Client Alert

July 2018

HVCRE AND EGRRCPA

One of the signature accomplishments of the Trump administration thus far has been EGRRCPA, otherwise known as the Economic Growth, Regulatory Relief, and Consumer Protection Act. Signed into law by the president on May 24, 2018, this law modifies certain provisions from the Dodd-Frank Act and makes other changes to the financial regulatory system. This client alert will focus on one of those changes: high-volatility commercial real estate, better known as HVCRE.

What is HVCRE?

HVCRE is a Basel III, risk-weighted, bank capital concept. It is a subset of commercial real estate projects deemed by the regulators to be high risk and, therefore, necessitating a higher capital buffer to protect the bank against the risk that the loan associated with the project will go bad.

Bad commercial real estate loans played a disproportionate role in the failures of banks after the financial crisis of 2007–2008. Thus, the Basel III capital standards that were developed in response to the financial crisis included a provision that established the concept of HVCRE and required HVCRE loans to carry a capital risk-weighting of 150 percent.

What was the problem with HVCRE?

According to critics of the HVCRE regime, there were three problems with the initial formulation of HVCRE: (i) the definition was too complex and ambiguous; (ii) the 150 percent risk-weighting was too conservative; and (iii) it unnecessarily tightened credit for commercial real estate projects.

When the Basel III capital regulations were finalized in 2013, HVCRE was defined as a credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development, or construction (ADC) of real property, unless the facility finances:

> (1) One- to four-family residential properties;
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> (2) Real property that:
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> > (i) Would qualify as an investment in community development under 12 U.S.C. 338a or 12 U.S.C. 24 (Eleventh), as applicable, or as a "qualified investment" under 12 CFR parts 25 (national banks) and 195 (Federal savings associations), and
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> > (ii) Is not an ADC loan to any entity described in 12 CFR 25.12(g)(3) (national banks) and 12 CFR 195.12(g)(3) (Federal savings associations), unless it is otherwise described in paragraph (1), (2)(i), (3) or (4) of this definition;
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> (3) The purchase or development of agricultural land, which includes all land known to be used or usable for agricultural purposes (such as crop and livestock production), provided

that the valuation of the agricultural land is based on its value for agricultural purposes and the valuation does not take into consideration any potential use of the land for non-agricultural commercial development or residential development; or

(4) Commercial real estate projects in which:

(i) The loan-to-value ratio is less than or equal to the applicable maximum supervisory loan-to-value ratio in the OCC's real estate lending standards at 12 CFR part 34, subpart D (national banks) and 12 CFR part 160, subparts A and B (Federal savings associations);

(ii) The borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 percent of the real estate's appraised "as completed" value; and

(iii) The borrower contributed the amount of capital required by paragraph (4)(ii) of this definition before the national bank or Federal savings association advances funds under the credit facility, and the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project. The life of a project concludes only when the credit facility is converted to permanent financing or is sold or paid in full. Permanent financing may be provided by the national bank or Federal savings association that provided the ADC facility as long as the permanent financing is subject to the national bank's or Federal savings association's underwriting criteria for long-term mortgage loans.[1]

Got that? In other words, HVCRE was defined as ***all*** nonpermanent ADC financing of real property, subject to four exceptions: (1) residential; (2) community development; (3) agricultural; and (4) certain commercial real estate projects.

It was this fourth categorical exception that was criticized as ambiguous and complex. In particular, the requirement (i) of contributing "at least 15 percent of the real estate's appraised value in the project" coupled with the requirement (ii) that "the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project" was generally interpreted by the regulators to mean that all funds contributed or generated by the project may not be withdrawn until the loan was converted to permanent financing. This is bizarre. Why establish a 15 percent threshold upon the commencement of the project and then prohibit any withdrawals? If the answer is that the riskiness of the projects necessitates an increasing amount of capital over time, then why not require more than 15 percent capital up front, especially since the loan is the most risky at origination? The best reading of the requirement should have been that withdrawals of equity in the project are not permitted if such withdrawals would cause the borrower's equity to dip below the initial 15 percent threshold. But that, admittedly, is not what the definition says, and not, unfortunately, how the regulators interpreted it.

Three and a half years later, in 2017, even the regulators favored "replacing the framework's complex treatment of HVCRE exposures with a more straightforward treatment for most ADC loans."[2] The same year, the regulators issued a proposed rulemaking with a simplified HVCRE definition and a reduction in the bank capital risk-weighting from 150 percent to 130 percent.[3] EGRRCPA essentially overrules the HVCRE changes proposed by the regulators in 2017.

[1] 12 C.F.R. § 3.2.
[2] Joint Report to Congress, Economic Growth and Regulatory Reduction Act, March 2017, p.22.
[3] 82 Fed. Reg. 49,984 (Oct. 27, 2017).

So how did EGRRCPA change HVCRE?

