

Client Alert

September 24, 2018

Agencies to Conform HVCRE Exposure Definition to New Law

By Henry M. Fields and Mark R. Sobin

As reported in a prior [Client Alert](#), new federal legislation enacted into law on May 24, 2018¹ narrows the types of acquisition, development, and construction (ADC) loans that may be subject to a heightened risk weight under the U.S. capital rules. Under the U.S. capital rules, ADC loans characterized as high-volatility commercial real estate (HVCRE) exposures are required to be risk-weighted at 150%, rather than the 100% risk-weighting generally accorded to other commercial loans.² Now, under the new law, to be subject to the 150% risk weight, HVCRE exposures must meet a narrower definition of “HVCRE ADC loans.” In other words, unless an HVCRE exposure meets the HVCRE ADC loan definition, it is subject to a 100% risk weight (unless it would carry another risk weight by reason of other circumstances, such as being in default).

On July 6, 2018, the Agencies³ issued Guidance⁴ to the effect that, prior to any further action from the Agencies, financial institutions may rely on the definition of an HVCRE ADC loan in the new law or, alternatively, on the definition of an HVCRE exposure under current regulations.⁵ By issuing the Guidance, the Agencies implicitly acknowledged the need to promulgate new regulations to take into account the new law.

As a first step toward making these conforming changes, on September 18, 2018, the Agencies jointly issued a notice of proposed rulemaking to revise the definition of an “HVCRE exposure” to conform to the definition of an “HVCRE ADC loan” in the new law (the “Proposed Rule”).⁶ The Agencies also solicited comments from the public on the Proposed Rule. The comments will be due 60 days after the date of the publication of the Proposed Rule in the *Federal Register*.

¹ Section 214 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA). The text of EGRRCPA is available here: <https://www.congress.gov/115/bills/s2155/BILLS-115s2155enr.pdf>. For a summary of the provisions included within EGRRCPA, please see our Client Alert, available at: <https://media2.mofo.com/documents/180522-financial-regulatory-reform.pdf>.

² See 12 C.F.R. § 324.2 (FDIC); 12 C.F.R. § 217.2 (Federal Reserve); 12 C.F.R. § 3.2 (OCC) (defining “HVCRE exposure”). 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) (Federal Reserve); 12 C.F.R. § 3.32(j) (OCC).

³ The term “Agencies” refers to, collectively, the Board of Governors of the Federal Reserve System (“Federal Reserve”); the Office of the Comptroller of the Currency (OCC); and the Federal Deposit Insurance Corporation (FDIC).

⁴ The term “Guidance” refers to two separate statements from the Agencies. First, the Federal Reserve issued the “Statement regarding the impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA),” which is available here: <https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706b1.pdf>. Second, the Agencies jointly issued the “Interagency statement regarding the impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA),” which is available here: <https://www.occ.gov/news-issuances/news-releases/2018/nr-ia-2018-69a.pdf>. Both statements take a consistent approach with respect to EGRRCPA’s changes to the treatment of ADC loans as HVCRE exposures. For our Client Alert discussing these guidance documents, please see: <https://www.mofo.com/resources/publications/180712-hvcre-exposures.html>.

⁵ Under the notice of proposed rulemaking, the Agencies request comment on whether banks should be required to reevaluate ADC loans under the revised HVCRE exposure definition for all ADC loans originated on or after January 1, 2015 once the Proposed Rule becomes final.

⁶ For a copy of the Proposed Rule, please see: <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180918a.htm>.

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At its core, the notice of proposed rulemaking would simply import the new law's definition of an HVCRE ADC loan into the capital rules.⁷ In addition, the discussion of the Proposed Rule in the notice of proposed rulemaking (the "Preamble") addresses some interpretative issues surrounding the new HVCRE ADC loan definition and seeks comments on others, as described below.

