April 1, 2015

Honorable Janet L. Yellen
Chair
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Honorable Thomas J. Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Honorable Martin J. Gruenberg
Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Basel III HVCRE Final Rule: Agency Meeting Follow-Up Letter

Ladies and Gentlemen:

On March 17, 2015, the Mortgage Bankers Association[1] (MBA) greatly appreciated the opportunity to meet with representatives from the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Comptroller of the Currency (collectively, the Agencies) for a productive and engaging discussion regarding MBA's concerns for the portion of the Basel III final rule[2] that involves High Volatility Commercial Real Estate (HVCRE)[3]. This submittal is intended to supplement MBA's prior HVCRE comment letters[4]

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[1] The Mortgage Bankers Association (MBA) is the national association representing the real estate finance industry, an industry that employs more than 280,000 people in virtually every community in the country. Headquartered in Washington, D.C., the association works to ensure the continued strength of the nation's residential and commercial real estate markets; to expand homeownership and extend access to affordable housing to all Americans. MBA promotes fair and ethical lending practices and fosters professional excellence among real estate finance employees through a wide range of educational programs and a variety of publications. Its membership of over 2,200 companies includes all elements of real estate finance: mortgage companies, mortgage brokers, commercial banks, thrifts, REITs, Wall Street conduits, life insurance companies and others in the mortgage lending field. For additional information, visit MBA's Web site: www.mortgagebankers.org.

[2] 78 Fed. Reg. 62018 (October 11, 2013).

[3] 78 Fed. Reg. 62165.

[4] See Basel III HVCRE Final Rule: Request for Clarification, MBA, January 26, 2015 and Regulatory Capital Rules, MBA, October 17, 2012.

and address issues raised during the recent meeting with the Agencies. As indicated during this meeting, the Agencies are in the process of developing potential guidance (the Guidance) for the Basel III final rule (Basel III HVCRE Rule), including HVCRE. Not excluding other issues raised in MBA's January 26, 2015 letter, we would highly encourage the Agencies to address in their pending Guidance the following topics:

Reclassification of an ADC loan from HVCRE to IPRE Status

The Basel III HVCRE Rule allows for a bank to provide permanent financing for a HVCRE loan provided that the "permanent financing is subject to the same [Bank]'s underwriting criteria for long-term mortgage loans"[5]. The Guidance should specify that at such time when the HVCRE loan, including extension options, meets the same underwriting criteria (stabilized cash flow, lease-up completed, etc.) that a bank follows to provide permanent financing, the loan should be reclassified from HVCRE to income producing real estate (IPRE) in order to remove the construction risk (HVCRE) capital requirement.

We would encourage the Guidance to reflect the same flexibility demonstrated in the "Agency Information Collection Activities: Announcement of Board Approval Under Delegated Authority and Submission to OMB With Request" final rule.[6] This final rule modified the Y-14Q reporting data fields for the Federal Reserve's stress testing regime. For field 25, Loan Purpose, a new descriptor was added – "Mini-perm". It is described in the proposed modification to the Y-14Q form as "A form of short-term financing for completed construction projects. Typically this type of loan is used when the developer or builder plans to sell the property after stabilized occupancy is established"[7]. For Y14Q reporting purposes, the status of a loan can be changed from "Land Acquisition & Development" to Mini-perm after the project has been completed. We strongly recommend that the Guidance provide similar flexibility in allowing HVCRE loans to be reclassified as non-HVCRE loans when the loan would meet the bank's criteria for permanent financing.

Prohibition on the Withdrawal of Internally Generated Capital

Under a certain reading of the Basel III HVCRE Rule, even after the 15 percent capital contribution is met, there would be a prohibition of withdrawing from the project internally generated capital. The ongoing retention requirement for internally generated capital could result in capital in excess of 15 percent being retained within the project. We are strongly concerned that this requirement could result in differing amounts of contributed capital being required based upon differences in internally generated capital. For example, a project that

[5] Fed. Reg. Vol. 78, p. 62165 (October 11, 2013).

[6] Fed. Reg. Vol. 79, p. 59264 (October 1, 2014).

[7] OMB No. 7100-0341, Expiration Date: March 31, 2017, Instructions for the Capital Assessments and Stress Testing information collection (Reporting Form FR Y-14Q), p. 249.

benefits from significant internally generated capital (i.e. pad sale within a retail shopping center loan) could result in retained capital in excess of 15 percent. Meanwhile, a project without internally generated capital would have contributed capital that remains at 15 percent. Instead of requiring internally generated capital to be retained in the project for the life of the ADC loan, the Guidance should focus on the threshold requirement of 15 percent of contributed capital being maintained within the project. The 15 percent capital contribution requirement at the inception of funding represents significant skin in the game. MBA is concerned that additional capital retention requirements could have adverse operational impacts during the construction phase of the project.

