

**FEDERAL RESERVE BANK
OF NEW YORK**

[Circular No. **10640**
May 24, 1993]

**RISK-BASED CAPITAL GUIDELINES
Final Rule on Certain Residential Construction Loans**

Effective April 26, 1993

*To All State Member Banks and Bank Holding
Companies in the Second Federal Reserve District:*

In December 1992, the Board of Governors of the Federal Reserve System issued an interim rule that lowered from 100% to 50% the risk weight on certain residential construction loans (see our Circular No. 10610, dated January 7, 1993). Effective April 26, 1993, the Board made the rule final. Printed below is the text of the Board's announcement:

The Federal Reserve Board has issued a final rule amending the risk-based capital guidelines for State member banks and bank holding companies to lower from 100 to 50 percent the risk weight on loans to finance the construction of 1- to 4-family residences that have been presold.

The final rule amends the Board's Regulation H and Regulation Y and is effective April 26, 1993, and implements section 618(a) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991 (RTCRIA).

Printed on the following pages is the Board's official notice of this action, as printed in the *Federal Register* of May 14. Questions on this matter may be directed to Manuel J. Schnaidman, Manager, Bank Analysis Department (Tel. No. 212-720-6710), or to Anne Wakelin of that Department (Tel. No. 212-720-6962).

E. GERALD CORRIGAN,
President.

FEDERAL RESERVE SYSTEM

12 CFR Parts 208 and 225

[Regulations H and Y; Docket No. R-0787]

Capital; Capital Adequacy Guidelines

AGENCY: Board of Governors of the Federal Reserve System.

ACTION: Final rule.

SUMMARY: The Board of Governors of the Federal Reserve System (Board or Federal Reserve) is adopting as a final rule its interim rule amending the risk-based capital guidelines for bank holding companies and state member banks to lower from 100 percent to 50 percent the risk weight assigned to certain loans to builders to finance the construction of presold residential (1- to 4-family) properties. This final rule implements section 618(a) of the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991.

EFFECTIVE DATE: April 26, 1993.

FOR FURTHER INFORMATION CONTACT:

Rhoger H Pugh, Assistant Director (202/728-5883), Norah M. Barger, Manager (202/452-2402), Robert E. Motyka, Supervisory Financial Analyst (202/452-3621), Barbara J. Bouchard, Senior Financial Analyst (202/452-3072), Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, NW., Washington, DC 20551. For the hearing impaired *only*, Telecommunication Device for the Deaf (TDD), Dorothea Thompson (202/452-3544).

SUPPLEMENTARY INFORMATION:

Background

On December 12, 1991, the Congress enacted the Resolution Trust Corporation Refinancing, Restructuring, and Improvement Act of 1991

(RTCRRIA).¹ Section 618(a) of the Act requires the Federal banking agencies to provide for a risk weight of 50 percent in their regulations and guidelines for any single-family residential construction loan that meets the following criteria:

(1) The loan is for the construction of 1- to 4-family residential property;

(2) The bank has sufficient documentation, as may be required by the appropriate Federal banking agency, to demonstrate the intent and ability of the buyer to purchase the property;

(3) The purchaser provides to the builder a nonrefundable deposit in an amount determined by the appropriate Federal banking agency, but not less than 1 percent of the principal amount of the mortgage; and

(4) The loan satisfies prudent underwriting standards as established by the appropriate Federal banking agency.

To comply with the legislation, the Federal banking agencies, under the auspices of the Federal Financial Institutions Examination Council (FFIEC), published for public comment, on February 3, 1992 (57 FR 4027), a proposal expanding the definition of loans secured by 1- to 4-family residential properties contained in the Reports of Condition and Income for commercial banks (Call Report) to encompass construction loans for presold residential properties meeting certain criteria. For state member banks, the proposed definitional change would have resulted in lowering the risk weight for construction loans for presold 1- to 4-family residential properties to 50 percent because the Board's guidelines reference the Call Report definition in specifying the appropriate capital treatment for 1- to 4-family residential property loans.

In response to the proposal to expand the definition comments were received from forty-one public respondents. Thirty-two commenters agreed with the proposal. The nine commenters that opposed the FFIEC proposal did so on the grounds that the perceived reporting burden to implement the proposal did not justify the merits of the change. It was suggested that the Federal banking agencies implement the provisions of section 618(a) of RTCRRIA by amending the risk-based capital guidelines rather than by changing the Call Report

definition. This approach would make the application of the lower risk weight optional.

After review of these comments and reconfirming agreement with the other Federal banking agencies, the Board issued, on December 30, 1992 (57 FR 62177), an immediately effective interim rule amending the risk-based capital guidelines with a request for public comment. Under the interim rule, construction loans for presold 1- to 4-family residential properties could be assigned to the 50 percent risk weight category if they conform to prudent underwriting standards including a conservative loan-to-value ratio; are performing in accordance with their original terms; and are not 90 days or more past due or carried in nonaccrual status. The notice further stated that the Board, after consultation and in agreement with the other banking agencies, would assign a 50 percent risk weight to such loans only if the bank has met certain requirements including: documentation of the intent and ability of the buyer to purchase and occupy the home; evidence of at least 10 percent of the direct costs incurred by the builder; and, an earnest money deposit from the purchaser of at least 3 percent of the purchase price held in escrow to first defray costs incurred by the lender in the event of default. The interim rule was made effective immediately to permit state member banks and bank holding companies to take immediate advantage of a lower risk weight for qualifying construction loans for presold residential properties.

