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House Passes Bill Addressing Industry Concerns Regarding the Capital Treatment of High Volatility Commercial Real Estate (HVCRE) Exposures

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STATUS AND BACKGROUND OF LEGISLATION

On November 7, 2017, the House of Representatives, by voice vote, passed H.R. 2148, the Clarifying Commercial Real Estate Loans Act (the "Bill"). The Bill was reported favorably out of the House Financial Services Committee (the "HFSC") with a bipartisan vote of 59 to 1.[1] The Bill is now pending in the Senate where it has been referred to the Committee on Banking, Housing, and Urban Affairs.[2] The prospects for passage in the Senate are uncertain.

If enacted, the Bill would add a new Section 51 to the Federal Deposit Insurance Act (the "FDIA") to address the capital treatment under the U.S. Basel III capital rules of acquisition, development, and construction (ADC) loans characterized as high volatility commercial real estate (HVCRE) exposures. The capital rules currently in effect require that, under the "standardized approach," as of January 1, 2015, HVCRE exposures must be risk-weighted at 150% rather than the 100% risk weighting accorded to other commercial loans.[3] This higher risk weighting increases the capital that banks are required to carry against HVCRE exposures.

Banks and representatives of the real estate industry have criticized the complexity of the HVCRE exposure definition, its uncertain application, and its burden on ADC lending. The Bill seeks to remove some of this uncertainty and reduce the burden of the rule by complementing the rule's HVCRE exposure definition with a new definition of "HVCRE ADC loans." A fair reading of the intention of the Bill is that for an ADC loan to qualify for higher capital treatment as an HVCRE exposure under the capital rules, it must meet both the definition of an HVCRE exposure in the capital rules *and* the HVCRE ADC loan definition in the Bill.[4] As the HVCRE ADC loan definition is narrower in scope than the definition of an HVCRE exposure in the current capital rules, based on this reading, the Bill has the effect of narrowing the scope of ADC loans that would be subject to the higher capital charge. In effect, this would prevent the Federal Banking Agencies from setting a higher risk weight for any HVCRE exposure that is not also an HVCRE ADC loan.

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[1] *See* H.R. Rep. No. 115-392, *available at*: https://www.congress.gov/115/crpt/hrpt392/CRPT-115hrpt392.pdf.

[2] There does not appear to be companion legislation with any Senate sponsors or co-sponsors. Further, similar legislation was not included in a recently released draft of a financial regulatory reform bill proposed by Sen. Mike Crapo (R-ID), chairman of the Senate Committee on Banking, Housing, and Urban Affairs.

[3] *See* definition of HVCRE exposure at 12 C.F.R. § 324.2(FDIC); 12 C.F.R. § 217.2 (Board); 12 C.F.R. § 3.2 (OCC). 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).

[4] The language of the Bill (proposing to add a new Section 51(a) to the FDIA) does not literally support this construction, but a literal reading of the language is inconsistent with the Bill taken as a whole and its apparent purpose. It is beyond the scope of this Client Alert to discuss this analytical issue.

The Bill was originally introduced on April 26, 2017. The passage of the Bill by the House on November 17, 2017, closely followed the September 27, 2017 publication of a notice of proposed rulemaking (NPR)[5] by the Board of Governors of the Federal Reserve System (the "Board"), the Federal Deposit Insurance Corporation (the "FDIC"), and the Office of the Comptroller of the Currency (the "OCC", and, together with the Board and the FDIC, the "Federal Banking Agencies"). The NPR is a separate effort by the Federal Banking Agencies to address uncertainties raised by the existing HVCRE exposure definition. The approach taken in the NPR is discussed at length in one of our recent Client Alerts.[6] In short, the NPR redefines an HVCRE exposure under the standardized approach for calculating risk weighted assets as a high volatility acquisition, construction, or development (HVADC) credit facility. Although real estate industry representatives have praised elements of the NPR, they have noted that in certain respects the NPR would increase the capital burden of making ADC loans. One of the most contentious aspects of the NPR is its broadening of the class of ADC loans subject to higher capital requirements by repealing an exemption for ADC loans that meet an appropriate loan-to-value (LTV) ratio and for which the borrowers have contributed equity of not less than 15% of the "as completed" value of the project. On the other hand, the NPR would lower the risk weight for HVADC credit facilities from 150% to 130%, in an effort, in part, to mitigate the effect of broadening the class of ADC loans subject to a higher capital charge.

