

October 3, 2018

## Bank Capital Requirements

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### Federal Banking Agencies Issue Proposed Rule Revising the Regulatory Capital Definition of High Volatility Commercial Real Estate Exposures

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#### SUMMARY

On September 18, the Federal Reserve, the OCC, and the FDIC issued a proposed rule<sup>1</sup> that would revise the definition of High Volatility Commercial Real Estate (“*HVCRE*”) exposure under the capital rules of each agency to conform to the statutory definition in Section 214 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (“*EGRRCPA*”) enacted in May 2018.<sup>2</sup> Specifically, the proposal would conform the agencies’ “*HVCRE* exposure” definitions to the *EGRRCPA* definition of “high volatility commercial real estate acquisition, development or construction (“*HVCRE ADC*”) loans.”

*EGRRCPA* defines *HVCRE ADC* loans as credit facilities that (i) are secured by real property, (ii) primarily finance, have financed, or refinance the acquisition, development, or construction (“*ADC*”) of real property, (iii) have the purpose of providing financing to acquire, develop, or improve such real property so that it will become income-producing property, and (iv) are dependent on future income or sales proceeds from, or the refinancing of, such real property for repayment. Consistent with *EGRRCPA* Section 214, the agencies’ proposal excludes certain *ADC* loans from the revised definition, including (i) loans financing the *ADC* of properties that are one- to four-family residential properties, real property that would qualify as a community development investment, or agricultural land, (ii) loans financing existing income-producing real property with sufficient cash flow to support the debt service and expense of the property, (iii) loans financing certain commercial real property projects with borrower-contributed capital, (iv) loans that have been permissibly reclassified as non-*HVCRE ADC* loans following substantial completion of the development or construction on the real property, and (v) loans originated prior to January 1, 2015.

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To facilitate the consistent application of the revised HVCRE exposure definition, the agencies also invite comment on proposed interpretations of certain terms from EGRRCPA Section 214 that are used in the revised HVCRE definition but are not currently defined in the agencies' capital rules. These proposed interpretations of EGRRCPA terms are generally consistent either with similar terms used in other agency regulations or with the instructions to the Consolidated Reports of Condition and Income (the "*Call Report*") filed by depository institutions. Notably, the agencies invite comment "on the potential advantages and disadvantages of incorporating the agencies' interpretations of the terms used in the revised HVCRE exposure definition into the rule text or in another published format."<sup>3</sup> The proposed changes would apply to both standardized and advanced approaches calculations.<sup>4</sup>

Comments on the proposed rule are due November 27, 2018.

### BACKGROUND ON THE PROPOSAL

In October 2017, the Federal Reserve, the OCC, and the FDIC issued a proposed rule intended to simplify compliance with certain aspects of the agencies' capital rules, which included revisions to the treatment of HVCRE exposures (the "*2017 Simplifications Proposal*").<sup>5</sup> The agencies' capital rules include a complex definition of HVCRE exposures, defined as any credit facility that, prior to conversion to permanent financing, finances or has financed the ADC of real property, unless the facility finances one-to four-family residential properties, certain agricultural or community development investments, or commercial real estate projects where the borrower meets certain contributed capital requirements and other prudential criteria. The 2017 Simplifications Proposal sought to replace this HVCRE definition with one intended to be more straightforward for purposes of calculating risk-weighted assets for all banking organizations under the agencies' standardized approach capital framework. The definition included in the 2017 Simplifications Proposal would have (i) included credit facilities that *primarily* finance or refinance ADC activities, and (ii) eliminated the exemption for loans that finance projects with substantial borrower contributed capital. The 2017 Simplifications Proposal also would have applied a lower risk weight of 130 percent to HVCRE exposures in place of the then-applicable 150 percent risk weight under the standardized approach, reflecting the agencies' expectation that a broader scope of exposures would be captured by the definition in the 2017 Simplifications Proposal.

