

[6705-01-P]

FARM CREDIT ADMINISTRATION

12 CFR Part 628

RIN 3052-AD42

Risk Weighting of High Volatility Commercial Real Estate

(HVCRE) Exposures

AGENCY: Farm Credit Administration.

ACTION: Proposed rule.

SUMMARY: The Farm Credit Administration (FCA, we, or our) is seeking comments on this proposed rule that would revise our regulatory capital requirements for Farm Credit System (FCS or System) institutions to define and establish risk-weightings for High Volatility Commercial Real Estate (HVCRE) exposures.

DATES: Please send us your comments on or before [INSERT DATE 90 DAYS AFTER DATE OF PUBLICATION IN THE FEDERAL REGISTER].

ADDRESSES: For accuracy and efficiency reasons, please submit comments by e-mail or through FCA's Web site. We do not accept comments submitted by facsimiles (fax), as faxes are difficult for us to process and achieve compliance with section 508 of the Rehabilitation Act of 1973. Please do not submit your comment multiple times via different

methods. You may submit comments by any of the following methods:

- E-mail: Send us an e-mail at reg-comm@fca.gov.
- FCA Web site: <http://www.fca.gov>. Click inside the "I want to..." field near the top of the page; select "comment on a pending regulation" from the dropdown menu; and click "Go." This takes you to an electronic public comment form.
- Mail: Kevin J. Kramp, Director, Office of Regulatory Policy, Farm Credit Administration, 1501 Farm Credit Drive, McLean, VA 22102-5090.

You may review copies of comments we receive on our Web site at <http://www.fca.gov>. Once you are on the Web site, click inside the "I want to..." field near the top of the page; select "find comments on a pending regulation" from the dropdown menu; and click "Go." This will take you to the Comment Letters page where you can select the regulation for which you would like to read the public comments.

We will show your comments as submitted, including any supporting data provided, but for technical reasons we may omit items such as logos and special characters. Identifying information that you provide, such as phone numbers and addresses, will be publicly available.

However, we will attempt to remove e-mail addresses to help reduce Internet spam. You may also review comments at our office in McLean, Virginia. Please call us at (703) 883-4056 or email us at reg-comm@fca.gov to make an appointment.

FOR FURTHER INFORMATION CONTACT:

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I. Introduction

A. *Objectives of the Proposed Rule*

The FCA's objectives in proposing this rule are to:

- Update capital requirements to reflect the increased risks that exposures to certain acquisition, development or construction loans pose to System institutions; and
- Ensure that the System's capital requirements are comparable to the Basel III framework and the standardized approach the Federal banking regulatory agencies have adopted, with deviations as

appropriate to accommodate the different operational and credit considerations of the System.

B. Background

In October 2013 and April 2014, the Federal banking regulatory agencies (FBRAs)¹ published in the **Federal Register** capital rules governing the banking organizations they regulate.² Those rules follow the Basel Committee on Banking Supervision's (BCBS or Basel Committee) document entitled "Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems" (Basel III), including subsequent changes to the BCBS's capital standards and BCBS consultative papers.³

On September 4, 2014, FCA published in the **Federal Register** a notice of proposed rulemaking seeking public comment on revisions to our regulatory capital requirements.⁴ Our proposed rule was comparable to the final rule of the FBRAs and the Basel III framework, while

¹The FBRAs are the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC).

²78 FR 62018 (October 11, 2013) (final rule of the OCC and the FRB); 79 FR 20754 (April 14, 2014) (final rule of the FDIC).

³Basel III was published in December 2010 and revised in June 2011. The text is available at <http://www.bis.org/publ/bcbs189.htm>. The BCBS was established in 1974 by central banks with bank supervisory authorities in major industrial countries. The BCBS develops banking guidelines and recommends them for adoption by member countries and others. BCBS documents are available at <http://www.bis.org>. The FCA does not have representation on the Basel Committee as the FBRAs do.

⁴79 FR 52814.

taking into account the cooperative structure and the organization of the System. Beginning in 2010, System institutions had sought for FCA to adopt a capital framework that was as similar as possible to the capital guidelines of the FBRAs as revised to implement the Basel III standards. In particular, System institutions had asserted that consistency of FCA capital requirements with those of the FBRAs would allow investors, shareholders, and others to better understand the financial strength and risk-bearing capacity of the System.⁵

Included in the provisions we proposed to adopt was a 150 percent risk-weight for HVCRE exposures. Our proposed definition of HVCRE was very similar to the definition the FBRAs had adopted at the time. System commenters expressed concern about parts of the proposed HVCRE definition and asked us not to adopt the definition. We did not adopt the HVCRE provisions when we adopted our final capital rules because we wanted to further consider and analyze HVCRE.⁶ In the preamble to the final capital rule, we said that we expected to engage in additional HVCRE rulemaking in the future.⁷

⁵ See 79 FR 52814, 52820. FCA is not required by law to follow the Basel Committee standards.

