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U.S. BANKING AGENCIES FINALIZE REGULATION ON "HIGH VOLATILITY COMMERCIAL REAL ESTATE" CAPITAL TREATMENT

To Our Clients and Friends:

On November 19, 2019, the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation (Agencies) finalized their regulation (Final Rule) on High Volatility Commercial Real Estate (HVCRE) that had been proposed in September 2018.

The Final Rule made few changes from the 2018 proposal. Although the text of the rule and its preamble do not answer all HVCRE questions, there is now a much more reasonable framework for borrowers than under the original Basel III capital rule and the Agencies' interpretations of it.

The Original Basel III Capital Rule and the Agencies' Interpretations

HVCRE treatment is a purely American phenomenon; it was not included in the international Basel III framework. A form of capital "gold plating," it imposes a 50% heightened capital treatment on certain real estate loans that are characterized as HVCRE exposures. The original Basel III capital rule defined an HVCRE exposure as follows:

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:

- One- to four-family residential properties;
- Certain community development properties
- The purchase or development of agricultural land, provided that the valuation of the agricultural land is based on its value for agricultural purposes; or
- Commercial real estate projects in which:
    - The loan-to-value ratio is less than or equal to the applicable maximum supervisory loan-to-value ratio under Agency standards – *e.g.*, 80% for a commercial construction loan;
    - 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% of the real estate's appraised "as completed" value; and

- The borrower contributed the amount of capital required before the bank 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.[1]

The original Basel III capital rule raised many interpretative questions; the few to which the Agencies responded were answered in a non-intuitive, unduly conservative manner.[2] In particular, the Agencies interpreted the requirement relating to "internally generated capital" as forbidding distributions of earned income even if the amount of capital in the project would exceed the 15% of "as completed" value post-distribution.[3] In addition, the Agencies did not permit appreciated land value to be taken into account for purposes of the borrower's capital contribution – even though it would count if the land were sold and the cash contributed instead.

In May 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 became law, and certain of its provisions overrode the original Basel III capital rule. The Final Rule implements the 2018 statute.

Final Rule – Definition of HVCRE

The Final Rule follows the statute in narrowing the definition of an HVCRE exposure requiring 50% additional capital to be held. Such an exposure is:

- A credit facility secured by land or improved real property that—
  - (A) primarily finances or refinances the acquisition, development, or construction of real property;
  - (B) has the purpose of providing financing to acquire, develop, or improve such real property into income-producing real property; and
  - (C) is dependent upon future income or sales proceeds from, or refinancing of, such real property for the repayment of such credit facility.

The Final Rule states that a "credit facility secured by land or improved real property" is a credit facility where "the estimated value of the real estate collateral at origination (after deducting all senior liens held by others) is greater than 50 percent of the principal amount of the loan at origination." In addition, the preamble states that "other land loans" – *i.e.*, loans secured by vacant land other than land known to be used for agricultural purposes – are not automatically included as an HVCRE exposure, but must be analyzed under the three-prong test.

HVCRE Exclusion for Certain Commercial Real Estate Projects

With respect to commercial real estate projects, under the Final Rule, as in the original regulation, the loan-to-value (LTV) ratio for the loan must be less than or equal to the applicable regulatory maximum LTV for the type of property at issue.

Unlike the original regulation, the Final Rule permits internally generated income to be distributed out of the project as long as the 15% originally contributed stays in. With respect to the 15% test itself, the preamble indicates that funds borrowed (such as from a corporate parent) can count as equity if they are not "derived from [or] related to," or do not "encumber" the project that the credit facility is financing or "encumber any collateral that has been contributed to the project."

The Final Rule also permits real property and improvements "directly related to" the project to count as part or all of the required 15% capital (reduced by the amount of any liens), along with cash, unencumbered readily marketable assets, and development expenses paid out-of-pocket.[4]It states that "readily marketable assets" are insured deposits, other financial instruments, and bullion, in each case that can be sold reasonably promptly for fair value. With respect to the value of contributed real property, the Final Rule states that it is "the appraised value" under a qualifying appraisal, reduced by the aggregate amount of any other liens on such property.