Before the 2017 Simplifications Proposal was finalized, on May 24, 2018, Congress enacted EGRRCPA.<sup>6</sup> EGRRCPA Section 214 restricts the agencies' ability to assign heightened risk weights to HVCRE exposures, with these changes effective immediately upon enactment.<sup>7</sup> As noted above, Section 214 provides that the agencies may only require a depository institution to assign a heightened risk weight (*i.e.*, a risk weight greater than 100 percent) to an HVCRE exposure if the exposure is an "HVCRE ADC Loan," as defined in Section 214 of EGRRCPA. Accordingly, to provide interim guidance on this revised definition, in July 2018 the agencies released an "Interagency statement regarding the impact of the EGRRCPA," which provided in part that "a depository institution is permitted to risk weight at 150 percent only those commercial real estate exposures it believes meet the statutory definition of HVCRE ADC

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Loan.” Because, by its terms, Section 214 only applies to depository institutions, the July 2018 guidance further provided that the Federal Reserve would not take action to require a bank holding company, savings and loan holding company, or the intermediate holding company of a foreign banking organization to apply the existing definition for HVCRE exposures so long as it reports in a manner consistent with its subsidiary depository institution(s).<sup>8</sup>

The proposal will revise the definition under the agencies’ regulations to conform to the EGRRCPA Section 214 definition.

### KEY ELEMENTS OF THE PROPOSAL

- **Revised definition and scope of HVCRE exposure.** Section 214 of the EGRRCPA defines an HVCRE ADC Loan, with respect to a depository institution, as 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, (i) primarily finances,<sup>9</sup> has financed, or refinances the ADC 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.<sup>10</sup> The proposal will incorporate each of these three criteria into the revised HVCRE exposure definition in the agencies’ capital rules (for determining risk-weighted assets under both the standardized and advanced approaches).<sup>11</sup>
  - Although Section 214 of EGRRCPA applies only to depository institutions, the revised definition would apply to all Federal Reserve-regulated institutions that are subject to the Federal Reserve’s capital rules, including bank holding companies, savings and loan holding companies, and intermediate holding companies of foreign banking organizations, in order to avoid the burden of complying with separate definitions for HVCRE exposures at different levels of an organization.
  - Once substantial completion of development and construction has occurred and the property generates a cash flow that covers debt service and expenses, the proposal provides that a banking organization may reclassify an HVCRE exposure as a non-HVCRE exposure, so long as this classification accords with the banking organization’s loan underwriting standards for permanent financings.
- **No changes to assigned risk-weights.** As discussed above, the 2017 Simplifications Proposal included both a broader definition of HVCRE exposures and a lower 130 percent risk weight for those exposures. Although the proposal would introduce a definition of HVCRE exposure with broader exclusions and, correspondingly, a narrower scope, the proposal does not include revised risk weights. Rather, the agencies affirm that “[o]ther than the definition change, no change to the calculation of risk-weighted assets is being proposed. Loans that meet the revised definition of an HVCRE exposure would continue to receive a 150 percent risk weight” under the standardized approach.<sup>12</sup>
- **Exclusions from the revised definition of HVCRE exposure.** The proposal provides that a loan that meets the revised definition of HVCRE exposure may still be excluded from this categorization, and not subject to a heightened risk weight, if it meets one of the following statutory exclusions.<sup>13</sup>
  - **Loans originated prior to January 1, 2015.** Unless a lower risk weight would apply, the proposal provides that banking organizations may apply a 100 percent risk weight to a loan originated prior to January 1, 2015 (the date that the heightened risk weight for HVCRE exposures became effective for all banking organizations) that would otherwise qualify under the revised definition of HVCRE exposure (provided that the loan is not past due 90 days or more on accrual). There is not a corresponding exclusion in the current definition of HVCRE exposure.
  - **One- to four-family residential properties.** Consistent with the current definition of HVCRE exposure, credit facilities financing the ADC of one- to four-family residential properties would be

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exempt from the revised HVCRE exposure definition (while loans to finance or refinance the ADC of apartments and condominiums generally would be considered HVCRE exposures unless another exception applies). The agencies note that loans used solely to acquire undeveloped land are outside the scope of this exemption, regardless of how the land is zoned.