⁶ 81 FR 49719, 49736 (July 28, 2016).

⁷ See *supra* footnote 6.

Beginning in 2017, the FBRAs issued several proposed rules on HVCRE exposures, in an effort to address concerns with the original definition.⁸ On May 24, 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)⁹ was enacted, adding a new statutory definition that would have to be satisfied for an exposure to be risk-weighted as an HVCRE exposure. On December 13, 2019, the FBRAs published a final rule, which became effective on April 1, 2020, implementing the EGRRCPA requirements.¹⁰

Many of the provisions in the FBRAs' final rule address the concerns commenters raised in response to the FCA's 2014 proposed rule. Accordingly, to ensure that System institutions continue to hold enough regulatory capital to fulfill their mission as a Government-sponsored enterprise, we propose provisions that are, in general, similar to the FBRA provisions. However, we propose differences in two general areas. First, in their rule the FBRAs clarified the interpretation of certain terms generally to be consistent with their usage in other FBRA regulations or Call Report instructions; while we do not

⁸ FCA staff submitted a comment letter in response to one of the proposals that communicated our concerns with a proposed exemption for agricultural land.

⁹ Public Law 115-174, 132 Stat. 1296 (2018).

¹⁰ 84 FR 68019.

propose different interpretations of these terms, we do not propose to refer to these FBRA references, as we do not believe that is appropriate in our rules. Second, we propose some differences where appropriate to accommodate the different operational and credit considerations of the System, while continuing to maintain appropriate safety and soundness.

II. Proposed Rule

Because of the increased risk in exposures that fall within the definition of HVCRE exposures, we propose, consistent with the FBRAs, to assign a 150 percent risk-weight to those exposures, rather than the 100 percent risk-weight generally assigned to commercial real estate and other corporate exposures under FCA regulation § 628.32(f)(1). As discussed below, our proposed rule is similar to the FBRAs' rule in most respects. In general, the same loan to the same borrower - whether it is made by a commercial bank or a System institution - carries the same risk and should be assigned the same risk-weight. The proposed definition of HVCRE exposure is intended to capture only those exposures that have increased risk characteristics in the acquisition, development, or construction of real property.

As with the risk-weighting provisions of our capital rules generally, language in the proposed definition of HVCRE exposure that refers to the financing of certain types of property or projects does not itself provide authority for an institution to engage in that financing, or to have an exposure to that property or project. This is a risk-weighting regulation only.¹¹ System scope and eligibility authorities are contained in other provisions of our regulations and in the Farm Credit Act of 1971, as amended (Act).¹²

A. Scope of HVCRE Exposure Definition

As the FBRAs did, we propose to define an HVCRE exposure as “a credit facility secured by land or improved real property” that meets three criteria (and that does not meet any of the definition’s exclusions, which are discussed below).¹³ The FBRAs defined this term in a manner that is consistent with the definition of “a loan secured

¹¹ As stated in the preamble to the Tier 1/ Tier 2 Capital Framework final rule, “We remind System institutions that the presence of a particular risk weighting does not itself provide authority for a System institution to have an exposure to that asset or item.” See 81 FR 49719, 49722 (July 28, 2016).

¹² There may be overlap between HVCRE exposures and exposures to land in transition-agricultural land in the path of development. System institutions contemplating land in transition financing must review and understand FCA Bookletter BL-058 and must ensure they are in full compliance with all FCA regulations.

¹³ FCA regulation § 614.4240(q) defines “real property” as “all interests, benefits, and rights inherent in the ownership of real estate.”

by real estate" in their Call Report forms and instructions. In that definition, a loan is secured by real estate if the estimated value of the real estate collateral at origination (after deducting all senior liens held by others) is greater than 50 percent of the principal amount of the loan at origination.

We propose to adopt the same meaning of "a credit facility secured by land or improved real property" as the FBRAs have adopted. Therefore, for example, if an institution makes a loan to construct and equip a building, and the loan is secured by both the real estate and the equipment, the institution must estimate the value of the building, upon completion, and of the equipment. If the value of the building is greater than 50 percent of the principal amount of the loan at origination, the loan would be a "loan secured by real estate," and it would therefore be a "credit facility secured by land or improved real property."¹⁴ If the value of the building, upon completion, is less than 50 percent of the principal amount of the loan at origination, it would not be a "loan secured by real estate," and it would therefore not be a "credit facility

¹⁴ A determination that a loan is a "credit facility secured by land or improved real property" does not mean that the loan is necessarily an HVCRE exposure. As mentioned above, a loan also has to satisfy three criteria, and not be subject to an exclusion, to be an HVCRE exposure.

secured by land or improved real property." Accordingly, it would not be an HVCRE exposure.

