Agencies Propose Amendments Relaxing Capital Requirements for ADC Loans

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On September 18, 2018, the three federal banking agencies – the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation – jointly announced a proposed regulation[1] implementing Section 214 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (**EGRRCPA**).[2] Section 214 effectively provides relief to banking organizations with acquisition, development or construction (ADC) lending exposure by narrowing the types of exposures that constitute a "high volatility commercial real estate exposure" (***HVCRE exposure***), a concept relevant for determining the capital charge for such a loan under U.S. bank capital regulations.

The original concept of *HVCRE exposure* was adopted by the agencies in 2013 as part of the U.S. Basel III capital regulations. In the view of the agencies, real estate secured loans extended in connection with the acquisition, construction or development of real estate are considered inherently more risky than other real estate loans, such as those secured by income-producing property. Thus, under the U.S. Basel III capital regulations, *HVCRE exposure*s attract a higher capital charge under the Basel III risk-based capital regulations; such exposures carry a risk-weighting of 150% versus a risk-weighting of 100% applied to corporate exposures generally – in essence, requiring a banking organization to hold 33% more capital with respect to real estate secured loans if deemed to be an *HVCRE exposure*.[3]

Section 214 was enacted in reaction to widespread complaints that the Basel III *HVCRE exposure* definition was ambiguous, difficult to apply, and too restrictive. Moreover, the emergence of a substantial number of non-bank lenders in the field of ADC lending has resulted in a significant reduction in the percentage of ADC loans being provided by banking organizations. Legislative commentary indicate that Section 214 seeks to address imbalance by leveling the playing field with respect to ADC lending.

Section 214 and bars the agencies from requiring depository institutions to assign a heightened risk-weight to an *HVCRE exposure* unless the exposure meets Section 214's definition of *HVCRE ADC* *loan* – a term which differs somewhat from the definition of *HVCRE exposure* currently found in U.S. Basel III. In effect, Congress mandated a revision to the agencies' Basel III regulations.

In response to Congress's enactment of Section 214 of EGRRCPA, in July 2018 the banking agencies took the initial step of issuing an interagency statement, acknowledging that, effective upon the enactment of Section 214, "the agencies may only require a depository institution to assign a heightened risk weight to an *HVCRE exposure* if such exposure is an 'HVCRE ADC Loan,' as defined in section 214 of EGRRCPA."[4] The agencies are now taking the second step of issuing a proposed amendment to the U.S. Basel III definition of *HVCRE exposure* to conform to the changes made by Section 214.[5]

The key aspects of the agencies' proposed amendments are as follows:

- ***More precise definition of loans captured***. The agencies' existing definition of *HVCRE exposure* includes "a credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development, or construction (ADC) of real property," subject to certain exceptions (*e.*, loans secured by residential property, loans secured by agricultural land, and loans made for community development purposes, as well as certain loans in which the borrower has contributed certain assets which have an aggregate value of at least 15% of the project's completion value). In the agencies' Basel III regulations, there was no explanation of the phrase, "financing …. the acquisition, development, or construction of real property," which led to uncertainty whether a given real estate loan should be considered an *HVCRE exposure* and thus subject to the higher 150% capital charge.

The new definition of *HVCRE exposure* would provide somewhat more clarity regarding the type of loans captured. The proposed definition, which largely tracks the language of Section 214, focuses on whether the loan is primarily secured by real estate not producing income sufficient to service the loan in question (as well as covering any expenses). Specifically, the new definition of *HVCRE exposure* would be as follows:

A credit facility secured by land or improved real property that . . .

(A) Primarily finances, has financed, or refinances the acquisition, development, or construction of real property;

(B) Has the purpose of providing financing to acquire, develop, or improve such real property into income-producing real property; and

(C) Is dependent upon future income or sales proceeds from, or refinancing of, such real property for the repayment of such credit facility . . .

The accompanying Preamble to the proposed regulation states that whether a loan is "secured by land or improved real property" would be based on Call Report instructions. To meet the Call Report definition of a loan that is secured by real estate, the estimated value of the real estate collateral at origination (after deducting any senior liens held by others) must be at least 50% of the principal amount of the loan at origination. The Preamble also states that the definition of *HVCRE exposure* would include land loans, such as loans primarily secured by vacant, non-agricultural land not scheduled for development.

