

# Client Alert

May 23, 2018

## HVCRE Clarification Finally Arrives – Congress Passes Legislation Addressing Treatment of ADC Loans under the Capital Rules

On May 22, 2018, Congress passed a financial regulatory reform bill, S. 2155, the “Economic Growth, Regulatory Relief, and Consumer Protection Act” (the “Reform Bill”).<sup>1</sup> Among other things, the Reform Bill clarifies the treatment of acquisition, development, and construction (ADC) loans characterized as high volatility commercial real estate (HVCRE) exposures under the U.S. Basel III capital rules.<sup>2</sup> It is expected that President Trump will soon sign the legislation.

Under the “standardized approach” for risk weighting bank assets, the existing capital rules require ADC loans that are deemed to be “HVCRE exposures” to be risk weighted at 150% rather than the 100% risk weighting accorded to other commercial loans.<sup>3</sup> This higher risk weighting increases the capital that banks are required to carry against HVCRE exposures. The complexity of the current HVCRE exposure definition has created uncertainty in its application, and the definition has been criticized for covering certain ADC loans that may not merit higher capital requirements. In response to these criticisms, the Reform Bill requires that HVCRE exposures must also meet a new, narrower definition of “HVCRE ADC loans” to trigger the 150% risk weight.<sup>4</sup>

The passage of the Reform Bill represents the culmination of parallel efforts by Congress and the federal banking agencies<sup>5</sup> to revise certain definitional elements of HVCRE exposures. On September 27, 2017, the federal banking agencies published a notice of proposed rulemaking, which, if adopted, would have addressed some uncertainties raised by the existing HVCRE exposure definition using a different approach than the Reform Bill, including a proposed change to risk weighting and the elimination of an important exemption.<sup>6</sup> It is unlikely that this rulemaking effort will proceed, given the Congressional action.<sup>7</sup>

The following is a summary of how ADC loans will be treated under the Reform Bill once it becomes effective.

<sup>1</sup> The text of the bill is available [here](#).

<sup>2</sup> For a summary of the provisions included within S. 2155, please see our Client Alert, *available at*: <https://www.mofo.com/resources/publications/180522-financial-regulatory-reform.html>.

<sup>3</sup> See 12 C.F.R. § 324.2 (FDIC); 12 C.F.R. § 217.2 (Board); 12 C.F.R. § 3.2 (OCC) (defining “HVCRE exposure”). The 150% risk weight for HVCRE exposures is designated at 12 C.F.R. § 324.32(j) (FDIC); 12 C.F.R. § 217.32(j) (Board); 12 C.F.R. § 3.32(j) (OCC).

<sup>4</sup> The new definition will apply to the standardized approach under the capital rules as well as to the internal ratings-based method for calculating capital used by complex financial institutions characterized in the capital rules as “advanced approaches” banks. For the definition of “advanced approaches” banks, see 12 C.F.R. § 324.2 (FDIC); 12 C.F.R. § 217.2 (Board); 12 C.F.R. § 3.2 (OCC).

<sup>5</sup> For purposes of this Client Alert, the term “federal banking agencies” refers to the Office of the Comptroller of the Currency (OCC); the Board of Governors of the Federal Reserve System (“Board”); and the Federal Deposit Insurance Corporation (FDIC).

<sup>6</sup> 82 Fed. Reg. 49984 (Oct. 27, 2017), *available at*: <https://www.fdic.gov/news/board/2017/2017-09-27-notice-dis-b-fr.pdf>. For a discussion of the proposal by the federal banking agencies, please see our Client Alert, *available at*: <https://www.mofo.com/resources/publications/170928-capital-treatment-adc-loans.html>.

<sup>7</sup> For a discussion of the differences between the Congressional approach and the proposed approach taken by the federal banking agencies, please see our Client Alert regarding the legislation as passed by the U.S. House of Representatives, *available at*: <https://www.mofo.com/resources/publications/171127-high-volatility-commercial-real-estate.html>.

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## CORE DEFINITION OF AN HVCRE ADC LOAN

The existing HVCRE exposure definition is a “credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development, or construction (ADC) of real property” unless one of the enumerated exemptions applies.<sup>8</sup> The Reform Bill defines an “HVCRE ADC loan” as a real estate secured credit (before application of various exemptions) that:

- primarily finances, has financed, or refinanced the acquisition, development, or construction of real property;
- has the purpose of providing financing to acquire, develop, or improve such real property into income-producing real property; and
- is dependent upon future income or sales proceeds from, or refinancing of, such real property for the repayment of such credit facilities.

Under the Reform Bill, a loan must meet both the definition of an HVCRE exposure and an HVCRE ADC loan in order to be subject to the higher capital requirements.

The definition of an HVCRE ADC loan will clarify some interpretive uncertainty that has arisen under the existing HVCRE exposure definition. First, a credit must be secured by real estate in order to be an HVCRE ADC loan. This removes the uncertainty under the definition of an HVCRE exposure as to whether an unsecured ADC loan is subject to the higher capital requirements.