Under our proposal, a "credit facility secured by land or improved real property" would not be classified as an HVCRE exposure unless it met the following three criteria. If such a credit facility did not meet all three criteria, it would not be an HVCRE exposure. First, the credit facility must primarily finance or refinance the acquisition, development, or construction of real property. Second, the purpose of the credit facility must be to provide financing to acquire, develop, or improve such real property into income-producing property. Finally, the repayment of the credit facility must depend upon the future income or sales proceeds from, or refinancing of, such real property.

The first criterion is that the credit facility must primarily finance or refinance the acquisition, development, or construction of real property. This criterion is satisfied if more than 50 percent of the proposed use of the loan funds is for the acquisition, development, or construction of real property. The criterion is not satisfied if 50 percent or less of the proposed use of the loan funds is for the acquisition, development, or construction of real property.

The second criterion is that the credit facility has the purpose of providing financing to acquire, develop, or improve the real property into income-producing property.

The third criterion is that the credit facility is dependent for repayment upon future income or sales proceeds from, or refinancing of, the real property. This criterion narrows the scope of the definition of HVCRE exposure from the definition we proposed in 2014. The definition we proposed in 2014 would have included within the scope of HVCRE exposures credit facilities for which repayment would be from the ongoing business of the borrower, as well as credit facilities that were dependent for repayment upon future income or sales proceeds.

The Farm Credit Council and several System banks and association commenters expressed concern with the breadth of this definition from the 2014 proposal.¹⁵ This proposal addresses that concern, since credit facilities that will be repaid from the borrower's ongoing business would not be classified as an HVCRE exposure. We believe that a majority of System loans are repaid from the borrower's ongoing business rather than from future income or sales proceeds, and therefore that a majority of potential System

¹⁵ See e.g., Farm Credit Council comment letter, Regulatory Capital, Implementation of Tier1/Tier2 Framework, dated February 13, 2015.

HVCRE exposures would not meet this criterion and would not be HVCRE exposures.

B. Exclusions From HVCRE Exposure Definition

Under this proposal, the exposures described in the following paragraphs would be excluded from the definition of HVCRE exposure:

1. One- to Four-Family Residential Properties

Under this proposal, as in the FBRA rule, an HVCRE exposure would not include a credit facility financing the acquisition, development, or construction of properties that are one- to four-family residential properties, provided that the dwelling (including attached components such as garages, porches, and decks) represents at least 50 percent of the total appraised value of the collateral secured by the first or subsequent lien.

Manufactured homes permanently affixed to the underlying property, when deemed to be real property under state law, would qualify for this exclusion, as would construction loans secured by single family dwelling units, duplex units, and townhouses. Condominium and cooperative construction loans would qualify for this exclusion, even if the loan is financing the construction of a building with five or more dwelling units, as long as the repayment of the loan comes from the sale of individual condominium

dwelling units or individual cooperative housing units. This exclusion would apply to all credit facilities that fall within its scope, whether rural home financing under § 613.3030 or one- to four-family residential property financing under § 613.3000(b). Similar to the reduced risk-weight assigned to residential mortgage exposures under § 628.32(g)(1), a credit facility would qualify for this exclusion only if the property securing the credit facility exhibits characteristics of residential property rather than agricultural property including, but not limited to, the requirement that the dwelling (including attached components such as garages, porches, and decks) represents at least 50 percent of the total appraised value of the collateral secured by the first or subsequent lien. If examiners determined that the property was not residential in nature, the credit facility would not qualify for this exclusion.

Loans for multifamily residential property construction (such as apartment buildings where loan repayment is dependent upon apartment rental income) would not qualify for this exclusion.¹⁶

¹⁶ See *supra* footnote 11. Additionally, certain multifamily residential property may meet the "other credit needs" financing available to eligible borrowers as authorized by sections 1.11(a)(1) and 2.4(a)(1) of the Act and referenced in § 613.3000.

Loans used solely to acquire undeveloped land would not qualify for this exclusion; the credit facility would also have to include financing for the construction of one- to four-family residential structures. Moreover, credit facilities that do not finance the construction of one- to four-family residential structures (as defined above), but instead solely finance improvements such as the laying of sewers, water pipes, and similar improvements to land, would not qualify for this exclusion. A credit facility that combines the financing of land development and the construction of one- to four-family structures would qualify for this exclusion.

2. Agricultural Land

We propose to exclude from the HVCRE definition credit facilities financing "agricultural land," as defined in FCA regulation § 619.9025, or real estate used as an integral part of an aquatic operation. Section 619.9025 defines "agricultural land" as "land improved or unimproved which is devoted to or available for the production of crops and other products such as but not limited to fruits and timber or for the raising of livestock."

This exclusion would apply only to financing for the agricultural and aquatic needs of bona fide farmers, ranchers, and producers and harvesters of aquatic products

under § 613.3000 of FCA regulations. It would not apply to loans for farm property construction and land development purposes.