- **Community Development Investment.** Consistent with the current definition of HVCRE exposure, loans financing the ADC of real property that would qualify as a “community development investment” would be exempt from the revised HVCRE definition where the project’s primary purpose is “community development,” as each of those terms is defined in the agencies’ Community Reinvestment Act regulations (*i.e.*, affordable housing or community services targeted to low- and moderate-income individuals).
- **Agricultural land.** The proposal would exempt loans financing the ADC of agricultural land from the revised definition of HVCRE exposures, which includes all land known to be used or usable for agricultural purposes (consistent with the Call Report definition of “farmland”). Compared to the current exception relating to agricultural land, the proposal would remove the requirements that the valuation of the land be based on its value for agricultural purposes and not take into consideration potential non-agricultural uses.
- **Permanent loans.** So long as the cash flow generated by an existing income-producing real property covers the debt service and expenses of the property in accordance with a depository institution’s underwriting criteria for permanent loans, the revised HVCRE exposure definition would exclude ADC loans on such property. The existing definition of HVCRE exposure similarly excludes credit facilities that convert to permanent financing, but the proposed definition provides greater detail as to when a credit facility may be reclassified as permanent financing.
- **Certain commercial real property projects.** A credit facility that finances a commercial real property project would be exempt from the revised HVCRE definition if it meets four distinct criteria: (i) the loan-to-value ratio is less than or equal to the supervisory maximum; (ii) the borrower has contributed at least 15 percent of the “as completed” value of the project; (iii) the borrower’s 15 percent contribution is made prior to the institution’s advance of funds; and (iv) the borrower’s capital contribution is contractually required to remain in place until the loan can be reclassified as a non-HVCRE exposure. Compared to the current exception for projects with borrower contributed capital, the proposed exception contains the following notable features broadening its scope:
  - The proposal would require only the contributed capital to remain in the project until the credit facility converts to permanent financing, in contrast to the current definition, which requires that both the contributed capital and any internally generated capital remain in the project for the life of the project (*i.e.*, until the credit facility converts to permanent financing, or is sold or paid in full).
  - The proposal would permit contributed capital to be in the form of contributed real property or improvements, in addition to the forms currently permitted (*i.e.*, cash, unencumbered readily marketable assets, and paid development expenses out of pocket).
- **Interpretation of certain undefined terms.** Where EGRRCPA does not define certain terms included in its revised HVCRE exposure definition, and substantially similar terms are defined in the Call Report instructions or the agencies’ other regulations, the agencies propose to interpret these undefined terms in a manner consistent with other applicable definitions. Examples include:
  - Section 214 of EGRRCPA defines an HVCRE ADC loan as “a credit facility secured by land or improved property,” without defining “a credit facility secured by land or improved property.” For purposes of the revised HVCRE exposure definition, the agencies propose to interpret this definition in a manner consistent with the current Call Report definition for “a loan secured by real estate.”<sup>14</sup>
  - Consistent with the Call Report’s inclusion of “other land loans” (generally loans secured by vacant land other than land known to be used for agricultural purposes) with construction and

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development loans, the proposal would also interpret “other land loans” as included in the scope of the revised HVCRE definition.<sup>15</sup>

- **Approaches to estimating and reporting HVCRE exposures.** Referring to the Interagency Statement, the agencies note that “until the agencies take further action,” banking institutions may use available information to “reasonably estimate” and report only HVCRE ADC loans in their Call Report, and may refine these estimates “in good faith as they obtain additional information.” Banking institutions will also not be required to amend previously filed regulatory reports as these estimates are adjusted.<sup>16</sup>
  - As an alternative to reporting only HVCRE ADC loans under the new definition, an institution may continue to report risk-weighted HVCRE exposures in a manner consistent with the current instructions to the Call Report, until the agencies take further action.
  - The agencies also invite comment on whether the final rule should require re-evaluation of ADC loans originated on or after January 1, 2015 under the revised definition.

### OBSERVATIONS AND IMPLICATIONS

Throughout the proposal, the agencies solicit comment on whether their proposed interpretations of various terms used in the revised HVCRE exposure definition are appropriate and clear, or whether they require further discussion and interpretation. As noted above, the agencies also invite comment “on the potential advantages and disadvantages of incorporating the agencies’ interpretations of the terms used in the revised HVCRE exposure definition into the rule text or in another published format.” As proposed, neither the proposed interpretations nor their cross-referenced definitions in the Call Report instructions or other agency regulations are included in the rule text, but rather are reflected only in the supplementary information to the proposed rule. Absent incorporation of these interpretations and cross-references into the rule text of the final rule, subject banking institutions would be required to reference supplementary information published in the Federal Register to access this guidance in the future. The agencies have frequently provided guidance in the supplementary information accompanying their rules, and it remains to be seen whether the request for comment on this approach indicates that the agencies may be considering broader changes to their practices for providing guidance.