On October 11, 2017, during the Bill's mark-up in the HFSC, Rep. Carolyn Maloney (D-NY) introduced several amendments (the "Maloney Amendments"), some of which clearly respond to the NPR. The most important of these is the addition of an explicit reference to successor regulations to the current capital rules that might be adopted before the enactment of the Bill. Rep. Maloney's stated intention was to ensure that the definition of HVCRE ADC loans contained in the Bill would override any successor regulation (such as the proposed regulations set forth in the NPR) adopted before the Bill's enactment to the extent that the successor regulations broadened the HVCRE exposure definition beyond the HVCRE ADC loan definition contained in the Bill. In other words, the specific intention was to nullify the broader coverage given to HVCRE exposures by the HVADC credit facility definition contained in the NPR.[7]

The change in definition of an HVCRE exposure accomplished by the Bill would 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.[8] By contrast, the NPR would change the HVCRE exposure definition only under the standardized approach, leaving advanced approaches banks to use the existing HVCRE exposure definition under the internal ratings-based method while using the HVADC credit facility definition for the standardized approach.

As discussed, the prospects for passage of the Bill in the Senate during this Congress are unclear.[9] Capital rules are complex. Congress has, as a general rule, delegated to the Federal Banking Agencies the responsibility for prescribing capital standards.[10] Congress last addressed risk-based capital in 2010 under the Dodd-Frank Wall

[5] 82 Fed. Reg. 49984 (Oct. 27, 2017), *available at*: https://www.fdic.gov/news/board/2017/2017-09-27-notice-dis-b-fr.pdf.

[6] *See* https://media2.mofo.com/documents/170928-capital-treatment-adc-loans.pdf.

[7] As discussed above in note 4, the Bill's text adding proposed Section 51(a) to the FDIA (which contains the reference to successor regulations) does not appear to have literally accomplished this result. However, the intention of the Maloney Amendments appears clear enough.

[8] *See* definition of "advanced approaches" financial institutions at 12 C.F.R. § 324.2 (FDIC); 12 C.F.R. § 217.2 (Board); 12 C.F.R. § 3.2 (OCC).

[9] *See* note 2 *supra*.

[10] Section 38 of the FDIA, 12 U.S.C. § 1831o (effective Dec. 19, 1992).

Street Reform and Protection Act (the “Dodd-Frank Act”). Under Section 171 of the Dodd-Frank Act, Congress required the Federal Banking Agencies to establish minimum capital floors.[11] Congress did not, however, prescribe or recommend particular risk weights or, as in the case of the Bill, attempt to limit regulatory discretion in this connection. Seen in this light, the Bill represents an unusual legislative initiative in the bank capital arena and may give the Senate pause.[12]

Notwithstanding the observations made above, enactment of the Bill is certainly possible. The Bill passed with broad bipartisan support in the House and can be presumed to have bipartisan support in the Senate. However, another path to address the uncertainties and infirmities in the current HVCRE exposure definition and interpretations may also be followed. It may well be that these issues will be successfully addressed in regulation rather than, ultimately, in legislation. Even if never enacted, the Bill, now that it has passed the House with bipartisan support, is bound to exercise considerable influence on the regulatory initiative, discussed above, set forth in the NPR. The comment period under the NPR ends on December 26, 2017. It may be that the Senate will defer action on the Bill until it determines what the Federal Banking Agencies are likely to do under the NPR initiative. At the end of the day, the Federal Banking Agencies may settle on an approach that incorporates many or some of the elements of the Bill. If regulatory action satisfies the Senate, there may be no need to take legislative action.

CORE DEFINITION OF AN HVCRE ADC LOAN

The existing HVCRE 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.[13] Instead, the Bill would define an “HVCRE ADC loan” as a real estate secured credit (before application of various exemptions) that:

i. primarily finances, has financed, or refinanced the acquisition, development, or construction of real property;

ii. has the purpose of providing financing to acquire, develop, or improve such real property into income-producing real property; and

iii. is dependent upon future income or sales proceeds from, or refinancing of, such real property for the repayment of such credit facilities.

The proposed definition of an HVCRE ADC loan purports to clarify some interpretive uncertainty that has arisen under the existing definition.

- *Treatment of unsecured ADC credits.* To be an HVCRE ADC loan under the Bill, the credit in question must explicitly be real estate secured. This addresses uncertainty under the current definition of an HVCRE exposure as to whether an unsecured ADC loan could constitute an HVCRE exposure. The NPR takes the

[11] 12 U.S.C. § 5371, commonly referred to as the “Collins Amendment.”

[12] In addition, its text will need to be carefully analyzed to determine whether it accomplishes its mission, and whether it meshes properly with existing capital rules. *See* note 4 *supra*. For example, what is the effect of the Bill on the 150% risk weight assigned to defaulted loans under the capital rules? Does the language of the Bill preclude the Federal Banking Agencies from assigning a risk weight of 150% to defaulted ADC loans that are not HVCRE exposures or HVCRE ADC loans?