With one exception, we intend our proposed agricultural land exclusion to have the same scope as the agricultural land exclusion of the FBRAs. The FBRAs' definition of agricultural land has the same meaning as "farmland" in their Call Report forms and instructions.¹⁷ They define farmland as "all land known to be used or usable for agricultural purposes, such as crop and livestock production. Farmland includes grazing or pastureland, whether tillable or not and whether wooded or not." Loans for farm property construction and land development purposes are not loans on "farmland," and therefore such loans do not fall within the agricultural land exclusion. Unlike the FBRAs, we propose to expressly include within the agricultural land exclusion real estate that is an integral part of an aquatic operation.

As the FBRAs did in their final rule, loans for land development purposes and farm property construction would not be eligible in this proposed rule for the agricultural land exclusion from the HVCRE exposure definition. Loans

¹⁷ See Federal Financial Institutions Examination Council (FFIEC) 031 and FFIEC 041 - Instructions for Preparation of Consolidated Reports of Condition and Income.

made for land development purposes would include loans made to finance property improvements, such as laying sewers or water pipes preparatory to erecting new structures. Loans made for farm property construction would include loans made to finance the on-site construction of industrial, commercial, residential, or farm buildings. For the purposes of this exclusion, "construction" includes not only construction of new structures, but also additions or alterations to existing structures and the demolition of existing structures to make way for new structures.

3. Loans on Existing Income Producing Properties That Qualify as Permanent Financings

As in the FBRA rule, we propose to exclude from the definition of HVCRE exposure credit facilities that finance the acquisition or refinance of existing income-producing real property secured by a mortgage on such property, so long as the cash flow generated by the real property covers the debt service and expenses of the property in accordance with the System institution's underwriting criteria for permanent loans. We also propose to exclude credit facilities financing improvements to existing income-producing real property secured by a mortgage on such property. Examiners may review the reasonableness of a System institution's underwriting criteria for permanent

loans through the regular examination process to ensure the real estate lending policies are consistent with safe and sound banking practices.

We believe this income-producing property exclusion would address certain concerns expressed in comment letters from FCA's 2014 proposed HVCRE definition regarding agribusiness and rural utility loans. System institutions commented they did not believe the definition of HVCRE was intended to include agribusiness or rural project financing transactions to build processing and marketing facilities or rural infrastructure. Under this proposal, these types of loans could qualify for the income-producing property exclusion if the cash flow being generated by the real property is sufficient to support the debt service and expenses of the real property in accordance with the System institution's underwriting criteria for permanent loans.

Agribusiness and rural project loans that are not secured by existing income-producing real property would not fall under this exclusion. Such loans often pose a greater credit risk than permanent loans. We believe it is appropriate to classify these loans as HVCRE exposures and impose a 150 percent risk-weight given their increased risk compared to other commercial real estate exposures (unless the loan satisfies one of the other exclusions). However,

as discussed in section 5 - Reclassification as a Non-HVCRE Exposure section below, a System institution would be allowed to reclassify these HVCRE exposures as a non-HVCRE exposure if two conditions are met:

- substantial completion of the development or construction on the real property has occurred; and
- the cash flow generated by the property covers the debt service and expenses on the property in accordance with the System institution's loan underwriting standards for permanent financings.

4. Certain Commercial Real Property Projects

As in the FBRA rule, we propose to exclude from the definition of HVCRE exposure credit facilities for certain commercial real property projects that are underwritten in a safe and sound manner in accordance with proposed loan-to-value (LTV) limits and where the borrower has contributed a specified amount of capital to the project. A commercial real property project loan generally is used to acquire, develop, construct, improve, or refinance real property, and the primary source of repayment is dependent on the sale of the real property or the revenues from third-party rent or lease payments. Commercial real property project loans do not include ordinary business loans and lines of credit in which real property is taken

as collateral. As it relates to the System, we believe this exclusion is most relevant to agribusiness (processing and marketing entities and farm-related businesses) and rural project loans.

In order to qualify for this exclusion, a credit facility that finances a commercial real property project would be required to meet four distinct criteria. First, the LTV ratio would have to be less than or equal to the applicable maximum set forth in proposed Appendix A. Second, the borrower would have to contribute capital of at least 15 percent of the real property's value to the project. Third, the 15 percent amount of contributed capital would have to be contributed prior to the institution's advance of funds (other than a nominal sum to secure the institution's lien on the real property). Fourth, the 15 percent amount of contributed capital would have to be contractually required to remain in the project until the loan could be reclassified as a non-HVCRE exposure. The proposed interpretations of terms relevant to the four criteria for this exclusion are discussed below.

a. Loan-to-Value Limits

To qualify for this exclusion from the HVCRE exposure definition, the FBRAs' rule requires that a credit facility

be underwritten in a safe and sound manner in accordance with the Supervisory Loan-to-Value Limits contained in the Interagency Guidelines for Real Estate Lending Policies.¹⁸ These Interagency Guidelines require banking institutions, for real estate loans, to establish internal LTV limits that do not exceed specified supervisory limits ranging from 65 percent for raw land to 85 percent for 1- to 4-family residential and improved property.

