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Long Awaited HVCRE Rule Clarifies Capital Treatment of Certain Real Estate Loans

Henry M. Fields and Mark R. Sobin*

The Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation recently published a final rule that incorporates a new definition of an "HVCRE (high-volatility commercial real estate) exposure" into the U.S. regulatory capital rules. The authors of this article discuss the final rule, which is scheduled to go into effect on April 1, 2020.

The federal banking agencies[1] recently published a final rule (the "Final Rule") that incorporates a new definition of an "HVCRE [high-volatility commercial real estate] exposure" into the U.S. regulatory capital rules.[2] The new definition is substantially that of an "HVCRE ADC loan" from Section 214 of the Economic Growth, Regulatory Relief, and Consumer Protection Act, enacted into law on May 24, 2018 ("Reform Act").[3]

The Final Rule is scheduled to go into effect on April 1, 2020. Under the Final Rule, as under the Reform Act, loans originated prior to January 1, 2015 are excluded from characterization as an HVCRE exposure. For loans originated after January 1, 2015 and before April 1, 2020, banking organizations have the option of maintaining their current capital treatment or reevaluating the loans under the revised HVCRE exposure definition.[4]

The Final Rule deviates from prior proposals in several key ways that are favorable to bank lenders, including the treatment of loans to acquire or develop residential condominiums and cooperatives and the use of borrowed

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[1] The Final Rule was approved by the federal banking agencies on November 19, 2019. The term "federal banking agencies" refers, collectively, to the Board of Governors of the Federal Reserve System ("Federal Reserve"); the Office of the Comptroller of the Currency ("OCC"); and the Federal Deposit Insurance Corporation ("FDIC").

[2] 84 Fed. Reg. 68019. For a copy of the Final Rule, *see* https://www.fdic.gov/news/board/2019/2019-11-19-notice-sum-c-fr.pdf.

[3] Public Law No. 115–174, Section 214, *available at* https://www.congress.gov/115/bills/s2155/BILLS-115s2155enr.pdf.

[4] *See* 84 Fed. Reg. at 68020–68021.

funds under certain circumstances to meet the 15 percent contributed capital requirement for one of the available exemptions. These developments will be discussed below.

In addition, the preamble to the Final Rule (the "Preamble") provides some clarity around certain interpretative issues of concern. Of significant practical importance is the linkage of certain terms to specific definitions and report items in the Federal Financial Institutions Examination Council ("FFIEC") Call Report instructions. Lastly, the Final Rule relies in certain critical respects on a banking institution's underwriting criteria to determine whether a financing may be an HVCRE exposure.

BACKGROUND

The Final Rule represents the culmination of a long process of deliberation by the federal banking agencies and intervention by Congress.

As of January 1, 2015, the U.S. version of the Basel III risk-based capital rules required banks to assign a risk weight of 150 percent (rather than 100 percent, as is the case for most commercial loans) to acquisition, development, and construction ("ADC") loans characterized as HVCRE exposures. If an ADC loan is subject to the higher risk weight, the bank lender, in essence, is required to carry additional capital against the loan to maintain its risk-based ratios. Accordingly, it has been (and continues to be) critical for banks to identify with clarity whether an ADC loan is an HVCRE exposure. However, the HVCRE exposure definition under the existing rule left open a number of difficult interpretive issues. Some of these have been addressed over time by FAQs issued by the federal banking agencies, but not all to the satisfaction of bank lenders. In addition, there remained significant industry criticism over the characterization criteria for HVCRE exposures and the terms of available exemptions.

It came to Congress to address certain of these issues. With its enactment on May 24, 2018, the Reform Act narrowed and clarified the types of ADC loans subject to the 150 percent risk weight. Under the Reform Act, to be subject to the 150 percent risk weight, HVCRE exposures must fall within a narrower class of ADC loans, defined as "HVCRE ADC loans." Unless an HVCRE exposure meets the HVCRE ADC loan definition, it is subject to a 100 percent risk weight (unless it would carry another risk weight by reason of other circumstances, such as being in default).