Importantly, in order to be compliant with this provision, banks would be required in their loan documents to eliminate and enforce the ability of the borrower to utilize internally generated capital. Such a blunt instrument would prohibit banks from negotiating contract terms that would be beneficial to the project and borrower if it involved the utilization of internally generated capital. For banks, commercial real estate lending is often a relationship business in which good will has been developed over years of positive interaction. ADC loan terms are highly negotiated to reflect the idiosyncratic nature of each deal. Inserting this limitation into every ADC loan could imperil the bank's long standing relationship with the borrower and hamstring the borrower from responsibly utilizing internally generated capital in a manner that would not diminish bank safety and soundness.

At a minimum, we would strongly urge the Agencies to more precisely define internally generated capital and provide a description for the uses of internally generated capital that are permitted within the Basel III HVCRE Rule. These should include but are not be limited to: interest payments, principal payments, development fees, and other ongoing development fees and expenses.

Example of Preferred Equity Investment

At the request of Agency staff during the March 17 meeting, MBA is providing background and structure information on preferred equity investment.

General Description of Preferred Equity Investment:

A preferred equity investment (PEI) is an investment of equity with a preferred return in an entity that owns commercial real estate. A preferred equity investor typically has payment priority over the holders of common shares with respect to ordinary distributions and liquidation payments. Below is a list of items a senior construction lender should consider if consenting to a preferred equity structure. The below points are for illustrative purposes only and do not reflect all of the general considerations, guidelines, recommended terms, and conditions required for a senior lender's consent including any items required pursuant to the HVCRE rule.

<u>**Description of Preferred Equity Structure:**</u>

STEP 1: Owner of commercial real estate ("Senior Loan Borrower") enters into a written agreement ("PEI Agreement") with preferred equity investor ("PEI")

STEP 2: Senior Loan Borrower agrees to issue preferred units in Senior Loan Borrower and PEI agrees to purchase preferred units for cash pursuant to the terms of the PEI Agreement

STEP 3: Senior Loan Borrower is required to use cash from PEI for approved development and project costs in the commercial real estate project pursuant to the terms of the PEI Agreement

<u>**Description of Preferred Equity General Provisions:**</u>

- PEI is subject to approval by senior lender
- PEI should not represent 100% of the non senior debt capital (i.e. there should be common equity in capital stack)
- Preferred equity structure should not include debt-like features such as:
    - Issuance of note or taking of collateral (preferred equity investment should be unsecured)
    - Recognition agreement or similar type agreement granting preferred equity investor "creditor" type rights such as additional notice and/or cure rights or senior loan purchase option
    - Any absolute right of payment
    - Guarantees or other credit support
- Any redemption date or mandatory right of redemption should not be earlier than the later of (a) the maturity date of the senior loan and (b) the completion and stabilization of the commercial real estate project
- Current pay provisions (return "on" investment) are permissible so long as non-payment only results in accrual of unpaid amounts and not a default

<u>**Inclusion of Preferred Equity in the 15 Percent Equity Contribution:**</u>

Preferred equity should be counted toward the 15 percent equity requirement because the risk profile of the borrower and project is improved by the infusion of additional equity. The proposed preferred equity structure would be subject to the lenders customary due diligence.

Appreciated Land Value

Given the potential vast differences in a developer's basis (purchase price) and fair market value for the land that comprises an ADC loan, we strongly recommend that a bank be permitted to recognize appreciated land value as part of the 15 percent equity requirement. It seems a punitive result not to recognize appreciated land value as part of the 15 percent capital contribution requirement, particularly, if the land has been held for a substantial period of time. For example, a developer that held a property for 10 years and paid $100,000 for it would only be able to count $100,000 towards the 15 percent contributed capital requirement. Whereas, if another developer recently purchased for cash that parcel for $250,000, reflecting the current market value, this developer would be able to include the fair market value, $250,000, as part of their contributed capital.

With the appropriated safeguards such as a FIRREA compliant appraisal and thorough bank review, the Guidance should allow for the appreciated value of the property to be included in the 15 percent equity contribution requirement. This would avoid the developer having to monetize the appreciated value with a third party in order to use the proceeds towards the 15 percent contributed capital requirement. It is important to note as support for inclusion of the appreciated land value that the market value of the land is part of the "as-completed" value in an appraisal.

MBA greatly appreciates the opportunity to highlight the areas of the Basel III HVCRE Rule that should be addressed in the Guidance. We also appreciate the constructive dialogue that the Agencies have provided for this important issue and we look forward to continuing this vital interaction. Any questions regarding this letter should be addressed to George Green, Associate Vice President, at ggreen@mba.org or (202) 557-2840.

Sincerely,

David H. Stevens
President and Chief Executive Officer