The FCA has not adopted these supervisory LTV limits.¹⁹ Nevertheless, FCA examination guidance from 2009 makes clear that FCA expectations are consistent with the Interagency Guidelines, including the supervisory LTV limits.²⁰ We believe exposures should satisfy these LTV limits to qualify for this exclusion to the HVCRE definition. We propose to adopt these LTV limits, for the purpose of the HVCRE definition only, in a new Appendix A to part 628.

¹⁸ See 12 CFR Part 365, Subpart A, Appendix A (FDIC); 12 CFR part 208, Appendix C (FRB); 12 CFR part 34, Appendix A (OCC).

¹⁹ Section 1.10(a) of the Act and § 614.4200(b)(1) of FCA regulations require at least an 85 percent LTV ratio for long-term real estate mortgage loans that are comprised primarily of agricultural or rural property, except for loans that have government guarantees or are covered by private mortgage insurance. Under § 614.4200(b)(1), agricultural or rural property includes agricultural land and improvements thereto, a farm-related business, a marketing or processing operation, a rural residence, or real estate used as an integral part of an aquatic operation.

²⁰ Examination Bulletin FCA 2009-2, Guidance for Evaluating the Safety and Soundness of FCS Real Estate Lending (focusing on land in transition), December 2009.

b. Contributed Capital

Under the proposal, cash, unencumbered readily marketable assets, paid development expenses out-of-pocket, and contributed real property or improvements would count as forms of capital for purposes of the 15 percent capital contribution criterion. A System institution could consider costs incurred by the project and paid by the borrower prior to the advance of funds by the System institution as out-of-pocket development expenses paid by the borrower.

The FBRAs' version of the rule provides that the value of contributed real property means the appraised value of real property contributed by the borrower as determined under the standards prescribed by the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (12 U.S.C. 3339) (FIRREA). Because FCA is not named in FIRREA as one of the Federal financial regulatory agencies covered by its real estate appraisal provisions, our proposal does not expressly require that the value must be determined under the FIRREA standards; rather, we propose to require that the value must be determined in accordance with FCA regulations at Subpart F of 12 CFR Part 614. FCA's collateral evaluation rules are generally similar, although not identical, to the FIRREA standards, however,

and therefore there should be few substantive differences in the approach to valuation.

FCA has long recognized that Congress, through the enactment of FIRREA, expressed a strong belief that all financial transactions involving real property collateral should be supported by adequate and accurate collateral evaluations. Congress also expressed the belief that such collateral evaluations should be based on standards and guidelines that are consistently applied by the financial and appraisal industries. We believe that following the collateral evaluation requirements of FIRREA and the overarching beliefs of Congress is an essential element of the safe and sound lending activities covered by the System. FCA's collateral evaluation regulations, at 12 CFR Part 614, Subpart F, are generally similar, although not identical, to the FIRREA appraisal requirements.²¹

The value of the real property that could count toward the 15 percent contributed capital requirement would be reduced by the aggregate amount of any liens on the real property securing the HVCRE exposure.

²¹ See FCA Informational Memorandum, Guidance on Addressing Personal and Intangible Property within Collateral Evaluation Policies and Procedures (§ 614.4245), August 29, 2016; FCA Examination Manual EM-22.6, Loan Portfolio Management: Collateral Risk management, dated August 20, 2014.

To ensure that tangible equity is invested in the project, funds borrowed from a third party (such as another lender, an owner or parent organization, or a related party) could count toward the capital contribution as long as the borrowed funds are not derived from, related to, or encumber any collateral that has been contributed to the project. Additionally, the recognition of any contribution of funds to a project would have to be in conformance with safe and sound lending practices and in accordance with the System institution's underwriting criteria and internal policies.

In addition, contributed property or improvements would have to be directly related to the project to be eligible to count towards the capital contribution. Real estate not developed as part of the project would not be counted toward the capital contribution.

