How CRE Loans Would Shift Under New Bank Capital Rules

By **Jason Shafer, Henry Fields and Jiang Liu** (October 25, 2023)

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On July 27, U.S. bank regulatory agencies — the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corp. — proposed major changes to how large banking organizations with $100 billion or more in total assets risk-weight their loans, including commercial real estate loans.

Under the proposal, covered institutions would be required to use both the existing standardized approach and a newly crafted regulatory "expanded risk-based approach" and be subject to the greater of the resulting ratios for their minimum risk-based capital requirements.

The internal ratings-based approach for credit risk would no longer be used.[1]

If adopted, the proposal could affect how covered institutions underwrite and price loans, including CRE loans, and ultimately affect the availability of bank credit.

According to the agencies' estimates, "the proposal would slightly decrease marginal risk-weighted assets attributable to retail and commercial real estate exposures and slightly increase marginal risk-weighted assets attributable to corporate, residential real estate, and securitization exposures."

The agencies do not anticipate making a final rule effective before July 1, 2025.

The proposal contemplates a three-year phase-in period, i.e., through June 30, 2028, for most of its provisions. As discussed below, the proposal has already generated significant adverse comment from industry trade groups.

Current Risk-Based Capital Framework

All U.S. banks calculate their risk-weighted capital using the so-called standardized approach. This is to say that the risk-weighting applied to specific categories of loans is set by regulation.

In addition, a designated group of the largest banks, known as "advanced approaches banks," also risk-weight their loans using internal modeling — the so-called internal ratings-based approach.

Generally, advanced approaches banking organizations are the largest U.S. banking organizations and the bank subsidiaries of those firms.[2]

Advanced approaches banks are required to use both the standardized approach and the

internal ratings-based approach and then determine their risk-based capital using the least favorable of the two approaches.

Current Risk-Weighting of CRE Loans Under the Standardized Approach

CRE loans are generally assigned a 100% risk weight. However, certain acquisition, development and construction CRE loans carry a 150% risk weight.[3]

These higher-risk loans are designated under the capital rules as high-volatility CRE, or HVCRE, loans.[4]

Generally, HVCRE loans are acquisition, development and construction, or ADC, loans the repayment of which depends on the future income or sales proceeds from, or the refinancing of, the CRE financed. A number of exemptions from HVCRE characterization avoid the 150% risk weight.

The exemptions include ADC loans meeting certain loan-to-value, or LTV, criteria and requiring the borrower to maintain a prescribed level of equity in the loans.

An HVCRE exposure is eligible for reclassification as a non-HVCRE exposure upon: (1) the substantial completion of development or construction of the real property being financed by the credit facility; and (2) the generation of cash flow by the real property sufficient to support debt service and expenses of the real property in accordance with the banking organization's applicable underwriting criteria for permanent financings.

Proposed Risk Weights for CRE Loans Under the Expanded Approach

The proposal would apply the same risk weights provided in the existing standardized approach to HVCRE loans. ADC loans that are not HVCRE loans would be risk-weighted at 100%, as is currently the case under the standardized approach.

Certain other CRE loans would be subject to a range of risk weights based on specified credit drivers. These so-called regulatory CRE exposures are those that meet the following criteria:

- The loans are primarily secured by fully completed real estate;
- The loans are fully secured by a first lien;
- The loans are made in accordance with prudent underwriting standards, including LTV standards;
- The loans are underwritten pursuant to credit policies that account for the ability of the borrower to repay in a timely manner based on clear and measurable underwriting standards that enable banking organizations to evaluate these credit factors; and
- The property is valued in accordance with proposed LTV requirements.[5]

The proposed risk weights for regulatory CRE exposures, where repayment is dependent on the cash flows generated by the property, range from 70% to 110% depending on the

applicable LTV ratio.

For regulatory CRE exposures not dependent on such cash flows, (1) if the applicable LTV ratio is 60% or less, these loans would be assigned the lesser of the risk weight applicable for credit extended to the particular borrower, or 60%, and (2) if the applicable LTV ratio is more than 60%, these loans would be assigned the risk weight for credit extended by the bank to the particular borrower, or 100% if insufficient information is available.

Final Observations

Financial institutions carefully ration their capital. As explained above, the higher the risk weight for a CRE loan, the more capital that a bank will need to apportion to that loan. In turn, the risk weight will likely influence pricing and credit availability.

While the proposal would appear to generally require less capital for CRE exposures than the current standardized approach and internal ratings-based approach, the proposal may be difficult to implement, especially the distinctions between various risk weights for regulatory CRE exposures.

Moreover, the entire proposal is expected to require the banking industry to increase capital substantially in the aggregate. The agencies estimate that the proposal would require covered institutions in the aggregate to increase common equity Tier 1 capital by approximately $170 billion, or 16%.

Major industry groups such as the American Bankers Association, American Bank Policy Institute and Financial Services Forum have already called on the agencies to withdraw and re-propose the proposed rule, claiming that the agencies violated the Administrative Procedure Act by relying on data and analysis that have not been made available to the public.

These industry groups have called on the agencies to disclose publicly the data and analysis on which they relied in proposing the rule, including any new data or analysis they may have received since the issuance of the proposal, re-propose the rule, and provide an extended 120-day comment period.[6] Last week, the agencies extended the comment period through Jan. 16.

Directly or through CRE industry interest groups, the real estate industry should carefully follow the proposal as it evolves and takes final shape under the weight of public comment and discourse.

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[1] Banking organizations may still be permitted to use internal models to measure market risk.

[2] In general, advanced approaches banking organizations are those that (i) are U.S. global systemically important banks, (ii) have over $700 billion in total assets, or (iii) have $100billion or more in total assets and over $75 billion in cross-jurisdictional exposures, as well as their bank subsidiaries.

[3] All risk-weights in this article are for performing loans.

[4] See our Client Alert on how HVCRE loans are so characterized, available here: https://www.mofo.com/resources/insights/191125-agencies-adopt-hvcre-rules.

[5] In addition, the exposure cannot be a regulatory residential real estate exposure, defaulted real estate exposure, ADC exposure, pre-sold construction loan, statutory multifamily mortgage, or HVCRE exposure (each of which is defined in the proposal).

[6] The industry groups assert that, absent a re-proposal, the Agencies must, at a minimum, "extend the comment period to no sooner than 120 days after the date on which the [A]gencies disclose all necessary information."