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Re: Regulatory Capital Rules: Treatment of Land Development Loans for the Definition of High Volatility Commercial Real Estate Exposure

Ladies and Gentlemen:

The American Bankers Association (ABA)[1] appreciates the opportunity to comment on the banking agencies' (the Agencies) proposed rulemaking (the Proposal). The Proposal addresses the treatment of land development loans for the purposes of the one-to-four-family residential properties exclusion in the definition of high volatility commercial real estate (HVCRE) exposure in the Agencies' regulatory capital rule. The Proposal expands upon the earlier notice of proposed rulemaking (HVCRE NPR) issued on September 28, 2018. That NPR also proposed to conform the definition of HVCRE exposure in the regulatory capital rule to section 214 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA).[2]

[1] The American Bankers Association (ABA) is the voice of the nation's $18 trillion banking industry, which is composed of small, regional, and large banks that together employ more than 2 million people, safeguard nearly $14 trillion in deposits, and extend more than $10 trillion in loans.
[2] Regulatory Capital Treatment for High Volatility Commercial Real Estate (HVCRE) Exposures, 83 Fed. Reg. 48990 (proposed Sept. 28, 2018)(to be codified at 12 C.F.R. pt. 3), https://www.govinfo.gov/content/pkg/FR-2018-09-28/pdf/2018-20875.pdf.

ABA does not believe that the Proposal aligns with EGRRCPA's statutory intent. We urge the Agencies to revise the definition so that land loans that do not meet the statutory three-prong definition are exempt from HVCRE treatment. Moreover, consistent with our November 27, 2018, comment on the HVCRE NPR, we maintain that HVCRE should not be treated as a separate class, and therefore all acquisition, development, and construction (ADC) lending should be subject to the general 100% risk weight.[3]

The Proposal Does Not Reflect the Statutory Definition

EGRRCPA generally defines the [HVCRE ADC] subject to heightened capital requirements as a credit facility secured by land or improved real property that—

- Primarily finances the ADC of real property;
- Has the purpose of providing financing to ADC or improve such real property into income-producing real property; and
- Is dependent upon future income or sales proceeds from, or the refinancing of, such real property for the repayment of the credit facility.

EGRRCPA also provides a list of exclusions from the HVCRE definition, including a credit facility financing the acquisition, development, or construction of properties that are one-to four-family residential properties. Under the Proposal, the Agencies would revise the definition of HVCRE exposure to provide that the exclusion for one-to-four-family residential properties does not include credit facilities that solely finance land development activities, such as the laying of sewers, water pipes, and similar improvements to land. Therefore, under the Proposal, a facility that solely finances land development would be categorized as an HVCRE exposure, unless the exposure meets another exclusion from the definition of HVCRE exposure. ABA disagrees with the proposal.

First, regardless of whether these exposures meet an exclusion, these exposures do not meet the three-prong general definition. The Proposal changes the intent of the statutory language from a conjunctive three-prong set of criteria to a disjunctive set of criteria where any one single prong suffices to define the facility as covered. This is a severe misapplication of the plain language of the legislation. ABA maintains that "other land loans" need to meet the same criteria.

The following are two examples for land loans that would not meet the three-prong test:

- A residential property/land owner purchasing surrounding property as a buffer and has no intention of selling or developing into income-producing property, who has outside cash flow to support the debt. This should *not* be automatically classified as HVCRE.
- A borrower holding raw or developed residential land (typically zoned 1-4 family) for future development/vertical construction with outside cash flow to support the debt service. This type of land loan is referred to as "land banking;" in a downturn market it would not meet

[3] See ABA comment letter at https://www.aba.com/Advocacy/commentletters/Documents/Letter-Agencies-HVCRE-ADC-112718.pdf.

an impaired loan standard, since repayment of the loan was not originally intended to be met from sale of the lots.

Second, the statute specifically addresses an exemption for one-to four-family construction development loans from the HVCRE definition. This Proposal changes the intended scope of coverage of this part of the statute. In order for a loan to be eligible for this exclusion, the credit facility would be required to include financing for the construction of one-to four-family residential structures. That is inconsistent with congressional intent.

Our members understand the Agencies' concern regarding the heightened risk for land development loans. Other protections exist in the supervisory process to address these risk concerns, including attention that banks' robust monitoring systems provide the oversight for construction lending and land development loans, with risk related controls. If a land development loan stalls, banks would appropriately monitor and downgrade the loan to the proper risk rating, according to regulatory standards. As a result of the new risk rating, an additional allowance specific to the loan would be made to reflect the incremental risk of the downgrade in the financial statements and ultimately in capital.

As Written, the Proposal Would Discourage HVCRE ADC Lending

ABA members have provided feedback that by changing the regulations implementing section 214 of EGRRCPA to include land development loans for one-to-four-family residential properties and other land loans, the associated increased capital costs would increase fees, costs, and rates to the ultimate homebuyers of one-to-four-family residential construction projects. Such homebuyers already struggle with a myriad of other challenges associated with finding affordable solutions for the consumers. These added burdens to consumers are unwarranted as banks have robust risk management systems that monitor the commercial concentration guidance outlined by the prudential regulators for ADC lending. These are clearly monitored by bank examiners in each bank's rigorous safety and soundness exams. Any supervisory loan-to-value exceptions are managed and tracked within their Risk Management Monitoring System for Performance and Migration.

ABA urges the Agencies' to clarify in the final rule that all prudentially underwritten loans with sufficient loan-to-value and equity should be allowed exemption from HVCRE classification the same as commercial projects.

Better Align the Capital Requirement to Underlying Risk

ABA maintains the position that the statutory text under section 214 clearly defines HVCRE ADC as a substantially narrow subset of HVCRE exposures. As a result, section 214 is intended to exclude most HVCRE exposures from a heightened risk weight.

The definition of HVCRE ADC remains complex and burdensome for banks to define for purposes of origination and tracking. We note that nothing in EGRRCPA requires banking agencies to apply a heightened risk weight to HVCRE ADC exposures. Rather, EGRRCPA's provisions simply prohibit banking agencies from applying a heightened risk weight to HVCRE exposures unless the exposures also meet the HVCRE ADC loan definition. However, considering the complexity of the HVCRE ADC definition and the small fraction of exposures that will be captured by that definition, HVCRE ADC should not be treated as a separate class; all ADC lending should be subject to the general 100% risk weight and wholesale correlation factor.

Conclusion

ABA supports efforts to simplify and improve the current regulatory capital framework, and we appreciate the efforts by the Agencies in this important process. However, we view the Proposal as unnecessary, and we encourage the Agencies to determine that 1) land loans that do not meet the three-prong test are not HVCRE, 2) horizontal construction (e.g. laying of pipes, etc.) for one-to-four-family residential homes are part of the one-to four-family residential properties exclusion, and 3) HVCRE are not subject to a higher risk weight, but rather should be at the 100% risk weight that applies to all ADC loans.

Sincerely,

[redacted]

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