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ENDNOTES

- <sup>1</sup> Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System and Federal Deposit Insurance Corporation, *Regulatory Treatment for High Volatility Commercial Real Estate (HVCRE) Exposures*, 83 Fed. Reg. 48990 (Sept. 18, 2018) (hereafter, the “proposal”).
- <sup>2</sup> See Pub. L. No. 115-174 (2018), available at <https://www.congress.gov/115/bills/s2155/BILLS-115s2155enr.pdf>. For further information, see our Client Memorandum, “*Economic Growth, Regulatory Relief, and Consumer Protection Act*” is Enacted, dated May 24, 2018, available at [https://www.sullcrom.com/siteFiles/Publications/SC\\_Publication\\_Financial\\_Services\\_Regulatory\\_Reform\\_Legislation\\_05\\_24\\_18.pdf](https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Financial_Services_Regulatory_Reform_Legislation_05_24_18.pdf).
- Section 214 of the EGRRCPA adds a new Section 51 to the Federal Deposit Insurance Act stating that the appropriate federal banking agencies may only require a depository institution to assign a heightened risk weight to an HVCRE exposure (as defined under 12 C.F.R. § 324.2 as of the date of EGRRCPA’s enactment) under any risk-based capital requirement if such exposure is an “HVCRE ADC loan” within the meaning of Section 214.
- <sup>3</sup> See Question 11, the proposal, at 48995 (“The agencies invite comment on the potential advantages and disadvantages of incorporating the agencies’ interpretations of the terms used in the revised HVCRE definition into the rule text or in another published format. What type of information should be included? What, if any, additional aspects of the revised HVCRE exposure definition, or its application and usage, should be included?”).
- <sup>4</sup> The proposal, at 48992. Advanced approaches banking organizations are generally those with \$250 billion or more in total consolidated assets or \$10 billion or more in foreign exposures (including subsidiary depository institutions of bank holding companies that meet one of these thresholds).
- <sup>5</sup> Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation, *Regulatory Capital Rules: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act 82*, Fed. Reg. 49984 (Oct. 27, 2017) (the “2017 Simplifications Proposal”). For further information, see our Client Memorandum, *Federal Banking Agencies Propose Capital Rule Simplifications to the Standardized Approach Calculations Applicable Primarily to Non-Advanced Approaches Banking Organizations*, dated October 4, 2017, available at [https://www.sullcrom.com/siteFiles/Publications/SC\\_Publication\\_Bank\\_Capital\\_Requirements\\_October\\_04\\_2017.pdf](https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_October_04_2017.pdf).
- <sup>6</sup> See *supra* note 2.
- <sup>7</sup> See *supra* note 2. Because of Section 214 of the EGRRCPA, the agencies stated in the proposal that they will take no further action with respect to the “high volatility acquisition, development, or construction (HVADC) exposure” definition that would have replaced HVCRE in the capital rule. However, “[o]ther aspects of the [2017 Simplifications Proposal], including simplifications to regulatory capital adjustments and deductions, are still under consideration.” The proposal, at 48992, n.7.
- <sup>8</sup> Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, *Interagency Statement Regarding the Impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)*, at 2-3 (July 6, 2018) (hereafter, the “Interagency Statement”), available at <https://www.fdic.gov/news/news/press/2018/pr18044a.pdf>. See also Board of Governors of the Federal Reserve System, *Statement Regarding the Impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)* (July 6, 2018), available at <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706b1.pdf>.
- <sup>9</sup> The proposed HVADC exposure definition in the 2017 Simplifications Proposal endeavored to clarify what it meant to “primarily finance” ADC activities with a purpose-based test: for purposes of the proposed HVADC exposure definition, an exposure would have been classified as an

ENDNOTES (CONTINUED)

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HVADC exposure only if 50 percent or more of the funds (e.g., loan proceeds) would be used for ADC activities. See the 2017 Simplifications Proposal, at 82 Fed. Reg. 49988. The proposal does not reiterate this guidance from the 2017 Simplifications Proposal; however, in Question 2, the agencies request comment on whether the term “primarily finances”—among other terms—is clear or whether further discussion or interpretation is needed. See Question 2, the proposal, at 48993.

10 The proposal, at 48999-49000.

11 A banking organization that calculates its risk-weighted assets under the advanced approaches would refer to the definition of an HVCRE exposure in section 2 of the capital rule for purposes of identifying wholesale exposure categories and subcategories. The proposal, at 48997.

12 The proposal, at 48992.

13 The proposal, at 48993.

14 *Id.*

15 *Id.*

16 The proposal, at 48992.

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ANNEX A

This Annex compares the revised definition of HVCRE exposures in the proposal to (i) the definition of HVADC exposure included in the 2017 Simplifications Proposal, and (ii) the currently applicable definition of HVCRE exposures in the agencies' capital rules. This Annex also compares the applicable exceptions to each of the revised HVCRE exposures definition, the HVADC exposures definition in the 2017 Simplifications Proposal, and the HVCRE exposures definition in the currently applicable capital rules.