We would interpret the term "unencumbered readily marketable assets" to mean insured deposits, financial instruments, and bullion in which the System institution has a perfected interest. For collateral to be considered "readily marketable" by a System institution, the institution's expectation would be that the financial instrument and bullion would be salable under ordinary circumstances with reasonable promptness at a fair market

value determined by quotations based on actual transactions, an auction or similarly available daily bid and ask price market.²² Readily marketable collateral should be appropriately discounted by the institution consistent with the institution's usual practices for making loans secured by such collateral. Examiners may review the reasonableness of a System institution's underwriting criteria to ensure the real estate lending policies are consistent with safe and sound banking practices.

c. Value Appraisal

Under the proposal, the 15 percent capital contribution would be required to be calculated using the real property's value. An appraised "as completed" value is preferred; however, an "as completed" value appraisal may not always be available, such as in the case of purchasing raw land without plans for development in the near term, which would typically have an "as is" value appraisal. Therefore, we propose to permit the use of an "as is" appraisal, if an "as completed" appraisal is not

²² This interpretation is consistent with the definitions of "unencumbered" and "marketable" in § 615.5134 of our regulations.

available, for purposes of the 15 percent capital contribution.²³

In addition, we would allow the use of a collateral evaluation of the real property instead of an appraisal to determine the value, for purposes of the HVCRE exposure definition, where our appraisal regulations²⁴ permit collateral evaluations to be used in lieu of appraisals.

The FBRAs' regulatory exclusion for Certain Commercial Real Property Projects specifies that an "as completed" value appraisal must be used. This is consistent with the EGRRCPA's statutory definition for the Certain Commercial Real Property Projects exclusion, which included only appraised "as completed" values. As explained by the FBRAs, the EGRRCPA required this appraised "as completed" value for their regulations. In the preamble of their final rule, the FBRAs clarified their definition allows "as is" appraisals for raw land loans and collateral evaluations for loans in amounts under certain specified

²³ We intend that the terms "as completed" and "as is," as used in the definition of HVCRE exposure, would have the same meaning as in the Interagency Appraisal and Evaluation Guidelines (December 2, 2010), issued by the OCC, the FRB, the FDIC, the Office of Thrift Supervision, and the National Credit Union Administration. Under these Guidelines, "as completed" reflects property's market value as of the time that development is expected to be completed, and "as is" means the estimate of the market value of real property in its current physical condition, use, and zoning as of the appraisal's effective date.

²⁴ See § 614.4260(c), which sets forth the types of real estate-related transactions that do not require appraisals.

thresholds in their appraisal regulations.²⁵ However, the FBRAs did not change the wording of the EGRRCPA's statutory definition in their regulations to reflect this interpretation. The EGRRCPA does not apply to System institutions, and FCA is not required to adopt the statutory definition. Accordingly, we propose to deviate from the statutory definition for Certain Commercial Real Property Projects to include "as is" appraisals and collateral evaluations to align our regulation with the FBRAs' interpretation of the definition.

d. Project

In this proposal, the 15 percent capital contribution and the appraisal or collateral evaluation would be measured in relation to a "project." Some credit facilities for the acquisition, development, or construction of real property may have multiple phases as part of a larger construction or development project. In the case of a project with multiple phases, in order for a loan financing a phase to be eligible for the contributed capital exclusion, the phase must have its own appraised value or an appropriate evaluation in order for it to be deemed a separate "project" for the purpose of the 15

²⁵ See 84 FR 68019, 68027 (December 13, 2019).

percent capital contribution calculation. We expect that each project phase being financed by a credit facility have a proper appraisal or evaluation with an associated "as completed" or "as is" value. Where appropriate and in accordance with the System institution's applicable underwriting standards, a System institution may look at a multiphase project as a complete project rather than as individual phases.

5. Reclassification as a Non-HVCRE Exposure

Under the proposal, a System institution would be allowed to reclassify an HVCRE exposure as a non-HVCRE exposure when the substantial completion of the development or construction on the real property has occurred and the cash flow generated by the property covered the debt service and expenses on the property in accordance with the institution's loan underwriting standards for permanent financings. We expect each System institution to have prudent, clear, and measurable underwriting standards, which we may review through the examination process.

6. Applicability Only to Loans Made After Effective Date

In consideration of the changes this rule would require, we propose that only loans made after the effective date of this rule would be subject to the HVCRE

risk-weighting requirements. Loans made prior to the rule's effective date could continue to be risk-weighted as if the rule had not been adopted.

After the effective date, when a System institution modifies a loan or if a project is altered in a manner that materially changes the underwriting of the credit facility (such as increases to the loan amount, changes to the size and scope of the project, or removing all or part of the 15 percent minimum capital contribution in a project), the institution must treat the loan as a new exposure and reevaluate the exposure to determine whether or not it is an HVCRE exposure.

