COSTLY THY HABIT AS THY PURSE CAN BUY: IMPLICATIONS OF THE PROPOSED HVADC RULES FOR BORROWERS AND LENDERS OF ACQUISITION, DEVELOPMENT AND CONSTRUCTION LOANS

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ON SEPTEMBER 27, 2017, THE OFFICE OF COMPTROLLER OF THE CURRENCY, THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, AND THE FEDERAL DEPOSIT INSURANCE CORPORATION (THE "AGENCIES") RELEASED A JOINT NOTICE OF PROPOSED RULEMAKING (THE "NOTICE") THAT WOULD, AMONG OTHER THINGS, SIMPLIFY THE CAPITAL TREATMENT OF HIGH-VOLATILITY COMMERCIAL REAL ESTATE ("HVCRE") LENDING EXPOSURES AND INTRODUCE A PROPOSED HIGH-VOLATILITY ACQUISITION, DEVELOPMENT, AND CONSTRUCTION ("HVADC") EXPOSURE FRAMEWORK. [1] THIS ARTICLE DESCRIBES THOSE CHANGES AND DISCUSSES LEGAL AND COMPETITIVE CONSIDERATIONS FOR BORROWERS AND LENDERS. THE DEADLINE FOR COMMENTS IS 60 DAYS AFTER PUBLICATION IN THE FEDERAL REGISTER.

I. THE EXISTING HVCRE EXPOSURE FRAMEWORK

Since January 1, 2015, the regulatory capital rules for U.S. banks (the "Existing HVCRE Capital Rules") have required loans [2] that are classified as HVCRE exposures to be reported separately from other commercial real estate ("CRE") loans. The Existing HVCRE Capital Rules also require banking organizations that are not subject to the advanced approaches regulatory capital rules implemented by the Agencies (and who thus are subject to the standardized approach) to assign a risk weight of 150% to HVCRE exposures, as opposed to the 100% risk weight for non-HVCRE exposures. [3]

An HVCRE exposure under the current capital rules is defined as a credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development, and construction ("ADC") of real property, unless the facility finances one- to four-family residential properties, certain agricultural or community development exposures, or commercial real estate projects that satisfy the requirements of a contributed capital exemption because the borrower meets certain contributed capital requirements and other prudential lending

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criteria. Because HVCRE exposures are classified as CRE loans to begin with, under the Existing HVCRE Capital Rules, they must be secured primarily by raw land, land development, and construction.

Banking organizations have expressed concern for some time that the regulatory capital rule is unduly burdensome and complex as applied to HVCRE exposures. Compliance traps are particularly sensitive in the details of the contributed capital exemption and determining when a take-out loan satisfies the definition of "permanent financing."

Banking organizations have expressed concern regarding the contributed capital exemption under which exposures are not considered HVCRE exposures if: (i) at the origination of the loan, the loan-to-value ("LTV") ratio is less than or equal to the relevant supervisory LTV ratio standard; (ii) before the advancement of funds, the borrower has contributed capital to the project in the form of cash (including cash paid for land) or readily marketable securities of at least 15% of the real estate's "as-completed" market value; and (iii) any internally generated capital is contractually required to stay in the project for the life of the project. Banking organizations have asserted that the conditions for meeting this exemption are unclear, complex, and burdensome to implement. Further, the Agencies have received numerous questions from banking organizations on the minimum 15% borrower capital contribution requirement, which is measured as a percentage of a project's "as completed" market value.

II. THE PROPOSED HVADC EXPOSURE FRAMEWORK

The Notice is intended to simplify and enhance consistency in the treatment of ADC loans under the standardized approach. The proposed rule, however, would not revise the treatment of HVCRE exposures under the advanced approaches, which would continue to be driven by the methodologies derived by the large and internationally active banks that use it. Below are highlights of the proposed modifications.

A. New Purpose-Based HVADC Exposure Definition

The Agencies propose to replace the HVCRE exposure category as applied in the standardized approach with a newly defined exposure category, termed "HVADC exposure," which would apply to credit facilities that finance ADC activities.

The Notice defines an HVADC exposure as a credit facility that "primarily" finances or refinances: (i) the acquisition of vacant or developed land; (ii) the development of land to prepare to erect new structures, including, but not limited to, the laying of sewers or water pipes and demolishing existing structures; or (iii) the construction of buildings or dwellings or other improvements, including additions or alterations to existing structures.