	Current Proposal	2017 Simplifications Proposal	Currently Applicable Capital Rules
<b>Base Definition</b>	<p>Any credit facility secured by land or improved real property that, prior to being reclassified as a non-HVCRE exposure,</p> <ul style="list-style-type: none"> <li>(i) primarily finances, has financed, or finances the ADC of real property,</li> <li>(ii) has the purpose of providing financing to acquire, develop, or improve such real property into income-producing real property, and</li> <li>(iii) is dependent upon future income or sales proceeds from, or refinancing of, such real property for the repayment of the facility.</li> </ul>	<p>Any credit facility originated on or after the effective date of the proposal that primarily finances or refinances the</p> <ul style="list-style-type: none"> <li>(i) acquisition of vacant or developed land,</li> <li>(ii) development of land to prepare to erect new structures, or</li> <li>(iii) construction of buildings, dwellings or other improvements.</li> </ul>	<p>Any credit facility that, prior to conversion to permanent financing, finances or has financed the ADC of real property.</p>
<b>Heightened Risk Weight</b>	150%	130%	150%
<b>Exclusions</b>			
<b>Loans Originated Prior to January 1, 2015</b>	Loans originated prior to January 1, 2015 that would otherwise qualify under the revised definition of HVCRE exposures.	No corresponding exclusion. (Loans originated prior to the effective date of the proposal would remain subject to the currently applicable definition of HVCRE exposure and 150% risk weight.)	No corresponding exclusion.
<b>One- to Four-Family Residential Properties</b>	Loans financing the ADC of one- to four-family residential properties.	Consistent with the Current Proposal.	Consistent with the Current Proposal.

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	Current Proposal	2017 Simplifications Proposal	Currently Applicable Capital Rules
<b>Community Development Investment</b>	Loans financing the ADC of real property that would qualify as a “community development investment” where the project’s primary purpose is “community development” as defined in the agencies’ Community Reinvestment Act regulations (so that each loan, including ADC loans taken out with U.S. Small Business Administration Section 504 financing, would have to be evaluated under the “community development” criteria).	Similar to the Current Proposal, included an exclusion for Community Development Investment ADC loans with the primary purpose of “community development,” as defined in the agencies’ Community Reinvestment Act regulations, and would remove the exception to the exclusion for loans financing activities that promote economic development by financing small businesses or farms that meet certain size eligibility or revenue standards (provided that they have a “community development” purpose).	Include a different exemption for loans financing the ADC of Community Development Investment projects, as defined by 12 U.S.C. § 24 (Eleventh) and 12 U.S.C. § 338a, except for activities that promote economic development by financing businesses or farms that meet size eligibility standards of the Small Business Administration’s Development Company or Small Business Investment Company programs (12 CFR 121.301), or have gross annual revenues of \$1 million or less, unless they meet another exemption in the rule.
<b>Agricultural Land</b>	Loans financing the ADC of agricultural land, including all land known to be used or usable for agricultural purposes.	Same as currently applicable capital rules.	Include an exclusion for loans financing the purchase of agricultural land, with a requirement that the valuation of the land be based on its value for agricultural purposes, and not take into consideration any potential non-agricultural uses (requirements that would be eliminated by the revised definition of HVCRE exposures).
<b>Permanent Loans</b>	Loans financing the acquisition or refinancing of, or improvements to, existing income-producing real property with a cash flow that covers the debt service and expenses of the property in accordance with the banking organization’s underwriting criteria for permanent loans.	Included a different exemption, defined to include any prudently underwritten loan that has a clearly identified source of repayment sufficient to service amortizing principal and interest payments aside from the sale of the property.	Exclude credit facilities that convert to permanent financing, but do not specify when a credit facility may be reclassified as permanent financing.
<b>Certain Commercial Real Property Projects</b>	Loans financing commercial real property projects that (i) have an LTV ratio less than or equal to the supervisory maximum and (ii) have at least 15 percent of borrower contributed capital in the form of cash, unencumbered readily marketable assets, paid development expenses out-of-pocket, or contributed real property or improvements (measured by the “as completed” value of the project) that is contributed prior to the institution’s advance of funds and contractually required to remain in place until the credit facility converts to permanent financing.	Eliminated the exemption for loans that finance projects with substantial borrower contributed capital from the proposed HVADC definition.	Include an exemption for loans to commercial real estate projects with borrower contributed capital that is narrower in scope than the Current Proposal (requires both contributed capital and internally generated capital to be contractually required to remain in place until the loan converts to permanent financial or is sold or paid in full, and permits contributed capital only in the form of cash, unencumbered readily marketable assets and out-of-pocket paid development expenses).