115TH CONGRESS 1st Session } HOUSE OF REPRESENTATIVES { REPORT 115–392

CLARIFYING COMMERCIAL REAL ESTATE LOANS

NOVEMBER 6, 2017.—Committed to the Committee of the Whole House on the State of the Union and ordered to be printed

Mr. HENSARLING, from the Committee on Financial Services, submitted the following

R E P O R T

[To accompany H.R. 2148]

[Including cost estimate of the Congressional Budget Office]

The Committee on Financial Services, to whom was referred the bill (H.R. 2148) to amend the Federal Deposit Insurance Act to clarify capital requirements for certain acquisition, development, or construction loans, having considered the same, report favorably thereon with amendments and recommend that the bill as amended do pass.

The amendments (stated in terms of the page and line numbers of the introduced bill) are as follows:

Page 2, line 7, strike "(as defined" and all that follows through "this section)" and insert the following: "(as such term is defined under section 324.2 of title 12, Code of Federal Regulations, as of October 11, 2017, or if a successor regulation is in effect as of the date of the enactment of this section, such term or any successor term contained in such successor regulation)".

Page 2, line 19, strike "finances or has financed" and insert "primarily finances, has financed, or refinances".

Page 3, line 17, after "property" insert ", if the cash flow being generated by the real property is sufficient to support the debt service and expenses of the real property, as determined by the depository institution, in accordance with the institution's applicable loan underwriting criteria for permanent financings".

PURPOSE AND SUMMARY

Introduced by Congressman Robert Pittenger (NC–09) on April 26, 2017, H.R. 2148, the "Clarifying Real Estate Loans", amends

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the Federal Deposit Insurance Act" would clarify capital requirements for certain acquisition, development, or construction (ADC) loans classified as high-volatility commercial real estate (HVCRE), including which types of loans should and should not be classified as HVCRE loans.

BACKGROUND AND NEED FOR LEGISLATION

In response to the 2008 financial crisis, the Basel Committee on Banking Supervision (Basel Committee) agreed to modify internationally negotiated bank regulatory standards known as the Basel Accords, to increase bank capital requirements. On July 9, 2013, the federal banking regulators, including the Federal Reserve, Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC), issued a final rule to implement most of the Basel III recommendations, including modifications to capital requirements.

The Basel III final rule applies to all banks and bank holding companies domiciled in the United States, with some exceptions, and went into effect on January 1, 2014, for the for the U.S. systemically important banking organizations, and on January 1, 2015, for all other banks.

Basel III imposes new rules for high volatility commercial real estate (HVCRE), which the regulations characterize as loans that finance the acquisition, development or construction (ADC) of real property. Loans that finance the acquisition, development and construction of one to four family residential properties, projects that qualify as community development investment and loans to businesses or farms with gross revenue exceeding $1,000,000 are exempt from the HVCRE classification.

All loans that meet the definition of HVCRE are reported separately from other commercial real estate (CRE) loans and are also assigned a risk weighting of 150% for risk-based capital purposes. Prior to January 1, 2015, a CRE loan would have typically been assigned a risk weighting of 100%. In addition HVCRE loans are to be reported separately from other CRE. Prior to the HVCRE rule banks could hold 8% of the value of the loans to alleviate risk, but under the rule are now required to hold 12%.

In September 2017, the OCC, FDIC and Federal Reserve proposed a rule that attempted simplify the regulatory capital calculations for HVCRE. The proposal would change the current definition of HVCRE and replace it with a new definition related to high volatility acquisition, development, or construction loans (HVADC).

The Committee adopted an amendment offered by Rep. Carolyn Maloney to simplify the capital rules to define what constitutes a HVCRE ADC loan, and broadens the types of equity that can be used to meet its capital requirements. This clarification will reduce the cost to finance these loans, and promote economically responsible CRE lending.

In a letter of support for H.R. 2148 dated October 10, 2017, the Real Estate Roundtable wrote:

> [H.R. 2148] helps address concerns regarding the Basel III HVCRE rules by amending the Federal Deposit Insurance Act to clarify the certain requirements for certain acquisition, development, or construction loans (ADC).