On September 18, 2018, the federal banking agencies jointly issued a notice of proposed rulemaking to revise the definition of an "HVCRE exposure" to conform to the definition of an "HVCRE ADC loan" in the Reform Act (the

"Initial NPR").[5] The preamble accompanying the Initial NPR also requested comment on a number of interpretive issues. Then, on July 12, 2019, the federal banking agencies proposed (in a second related notice of proposed rulemaking) that loans financing land improvements that do not finance the construction of residential homes on the land would not qualify for the exclusion from the definition of an HVCRE exposure for loans that finance one- to four-family residences (the "Land Development NPR").[6] The Final Rule addresses both the Initial NPR and the Land Development NPR.

While the text of the Reform Act's amendments applies only to depository institutions, the Final Rule, like the Initial NPR, also applies the revised HVCRE exposure definition to bank holding companies, savings and loan holding companies, and intermediate holding companies of foreign banking organizations.

CORE DEFINITION OF AN HVCRE EXPOSURE

Prior to the Final Rule, an HVCRE exposure was defined by regulation 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 one of the enumerated exemptions applies.[7] Consistent with the Reform Act, the Final Rule amends this definition to include, subject to exemptions, a credit facility secured by land or improved property that, prior to being reclassified as a non-HVCRE exposure:

- Primarily finances, has financed, or refinanced the acquisition, development, or construction of real property;
- Has the purpose of providing financing to acquire, develop, or improve such real property into income-producing real property; and
- Is dependent upon future income or sales proceeds from, or refinancing of, such real property for the repayment of such credit facilities.

The revised definition clarifies certain interpretive uncertainties that arose under the prior definition.

Secured by Real Estate

Under the new definition, a credit must be secured by real estate in order to be an HVCRE exposure. This removes the uncertainty as to whether an

[5] For a copy of the Initial NPR, *see* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20180918a.htm.

[6] For a copy of the Land Development NPR, *see* https://www.federalreserve.gov/newsevents/pressreleases/bcreg20190712a.htm.

[7] *See* 12 C.F.R. § 324.2 (FDIC); 12 C.F.R. § 217.2 (Board); 12 C.F.R. § 3.2 (OCC).

unsecured ADC loan is subject to the higher capital requirements. The term "credit facility secured by land or improved real property" should be interpreted in a manner consistent with the current definition of a "loan secured by real estate" in the Glossary of the Call Report and FR Y-9C instructions.[8] This means, among other things, that the real estate collateral securing the loan must be greater than 50 percent of the principal amount of the loan.

Primarily Finances the ADC of Real Property

To be an HVCRE exposure under the Final Rule, the credit must "primarily" finance the ADC of real property. In this respect (and contrary to the original regulation),[9] the Final Rule takes an all-or-nothing approach. If a majority of the loan proceeds are used for purposes that would qualify the credit as an HVCRE exposure, the entire credit would be an HVCRE exposure. If not, the entire credit would not be an HVCRE exposure.

Repayment Must Depend on Future Income or Sales Proceeds From, or Refinancing of, the Real Property. Permanent Financing Is Exempt from Characterization as an HVCRE Exposure

To be an HVCRE exposure under the Final Rule, the credit must depend upon future income or future sales proceeds (or refinancing) for repayment. In effect, this requirement should exempt ADC financing if the cash flow generated by the real property is sufficient to support the debt service and expenses of the real property in accordance with the banking organization's applicable loan underwriting criteria for permanent financings.

The corollary to this principle is contained in the exemption from the HVCRE exposure definition for permanent financing. As in the Reform Act,

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[8] 84 Fed. Reg. at 68022; *see also* Instructions for Preparation of Consolidated Reports of Condition and Income (FFIEC 031 and 041) (Sept 2019), *available at* https://www.ffiec.gov/pdf/FFIEC_forms/FFIEC031_FFIEC041_201909_i.pdf [hereinafter, "Call Report Instructions"] at A-58 (defining the term "Loan Secured by Real Estate" as the following: "For purposes of these reports, a loan secured by real estate is a loan that, at origination, is secured wholly or substantially by a lien or liens on real property for which the lien or liens are central to the extension of the credit—that is, the borrower would not have been extended credit in the same amount or on terms as favorable without the lien or liens on real property. To be considered wholly or substantially secured by a lien or liens on real property, the estimated value of the real estate collateral at origination (after deducting any more senior liens held by others) must be greater than 50 percent of the principal amount of the loan at origination.").