Section 214 of EGRRCPA narrows and simplifies the definition of HVCRE, but it does not change the 150 percent bank capital risk-weighting.[4] The change to the HVCRE definition was effective immediately—that is, as of May 24, 2018, no regulatory rulemaking is required.

Under EGRRCPA, only "HVCRE ADC" loans are subject to a 150 percent risk-weighting. HVCRE ADC loans are loans that:

1. primarily[5] finance the acquisition, development or construction of real property;
2. have the purpose of creating income-producing[6] real property; and
3. are dependent upon future income from such real property for the repayment of the loan.

The revised definition retained and simplified the four categorical carve-outs from the original HVCRE definition (i.e., residential, community development, agricultural and certain commercial real estate projects). In particular, the carve-out related to CRE was revised in just the same way as proposed above as the "best reading" of the original capital contribution requirement—the 15 percent capital contribution requirement was retained, but withdrawals were permitted so long as the withdrawals were not made against the initial 15 percent contribution.

Moreover, EGRRCPA narrowed the definition of HVCRE by adding the following categorical exceptions to the definition:

1. all loans made prior to January 1, 2015;
2. the acquisition or refinance of existing income-producing real property secured by a mortgage on such property, if the cash flow being generated by the real property is sufficient to support the debt service and expenses of the real property, in accordance with the institution's applicable loan underwriting criteria for permanent financings; and
3. improvements to existing income-producing improved real property secured by a mortgage on such property, if the cash flow being generated by the real property is sufficient to support the

[4] Not changing the 150 percent bank capital risk-weighting is less consequential than might otherwise be the case given the community bank leverage ratio (CBRL) provision that was included in EGRRCPA. The Congressional Budget Office estimated that 70 percent of community banks would opt into this bank regulatory capital regime. Although the CBRL implementing regulation is likely at least six months away from being finalized (the regulation will likely be first promulgated for notice and comment), once it is finalized, the risk-weighting of HVCRE will be moot for those community banks that opt in to the regime.

[5] Future regulatory guidance on this statute will likely address what is meant here by "primarily." For example, if a loan is for a mixed-used condominium project where the ground floor units are reserved for retail, income-producing units and the units above are dedicated to sale, is such a loan "primarily" an HVCRE ADC loan? Ordinary use of the word "primarily" suggests that if over 50 percent of the proceeds of the loan would be used for purposes consistent with the HVCRE ADC definition, then the HVCRE ADC label would apply to the entire loan. Conversely, if less than 50 percent of the proceeds of the loan are used for HVCRE ADC purposes, there is a good argument that the entire loan should be exempt from the HVCRE ADC classification.

[6] "Income-producing" means leasing real estate, not reselling developed real estate (e.g., condominium development). See the FDIC's FAQs on HVCRE Exposures here ("For an ***income-producing property***, stabilized occupancy is the occupancy level that a property is expected to achieve after the ***property is exposed to the market for lease*** over a reasonable period of time and at comparable terms and conditions to other similar properties." [emphasis added]). Therefore, condominium development projects are not HVCRE ADC because they are not created to be leased for "the purpose of creating income-producing real property."

debt service and expenses of the real property, in accordance with the institution's applicable loan underwriting criteria for permanent financings.

Additionally, banks themselves were given the authority to reclassify an HVCRE ADC loan as a non-HVCRE ADC loan upon:

1. substantial completion of the development or construction of the real property being financed by the credit facility; and

2. cash flow being generated by the real property being sufficient to support debt services and expenses.

In sum, EGRRCPA narrowed the definition of HVCRE by adding additional categorical exceptions and simplified the definition with respect to CRE by requiring retention in the project of just the initial 15 percent capital contribution.

How does this impact me?

Banks should systematically review their existing HVCRE exposures and consider how this change could impact their strategic plan. In particular, banks that have not done so already should:

1. review their risk-based capital calculations for HVCRE exposures (and remember, among other things, that all loans made prior to January 1, 2015, are now excluded from the 150 percent risk-weighting);

2. revise applicable policies and procedures, including underwriting policies and procedures;

3. contact existing HVCRE borrowers, advise them of the changes and discuss amending the governing loan documentation to permit fund withdrawals up to 15 percent of the originally contributed capital (potentially for a small fee); and

4. review HVCRE credit denials from the past year or so to determine whether such projects are now viable and, if so, contact those applicants to gauge interest.

We would be happy to help review and revise the ADC sections of loan policies to implement this change, or otherwise address any questions you might have about the new requirements.

One thing that this change does not do is clarify regulatory expectations with respect to banks' CRE concentration levels. We continue to see wide disparities among the regulators, and across the country, when it comes to the supervision of CRE concentration levels. Please contact us if you would like to receive our previous client alert regarding CRE concentration levels or would otherwise like to discuss concentrations at your institution.

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