The lack of clarity in the Rule and subsequent HVCRE Frequently Asked Questions (FAQs) published by the agencies on March 31, 2015 has resulted in a wide disparity in how banks classify their ADC portfolios as HVCRE or non-HVCRE. This result has negatively impacted ADC loan decisions for some banks, leaving some borrowers with fewer and potentially more costly sources of ADC loan capital. The legislation would clarify and modify the HVCRE rules to ensure that they are appropriately calibrated and do not impede credit capacity or economic activity, while still promoting economically responsible commercial real estate lending.

HEARINGS

The Committee on Financial Services, Subcommittee on Financial Institutions and Consumer Credit held a hearing examining matters relating to H.R. 2148 on July 12, 2017.

COMMITTEE CONSIDERATION

The Committee on Financial Services met in open session on October 11, 2017 and ordered H.R. 2148 to be reported favorably to the House as amended by a recorded vote of 59 yeas to 1 nays (Record vote no. FC–89), a quorum being present. Before the motion to report was offered, the Committee adopted an amendment offered by Ms. Maloney by voice vote.

COMMITTEE VOTES

Clause 3(b) of rule XIII of the Rules of the House of Representatives requires the Committee to list the record votes on the motion to report legislation and amendments thereto. The sole recorded vote was on a motion by Chairman Hensarling to report the bill favorably to the House as amended. The motion was agreed to by a recorded vote of 59 yeas to 1 nays (Record vote no. FC–89), a quorum being present.

Record vote no. FC-89

Representative	Yea	Nay	Present	Representative	Yea	Nay	Present
Mr. Hensarling	X			Ms. Maxine Waters (CA)	X		
Mr. McHenry	X			Mrs. Carolyn B. Maloney (NY)	X		
Mr. King	X			Ms. Velázquez	X		
Mr. Royce (CA)	X			Mr. Sherman	X		
Mr. Lucas	X			Mr. Meeks	X		
Mr. Pearce	X			Mr. Capuano	X		
Mr. Posey	X			Mr. Clay	X		
Mr. Luetkemeyer	X			Mr. Lynch		X	
Mr. Huizenga	X			Mr. David Scott (GA)	X		
Mr. Duffy	X			Mr. Al Green (TX)	X		
Mr. Stivers	X			Mr. Cleaver	X		
Mr. Hultgren	X			Ms. Moore	X		
Mr. Ross	X			Mr. Ellison	X		
Mr. Pittenger	X			Mr. Perlmutter	X		
Mrs. Wagner	X			Mr. Himes	X		
Mr. Barr	X			Mr. Foster	X		
Mr. Rothfus	X			Mr. Kildee	X		
Mr. Messer	X			Mr. Delaney	X		
Mr. Tipton	X			Ms. Sinema	X		
Mr. Williams	X			Mrs. Beatty	X		
Mr. Poliquin	X			Mr. Heck	X		
Mrs. Love	X			Mr. Vargas	X		
Mr. Hill	X			Mr. Gottheimer	X		
Mr. Emmer	X			Mr. Gonzalez (TX)	X		
Mr. Zeldin	X			Mr. Crist	X		
Mr. Trott	X			Mr. Kihuen	X		
Mr. Loudermilk	X						
Mr. Mooney (WV)	X						
Mr. MacArthur	X						
Mr. Davidson	X						
Mr. Budd	X						
Mr. Kustoff (TN)	X						
Ms. Tenney	X						
Mr. Hollingsworth	X						

Committee Oversight Findings

Pursuant to clause 3(c)(1) of rule XIII of the Rules of the House of Representatives, the findings and recommendations of the Committee based on oversight activities under clause 2(b)(1) of rule X of the Rules of the House of Representatives, are incorporated in the descriptive portions of this report.

Performance Goals and Objectives

Pursuant to clause 3(c)(4) of rule XIII of the Rules of the House of Representatives, the Committee states that H.R. 2148 will ease FDIC capital requirements by providing for the easement of High Volatility Commercial Real Estate designations that were created by Basel III requirements.

New Budget Authority, Entitlement Authority, and Tax Expenditures

In compliance with clause 3(c)(2) of rule XIII of the Rules of the House of Representatives, the Committee adopts as its own the estimate of new budget authority, entitlement authority, or tax expenditures or revenues contained in the cost estimate prepared by the Director of the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974.