- ***New carve-out for loans secured by income-producing property***. The proposed regulation would continue the exemption for loans secured by residential property, loans secured by agricultural land, and loans made for community development purposes. In addition, the proposed regulation adds new exemptions for financing secured by existing income-producing property, as mandated by Section 214. These exemptions would apply to:
  - "The acquisition or refinance of existing income-producing real property secured by a mortgage on such property, if the cash flow being generated by the real property is sufficient to support the debt service and expenses of the real property, in accordance with the [banking organization's] applicable loan underwriting criteria for permanent financings;" and
  - "Improvements to existing income-producing improved real property secured by a mortgage on such property, if the cash flow being generated by the real property is sufficient to support the debt service and expenses of the real property, in accordance with the [banking organization's] applicable loan underwriting criteria for permanent financings."

These two paragraphs make clear that a financing secured by real property will not be considered an HVCRE exposure, provided that the real property is expected to throw off income (at inception of the loan) sufficient to service the interest and principal payments plus any expenses, associated with the real property securing the loan. These exemptions would apply even if the purpose of the loan was made specifically to finance the acquisition of or improvements on the income-producing property.

- ***Exemption for Financing with 15% Borrower Contributed Capital***. The existing HVCRE exposure regulation provides an exemption for financing if the borrower contributed project capital in the form of cash, unencumbered readily marketable assets, or prepaid out-of-pocket development expenses in an amount equal to 15% of the "as completed" appraised value of the real estate, and the borrower is contractually required to maintain that contribution for the duration of the loan (*e.*, until converted to permanent financing, sold, or paid in full).

Consistent with Section 214, under the proposed regulation this exemption would be expanded to allow the 15% to include borrower contributions of real property or improvements (provided such property or improvements are valued in accordance with FIRREA appraisal standards). Moreover, the obligation to maintain the contributed capital would persist only until the *HVCRE exposure* is reclassified as a non-*HVCRE exposure* (discussed in greater detail below).

- ***Project Financing***. Existing regulations do not address the availability of the 15% borrower contributed capital exemption to a loan being made to finance a specific project or phase within an overall development. The Preamble accompanying the proposed regulation states that the 15% exemption can be applied to a loan financing a specific project or phase, provided that the particular project or phase is supported by a separate FIRREA-compliant appraisal or evaluation supporting the as-completed value of that particular project or phase.

- ***Reclassification of HVCRE exposures***. Consistent with the existing regulations, the proposed regulation would provide that whether a financing is considered an *HVCRE exposure* is determined at the outset of the financing. However, the proposed regulation would allow a banking organization to reclassify an HVCRE exposure as a traditional commercial loan exposure (reducing its risk-weighting to 100%) upon (i) the substantial completion of the development or construction of the real property being financed by the credit facility; and (ii) cash flow being generated by the real property being sufficient to support the debt service and expenses of the real property, in accordance with the banking organization's applicable loan underwriting criteria for permanent financings.

Moreover, with respect to the 15% borrower contribution exemption (discussed above), consistent with the idea that loans cease to be *HVCRE exposure*s once re-classified, the proposed regulation states that exemption requires only that the borrower be contractually obligated to maintain the contributed assets only until the exposure is reclassified as a non-HVCRE exposure.

The ability to reclassify existing loans once the real estate becomes income-producing was mandated by Section 214.

- ***Reclassification of HVCRE Loans Originated Prior to January 1, 2015***. Section 214 provides that its statutory definition of *HVCRE ADC loan* "does not include any loan made prior to January 1, 2015." Based on this statutory provision, the agencies stated in the Preamble that banking organizations may automatically (and immediately) reclassify *HVCRE exposure*s originated prior to January 1, 2015 as corporate exposures subject to a 100% risk-weighting (unless an even lower risk-weighting would otherwise apply).

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1 Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, and Office of the Comptroller of the Currency, *Regulatory Capital Treatment for High Volatility Commercial Real Estate (HVCRE) Exposures,* 83 Fed. Reg. 48990 (Sept. 28, 2018).

2 Public Law No: 115-174 (May 24, 2018).

3 *See, e.g.*, 12 C.F.R. § 217.2 (definition of *HVCRE exposure*); 12 C.F.R. § 217.32 (assigning a 150% risk-weight to HVCRE exposures).

4 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)* (July 6, 2018).

5 By its terms, Section 214 applies to the capital treatment of such exposures by "depository institutions" but, for reasons that are unclear, not to the capital treatment of exposures by other organizations subject to U.S. Basel III capital regulations, such as bank holding companies. In the proposed regulation, the agencies reasoned that it would be unnecessarily cumbersome to apply different capital standards for HVCRE exposures as between different organizations subject to Basel III and thus are proposing to apply the new HVCRE exposure provisions to all organizations subject to the U.S. Basel III regulations.

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