[9] Interagency FAQs on the Regulatory Capital Rule, (March 31, 2015), *available at* https://www.fdic.gov/regulations/capital/capital/faq-hvcre.html [hereinafter, "FAQ"] at No. 13. FAQ No. 13 explains that the banking organization should consider the contribution of the commercial real estate portion of the project to the total "as completed" value of the project when determining the portion of the loan applicable to the property's commercial real estate. As of April 1, 2020, the FAQ no longer applies.

the Final Rule creates two specific exemptions for permanent financing. The exemptions would apply to financing for either: (i) the acquisition or refinance of existing income-producing property secured by a mortgage on the property; or (ii) improvements to existing income-producing improved real property secured by a mortgage on the property. In both cases, the exemption applies only if the cash flow generated by the real property is sufficient to support the debt service and expenses of the real property in accordance with the banking organization's applicable loan underwriting criteria for permanent financings.

Under the principles discussed above, ADC loans for owner-occupied property should not generally be characterized as HVCRE exposures under the Final Rule because they are customarily not dependent on future income or future sales proceeds from, or refinancing of, the financed real property. Instead, such loans are generally underwritten based on the ongoing operations and activities conducted by the property's owner. The Preamble refers to a Call Report item to help further clarify this category of loans. Loans reported as "Loans secured by nonfarm residential properties" in item 1.e of Schedules RC-C, Part I and HC-C of the Call Report and FR Y-9C, are generally not HVCRE exposures "because such loans are not dependent upon future income or sales proceeds from, or refinancing of, the real property being financed for repayment."[10]

The Call Report Instructions for this reporting item are as follows:[11]

> Loans secured by owner-occupied nonfarm nonresidential properties" are those nonfarm nonresidential property loans for which the primary source of repayment is the cash flow from the ongoing operations and activities conducted by the party, or an affiliate of the party, who owns the property. Thus, for loans secured by owner-occupied nonfarm nonresidential properties, the primary source of repayment is not derived from third party, nonaffiliated, rental income associated with the property (*i.e.,* any such rental income is less than 50 percent of the source of repayment) or the proceeds of the sale, refinancing, or permanent financing of the property. Include loans secured by hospitals, golf courses, recreational facilities, and car washes unless the property is owned by an investor who leases the property to the operator who, in turn, is not related to or affiliated with the investor (in which case, the loan should be reported in Schedule RC-C, part I, item 1.e.(2), below). Also include loans secured by churches unless the

[10] 84 Fed. Reg. 68022.

[11] *See* Call Report Instructions, Report Item 1.e.(1) of Schedule RC-C, Part I at RC-C-6b.

property is owned by an investor who leases the property to the congregation (in which case, the loan should be reported in Schedule RC-C, part I, item 1.e.(2), below).

Land Loans Not Necessarily Covered

Not all land loans will be HVCRE exposures and will avoid classification if they do not meet the three prongs of the definition described above. For example, loans secured by vacant land will not necessarily be classified as an HVCRE exposure if repayment is not dependent on future income produced from the property or on the future sale of the property and the loan has been made in accordance with the banking organization's loan underwriting standards for permanent financings.[12]

EXEMPTIONS

Under the Final Rule, an ADC loan may qualify for one of a number of exemptions, as described below.

One- to Four-Family Residential ADC Loans

The revised HVCRE exposure definition retains the exemption for credit facilities that finance the ADC of one- to four-family residential properties. Under the existing regulation and in the preamble to the Initial NPR, a credit exposure would fall within this exemption if it met the definition of a one- to four-family residential property in the interagency real estate lending standards ("Lending Standards").[13] That definition includes "property 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)." Notably, the Lending Standards consider condominium and cooperatives to be multi-family construction (not one- to four-family residential property). Accordingly, under the Initial NPR, credit facilities financing the construction of residential condominiums or cooperatives with five or more units would not qualify for the one- to four-family exemption.