Congressional Budget Office Estimates

Pursuant to clause 3(c)(3) of rule XIII of the Rules of the House of Representatives, the following is the cost estimate provided by the Congressional Budget Office pursuant to section 402 of the Congressional Budget Act of 1974:

U.S. Congress,
Congressional Budget Office,
Washington, DC, November 6, 2017.

Hon. Jeb Hensarling,
Chairman, Committee on Financial Services,
House of Representatives, Washington, DC.

Dear Mr. Chairman: The Congressional Budget Office has prepared the enclosed cost estimate for H.R. 2148, the Clarifying Commercial Real Estate Loans.

If you wish further details on this estimate, we will be pleased to provide them. The CBO staff contact is Sarah Puro.

Sincerely,

Keith Hall,
Director.

Enclosure.

H.R. 2148—Clarifying Commercial Real Estate Loans

H.R. 2148 would revise the current requirement that banks hold more capital for high-volatility commercial real estate (HVCRE) loans. HVCRE loans are a subset of acquisition, development, and construction (ADC) loans, which banks make to borrowers who wish to purchase and improve real property. Under the bill, regulators could permit banks to hold between 8 percent and 10.4 percent of capital for certain new HVCRE loans instead of the 10.4

percent proposed by bank regulators. The effect of H.R. 2148 would be to exempt loans from the increased capital requirements if borrowers contribute resources, land, or property that is worth at least 15 percent of the appraised value of the financed property. Those loans are called contributed capital loans.

The bill would apply only to new HVCRE loans. Banks do not currently report the value of contributed capital loans to regulators, so the value of new loans subject to the exemption is uncertain. In addition, depending on future regulations, banks might change the way they structure those loans, or, if the capital requirements were perceived as too onerous, banks might stop making such loans altogether.

On the basis of publicly available data from bank balance sheets, CBO estimates that banks currently hold about $315 billion in ADC loans, which amounts to about 2 percent of their total assets. In CBO's baseline projections, bank assets grow by roughly 5 percent each year over the 2018–2027 period. CBO expects that the value of ADC loans will grow in line with other assets and thus ADC loans would constitute roughly 2 percent of those additional assets.

Banks now must hold 8 percent of the value of ADC loans that are not determined to be HVCRE loans in capital reserves. Under regulations proposed in September, banks would need to increase the reserve amount to 10.4 percent for loans that were subject to the additional-capital requirement.[1] CBO estimates that about one-quarter of ADC loans are exempt from the additional-capital requirement because they finance construction of properties that include between one and four family residences. Because it is unknown whether that new rule will become final under current law, CBO has assigned a 50 percent chance that the capital reserve requirement will increase to 10.4 percent for those loans for the purpose of estimating future reserve requirements in its baseline.

CBO estimates that, under the bill, banks' total capital reserves would be diminished by less than one one-thousandth of a percent (0.001 percent) relative to their reserves under current law.[2] Changes in the amount of capital that a bank holds can affect its probability of failure, which in turn can impose costs on the Deposit Insurance Fund (administered by the Federal Deposit Insurance Corporation). Those costs are recorded in the budget as increases in direct spending. However, because that estimated change is so small, CBO expects that there would be a very small probability of an increase in bank defaults resulting from the bill. Thus, CBO estimates that enacting H.R. 2148 would not have a significant effect on direct spending over the 2018–2027 period.

Because enacting the bill would affect direct spending, pay-as-you-go procedures apply. Enacting the bill would not affect revenues.

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[1] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, "Agencies Propose Simplifying Regulatory Capital Rules," NR 2017–111 (press release, September 27, 2017), *https://go.usa.gov/xnT6j*.

[2] The estimated change in capital reserve requirements equals: 2 percent of new bank assets (for ADC loans) × 75.0 percent (to exclude construction loans that include between one and four family residences) × 2.4 percent (the decrease in capital required under the bill relative to the proposed rule) × 50.0 percent (because of the uncertainty about the proposed increase in the reserve requirement under current law), divided by 100 percent of the banks' total capital reserves.

