GIBSON DUNN

May 24, 2018

DODD FRANK 2.0: REFORMING U.S. HVCRE CAPITAL TREATMENT

To Our Clients and Friends:

On Tuesday, May 22, 2018, the U.S. House of Representatives passed the Economic Growth, Regulatory Relief, and Consumer Protection Act (Reform Bill), which had already passed the Senate on a bipartisan basis. President Trump signed the Reform Bill into law today. Among the Reform Bill's more important provisions is a section reforming the current capital treatment of so-called High Volatility Commercial Real Estate (HVCRE) loans. The Reform Bill, in provisions that are now effective, overrides certain highly conservative provisions in both the federal banking agencies' (Banking Agencies) Basel III capital rule and their interpretations of it.

HVCRE Capital Treatment Under the Basel III Capital Rule and the Banking Agencies' Interpretations

Current 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 commercial real estate loans that are characterized as HVCRE loans.

The current Basel III capital rule defines an HVCRE loan 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 and the valuation does not take into consideration any potential use of the land for non-agricultural commercial development or residential development; 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 Banking 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]

Under the current Basel III capital rule, the life of a project concludes only when the credit facility is converted to permanent financing or is sold or paid in full.[2]

The current Basel III capital rule has raised many interpretative questions; however, many of the important ones have not been answered by the Banking Agencies, and others have been answered in a non-intuitive, unduly conservative manner. In particular, the Banking Agencies interpreted the requirement relating to internally generated capital as foreclosing distributions of such capital even if the amount of capital in the project exceeds 15% of "as completed" value post-distribution.[3] The Banking Agencies also have not permitted appreciated land value to be taken into account for purposes of the borrower's capital contribution.

The Reform Bill's Principal Provisions

The Reform Bill overrides the current Basel III capital rule.[4] Specifically, it states that the Banking Agencies may impose a heightened capital charge on an HVCRE loan (as currently defined) ***only if the loan is also an HVCRE ADC loan.*** Such a loan is defined as:

- A credit facility secured by land or improved real property that, prior to being reclassified by the depository institution as a non-HVCRE ADC loan—
    - (A) primarily finances, has financed, 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.

Thus the loan must not only finance or refinance the acquisition, development, or construction of real property, it must "primarily" do so, must have a development purpose, and must be dependent on future income, sales proceeds or refinancing – not current income. The "HVCRE ADC" loan definition also corrects some of the unduly conservative regulatory interpretations described above. It permits appreciated land value, as determined by a qualifying appraisal, to be taken into account for purposes of the 15% test, and it permits capital to be withdrawn as long as the 15% test continues to be met.

In addition, the Reform Bill overrides the current Basel III capital rule by stating that HVCRE status may end ***prior to*** the replacement of the 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.[5]

Additional exemptions from HVCRE treatment apply to loans for:

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

Finally, loans made prior to January 1, 2015 may not be classified as HVCRE loans.

Conclusion

The Reform Bill's HVCRE ADC provisions are a welcome development. They do not answer every question relating to HVCRE treatment, but they do purge regulatory interpretations that led to heightened capital treatment for many ADC loans in the absence of persuasive risk justifications. It is to be hoped that the Banking Agencies further the legislation's intent of aligning gold plated capital treatment more closely to risk when interpreting the new law.

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[1] *See, e.g.,* 12 C.F.R. § 3.2.

[2] *Id.*

[3] *See* Interagency HVCRE FAQ Response 15. It remains unclear how this interpretation squares with the text of the HVCRE regulation itself.

[4] The original version of the Senate bill, which was passed first, did not include this provision. Senator Tom Cotton, R-Ark, proposed the relevant amendment while the Senate was considering the bill.

[5] The Reform Bill retains the current exemptions for loans financing one- to four-family residential properties, certain community development properties, and the purchase or development of agricultural land.

The following Gibson Dunn lawyers assisted in preparing this client update: Arthur Long and James Springer.

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

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