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# One Year Later: Avoiding Unfavorable Risk Weighting of Acquisition, Development, and Construction Loans for Commercial Real Estate Projects

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If the number of cranes visible on skylines of metropolitan areas such as Raleigh, Charlotte, and Atlanta are any indication of the resurgence of the commercial real estate (CRE) market for now, the resounding silence of so many construction sites abandoned by their workers and financiers during the financial crisis is past. However, the move from dormant jobsites to active CRE construction and development in southeastern cities has led to the possibility of more balance sheet exposure to high volatility commercial real estate (HVCRE) credit facilities. The current capital requirements tied to HVCRE loans went into effect on January 1, 2015, under the final rule implemented under Basel III (Final Rule). Now in place for more than a year, banks and their CRE financing teams should revisit the Final Rule to ensure they clearly understand the criteria used in determining whether a loan will carry a HVCRE classification.

Under the Final Rule, an HVCRE exposure is, subject to limited exceptions, “a credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development, or construction . . . of real property.” An HVCRE loan carries a 150% risk-weighted capital charge. Under the prior rule, these loans typically carried a 100% risk weight. Today, a booked HVCRE loan might force a bank to carry millions more on its balance sheet than would have been required under prior regulation. Understanding the criteria used in determining an HVCRE classification is critical in pricing CRE loans appropriately.

Fortunately for a bank engaged in origination of acquisition, development and construction loans (ADC Loans), the Final Rule provides an exemption for CRE projects (CRE Exemption). An ADC Loan qualifying for CRE Exemption will be risk weighted at 100% if these three requirements are met:

1. The loan-to-value (LTV) ratio of the ADC Loan does not exceed the regulatory maximum LTV ratio allowed for a particular loan;

2. The borrower has contributed cash or unencumbered readily-marketable assets to the project, or has paid project development expenses out of pocket in an amount greater than or equal to 15% of the appraised *as completed* value of the CRE project; and

3. The borrower met the 15% contribution requirement before the bank advanced funds under

the ADC Loan, and the capital contributed by the borrower or internally generated by the project are contractually required to remain in the project for the life of the project. (Under the Final Rule, the life of the project ends when the borrower's obligations are paid in full or the loan is converted into permanent financing.)

Based on our review of the Final Rule and the guidance provided by regulators over the last year, a bank engaged in CRE financing should review its loan origination and supervision practices to determine whether its ADC Loans qualify for the CRE Exemption. A bank might:

1. **Evaluate loan-closing practices in light of the CRE Exemption**. The ADC Loan can avoid HVCRE status if the borrower contributed capital prior to the bank advancing funds and such contributed capital is contractually required to remain in the project for its life. This requires that either the borrower contribute before or at closing, or the lender withhold advances under the loan until the borrower demonstrates such contributions have been made. This sequencing is critical because, as the FDIC recently clarified, once an ADC loan is classified as an HVCRE loan, the loan must remain risk weighted at 150% throughout its term. A borrower's contribution after loan funds have been advanced by the bank will not cure a loan's HVCRE classification, however large the contribution.

2. **Draft protective provisions in loan agreements to address the CRE Exemption**. While all ADC Loans and their borrowers are different, the bank should draft ADC Loan documents to ensure the ADC Loan meets the CRE Exemption, and provide that the Bank may recover any increased costs from the borrower resulting from a HVCRE classification.

3. **Stay on top of regulators' interpretation of the CRE Exemption**. Even though the Final Rule has been in place for more than a year, the CRE Exemption remains subject to interpretation. For instance, uncertainty may exist as to what capital satisfies the "contributed capital" requirement and what assets constitute "readily-marketable assets" for the CRE Exemption. A bank should stay on top of regulatory developments to protect against the unwanted surprise of an adverse HVCRE loan classification.

The revived appetite for CRE development and the ever-present competition among banks to originate potentially-lucrative ADC Loans may tempt a bank to attract customers by loosening its credit standards and demanding less up-front capital. Be wary. The Final Rule was designed counter-cyclically: if a borrower does not meet the 15% capital contribution requirement under the Final Rule before the bank advances funds under the ADC loan and if such capital is not contractually committed to remain in the project throughout its life, the loan will be classified as an HVCRE loan and unfavorably risk weighted for the life of the loan. Increased awareness of the framework governing ADC Loans may well save a bank uncomfortable conversations with their borrower and millions of dollars.

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