A loan meets the "primarily finances" requirement if more than 50% of the loan proceeds are intended for ADC activities and none of the exemption criteria described below are met. Under the proposed rule, banks that issue a particular loan would be responsible for pre-determining whether that loan meets the "primarily finances" requirement. Significantly, the proposed "primarily finances" test would supersede the "secured-by" requirement that appears in the current HVCRE exposure definition, which states that CRE loans are secured by ADC real estate, including raw land, land development, and construction. This elimination of the "secured-by" requirement and adoption of the "primarily finances" requirement will likely broaden the scope of coverage under the proposed HVADC exposure definition and will require consideration of whether corporate financing transactions may implicate HVADC.

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B. Elimination of the Contributed Capital Exemption from the HVADC Exposure Definition Eliminates a Headache

The proposed HVADC exposure definition would remove the contributed capital exemption, thereby also removing the need to monitor compliance with supervisory LTV limits and with restrictions on the distribution of internally generated capital. This is an attempt to address banks' concerns about the complexity and potential inconsistent application of the exemption, due to the multiple requirements to qualify for the exemption and the potential conflict between the borrower's organizational documents and the contractual limitations on distributions from the project that result from complying with the requirements.

C. Carry-over and Clarification of Three Other Exemptions from the Existing HVCRE Capital Rules

The Agencies propose to carry over three other exemptions from the Existing HVCRE Capital Rules with only clarifying changes.

- *Residential properties.* The proposed HVADC exposure definition would exempt credit facilities that finance or refinance the ADC of one or more one- to four- family residential properties. Condominiums, cooperatives, and apartment buildings would generally not qualify as one- to four-family residential properties unless the related ADC project contained fewer than five individual dwelling units. Loans solely to acquire undeveloped land, however, would not qualify for this exemption.
- *Community development projects.* The proposed HVADC exposure definition would exempt community development projects, but it would adopt a simpler approach than the HVCRE exposure definition by removing certain exceptions and statutory cross-references.
- *Agricultural exposures.* The proposed HVADC exposure definition would exempt loans that finance or refinance the purchase or development of agricultural land, without substantially differing from the current exemption for agricultural land development under the HVCRE exposure definition. The term "agricultural" would extend to timberland and fish farms but not include manufacturing or processing plants related to agricultural products, such as a diary processing plant.

D. New Definition of "Permanent Financing" Would Provide Greater Certainty When HVADC Status Falls Away

Similar to the current situation under the Existing HVCRE Capital Rules, an ADC exposure would cease to be an HVADC exposure under the proposed rule when it is converted to "permanent financing." Under the Existing HVCRE Capital Rules, whether a loan is permanent financing is subject to banks' underwriting criteria for long-term mortgage loans, which arguably injects an element of subjective determination to the definition of HVADC exposure. The HVADC exposure definition in the proposed rule would provide greater certainty as to when a financing becomes permanent by explicitly defining a "permanent loan" as "a prudently underwritten loan that has a clearly identified ongoing source of repayment sufficient to service amortizing principal and interest payment aside from the sale of the property." Note there is no requirement that a loan be fully amortizing during its term to satisfy the definition of "permanent loan".

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E. New Risk Weight; Grandfathering

The Notice also contains provisions that tend to ease the burden on banks when the proposed rule comes into force. The Notice states that the proposed reduction of the risk weight for HVADC exposures from 150% to 130% is intended to counterbalance the anticipated increase in the number of loans that would be captured by the proposed HVADC exposure definition owing to the elimination of the contributed capital exemption and replacement of the "secured-by" requirement with the "primarily finances" test.

The Notice also contains a grandfathering provision that would retain the capital rule's treatment for ADC exposures outstanding or committed as of the effective date of any final rule. Banks would not need to reevaluate their existing ADC loans against the new standard. Loans originated before the effective date could continue to benefit from provisions under the Existing HVCRE Capital Rules such as, for example, the contributed capital exemption. An existing HVCRE exposure would continue to carry a risk weight of 150% until it is sold or paid in full or is converted to permanent financing under the current HVCRE exposure definition.

III. IMPLICATIONS FOR PLAYERS IN THE ADC FINANCING MARKET

Different parts of the proposed rule will impact different market players in different ways. This section analyzes the proposed rule's implications for three major players in ADC financing market: bank lenders, borrowers, and nonbank lenders.