In response to critical comments on this issue, the Final Rule aligns the one- to four-family exemption with the definition of one- to four-family residential property loans set forth in the Call Report and FR Y-9C, rather than the definition in the Lending Standards. As a result, construction loans for

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[12] 84 Fed. Reg. 68022.

[13] *See* Interagency Guidelines for Real Estate Lending Policies. 12 C.F.R. Part 208, Subpart J, Appendix C (Federal Reserve); 12 C.F.R. Part 34, Subpart D, Appendix A (OCC); 12 C.F.R. Part 365, Subpart A, Appendix A (FDIC).

single-family dwelling units, duplex units, and town houses will qualify for the exemption. Condominium and cooperative construction loans (even if involving five or more units) will qualify if repayment of the loan comes from the sale of individual units.[14]

A loan that finances the construction of one- to four-family residential structures and also finances land development activities and/or land acquisition in connection with the residential project would qualify for the exemption. This is consistent with the reporting requirements on the Call Report and FR Y-9C.[15] However, as proposed in the Land Development NPR, the exemption will not be available for credit facilities used solely to finance land development activities, like the laying of sewers, water pipes, and similar improvements to land. In addition, loans used solely to acquire undeveloped land will not qualify for the exemption regardless of how the land is zoned.[16]

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[14] 84 Fed. Reg. 68023; *see also* Call Report Instructions, Report Item 1.a.(1) of Schedule RC-C, Part I at RC-C-5 (defining one- to four-family construction loans as follows: " '1–4 family residential construction loans' include:

- Construction loans to developers secured by tracts of land on which 1–4 family residential properties, including townhouses, are being constructed.
- Construction loans secured by individual parcels of land on which single 1–4 family residential properties are being constructed.
- Construction loans secured by single-family dwelling units in detached or semidetached structures, including manufactured housing.
- Construction loans secured by duplex units and townhouses, excluding garden apartment projects where the total number of units that will secure the permanent mortgage is greater than four.
- Combination land and construction loans on 1–4 family residential properties, regardless of the current stage of construction or development.
- Combination construction-permanent loans on 1–4 family residential properties until construction is completed or principal amortization payments begin, whichever comes first.
- Loans secured by apartment buildings undergoing conversion to condominiums, regardless of the extent of planned construction or renovation, where repayment will come from sales of individual condominium dwelling units, which are 1–4 family residential properties.
- Bridge loans to developers on 1–4 family residential properties where the buyer will not assume the same loan, even if construction is completed or principal amortization payments have begun."

[15] *Id.*

[16] 84 Fed. Reg. 68024. The Final Rule adds to the language of the Reform Act a specific exception to the one- to four-family exemption for such land development loans. Loans originated simultaneously, for example, a land acquisition loan and a one- to four-family

Community Development Exemption

The Final Rule carries forward from the existing regulation and the Reform Act credit facilities financing the ADC of real property projects the primary purpose of which are "community development," as such term is defined in the federal banking agencies' Community Reinvestment Act regulations.[17]

Agricultural Land Exemption

The revised HVCRE exposure definition retains the exemption for "agricultural land." As explained in the Preamble, "agricultural land" has the same meaning as the term "farmland" in the instructions to the Call Report and FR Y-9C.[18] The existing regulation had no specific definition for the term "agricultural land."

The LTV/Capital Contribution Exemption

The Final Rule's HVCRE exposure definition (as with the HVCRE ADC loan definition in the Reform Act) exempts ADC loans that finance commercial real estate projects that (i) meet applicable maximum loan-to-value ("LTV") ratios; (ii) for which the borrower has contributed capital of at least 15 percent of the real estate's appraised "as-completed" value to the project; (iii) for which the borrower contributed the minimum amount of capital prior to the advancement of funds (other than a nominal amount to secure a lien); and (iv) the 15 percent minimum capital contributed to the project is contractually required to remain in the project until the HVCRE exposure has been reclassified as a non-HVCRE exposure. To meet the contributed capital requirement, borrowers may contribute cash, unencumbered readily marketable assets, development expenses paid out-of-pocket, or contributed real property or improvements.