CBO estimates that enacting H.R. 2148 would not significantly increase net direct spending or on-budget deficits in any of the four consecutive 10-year periods beginning in 2028.

H.R. 2148 contains no intergovernmental mandates as defined in the Unfunded Mandates Reform Act (UMRA).

H.R. 2148 could impose a private-sector mandate, as defined in UMRA. A mandate would not occur if regulations proposed by the Federal Reserve in September were to become final because this bill would narrow the population of banks affected by capitalization requirements. If, however, the regulations are not finalized, the bill would broaden the population of banks affected by requirements relative to current law. In that case, some banks would need to meet higher capital requirements. Because of uncertainty about how those banks would respond and the lack of data about the value of new loans, CBO is unable to determine whether the costs of a private-sector mandate under such scenario would exceed the threshold established in UMRA ($156 million in 2017, adjusted annually for inflation).

The CBO staff contacts for this estimate are Sarah Puro (for federal costs) and Rachel Austin (for mandates). The estimate was approved by H. Samuel Papenfuss, Deputy Assistant Director for Budget Analysis.

Federal Mandates Statement

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995.

The Committee has determined that the bill does not contain Federal mandates on the private sector. The Committee has determined that the bill does not impose a Federal intergovernmental mandate on State, local, or tribal governments.

Advisory Committee Statement

No advisory committees within the meaning of section 5(b) of the Federal Advisory Committee Act were created by this legislation.

Applicability to Legislative Branch

The Committee finds that the legislation does not relate to the terms and conditions of employment or access to public services or accommodations within the meaning of the section 102(b)(3) of the Congressional Accountability Act.

Earmark Identification

With respect to clause 9 of rule XXI of the Rules of the House of Representatives, the Committee has carefully reviewed the provisions of the bill and states that the provisions of the bill do not contain any congressional earmarks, limited tax benefits, or limited tariff benefits within the meaning of the rule.

Duplication of Federal Programs

In compliance with clause 3(c)(5) of rule XIII of the Rules of the House of Representatives, the Committee states that no provision of the bill establishes or reauthorizes: (1) a program of the Federal Government known to be duplicative of another Federal program;

(2) a program included in any report from the Government Accountability Office to Congress pursuant to section 21 of Public Law 111–139; or (3) a program related to a program identified in the most recent Catalog of Federal Domestic Assistance, published pursuant to the Federal Program Information Act (Pub. L. No. 95–220, as amended by Pub. L. No. 98–169).

DISCLOSURE OF DIRECTED RULEMAKING

Pursuant to section 3(i) of H. Res. 5, (115th Congress), the following statement is made concerning directed rulemakings: The Committee estimates that the bill requires no directed rulemakings within the meaning of such section.

SECTION-BY-SECTION ANALYSIS OF THE LEGISLATION

Section 1. Short title

This Section cites H.R. 2148 as "Clarifying Commercial Real Estate Loans."

Section 2. Capital requirements for certain acquisition, development or construction loans

This Section amends the Federal Deposit Insurance Act to prescribe capital requirements as related to certain acquisition, development, or construction loans. This Section requires Federal Reserve, Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) only subject a depository institution to higher capital standards with respect to an HVCRE exposure (as defined under section 324.2 of title 12, Code of Federal Regulations, as in effect on October 11, 2017, and any successive regulations after the date of the enactment of this section) if such exposure is an HVCRE ADC loan.

This Section also clarifies the definition of an HVCRE ADC loan to include secured real property loans that primarily finances, has financed, or refinances ADC, and where repayment is dependent upon future income and sale proceeds of such property.

This Section adds an exemption from HVCRE classification for loans that finance one to four family residential properties; projects that qualify as community development investment and loans to businesses; agricultural loans; refinancing or acquiring an existing, income producing property so long as it is producing sufficient income to cover debt service payments; CRE projects in which the loan-to-value ratio is less than or equal to the applicable maximum amount, the borrower has contributed capital in the form of cash or unencumbered readily marketable assets of at least 15 percent of the project's as completed value, and the borrower has contributed the amount of capital required above before the lender advances funds, and such 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 (concluding only when the loan is converted to permanent financing, is sold or is paid in full); and loans made prior to Jan. 1, 2015.