A. Implications for Bank Lenders and Their Borrowers

The Agencies have stated that they believe the proposed HVADC exposure definition would likely capture more ADC exposures than are currently captured by the definition of HVCRE exposures. Although this prediction may justify a general expectation that ADC financing will be more expensive for bank lenders, that would not necessarily be true for every bank. Therefore, bank lenders are advised to make a careful assessment of the proposed rule's net effect on their lending activities and the resulting regulatory capital consequences. The analysis below may serve as guidance for banks.

The replacement of the "secured-by" test with the "primarily finances" test and the elimination of the contributed capital exemption can be expected to broaden the scope of loans that would be considered to be HVADC exposures. The elimination of the contributed capital exemption will likely broaden the coverage because it prevents bank lenders from exempting ADC loans by requiring borrowers to contribute a certain amount of capital and prohibiting distributions during construction. The "primarily finances" test will likely capture loans that are not secured by land and thus would not have been captured by the HVCRE exposure definition. On the other hand, the "primarily finances" test may also exclude certain multipurpose loans that would have been designated as HVCRE exposures where more than 50% of loan proceeds finance non-ADC activities, such as equipment financing. Therefore, for individual bank lenders, the change of the scope of the captured loans can go either way, and the net effect will depend on their ADC financing activities going forward.

The proposed risk weight reduction further complicates the assessment with respect to banks' regulatory capital requirements. Certain new ADC exposures that would have been designated as HVCRE exposures might carry a lower risk weight of 130% going forward as opposed to the 150% risk weight they would have received under the Existing HVCRE Capital Rules. Other new ADC exposures that would not be considered HVCRE exposures

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under the Existing HVCRE Capital Rules definition might receive a higher risk weight of 130% as opposed to the 100% risk weight they would otherwise have received. The net effect, again, will vary from bank to bank.

The replacement of the "secured-by" test with a "primarily finances" test, however, may impose new due diligence and compliance burdens on both bank lenders and borrowers, similar in general terms to the compliance burdens imposed by the margin lending rules. This may result in bank lenders seeking to cover HVADC compliance in covenants regarding the use of proceeds and perhaps requesting corresponding legal opinions even in loans that do not appear to have a CRE function.

To the extent borrowers may find it more costly to finance ADC activities through bank lenders, including through non-real estate secured facilities, they may turn to nonbank lenders for alternative financing options.

B. Implications for Nonbank Lenders

The proposed rule could affect the competitive position for nonbank lenders in ADC lending to the extent that the proposed rule makes it more expensive on a net basis for banks to fund ADC. To the extent that ADC financing becomes more expensive for bank lenders, nonbank lenders will find themselves in a better position to compete with bank lenders and to attract borrowers. For the reasons discussed above, the competitive position will depend in part on whether the lowering of the risk weight is offset by the broadening of the scope of coverage.

IV. CONCLUSION

The proposed HVADC rules give with one hand and they take away with the other. For banks, the HVADC rules should simplify the task of determining whether a loan is subject to a heightened regulatory capital charge, albeit at the cost of covering more loans. This is mitigated by a proposed reduction of the risk weight from 150% to 130%. For borrowers and for banks, the proposed rule would require greater focus on the use of proceeds of general corporate loans regardless of whether secured by real property. The competitive position of nonbank lenders that filled the ADC financing space may be affected as the economics of ADC lending for banks is affected.

The Agencies are soliciting comments on the clarity of proposed changes, the operational concerns with the proposed HVADC exposure definition, and the implementation challenges with the exemptions. They also seek market input to assist their evaluation of the effectiveness of their proposed modifications and are open to alternative ideas. The comment period will end 60 days after the Notice is published in the Federal Register. The Notice has not yet been published.

We acknowledge the material contribution of Hilda Li, an associate in the New York office of K&L Gates.

Notes:

[1] A link to the Notice appears here.

[2] 12 C.F.R. pts. 3, 5, 6, et al. (OCC); 12 C.F.R. pts. 208, 217, 225 (Federal Reserve); 12 C.F.R. pts. 303, 308, 324, et al. (FDIC).

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[3] The U.S. regulatory capital rules, which implement the Basel III framework in the United States, detail two implementation approaches to determining risk-weighted regulatory capital requirements. Under the "standardized approach," banks apply standard risk weightings to different categories of exposures without distinguishing among different levels of risk within a single asset category based on the relative creditworthiness of the obligor and the tenor of the obligation. A small number of large, internationally active U.S. banking organizations are required, and other institutions may elect – with the consent of their primary regulators, to use one of two advanced approaches for measuring operational risk and credit risk based on their own experience and internal credit scoring methodologies. *See* 78 Fed. Reg. 62018 (Oct. 11, 2013).

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