C. Impact on Prior FCA Board Actions

FCA Bookletter BL-070 authorizes System institutions to assign a reduced risk-weight (lower than the 100 percent risk-weight generally assigned to commercial real estate exposures under FCA regulation § 628.32(f)(1)) for rural water and wastewater (RWW) facilities that satisfy criteria.²⁶ BL-070 does not permit this reduced risk-weight for exposures when a RWW facility is not fully operational due to initial construction or major renovation; instead, institutions must assign risk-weights to these "major

²⁶ BL-070: Revised Capital Treatment for Certain Water and Wastewater Exposures, November 8, 2018.

construction" exposures in accordance with Part 628 of our regulations.²⁷ If this proposed regulation is adopted, BL-070 would continue to assign risk-weights to these "major construction" exposures in accordance with Part 628 as it would be amended; in other words, an exposure to a RWW facility that is not fully operational due to initial construction or major renovation would continue to be assigned a risk-weight in accordance with Part 628 (either as an HVCRE exposure or as a corporate exposure under § 628.32(f)(1), depending on whether it satisfies the definition of HVCRE exposure or not). Under BL-070, a RWW exposure during construction or major renovation, when the facility is not fully operational, may not be assigned a reduced risk-weight. All other RWW exposures would continue to receive reduced risk-weights in accordance with BL-070.

FCA Bookletter BL-053 authorizes System institutions to assign a reduced risk-weight to certain electric cooperative exposures, including for some power plants that are in the construction phase.²⁸ This treatment is

²⁷ BL-070 does allow the reduced risk-weight for exposures during routine repair, upgrade, or maintenance projects that do not impede the facility's full operation.

²⁸ FCA BL-053: Revised Regulatory Capital Treatment for Certain Electric Cooperatives Assets, February 12, 2007.

authorized under our reservation of authority.²⁹ In the future, we may consider whether the risk-weight authorized by BL-053 remains appropriate.

III. Regulatory Flexibility Act Analysis

Pursuant to section 605(b) of the Regulatory Flexibility Act (5 U.S.C. 601 et seq.), FCA hereby certifies that the proposed rule would not have a significant economic impact on a substantial number of small entities. Each of the banks in the System, considered together with its affiliated associations, has assets and annual income in excess of the amounts that would qualify them as small entities. Therefore, System institutions are not "small entities" as defined in the Regulatory Flexibility Act.

List of Subjects

12 CFR Part 628

Accounting, Agriculture, Banks, Banking, Capital, Government securities, Investments, Rural areas.

For the reasons stated in the preamble, part 628 of chapter VI, title 12 of the Code of Federal Regulations is proposed to be amended as follows:

PART 628--CAPITAL ADEQUACY OF SYSTEM INSTITUTIONS

²⁹ See § 628.1(d)(3).

1. The authority citation for part 628 continues to read as follows:

Authority: Secs. 1.5, 1.7, 1.10, 1.11, 1.12, 2.2, 2.3, 2.4, 2.5, 2.12, 3.1, 3.7, 3.11, 3.25, 4.3, 4.3A, 4.9, 4.14B, 4.25, 5.9, 5.17, 8.0, 8.3, 8.4, 8.6, 8.8, 8.10, 8.12 of the Farm Credit Act (12 U.S.C. 2013, 2015, 2018, 2019, 2020, 2073, 2074, 2075, 2076, 2093, 2122, 2128, 2132, 2146, 2154, 2154a, 2160, 2202b, 2211, 2243, 2252, 2279aa, 2279aa-3, 2279aa-4, 2279aa-6, 2279aa-8, 2279aa-10, 2279aa-12); sec. 301(a), Pub. L. 100-233, 101 Stat. 1568, 1608 ((12 U.S.C. 2154 note); sec. 939A, Pub. L. 111-203, 124 Stat. 1326, 1887 (15 U.S.C. 78o-7 note).

2. Amend § 628.2 by revising (6) in the definition of "corporate exposure" to replace "[Reserved]" with "A high volatility commercial real estate (HVCRE) exposure".

3. Amend § 628.2 by adding a definition in alphabetical order, as follows:

High volatility commercial real estate (HVCRE) exposure means:

(1) a credit facility secured by land or improved real property that, prior to being reclassified by the

System institution as a non-HVCRE exposure pursuant to paragraph (6) of this definition:

(i) Primarily finances, has financed, or refinances the acquisition, development, or construction of real property;

(ii) Has the purpose of providing financing to acquire, develop, or improve such real property into income producing real property; and

(iii) Is dependent upon future income or sales proceeds from, or refinancing of, such real property for the repayment of such credit facility.

(2) An HVCRE exposure does not include a credit facility financing:

(i) The acquisition, development, or construction of properties that are:

(A) One- to four-family residential properties, provided that the dwelling (including attached components such as garages, porches, and decks) represents at least 50 percent of the total appraised value of the collateral secured by the first or subsequent lien. Credit facilities that do not finance the construction of one- to four-family residential structures, but instead solely finance improvements such as the laying of sewers, water pipes, and

similar improvements to land, do not qualify for the one-to four-family residential properties exclusion;

(B) [Reserved]

(C) Agricultural land, as defined in § 619.9025, or real estate used as an integral part of an aquatic operation. This provision applies only to financing for the agricultural and aquatic needs of bona fide farmers, ranchers, and producers and harvesters of aquatic products under § 613.3000 of FCA regulations. This provision does not apply to loans for farm property construction and land development purposes;

