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December 21, 2017

Ms. Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System
20th & Constitution Avenue, N.W.
Washington, D.C. 20551

RE: Docket No. R-1576 and RIN 7100

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 Seventeenth Street, N.W.
Washington, D.C. 20429

RE: RIN 3064-AE59

Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop 1-5
Legislative and Regulatory Activities Division
Washington, D.C. 20219

Office of the Comptroller of the Currency
400 7th Street SW
Suite 3E-218
Mail Stop 9W-11
Washington DC 2021

RE: Docket No. OCC-2017-0018 and RIN1557 AE-74

RE: Simplification to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996

Dear Sirs and Madam:

I am writing on behalf of the 1.3 million members of the National Association of REALTORS® (NAR), and its commercial affiliates: CCIM Institute, Institute of Real Estate Management, REALTORS® Land Institute, and Society of Industrial and Office REALTORS®, to provide our comments on proposed changes to the capital treatment of acquisition, development, and construction financing (ADC loans). REALTORS® are involved in all aspects of the residential and commercial real estate industries and belong to one or more of some 1,400 local associations or boards, and 54 state and territory associations of REALTORS®.

NAR's membership includes nearly 80,000 Commercial REALTORS® and twenty-nine commercial overlay boards throughout the country, and these members are very concerned about the impact of capital regulation on commercial credit availability. We congratulate you on conducting the regulatory relief study under the Economic Growth and Regulatory Relief Act in 2014 and 2015, and are pleased that you are addressing some of the issues raised by the current rules on acquisition, development and construction (ADC) financing, and in particular with respect to those ADC loans that are considered to be "high volatility commercial real estate"

(HVCRE) exposures.[1] Under the notice of proposed rulemaking (NPR), these loans would be designated "high volatility acquisition, development and construction" (HVADC) exposures.

[1] The proposed rule would change the designation of "High Volatility Commercial Real Estate" exposures to "High Volatility Acquisition, Development and Construction" (HVADC) exposures.

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We believe that the notice of proposed rulemaking (NPR) provides an excellent opportunity for the agencies to rationalize the capital treatment of HVCRE loans and the actual risks posed by these exposures. The impact of the regulatory capital requirements on bank ADC lending cannot be overemphasized. The current rules impose a 50 percent capital surcharge on HVCRE financings without regard to the risk inherent in the actual loan. As a result, loans necessary to support a vital segment of our economy are either hard to obtain or overly expensive. Many community banks, in particular, are deterred by the capital rules from making this type of loan, thereby impeding economic development across the nation.[2] In practice, this means developers are having difficulty securing financing from banks at the right price, under the right conditions.[3]

We appreciate that the agencies recognize that the current rule needs to be simplified and that the capital charge reduced. This is an excellent first step, and we thank you for undertaking this rulemaking initiative. Below, we will address several areas in which we believe the rule could be further improved.

I. Definition of High Volatility Acquisition, Development and Construction Exposures

A. Primarily Finances Test

As noted, the NPR changes the terminology, so the class of ADC loans that is subject to the penalty risk-weight would become "high volatility acquisition, development and construction" (HVADC) exposures. The NPR clarifies that a loan will not be considered an HVADC loan unless it "primarily finances" an ADC project. The "primarily finances" test is met if more than 50 percent of the loan proceeds will be used for acquisition, development, or construction activities, regardless of whether the loan is secured by real property.

We support the clarification that at least 50 percent of the loan proceeds must be intended for ADC purposes in order for the HVADC risk-weight to be triggered. However, we question whether loans that are not secured by the commercial real estate being developed should be considered HVADC loans. Loans that are secured by non-real estate assets of a developer, or secured by real estate assets of completed but distinct project, present different risks than a project secured by the property under development. We recommend that the agencies consider tying the definition of HVADC to loans that are truly dependent on the successful completion of the project being financed, and which are not supported by other assets that are financially independent of the project.

B. Permanent Loan Defined

The current rule provides that an HVCRE loan does not include "permanent financing." The NPR includes a definition of "permanent loan" to clearly articulate when an exposure ceases being subject to the higher capital charge. This is an important improvement over the current rule.