Comments Received

In response to the interim rule request for comment, responses were received from twelve public commenters: nine banking institutions and three trade associations. Ten of the twelve respondents agreed that construction loans for presold 1- to 4-family residential properties should be assigned to the 50 percent risk category if certain criteria are met. Three commenters based their support for the amendment on what they viewed as the inherent low risk associated with these types of construction loans for presold properties. Several commenters noted their approval of an amendment to the guidelines as opposed to a definitional change in the Call Report. The one commenter that disagreed with the

¹ Pub. L. 102-233, 105 Stat. 1761.

interim rule expressed the view that such construction loans are risky and, hence, a preferential risk weight was not justified. One commenter offered no overall opinion.

Commenters requested clarification on several issues. These included: whether any time restraints between the extension of the construction loan and the actual start of construction would be applied; the practicality of requiring a builder to fund at least the first 10 percent of the direct costs; clarification as to what could be included in the calculation of total direct costs; whether the earnest money requirements could be reduced or altered so as to allow builders the use of earnest money where permissible by law and to provide some protection to the builder through the return of excess earnest money funds in the event of default by the buyer; and, whether the portion of a construction loan extended under a master-note agreement for a multiple home project that represents presold units could be assigned a 50 percent risk weight.

Final Rule

Based upon discussions with the other Federal banking agencies and the public comments received, the Board is adopting in final form its interim rule amending the risk-based capital guidelines for state member banks and bank holding companies to state that loans secured by 1- to 4-family residential properties eligible for the 50 percent risk category for risk-based capital purposes include "loans to builders with substantial project equity for the construction of 1- to 4-family residences that have been presold under firm contracts to purchasers who have obtained firm commitments for permanent qualifying mortgage loans and have made substantial earnest money deposits." Presold residential construction loans may be placed in the 50 percent risk category if they conform to prudent underwriting standards including a conservative loan-to-value ratio; are performing in accordance with their original terms; and are not 90 days or more past due or carried in nonaccrual status. In addition, as stated in the interim rule, the Board, in agreement with the other Federal banking agencies, will expect institutions to apply a 50 percent risk weight to loans to builders for 1- to 4-family residential property construction only when the bank has obtained sufficient documentation that the buyer of the home intends to purchase the home (*i.e.*, has a legally binding written sales contract), has the ability to obtain a mortgage loan sufficient to purchase

the home (*i.e.*, has a firm written commitment for permanent financing of the home upon completion), and when the following additional criteria are met:

(A) The purchaser is an individual(s) who intends to occupy the residence and is not a partnership, joint venture, trust corporation, or other entity (including an entity acting as a sole proprietorship) that is purchasing one or more of the homes for speculative purposes.

(B) The builder must incur at least the first 10 percent of the direct costs (*i.e.*, actual costs of the land, labor, and material) before any drawdown is made under the construction loan and the construction loan may not exceed 80 percent of the sales price of the presold home.

(C) The purchaser has made a substantial "earnest money deposit" of no less than 3 percent of the residence's sales price and that deposit must be subject to forfeiture if the purchaser terminates the sales contract.

(D) The earnest money deposit must be held in escrow by the bank financing the builder or by an independent third party in a fiduciary capacity and the escrow agreement must provide that, in the event of default arising from the cancellation of the sales contract by the buyer, the escrow funds must first be applied for and used to defray any costs incurred by the lending bank.

Furthermore, in the case of 1- to 4-family residences in multiple home projects such as townhouses and condominiums under a master-note where all of the units have not been presold, banks are permitted to apply the preferential 50 percent risk weight to that portion of the loan representing presold units while assigning the portion representing unsold units to the 100 percent risk category. Additionally, the Board notes that prudent underwriting standards require that, although there are no specified time limitations between the extension of the loan and the actual start of construction, banks should ensure that construction begins within a reasonable amount of time after disbursement of funds.

Regulatory Flexibility Act Analysis

The Federal Reserve Board does not believe that adoption of this final rule would have a significant economic impact on a substantial number of small business entities in accord with the spirit and purposes of the Regulatory Flexibility Act (5 U.S.C. 601 *et seq.*). In that regard, the final rule would reduce certain regulatory burdens on bank holding companies. In addition, because the risk-based and leverage capital guidelines generally do not apply to

bank holding companies with consolidated assets of less than \$150 million, this amendment will not affect such companies.

List of Subjects

12 CFR Part 208

Accounting, Agricultural loan losses, Applications, Appraisals, Banks, banking, Branches, Capital adequacy, Confidential business information, Currency, Dividend payments, Flood insurance, Publication of reports of condition, Reporting and recordkeeping requirements, Securities, State member banks.

12 CFR Part 225

Administrative practice and procedure, Appraisals, Banks, banking, Capital adequacy, Holding companies, Reporting and recordkeeping requirements, Securities, State member banks.

For the reasons set forth in the preamble, and pursuant to the Board's authority under 12 U.S.C. 1844(b) and 3909, the interim rule amending 12 CFR part 208, appendix A and 12 CFR part 225, appendix A published at 57 FR 62177 on December 30, 1992, is adopted by the Board as a final rule without change.

Board of Governors of the Federal Reserve System, May 10, 1993.

William W. Wiles,

Secretary of the Board.

[FR Doc. 93-11500 Filed 5-13-93; 8:45 am]

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