The Final Rule and the Preamble clarify certain policy and interpretive issues, as follows:

- *What counts as contributed capital?*
  - *Contributed real property or improvements*. Contributed real property or improvements must be directly related to the project

construction loan, must be evaluated separately to determine whether each loan on its own qualifies for the exemption. *Id*.

[17] 84 Fed. Reg. 68025; *see also* 12 C.F.R. Part 24 (OCC); Part 345 (FDIC); Part 228 (Federal Reserve).

[18] 84 Fed. Reg. 68025; *see also* Call Report Instructions, Report Item 1.b of Schedule RC-C, Part I at RC-C-5 ("Farmland includes all land known to be used or usable for agricultural purposes, such as crop and livestock production. Farmland includes grazing or pasture land, whether tillable or not and whether wooded or not.").

being financed.[19] In addition, consistent with the Reform Act, the value of any contributed real property is based on the appraised value of the real property, rather than the original cost of the property (as required under the existing rules).

  - *Borrowed funds*. Borrowed funds that the borrower obtains from another lender may count toward the capital contribution as long as borrowed funds are not derived from, related to, or encumber the project or any collateral that has been contributed to the project.[20]
  - *Unencumbered readily marketable assets*. "Unencumbered readily marketable assets" will be interpreted in a manner consistent with the Lending Standards. This means that readily marketable assets would include insured deposits, financial instruments, and bullion. Financial instruments and bullion must be promptly salable under ordinary circumstances at fair market value. Such assets must be given a haircut (discounted) by the lender consistent with its usual practice regarding making loans secured by such assets.[21]

- *Appraisal of "as-completed" value.* The 15 percent capital contribution requirement is measured against the appraised, "as-completed" value of the real estate. However, there are two instances in which a different valuation method for purposes of this calculation will be accepted. First, where an "as-completed" value appraisal is not available, such as with respect to raw land without plans for near-term development, an "as-is" appraisal value may be used. Second, an evaluation, rather than an appraisal, will be permitted to determine the "as-completed" value of real estate where the appraisal regulations permit the use of evaluations in lieu of appraisals.[22]
  - *Multi-phase projects*. To determine whether the contributed capital meets the 15 percent minimum, the calculation of the "as-completed" value of real property should be conducted with respect to a "project." As certain "projects" may be financed in multiple phases, an individual phase of a project may be viewed as a single project for purposes of calculating the 15 percent

[19] 84 Fed. Reg. 68026.

[20] *See id.*

[21] *Id.*

[22] 84 Fed. Reg. 68026–68027.

contributed capital requirement if the individual phase has its own appraised "as-completed" value or an appropriate evaluation.[23]

- *Distribution of Excess Capital*. As under the Reform Act, the amount of contributed capital required to remain in the project is only the 15 percent minimum requirement. As a result, there is no restriction on distributing capital contributed in excess of the 15 percent requirement. This is not permitted under the existing rules.

RECLASSIFICATION AS A NON-HVCRE EXPOSURE

Under the Final Rule (as under the Reform Act), an HVCRE exposure is eligible for reclassification as a non-HVCRE exposure upon: (i) the substantial completion of development or construction of the real property being financed by the credit facility; and (ii) the generation of cash flow by the real property sufficient to support debt service and expenses of the real property in accordance with the banking organization's applicable underwriting criteria for permanent financings. Banking organizations may rely on their loan underwriting standards for permanent financings for purposes of reclassifying HVCRE exposures.[24]

RESCISSION OF PRIOR GUIDANCE

All HVCRE exposure-related FAQs will be rescinded as of the effective date of the Final Rule. In addition, at that time, the HVCRE exposure section of the Interagency Guidance on CRE Concentration Risk Management will no longer apply.[25]

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[23] 84 Fed. Reg. 68027.

[24] *Id.*

[25] *See* SR 07-1: Interagency Guidance on Concentrations in Commercial Real Estate (Jan. 4, 2007), *available at* https://www.federalreserve.gov/boarddocs/srletters/2007/SR0701.htm.