[13] *See* 12 C.F.R. § 324.2 (FDIC); 12 C.F.R. § 217.2 (Board); 12 C.F.R. § 3.2 (OCC).

position that an ADC loan not secured by real estate can still qualify as an HVADC credit facility if it otherwise meets the definitional elements and does not qualify for an exemption.[14]

- *Multi-purpose loans*. To be an HVCRE ADC loan under the Bill, the credit must "primarily" finance acquisition, development, or construction. The use of the term "primarily" may be seen as addressing two situations. The first is where a portion of the credit is used for purposes other than for acquisition, construction, or development of real property—*e.g.*, to acquire equipment. The second is where a portion of the credit is used for purposes that would qualify for an exemption, such as 1-4 family residential financing (discussed below). Under the existing definition of an HVCRE exposure, the Federal Banking Agencies take the position that only the portion of a multi-purpose loan that finances the commercial real estate (and would qualify for HVCRE treatment on a stand-alone basis) will be deemed to be an HVCRE exposure.[15] In other words, an allocation is required between the portion of the loan that is an HVCRE exposure and the portion that is not. By contrast, the "primarily finances" language in the Bill takes an all-or-nothing approach, which is the same as in the NPR.[16] If a majority of the loan proceeds are used for purposes that would qualify the credit as an HVCRE exposure, the entire credit would be an HVCRE exposure. If not, the credit would not be an HVCRE exposure.

- *Purpose test*. 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."[17]

- *Source of repayment*. To be an HVCRE ADC loan under the Bill, the credit must depend upon future income or sales proceeds (or refinancing) for repayment. In effect, this requirement, as discussed below, 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, as determined by the bank, in accordance with the bank's applicable loan underwriting criteria for permanent financings.

THE LTV/CAPITAL CONTRIBUTION EXEMPTION

Under the existing HVCRE exposure definition, there is an exemption for 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 stay in the project through the life of the project.[18] The Bill retains this exemption—one upon which many bank lenders have relied to avoid HVCRE exposure characterization. By contrast, the NPR does not retain the exemption. Even though the NPR lowers the capital charge to 130%, the failure to include the

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[14] 82 Fed. Reg. 49988.

[15] 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.

[16] *See* 82 Fed. Reg. 49988. "For purposes of the proposed HVADC exposure definition, an exposure would be classified as an HVADC exposure only if the lending facility 'primarily finances' acquisition, development, or construction activities, meaning that more than 50 percent of the funds (*e.g.*, loan proceeds) will be used for acquisition, development, or construction activities."

[17] This may suggest that the loans to finance the acquisition, development, or construction of owner-occupied commercial real estate are not intended to be covered by the Bill, as such property would not ordinarily be deemed to be income producing.

[18] 12 C.F.R. § 324.2 (FDIC); 12 C.F.R. § 217.2 (Board); 12 C.F.R. § 3.2 (OCC).

capital contributed exemption in the NPR, if adopted as proposed, may have a significant adverse capital effect on banks' ADC lending.

In retaining the capital contributed exemption, the Bill makes two important clarifications/changes to existing interpretations of the exemption from the current HVCRE exposure definition.

- *Value of Contributed Real Property.* Existing regulatory interpretation of the HVCRE exposure definition does not allow a developer to count appreciation in the value of real property when calculating compliance with the 15% contributed capital requirement.[19] Under the 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 Bill, the amount of contributed capital required to stay 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 stay in the project.[20]

EXEMPTIONS FOR RECLASSIFICATION AND PERMANENT FINANCING

Under the Bill, an ADC credit facility would be eligible for reclassification as a non-HVCRE ADC loan upon: (i) the 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 the concern that banks may need formally to restructure ADC loans to qualify for such conversion. No such restructuring is suggested by the Bill's text.[21]

In addition, the Bill would create two specific exemptions for permanent financing, 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 debt service and expenses of the real property, as determined by the bank, in accordance with the bank's applicable loan underwriting criteria for permanent financings.[22]

EXEMPTION FOR LOANS ORIGINATED BEFORE 2015

The existing 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.[23] The Bill would exempt all ADC loans originated before January 1, 2015, from capital treatment as an HVCRE ADC loan.

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[19] FAQ No. 7.

[20] FAQ No. 15.

[21] It is possible to construe the existing HVCRE exposure definition not to require formal restructuring of a credit facility to escape HVCRE exposure characterization.

[22] 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.

[23] *See* FAQ No. 2.

RETENTION OF OTHER EXEMPTIONS

The Bill retains the exemptions for credit facilities financing the acquisition, development, or construction 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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