Second, to be an HVCRE ADC loan, the credit must “primarily” finance the ADC of real property. The use of the term “primarily” addresses two situations: (1) where a portion of the credit is used for purposes other than the ADC of real property—*e.g.*, to acquire equipment; and (2) where a portion of the credit is used for purposes that would qualify for an exemption. The Reform Bill takes an all-or-nothing approach: credits that do not “primarily” finance the ADC of real property are not HVCRE ADC loans. That is, if a majority of the loan proceeds are used for purposes that would qualify the credit as an HVCRE ADC loan, the entire credit would be an HVCRE ADC loan. If not, the entire credit would not be an HVCRE ADC loan. In contrast, the federal banking agencies currently require an allocation for a mixed purpose loan.<sup>9</sup>

Third, the second prong of the definition of an HVCRE ADC loan requires that the credit be for the purpose of acquiring, developing, or improving the real property financed into “income-producing real property.”<sup>10</sup>

In addition, to be an HVCRE ADC loan under the Reform Bill, the credit must depend upon future income or sales proceeds (or refinancing) for repayment. In effect, this requirement should exempt all ADC financing if the cash flow generated by the real property is sufficient to support the debt service and expenses of the real property in accordance with the bank’s applicable loan underwriting criteria for permanent financings. Note that this parallels

<sup>8</sup> See 12 C.F.R. § 324.2 (FDIC); 12 C.F.R. § 217.2 (Board); 12 C.F.R. § 3.2 (OCC).

<sup>9</sup> Interagency FAQs on the Regulatory Capital Rule, No. 13 (March 31, 2015), available at: <https://www.fdic.gov/regulations/capital/capital/faq-hvcre.html> (hereinafter, “FAQ”). FAQ No. 13 explains that the banking organization should consider the contribution of the commercial real estate portion of the project to the total “as completed” value of the project when determining the portion of the loan applicable to the property’s commercial real estate.

<sup>10</sup> This may suggest that the loans to finance the ADC of owner-occupied commercial real estate are not intended to be covered by the Reform Bill, as such property would not ordinarily be deemed to be income producing.

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exemptions provided for the reclassification of HVCRE ADC loans to non-HVCRE ADC loans and for permanent financing, which are further explained below.

## THE LTV/CAPITAL CONTRIBUTION EXEMPTION

The existing HVCRE exposure definition exempts commercial real estate projects that (i) meet applicable maximum LTV ratios; (ii) for which the borrower has contributed capital of at least 15% of the real estate's "as completed" value; and (iii) the capital contributed to, or internally generated by, the project is contractually required to remain in the project through the life of the project.<sup>11</sup> The Reform Bill retains this exemption<sup>12</sup>—one upon which many bank lenders have relied to avoid HVCRE exposure characterization—and makes two important clarifications/changes to existing interpretations:

- **Value of Contributed Real Property.** Existing regulatory interpretations of the HVCRE exposure definition do not allow a developer to count appreciation in the value of real property when calculating compliance with the 15% contributed capital requirement.<sup>13</sup> Under the Reform Bill, the value of any real property contributed to an ADC project is equal to the appraised value of the property at the time of contribution.
- **Distribution of Excess Capital.** Under the Reform Bill, the amount of contributed capital required to remain in the project is only the 15% minimum requirement. As a result, there is no restriction on distributing capital contributed in excess of the 15% requirement. By contrast under existing interpretations of the current HVCRE exposure definition, excess contributions must remain in the project.<sup>14</sup>

## EXEMPTION FOR RECLASSIFICATION AND PERMANENT FINANCING

Under the Reform Bill, an HVCRE ADC loan would be eligible for reclassification as a non-HVCRE ADC loan upon: (i) the substantial completion of development or construction of the real property being financed by the credit facility; and (ii) the generation of cash flow by the real property sufficient to support debt service and expenses of the real property in accordance with the bank's applicable underwriting criteria for permanent financings. By contrast, under the existing capital rules, an HVCRE exposure remains as such until the credit facility is converted to permanent financing. The requirement that a credit facility be "converted" to permanent financing has raised concern that banks may need to formally restructure HVCRE exposure loans to qualify for such conversion. However, no such restructuring is suggested by the Reform Bill's text.<sup>15</sup>

In addition, the Reform Bill would create two specific exemptions for permanent financing that are not linked to any reclassification of an existing HVCRE ADC loan. The exemptions would apply to financing either for: (i) the acquisition or refinance of existing income-producing property secured by a mortgage on the property; or (ii) improvements to existing income-producing improved real property secured by a mortgage on the property. In both cases, the exemption would apply if the cash flow generated by the real property is sufficient to support the

<sup>11</sup> 12 C.F.R. § 324.2 (FDIC); 12 C.F.R. § 217.2 (Board); 12 C.F.R. § 3.2 (OCC).

<sup>12</sup> One of the most controversial aspects of the federal banking agencies' proposal was that it purported to eliminate this exemption.

<sup>13</sup> FAQ No. 7.

<sup>14</sup> FAQ No. 15.

<sup>15</sup> It is possible to construe the existing HVCRE exposure definition not to require formal restructuring of a credit facility to avoid HVCRE exposure characterization.

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debt service and expenses of the real property in accordance with the bank's applicable loan underwriting criteria for permanent financings.<sup>16</sup>

## APPLICABILITY TO PRIOR LOANS

The HVCRE exposure definition under the current capital rules has been construed as applying to ADC loans that meet the definition of an HVCRE exposure, regardless of the date of origination.<sup>17</sup> However, the Reform Bill would characterize as HVCRE ADC loans only those loans originated on or after January 1, 2015. In other words, under the Reform Bill, loans made prior to January 1, 2015 will not be subject to the higher risk weight.

## RETENTION OF OTHER EXEMPTIONS

The Reform Bill retains the exemptions for credit facilities financing the ADC of properties that are: (i) one- to four-family residential properties; (ii) real property that would qualify as an investment in community development; and (iii) agricultural land.

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<sup>16</sup> The language is consistent with an existing determination that financing to acquire commercial real estate is not an HVCRE exposure if extended in accordance with the bank's normal lending terms for permanent financing. See FAQ No. 12.

<sup>17</sup> See FAQ No. 2.

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