- **Application to Holding Companies.** Even though the new law by its terms applies only to depository institutions, the revised HVCRE exposure definition would also apply to bank holding companies, savings and loan holding companies, and intermediate holding companies of foreign banking organizations.
- **Land Loans.** The Agencies take the position in the Preamble that loans secured by vacant land (except land known to be used for agricultural purposes) would be included within the scope of the HVCRE exposure definition. However, under the new definition, to be an HVCRE exposure, an ADC loan must, among other characteristics, have the purpose of providing financing to acquire, develop, or improve real property into "income-producing real property" and be dependent upon future income or sales proceeds from, or refinancing of, such real property for the repayment of the loan. It is not clear that all land loans would meet these components of the definition. The Agencies solicited comment on this point, and we expect arguments to be raised against the Agencies' proposed interpretation.
- **One- to Four- Family Exclusion.** The revised HVCRE exposure definition would retain the exclusion for credit facilities that finance the ADC of one- to four-family residential properties. To determine whether a credit exposure falls within this exclusion, the Agencies would look to the Interagency real estate lending standards ("Lending Standards").⁸ The Lending Standards define a one- to four-family residential property to include "property containing fewer than five individual dwelling units, including manufactured homes permanently affixed to the underlying property (when deemed to be real property under state law)." In addition, the Lending Standards consider condominium and cooperatives as multi-family construction (not one- to four-family residential property), and as a result, the Agencies would consider the one- to four-family exclusion as inapplicable to credit exposures that finance the ADC of condominiums and cooperatives. This is another interpretative issue on which the Agencies have solicited comment and on which disagreement can be expected.⁹
- **Community Development Investment.** As in the new law, the Proposed Rule would exclude credit facilities financing the ADC of real property that qualify as an investment in community development. The Agencies explain in the Preamble that credit facilities will qualify for this exemption if they finance the ADC of real property projects the primary purpose of which is "community development," as such term is defined in the Agencies' Community Reinvestment Act regulations.¹⁰
- **Agricultural Land.** The revised HVCRE exposure definition would retain the exemption for "agricultural land." The Agencies explain in the Preamble that "agricultural land," as used in the Proposed Rule, would

⁷ If the Proposed Rule is adopted, the definition of an "HVCRE exposure" and an "HVCRE ADC loan" will be substantively identical.

⁸ See Interagency Guidelines for Real Estate Lending Policies. 12 C.F.R. Part 208, Subpart J, Appendix C (Federal Reserve); 12 C.F.R. Part 34, Subpart D, Appendix A (OCC); 12 C.F.R. Part 365, Subpart A, Appendix A (FDIC).

⁹ This interpretation is consistent with the approach the Agencies took in a notice of proposed rulemaking published in October 2017.

¹⁰ See 12 C.F.R. Part 24 (OCC); Part 345 (FDIC); Part 228 (Federal Reserve). This is also consistent with the approach that the Agencies proposed in a notice of proposed rulemaking published in October 2017.

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have the same meaning as the term “farmland” is defined in the instructions to the Call Report.¹¹ The Agencies also have solicited comment on this point.

- **LTV/Contributed Capital Exemption.** The revised HVCRE exposure definition (consistent with the new law) would exempt 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 appraised, “as-completed” value to the project; (iii) for which the borrower contributed the minimum amount of capital prior to the advancement of funds (other than a nominal amount to secure a lien); and (iv) the 15% minimum capital contributed to the project is contractually required to remain in the project until the HVCRE exposure has been reclassified as a non-HVCRE exposure. The Preamble discusses the application of this exemption and solicits comments, as follows:
 - *Appraisal of Contributed Real Property.* The revised HVCRE exposure definition (consistent with the new law) would allow the use of the appraised value of the real property contributed by the borrower to satisfy the contributed capital requirement, rather than using the original cost of the property (as required under the existing capital rules). As explained in the Preamble, the value of the contributed real property for purposes of the exemption would be reduced by the amount of any liens on the real property securing the HVCRE exposure.
 - *Appraisal of “As-Completed” Value.* Under the revised HVCRE exposure definition (consistent with the new law), to qualify for the LTV/Contributed Capital Exemption, the borrower must contribute capital of at least 15% of the appraised, “as-completed” value of the real estate. The Preamble describes several instances in which the Agencies would accept a different valuation method for purposes of this calculation. First, with respect to raw land without plans for near-term development, it is proposed that an “as-is” appraisal value may be used rather than an “as-completed” appraisal value. Second, the Agencies would permit an evaluation, rather than require an appraisal, to determine the “as-completed” value of real estate for (i) transactions that are under \$500,000 and are not secured by a single one- to four-family residential property; and (ii) for certain transactions with values of less than \$400,000 in rural areas.¹²
 - *Multi-Phase Projects.* To determine whether the contributed capital meets the 15% minimum, the calculation of the “as-completed” value of real property should be conducted with respect to a “project.” In the Preamble, the Agencies recognize that certain “projects” may be financed in multiple phases. Accordingly, the Agencies propose that an individual phase of a project may be viewed as a single project for purposes of calculating the 15% contributed capital requirement if the individual phase has its own appraised “as-completed” value or an appropriate evaluation.

¹¹ See Call Report Instructions for Schedule RC-C, Part I, Item 1.b. (“Farmland includes all land known to be used or usable for agricultural purposes, such as crop and livestock production. Farmland includes grazing or pasture land, whether tillable or not and whether wooded or not.”), available at: https://www.ffiec.gov/PDF/FFIEC_forms/FFIEC031_034inst_200006.pdf.

¹² This is consistent with the Agencies’ appraisal regulations (12 C.F.R. §§ 225.63 (Federal Reserve); 323.3 (FDIC); 34.43 (OCC)) and with Section 103 of EGRCPA (exempting certain transactions less than \$400,000 in rural areas from appraisal requirements).

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