the Agencies state the "treatment of this exposure in the advanced approaches diverges substantially from its treatment in the standardized approach. . . ."[4]

The proposed requirement that advanced approaches banking organizations evaluate their exposures based on both the HVCRE and HVADC definitions greatly increases the complexity of the Agencies' regulatory capital rules and increases—rather than reduces—the regulatory compliance burdens associated with the rules by requiring advanced approaches banking organizations to evaluate ADC exposures using two divergent sets of standards.

In addition, a regulatory capital framework that provides two definitions for the same exposure likely would result in opportunities for unintended regulatory arbitrage. In particular, banking organizations for which the advanced approaches risk-based capital rules is a binding constraint (applying the HVCRE definition with the Contributed Capital Exception) could offer more competitive pricing than banking organizations for which the standardized approach is the binding constraint. Borrowers unable to satisfy the conditions for the Contributed Capital Exception could be driven to borrow from these banking organizations, further concentrating risk in the ADC lending market.

Consequently, FSR recommends the Agencies retain a single framework (*i.e.*, HVADC with requested revisions) for evaluating ADC exposures HVADC with the revisions suggested herein.

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[4] Proposing Release at 49,991.

## IV. Provide Justification for the 130% Risk Weight for HVADC Exposures

The current proposal mandates a 130% risk weight for all HVADC exposure without much explanation as to why this specific amount was chosen. This risk weight is both inconsistent with the current risk weight for HVCRE and the risk weight specified under the Basel Committee's Basel III capital adequacy framework for ADC exposures. We request that the agencies provide additional analysis to support the calibration of this risk weight.

## V. Allow Banking Organizations to Elect HVADC or HVCRE for Legacy Exposures

The current proposal does not give banking organizations the option to characterize their legacy loans as HVADC exposure in lieu of grandfathering them as HVCRE exposures. If the Agencies do not adopt a single treatment for HVCRE and HVADC (as suggested above), we believe that banking organizations should be able to make their own determinations as to legacy loans, as long as banking organizations do so consistently across all of their exposures. From an operational and reporting perspective, applying one framework (either HVADC or HVCRE) for all loans would be simpler and more efficient.

## VI. Extend the Simplified Framework for MSAs, DTAs, etc. to All Banking Organizations

To reiterate the above, we fully support the revisions to the deduction thresholds for MSAs, DTAs and significant investments in the capital of unconsolidated financial institutions**.** We request that the proposed treatment of DTAs, MSAs, and investments in the capital of unconsolidated financial institutions be extended to all institutions, rather than apply only to non-advanced approaches banking organizations. We believe that regulatory tailoring should not be based on arbitrary, size-only thresholds and that any regulatory relief should be extended to all banking organizations when warranted.

## VII. Reduce the Risk-Weight for MSAs Not Deducted to 100%

Under the transition provisions set forth in the capital rules, MSAs not deducted from capital are assigned a 100% risk weight. Under the capital rules as originally adopted, beginning on January 1, 2018, the 100% risk weight for MSAs increases to 250%. However, pursuant to a recently finalized rule regarding the retention of certain existing transition provisions for non-advanced approaches banking organizations,[5] the 100% transitional risk weight would continue to apply after January 1, 2018.

Although the proposal would make modifications to the deduction thresholds for MSAs, banking organizations would revert back to the 250% risk to any MSAs not deducted from capital. Consistent with recently finalized transition rule, we believe that MSAs not deducted from capital should be assigned a 100% risk weight.

A Report to the Congress on the Effect of Capital Rules on Mortgage Servicing Assets issued by the Agencies and the National Credit Union Administration in June 2016 revealed a number of disturbing trends. In particular, nonbank servicers have gained significant market

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5 *See* 82 Fed. Reg. 55,309 (Nov. 21, 2017).

share since 2011, largely attributable to large-bank sales of legacy MSA portfolios and an increase in mortgage origination activity among nonbanks. This shift is due in part to the difficulties created by the Agencies' capital rules, which make it difficult for many firms to maintain an amount of MSAs that is below the deduction threshold and to achieve an efficient cost structure (due in part to the 250% risk weight for MSAs below the deduction threshold). In short, overly punitive capital treatment has been a significant driver in shifting the risk associated with MSAs to non-banks not subject to comparable supervision and regulation as banking organization, putting borrowers at risk.

For the foregoing reasons, we propose that the Agencies continue to apply the recently finalized 100% transitional risk weight for MSAs not deducted from capital. A 100% risk weight not only would be consistent with the historical treatment of these exposures, but also would be consistent with evolving risk management practices in the industry; since 2007, many institutions have implemented formal MSA hedging programs to mitigate the risks (*e.g.*, interest rate risk) inherent in the asset.

## VIII. Technical Clarifications

In addition to the foregoing comments, we request the Agencies clarify:

- With respect to the proposed definition of HVADC, that lenders may rely on determinations as to the "primary purpose" of a loan made at the time of origination.
- With respect to the Contributed Capital Exception, that projects are deemed to conclude upon conversion of the credit facility, or *eligibility of the facility for conversion* based on a banking organization's underwriting standards for permanent financing, regardless of whether a conversion is actually made.

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Thank you for your consideration. We look forward to working with the Agencies to improve the proposed capital rule. If it would be helpful to discuss the FSR's specific comments or general views on this issue, please contact me via telephone at (202)-589-2424 or email at Richard.Foster@FSRoundtable.org.

Sincerely yours,

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