The appraised value of any real property, including land, may count towards the 15 percent contributed capital requirement, as long as it meets statutory requirements prescribed pursuant to sec-

tion 1110 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.

An ADC loan may be deemed a non-HVCRE ADC loan once the project is completed and cash flow being generated by the real property is sufficient to support the debt services and operating expenses of the real property, and the project meets underwriting requirements for permanent financing.

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (existing law proposed to be omitted is enclosed in black brackets, new matter is printed in italic, and existing law in which no change is proposed is shown in roman):

CHANGES IN EXISTING LAW MADE BY THE BILL, AS REPORTED

In compliance with clause 3(e) of rule XIII of the Rules of the House of Representatives, changes in existing law made by the bill, as reported, are shown as follows (new matter is printed in italic and existing law in which no change is proposed is shown in roman):

FEDERAL DEPOSIT INSURANCE ACT

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SEC. 51. CAPITAL REQUIREMENTS FOR CERTAIN ACQUISITION, DEVELOPMENT, OR CONSTRUCTION LOANS.

(a) IN GENERAL.—The appropriate Federal banking agencies may only subject a depository institution to higher capital standards with respect to a high volatility commercial real estate (HVCRE) exposure (as such term is defined under section 324.2 of title 12, Code of Federal Regulations, as of October 11, 2017, or if a successor regulation is in effect as of the date of the enactment of this section, such term or any successor term contained in such successor regulation) if such exposure is an HVCRE ADC loan.

(b) HVCRE ADC LOAN DEFINED.—For purposes of this section and with respect to a depository institution, the term "HVCRE ADC loan"—

(1) means a credit facility secured by land or improved real property that, prior to being reclassified by the depository institution as a Non-HVCRE ADC loan pursuant to subsection (d)—

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

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

(C) is dependent upon future income or sales proceeds from, or refinancing of, such real property for the repayment of such credit facility;

(2) does not include a credit facility financing—

(A) the acquisition, development, or construction of properties that are—

(i) one- to four-family residential properties;

(ii) real property that would qualify as an investment in community development; or

(iii) agricultural land;

(B) 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, as determined by the depository institution, in accordance with the institution's applicable loan underwriting criteria for permanent financings;

(C) 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, as determined by the depository institution, in accordance with the institution's applicable loan underwriting criteria for permanent financings; or

(D) commercial real property projects in which—

(i) the loan-to-value ratio is less than or equal to the applicable maximum supervisory loan-to-value ratio as determined by the appropriate Federal banking agency; and

(ii) the borrower has contributed capital of at least 15 percent of the real property's appraised, "as completed" value to the project in the form of—

(I) cash;

(II) unencumbered readily marketable assets;

(III) paid development expenses out-of-pocket; or

(IV) contributed real property or improvements; and

(iii) the borrower contributed the minimum amount of capital described under clause (ii) before the depository institution advances funds under the credit facility, and such minimum amount of capital contributed by the borrower is contractually required to remain in the project until the credit facility has been reclassified by the depository institution as a Non-HVCRE ADC loan under subsection (d);

(3) does not include any loan made prior to January 1, 2015; and

(4) does not include a credit facility reclassified as a Non-HVCRE ADC loan under subsection (d).

(c) VALUE OF CONTRIBUTED REAL PROPERTY.—For purposes of this section, the value of any real property contributed by a borrower as a capital contribution shall be the appraised value of the property as determined under standards prescribed pursuant to section 1110 of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (12 U.S.C. 3339), in connection with the extension of the credit facility or loan to such borrower.

(d) RECLASSIFICATION AS A NON-HVCRE ADC LOAN.—For purposes of this section and with respect to a credit facility and a depository institution, upon—

(1) the completion of the development or construction of the real property being financed by the credit facility; and

(2) cash flow being generated by the real property being sufficient to support the debt service and expenses of the real property,

in either case to the satisfaction of the depository institution, in accordance with the institution's applicable loan underwriting criteria for permanent financings, the credit facility may be reclassified by the depository institution as a Non-HVCRE ADC loan.

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