The NPR defines a "permanent loan" as a prudently underwritten loan that has a clearly identified ongoing source of repayment sufficient to service the loan on an amortizing basis, aside from the sale of the property. The source of repayment may be income generated by the ADC project, or by another source of funds contractually obligated to make loan repayments. The NPR explains that "bridge loans" generally would not qualify as permanent loans. However, a loan that does not meet the definition of permanent

[2] These concerns are shared by many in the real estate industry. See, for example, the comments of the Real Estate Roundtable at www.rer.org/Media/News_Releases/2017/HVCRE_bill_News_final.aspx

[3] See: "Lending Constraints Put the Squeeze on Developers" at https://therealdeal.com/la/issues_articles/lending-constraints-put-the-squeeze-on-developers/

financing at origination, can subsequently become a permanent loan as the property generates additional revenue sufficient to service amortizing principal and interest payments.
We believe that providing this clarification is an important improvement to the rule, and support its inclusion in the final regulation. We note, however, that the approach adopted in H.R. 2148, which passed the House of Representatives on November 7, 2017, permits a bank to reclassify a loan from the "high volatility" category when a project is completed and the cash flow from the project is "sufficient to support the debt service and expenses of the real property to the satisfaction of the depository institution, in accordance with the institution's applicable loan underwriting criteria for permanent financing."[4]

Rather than tying the definition of a "permanent loan" to the complex standard used in the NPR, it would be less burdensome to define a permanent loan to include loans in which the source of repayment generates sufficient funds to "support the debt service and expenses of the real property to the satisfaction of the depository institution, in accordance with the institution's applicable loan underwriting criteria for permanent financing." This would not only ease regulatory burden, but would make the definition of permanent financing consistent with the provision allowing for reclassification of a high volatility loan.

II. Risk-Weight for ADC Loans

Banking organizations with less than $250 billion in assets and less than $10 billion in foreign exposures are subject to the so-called "Standardized Approach" capital framework. Under this framework, assets are given a "risk-weight." The higher the risk-weight, the more capital that must be allocated to support that asset. Thus, for example, a commercial loan is given a risk-weight of 100 percent, while an HVCRE loan is currently given a risk-weight of 150 percent. Therefore, for loans of the same amount of principal, a bank will have to hold 50 percent more capital for an HVCRE loan than for a loan made for almost any other type of commercial purpose.

The NPR would reduce the "penalty" risk-weight for these ADC loans from 150 percent to 130 percent. This is definitely a step in the right direction, which we support. However, we believe that even a 130 percent risk-weight may not be appropriate in many cases. Many HVCRE loans are conservatively underwritten and present no greater risk than any other kind of commercial financing. This was implicitly recognized by all three Federal banking agencies. For example, in 2015, the agencies issued a document entitled "Prudent Risk Management for Commercial Real Estate Lending."[5] In this joint issuance, the agencies acknowledged that banks that made commercial real estate loans made in conformity with supervisory standards and expectations were able to withstand difficult economic cycles.

Having a uniform penalty risk-weight of 130 percent does not provide an incentive for banking institutions to carefully underwrite and manage their commercial real estate portfolio. Since under the NPR the capital charge for a conservatively underwritten ADC loan would be the same as for a riskier loan, which typically will bear a higher interest rate, the NPR actually provides an incentive to make the riskier loan.

Finally, we are aware of no empirical data or analysis that supports a 130 percent risk-weight as opposed to a lower risk-weight. If the agencies have statistical evidence justifying this risk-weight, it should be disclosed as part of this rulemaking so that the public may review this information and comment on the methodology.

In sum, we recommend that the 130 percent risk-weight be reduced to 100 percent for banks that make ADC loans in conformity with the supervisory guidance and expectations noted in the 2015 issuance. This

[4] H.R. 2148, 163 Cong. Rec. H8547 (Nov. 7, 2017).
[5] www.occ.gov/news-issuances/news-releases/2015/nr-ia-2015-163a.pdf

would provide an added incentive for banks to make safe and sound ADC loans and would increase the availability of bank funding for well-thought out commercial real estate projects that are not high risk or unduly speculative.

III. Removal of the Contributed Capital Exemption

Under the current rule, an ADC loan is not considered to be an HVCRE subject to the penalty risk-weight if, at loan origination, the loan-to-value ratio meets prescribed standards and if before any bank funds are advanced the borrower has contributed capital equal to at least 15 percent of the project's "as completed" market value. The capital contribution must be in the form of cash or marketable securities. Any land that is contributed by the borrower is valued at the cash price paid for the land, not its appreciated value. Further, any internally generated capital must be contractually required to stay in the project for the life of the project.

According to the NPR, many banking institutions found this exemption to be complex and difficult to comply with. Therefore, in order to simplify the rule, the NPR proposes to remove the exemption altogether. As a result, these loans would be subject to the higher risk-weight.

We strongly disagree with this approach. The goal of bank regulation should be to encourage safe and sound lending. Obviously, the agencies determined that an ADC loan that meets loan-to-value requirements and had a significant capital contribution by the borrower represented a safe and sound ADC loan, and therefore should not be subject to the penalty risk-weight. If the rule is found to be confusing or complex, it would be far better to simplify the rule in order to encourage loans that meet these underwriting conditions, rather than to remove any capital based incentive to make these loans.

