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## Proposed Changes to HVCRE in 2018

### Overview

International banking regulators responded to the 2008 financial crisis by increasing capitalization requirements with the Basel III Capital Accords.<sup>1</sup> Increased capitalization requirements affect any loan secured by High Volatility Commercial Real Estate (HVCRE). HVCRE loans are credit facilities that finance the acquisition, development, or construction of real property. They typically contain a loan-to-value ratio above 80%, with the borrower contributing less than 15% equity toward the project.<sup>2</sup>

In the U.S., Basel III is implemented through administrative rules set forth by federal agencies (the Federal Reserve, the FDIC and the Office of the Comptroller of the Currency) and through Congressional legislation. Change is coming up both avenues in the form of an agency rule and a bill known as the Pittenger Bill.<sup>3</sup>

The Pittenger Bill was passed by the House on November 7, 2017 and awaits Senate review.

### The Proposed Rule

Under the proposed agency rule, HVCRE exposure is proposed to be referred to as High Volatility Acquisition, Development or Construction (HVADC) exposure, in an attempt to add more specificity to the description.<sup>4</sup>

The proposed rule also creates additional clarity and broadens the scope of affected loans by incorporating a “*primarily* finances” test—in other words, increased capital requirements are required for facilities that *primarily* finance or refinance HVADC real property,<sup>5</sup> as opposed to the existing rule that is understood to impose increased capital requirements only upon loans that *solely* finance or refinance HVADC real property.

The proposal would further expand the scope of HVADC by removing the capital contribution exemption, which allows borrowers with 15% equity in the project to avoid HVADC classification. The Real Estate Roundtable,

<sup>1</sup> Basel Committee on Banking Supervision, [Basel III leverage ratio framework and disclosure requirements](https://www.bis.org/publ/bcbs270.pdf) <https://www.bis.org/publ/bcbs270.pdf> (January 2014) (Basel Accords I and II preceded the 2008 financial crisis).

<sup>2</sup> HVCRE as defined in the current U.S. rule, <https://www.federalregister.gov/documents/2013/10/11/2013-21653/regulatory-capital-rules-regulatory-capital-implementation-of-basel-iii-capital-adequacy-transition> (October 2013).

<sup>3</sup> The Pittenger Bill passed in the House and is pending in the Senate, Clarifying Commercial Real Estate Loans, <https://www.congress.gov/bill/115th-congress/house-bill/2148/text> (November 2017).

<sup>4</sup> [Proposed Rule] Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996, <https://www.fdic.gov/news/board/2017/2017-09-27-notice-dis-b-fr.pdf> (October 2017).

There are two methods for determining exposure to risk: the Standard Approach (which applies to all board-regulated institutions) and the Advanced Approach (which applies to certain large/international banking organizations). The new definition applies only to Standard Approach banks, not the whole scheme of Standard Approach and Advanced Approach banks. Some feel that two parallel schemes will add complexity, rather than simplicity. Comment Letter dated December 22, 2017 from L. Pendergast to OCC, FDIC, and the Federal Reserve, page 3.

<sup>5</sup> [Proposed Rule] Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996, <https://www.fdic.gov/news/board/2017/2017-09-27-notice-dis-b-fr.pdf> (October 2017).

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Mortgage Bankers Association, and CRE Finance Council all oppose this, describing the change as eliminating a risk-sensitive incentive.<sup>6</sup>

Acknowledging that more loans will be subject to the new rule, the rule proposes a reduction in the required risk weight for HVADC loans from 150% to 130%.<sup>7</sup> In other words, the proposed rule would require banks to reserve capital at a rate of \$1.30, rather than the existing \$1.50, per \$1.00 of credit extended. In comparison, non-HVCRE loans require the bank to reserve \$1.00 reserve per each \$1.00 of credit extended.<sup>8</sup>

The proposed rule also clarifies when loans cease being HVADC loans and become newly defined “permanent loans” to which the increased capital requirements no longer apply. A permanent loan is defined as a “prudently underwritten loan that has a clearly identified ongoing source of repayment sufficient to service amortizing principal aside from the sale of the property.”<sup>9</sup>

### The Proposed Law

Like the agency rule, the congressional bill changes the definition of HVCRE and expands the pool of affected loans. The bill is less nuanced than the rule, but the net effect is the same.

The bill does not prescribe specific capital weighting requirements, leaving the 130% or 150% determination to the administrative rule.

Like the rule, the bill makes clear that a loan ceases to be considered an HVCRE loan when: (a) development or construction is complete, and (b) cash flow is sufficient to support the debt service and operating expenses to the satisfaction of the depository institution and determined in a manner that is consistent with its underwriting criteria.<sup>10</sup>

Finally, consistent with the existing regulation, the proposed law removes current restrictions on cash distributions as long as 15% of the borrower’s equity is invested in the deal.

### **Regulatory and Legal Changes: How Are Borrowers Benefitted?**

The rule is more nuanced and the bill more succinct, but the proposals could benefit borrowers in the following three ways.

First, upcoming changes may allow HVCRE loans to be re-classified once the borrower secures permanent financing. Second, changes may ease current prohibitions on cash distributions. And third, changes that reduce capital requirements will allow banks to provide more competitive terms on loans to finance HVCRE.

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<sup>6</sup> Comment Letter dated December 21, 2017 from J. DeBoer to OCC, FDIC, and the Federal Reserve; Comment Letter dated December 21, 2017 from D. Stevens to OCC, FDIC, and the Federal Reserve; Comment Letter dated December 22, 2017 from L. Pendergast to OCC, FDIC, and the Federal Reserve.

<sup>7</sup> [Proposed Rule] Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996, <https://www.fdic.gov/news/board/2017/2017-09-27-notice-dis-b-fr.pdf> (October 2017).

<sup>8</sup> In its comment to the proposed rule, The Real Estate Roundtable suggests that empirical data might not exist to support the conclusion that risk weight protects a bank from exposure. Comment Letter dated December 21, 2017 from J. DeBoer to the OCC, FDIC, and Federal Reserve, page 4. The CRE Finance Council suggests that risk weights be assigned commensurate with actual risk and performance, rather than at a single, pre-defined percentage weight. Comment Letter dated December 22, 2017 from L. Pendergast to OCC, FDIC, and the Federal Reserve, page 4.

<sup>9</sup> [Proposed Rule] Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996, <https://www.fdic.gov/news/board/2017/2017-09-27-notice-dis-b-fr.pdf> (October 2017).

<sup>10</sup> [Proposed Law] Clarifying Commercial Real Estate Loans, <https://www.congress.gov/bill/115th-congress/house-bill/2148/text> (November 2017).