GIBSON DUNN

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DODD FRANK 2.0: U.S. FEDERAL BANKING AGENCIES PROPOSE NEW HVCRE CAPITAL REGULATIONS

To Our Clients and Friends:

On September 18, 2018, the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation (together, the Banking Agencies) proposed revisions to their Basel III capital rules regarding so-called High Volatility Commercial Real Estate (HVCRE) loans. The purpose of the revisions is to conform the regulatory definition of HVCRE to the changes made by the Economic Growth, Regulatory Relief, and Consumer Protection Act of 2018 (EGRRCPA), which was enacted in May.

The proposed regulations generally follow the statutory changes, with certain clarifications, as we discuss below. The proposal, however, does not address certain interpretive issues that are still outstanding over five years after the original HVCRE regulations were promulgated, although the Banking Agencies do ask in the preamble's request for comments whether the proposed rule is ambiguous in certain areas and whether "further discussion or interpretation is appropriate."

HVCRE Capital Treatment Under the Original Basel III Capital Rule and the Banking 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 commercial real estate loans that are characterized as HVCRE exposures.

Prior to enactment of the EGRRCPA, the Banking Agencies' 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 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]

The original rule provided that the life of a project concluded only when the credit facility was converted to permanent financing or was sold or paid in full.[2]

The original Basel III capital rule raised many interpretative questions; few, however, were answered by the Banking Agencies, and others were answered in a non-intuitive, unduly conservative manner.[3] 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 exceeded 15% of "as completed" value post-distribution.[4] In addition, the Banking Agencies did not permit appreciated land value to be taken into account for purposes of the borrower's capital contribution.

Proposed Regulations – Definition of HVCRE

The proposed regulations follow the statute in narrowing the definition of an HVCRE exposure, in particular by requiring that a credit facility have the purpose of improving property into income-producing property. The proposal defines an HVCRE exposure as:

- 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 proposal interprets this provision as follows. First, relying on the instructions to bank Call Reports, the proposed regulation defines a "credit facility secured by land or improved real property" as 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." Second, the determination of whether the credit facility meets the above HVCRE definition is made once, at the facility's origination. Third, the Banking Agencies propose that the HVCRE definition include "other land loans" – generally loans secured by vacant land except land known to be used for agricultural purposes.

Proposed Regulations – Exclusions from HVCRE Treatment

The statute retained, and in certain important cases, expanded, the exclusions from HVCRE treatment. The proposed regulations implement these provisions and provide additional definitional interpretation.

Certain Commercial Real Estate Projects

This exclusion proved the most controversial under the original Basel III treatment, and indeed the Banking Agencies' conservative approach to the exclusion is likely responsible for the statute's enactment.

Under the proposal, 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.

Next, the borrower must have contributed "capital" of at least 15 percent of the real property's appraised "as completed" value. The proposal permits real property (including appreciated land value) to count as capital, along with cash, unencumbered readily marketable assets, and development expenses paid out-of-pocket, that is, "costs incurred by the project and paid by the borrower prior to the advance of funds" by the lending bank. With respect to the value of contributed real property, the proposal follows the statute and defines it as "the appraised value" under a qualifying appraisal, reduced by the aggregate amount of any other liens on such property. Notably, the Banking Agencies invite comment on "whether it is appropriate and clear that the cross-collateralization of land in a project would not be included as contributed real property."

The Banking Agencies state that in certain circumstances, such as in the case of purchasing raw land without near-term development plans," an "as-is" appraisal may be used instead of an "as completed" one, and in certain cases, an evaluation is permissible – for transactions under $500,000 that are not secured by a single one- to four-family residential property and certain other transactions with values less than $400,000.

The proposal includes a clarification for what a "project" is for purposes of the "as completed" value and 15 percent capital contribution calculation. In the case of a project with multiple phases or stages, each phase or stage must have its own appraised "as completed" value, or if applicable, its own evaluation, in order for it to be deemed to be a separate "project."

Finally, the statute overrode the existing regulation by providing 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.

The proposed regulations do not further interpret these provisions – and although "substantial completion" is a term of art in the real estate industry, there is still some imprecision as to its exact meaning.

One- to Four-Family Residential Properties

With respect to the exclusion for one- to four-family residential properties, the proposal defines such properties as properties "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)." Condominiums and cooperatives would generally not qualify for the exclusion. However, if the underlying property is a true one- to four-family residential property, the exclusion would cover ADC as well as construction loans, and, in addition, lot development loans. The exclusion would not cover loans used solely to acquire undeveloped land.

Community Development Properties

With respect to this exclusion, the proposal refers to the Banking Agencies' Community Reinvestment Act (CRA) regulations and their definition of community development investment to determine which properties qualify – the "primary purpose" of the applicable loan must be to foster such investment. These regulations are quite detailed, and therefore a case-by-case analysis of particular properties will be required if the regulations are finalized as proposed.

Agricultural Land

Relying on bank Call Report Instructions, the Banking Agencies propose a broad definition for this exclusion – "all land known to be used or usable for agricultural purposes."

Existing Income-Producing Properties that Qualify 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 Banking Agencies state only that they "may review the reasonableness of a depository institution's underwriting criteria for permanent loans" as part of the regular supervisory process.

Loans Made Prior to January 1, 2015

Under the statute, loans made prior to January 1, 2015 may not be classified as HVCRE loans. A 100 percent risk weight may therefore now be applied to any such loans that were previously classified as HVCRE exposures unless a lower risk weight would apply, as long as the loans are not past 90 days or more past due or on nonaccrual.

Conclusion

With the HVCRE statute and this proposal, the door has closed on the Banking Agencies' unfortunate prior approach to HVCRE exposures. The proposed regulations, however, like the ones they replace, do not clearly state their application to the complex structures of real estate transactions, with multiple tranches of financing and different capital instruments, that are common in the market today. In addition, although it is clear that certain of the 2015 Interagency FAQs are no longer applicable, the proposal does not discuss those FAQs at all – thus missing an opportunity to subject them to the full notice and comment process that the Banking Agencies only recently stated is necessary for agency interpretation to be considered binding law.[5] It is hoped that the public comment period will provide the Banking Agencies with evidence of the proposal's ambiguities and that "further discussion and interpretation" of HVCRE treatment in the final regulation is appropriate.

[1] *See, e.g.*, 12 C.F.R. § 3.2.

[2] *Id.*

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

[4] *See* Interagency FAQ Response 15.

[5] *See* Interagency Statement Clarifying the Scope of Supervisory Guidance, September 11, 2018 (Banking Agencies and the National Credit Union Administration).

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:

Financial Institutions Group:
Arthur S. Long - New York (+1 212-351-2426, along@gibsondunn.com)
James O. Springer - Washington, D.C. (+1 202-887-3516, jspringer@gibsondunn.com)

Real Estate and Finance Groups:
Jesse Sharf - Los Angeles (+1 310-552-8512, jsharf@gibsondunn.com)
Erin Rothfuss - San Francisco (+1 415-393-8218, erothfuss@gibsondunn.com)
Aaron Beim - New York (+1 212-351-2451, abeim@gibsondunn.com)
Linda L. Curtis - Los Angeles (+1 213-229-7582, lcurtis@gibsondunn.com)
Drew C. Flowers - Los Angeles (+1 213-229-7885, dflowers@gibsondunn.com)
Noam I. Haberman - New York (+1 212-351-2318, nhaberman@gibsondunn.com)
Andrew A. Lance - New York (+1 212-351-3871, alance@gibsondunn.com)
Victoria Shusterman - New York (+1 212-351-5386, vshusterman@gibsondunn.com)

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