(ii) The acquisition or refinance of existing income-producing real property secured by a mortgage on such property, if the cash flow being generated by the real property is sufficient to support the debt service and expenses of the real property, in accordance with the System institution's applicable loan underwriting criteria for permanent financings;

(iii) Improvements to existing income producing improved real property secured by a mortgage on such property, if the cash flow being generated by the real property is sufficient to support the debt service and expenses of the real property, in accordance with the

System institution's applicable loan underwriting criteria for permanent financings; or

(iv) Commercial real property projects in which:

(A) The loan-to-value ratio is less than or equal to the applicable loan-to-value limit set forth in Appendix A to this part;

(B) The borrower has contributed capital of at least 15 percent of the real property's appraised, "as completed" value to the project. The use of an "as is" appraisal is allowed in instances where an "as completed" value appraisal is not available. The use of an evaluation of the real property instead of an appraisal to determine the "as completed" appraised value is allowed if § 614.4260(c) of this title permits evaluations to be used in lieu of appraisals. The contribution may be in the form of:

(1) Cash;

(2) Unencumbered readily marketable assets;

(3) Paid development expenses out-of-pocket;

or

(4) Contributed real property or improvements; and

(C) The borrower contributed the amount of capital required by paragraph (2) (iv) (B) of this definition before the System institution advances funds (other than the

advance of a nominal sum made in order to secure the System institution's lien against the real property) under the credit facility, and such minimum amount of capital contributed by the borrower is contractually required to remain in the project until the HVCRE exposure has been reclassified by the System institution as a non-HVCRE exposure under paragraph (6) of this definition;

(3) An HVCRE exposure does not include any loan made prior to the effective date of this rule;

(4) An HVCRE exposure does not include a credit facility reclassified as a non-HVCRE exposure under paragraph (6) of this definition.

(5) Value of contributed real property: For the purposes of this HVCRE exposure definition, the value of any real property contributed by a borrower as a capital contribution is the appraised value of the property as determined under standards prescribed in accordance with FCA regulations at subpart F of part 614, in connection with the extension of the credit facility or loan to such borrower.

(6) Reclassification as a non-HVCRE exposure: For purposes of this HVCRE exposure definition and with respect to a credit facility and a System institution, a System

institution may reclassify an HVCRE exposure as a non-HVCRE exposure upon:

- (i) The substantial completion of the development or construction of the real property being financed by the credit facility; and
- (ii) Cash flow being generated by the real property being sufficient to support the debt service and expenses of the real property, in accordance with the System institution's applicable loan underwriting criteria for permanent financings.

(7) [Reserved].

4. Amend § 628.32(j) by replacing “[Reserved]” with “*High volatility commercial real estate (HVCRE) exposures*.” A System institution must assign a 150-percent risk weight to an HVCRE exposure.”

5. Amend Table 3 to § 628.63 by replacing the “[Reserved]” in (b)(8) with “HVCRE exposures”.

6. Add Appendix A to Part 628 to read as follows:

Appendix A to Part 628—Loan-to-Value Limits for High Volatility Commercial Real Estate Exposures

Table A sets forth the loan-to-value limits specified in paragraph (2)(iv)(A) of the definition of high volatility commercial real estate exposure in § 628.2.

Table A: Loan-to-Value Limits for High Volatility

Commercial Real Estate Exposures

Loan Category	Loan-to-value limit (percent)
Raw Land	65
Land development	75
Construction:	
Commercial, multifamily, ¹ and other non-residential	80
1- to 4-family residential	85
Improved property	85
Owner-occupied 1- to 4-family and home equity	85 ²

¹ Multifamily construction includes condominiums and cooperatives.

² If a loan is covered by private mortgage insurance, the loan-to-value (LTV) may exceed 85 percent to the extent that the loan amount in excess of 85 percent is covered by the insurance. If a loan is guaranteed by Federal, State, or other governmental agencies, the LTV limit is 97 percent.

The loan-to-value limits should be applied to the underlying property that collateralizes the loan. For loans that fund multiple phases of the same real estate project (e.g., a loan for both land development and construction of an office building), the appropriate loan-to-value limit is the limit applicable to the final phase of the project funded by the loan; however, loan disbursements should not exceed actual development or construction outlays. In situations where a loan is fully cross-collateralized by two or more properties or is

secured by a collateral pool of two or more properties, the appropriate maximum loan amount under loan-to-value limits is the sum of the value of each property, less senior liens, multiplied by the appropriate loan-to-value limit for each property. To ensure that collateral margins remain within the limits, System institutions should redetermine conformity whenever collateral substitutions are made to the collateral pool.

* * * * *

Date: _____

Dale L. Aultman,
Secretary,
Farm Credit Administration Board.