One change that would simplify the exemption would be to change the computation of the capital contribution so that it would be based on the appraised market value of contributed land, rather than the historic price paid. Using the value of the property as determined by a state licensed and certified appraiser would more accurately represent the value of the contribution and the extent to which the borrower has "skin in the game." Also, it would avoid the problem that would otherwise arise when property values have depreciated after purchase, so that the market value of the land is actually lower than the purchase price.

This approach toward contributed capital would also be consistent with H.R. 2148.[6] This legislation allows the appraised value of contributed property to be part of the borrower's investment in the project, if the appraised value is determined under standards prescribed by the Appraisal Standards Board.[7]

IV. One-to-Four Family Residential Development

The current rule exempts from HVCRE loans that finance the acquisition, development or construction of one-to-four family residential properties. The NPR retains this exemption, but notes that it does not include ADC loans in connection with condominiums and cooperatives, unless the project is for less than five individual dwelling units. On the other hand, if each unit in a project is separated from other units by a wall that extends from ground to roof, such as in a town house development, then each unit is considered a single-family property, and the entire project is exempt.

It is difficult for us to understand why the agencies do not exempt condominium projects with single-family units sold on an individual basis. The existence of a ground to ceiling wall should not impact the risk of the loan. Many townhome projects include a neighborhood association that is responsible for

[6] 163 Cong. Rec. H8547 (Nov. 7, 2017)
[7] The Appraisal Standards Board is authorized to provide such standards under Federal law. See, 12 U.S.C. § 3339.

prescribed tasks, such as replacing exterior elements, roof replacement, street cleaning and snow removal. Except for the existence of a ground to roof wall, these townhome projects are essentially equivalent to condominium developments, where the condominium association is responsible for the repair and maintenance of exterior services.

We wholeheartedly agree with the agencies view that one-to-four family residential ADC loans should not be penalized. However, as our population ages, and with the increased popularity of urban living among all buyers, single-family condominium projects are enjoying an upsurge in interest and are playing a key role in meeting the housing needs of our country. The exemption for residential housing development should not arbitrarily distinguish between single-family condominiums projects and other forms of residential housing. In light of the array of reforms enacted in the Dodd-Frank Act, and the increased demand for home ownership in our urban areas, the current situation does not warrant punitive capital charges on conservatively underwritten condominium ADC loans. Therefore, unless the agencies have objective reasons to believe that the recent increase in condominium development is inherently riskier than other residential development, condominium financing should be included in the exemption from the higher risk-weight.

V. Agricultural and Community Development Lending

A. Agricultural exposures

The NPR would continue the current exemption for loans that finance the purchase or development of agricultural land. The NPR explains that the term "agricultural" is broadly defined and would include timberland or fish farms. However, it does not include manufacturing or processing plants related to agricultural products, such as a dairy processing plant. We support the continued exemption for agricultural lending.

B. Community development projects

Current rules exempt the financing of certain community development projects from the penalty risk-weight. The NPR would continue this exemption, and would also simplify the rule by including all projects that qualify as "community development" under the Community Reinvestment Act. In addition, the NPR would ease regulatory burden by removing an exception from the lower risk-weight category for certain loans based on the size of the borrower. Instead, all projects qualifying as community development under the Community Reinvestment Act would be included. We support this proposal.

VI. Timing

The NPR would apply prospectively, and only lower the capital requirements for loans originated on or after the effective date of the rule. We believe that the lower risk-weight should apply to all loans currently viewed as HVCRE. Since this would provide regulatory relief, retroactive application would not work a hardship on the banking industry. Further, it would immediately free up bank capital for lending and investment. On the other hand, to the extent that the final rule would remove current exemptions from the HVCRE definition, for example, by narrowing or eliminating the exemption for borrower "contributed capital" loans, the change would not be providing relief but instead increase regulatory burden. Fairness dictates that any sections of the rule that increase regulatory burden should be applied to the extent possible without an adverse reaction.

VII. Conclusion

We believe that this NPR is a step in the right direction and indicates the seriousness in which the regulatory agencies take the need to reduce regulatory burden. The current capital treatment of commercial

real estate acquisition, development and construction lending is seriously flawed. The NPR attempts to ease this burden by reducing the penalty risk-weight to 130 percent. On the other hand, the NPR takes a step back by removing an important exemption for loans with significant borrower capital investments.

In this comment letter, we have made several suggestions that we believe would improve the rulemaking and rationalize the capital treatment for ADC loans more closely to the risks associated with this lending. We appreciate the opportunity very much afforded by the NPR to make these comments. Please feel free to contact us if we can provide any further information or assistance.
Best regards,

Sincerely,

Elizabeth Mendenhall
2018 President, National Association of REALTORS®