The Final Rule includes a clarification regarding projects with separate phases, stating that each project phase being financed by a credit facility should have a proper appraisal or evaluation with an associated "as completed" value. Where appropriate and in accordance with the banking organization's applicable underwriting standards, however, a banking organization may look at a multiphase project as a complete project rather than as individual phases.[5]

The Final Rule also provides, without interpretive gloss, that HVCRE status may end prior to the replacement of an ADC loan with permanent financing, upon:

- the "substantial completion" of the development or construction of the real property being financed by the credit facility; and
- cash flow being generated by the real property being sufficient to support the debt service and expenses of the real property, in accordance with the bank's applicable loan underwriting criteria for permanent financings.

HVCRE Exclusion for One- to Four-Family Residential Properties

With respect to the exclusion for one- to four-family residential properties, the Final Rule is more generous to borrowers than the proposal. Construction loans secured by single-family dwelling units, duplex units, and townhouses will qualify for the one- to four-family residential property exclusion, as will condominium and cooperative construction loans, even if the loan is financing the construction of a building with five or more dwelling units as long as the repayment of the loan comes from the sale of individual condominium dwelling units or individual cooperative housing units. Loans secured by vacant lots in established multifamily residential sections, however, will not qualify for the exclusion, nor will credit facilities that solely finance land development activities, such as the laying of sewers, water pipes, and similar improvements to land, without any construction of one- to four-family residential structures.

The Agencies also clarified that when both a land acquisition and development loan and a loan to construct one- to four-family dwellings are originated simultaneously, the individual exposures must be evaluated separately to determine whether each loan on its own qualifies for an HVCRE exclusion.

HVCRE Exclusion for Community Development Properties

With respect to this exclusion, the Final Rule refers to Agencies' Community Reinvestment Act (CRA) regulations and their definition of community development investment to determine which properties qualify. These regulations are quite detailed, and therefore a case-by-case analysis of particular properties will be required when this exclusion is considered.

HVCRE Exclusion for Agricultural Land

Relying on bank Call Report Instructions, the Final Rule uses a broad definition for this exclusion – "all land known to be used or usable for agricultural purposes," but excluding loans for farm property construction and land development purposes.

HVCRE Exclusion for Income-Producing Properties Qualifying as Permanent Financings

Finally, the statute added a new exclusion, for credit facilities for:

- the acquisition or refinance of existing income-producing real property secured by a mortgage on such property; and
- improvements to existing income-producing improved real property secured by a mortgage on such property,

in each case, "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."

With respect to this exclusion, the Agencies stated that they expect banking institutions to have and rely on "prudent, clear and measurable" underwriting standards, which the Agencies may review as part of the regular supervisory process.

Effective Date; Treatment of Loans Made Prior to Effective Date; Agency FAQs

The Final Rule is effective on April 1, 2020. Under the 2018 statute, loans made prior to January 1, 2015 may not be classified as HVCRE loans. With respect to loans made between January 1, 2015 and March 31, 2020, banking institutions will have the option to apply the original Basel III capital rule or the Final Rule. Non-HVCRE determinations made in this period are generally <u>not</u> required to be re-evaluated, but if loans made after January 1, 2015 and prior to the effective date are amended in a manner that materially changes the underwriting (increases to the loan amount, changes to the size and scope of the project, or removal of all or part of the 15 percent minimum capital contribution in a project), then banking institutions should re-analyze the loan for HVCRE. As of the effective date, the Agency FAQs under the original Basel III capital rule are deemed superseded.

Conclusion

HVCRE has taken a long and somewhat winding road since 2013. With the Final Rule, a more reasonable approach to the heightened capital treatment for HVCRE loans is now in place, and one that fulfills the intent of Congress in the 2018 legislation.

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[1] *See, e.g.*, 12 C.F.R. § 3.2 (2013).

[2] The Banking Agencies published certain responses to HVCRE Frequently Asked Questions (Interagency FAQs) in April 2015.

[3] *See* Interagency FAQ Response 15.

[4] The 15 percent equity must be contributed before loan is made, except for nominal sums meant to secure the banking organization's lien on the real property.

[5] The Agencies do not provide any further gloss on this statement.

Gibson Dunn's lawyers are available to assist in addressing any questions you may have regarding these developments. Please contact the Gibson Dunn lawyer with whom you usually work in the firm's Financial Institutions or Real Estate practice groups, or the following:

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