PRESENTED AT

The Dallas Bar Association Real Property Section

High Volatility Commercial Real Estate Loans: New Federal Rules and their Impact on Loan Availability

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HIGH VOLATILITY COMMERCIAL REAL ESTATE LOANS: NEW FEDERAL RULES AND THEIR IMPACT ON LOAN AVAILABILITY

I. BACKGROUND.

A. BASEL III.

1. **What is Basel III?** Basel Committee on Banking Supervision is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries in 1975. The Basel Committee formulates broad supervisory standards and guidelines and recommends statements of best practice in banking supervision in the expectation that member authorities and other nations' authorities will take steps to implement them through their own national systems. Basel III (or the Third Basel Accord) is a global, voluntary regulatory framework on bank capital adequacy, stress testing, and market liquidity risk and was developed in response to the deficiencies in financial regulation revealed by the financial crisis of 2007–2008. Basel III is intended to strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage (*Wikipedia*). The requirements and phase-in schedules for Basel III were approved by the 27 member jurisdictions and 44 central banks and supervisory authorities on September 12, 2010. Basel III compliance requires banks to satisfy the enhanced requirements by 2019. *US Implementation of the Basel Capital Regulatory Framework. Congressional Research Service* Darryl E. Getter 2014 (https://www.fas.org/sgp/crs/misc/R42744.pdf) ("**US Implementation**") p. 1.

2. The Basel Accords are standards, guidelines and recommendations but are not treaties. In order for these standards to have the force of law, the individual countries must implement them with such modifications as they see fit to suit their specific needs.

B. BASEL III Implementation.

1. **US Implementation.** In the United States, Congress mandated enhanced bank capital requirements as part of financial sector reform in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (*Dodd-Frank Act; P.L. 111-203, 124 Stat.1376*). Specifically, the Collins Amendment to Dodd-Frank amends the definition of capital and establishes minimum capital and leverage requirements for banking subsidiaries, bank holding companies, and systemically important nonbank financial companies. The federal banking regulators issued a proposed rule on June 7, 2012; the final rule to implement most of the Basel III recommendations in the United States was approved by the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency (the "OCC") on July 2, 2013 and by the Federal Deposit Insurance Company (the "FDIC") on July 9, 2013. US Implementation p. 1.

2. **Reason for the US Implementation of Basel III**. According to the FDIC, "the proposed changes [contemplated by BASEL III and the implementing laws and regulations] to the Federal banking agencies' current capital rules would strengthen

the quality and loss-absorbance safeguards provided by regulatory capital and enhance banks' abilities to continue functioning as financial intermediaries, including during periods of financial stress." *Notices of Proposed Rule Making: Regulatory Capital Community Bank Informational Session (FDIC August3, 2012*). https://www.fdic.gov/regulations/capital/Presentation_on_Basel_III_and_Standardized_Approach_NPRs.pdf

C. Introduction of HVCRE.

1. **Prior to Basel III, all types of Commercial Real Estate were of equal risk weight.** Prior to the Basel III, all commercial real estate loans were treated the same and would have typically been assigned a risk weighting of 100% regardless of the loan purpose or asset class of the collateral. However, with Basel III, the "US standardized approach revise[d] the risk weights applicable to commercial real estate loans to range from 50% to 150%" and a new class of commercial real estate was introduced. See, *Basel III's implications for commercial real estate*. Rubin, Giczwewski and Olson, Ernst & Young (August 2013) (EY Implications) p. 2. This new class of commercial real estate related to acquisition, development, or construction (ADC) of real estate called High-Volatility Commercial Real Estate (HVCRE). (See e.g. US Implementation p. 9).

2. **150% Risk Weight**. As of January 1, 2015, the regulatory capital rules implementing Basel III required that all loans that meet the definition of HVCRE be reported separately from other commercial real estate loans. HVCRE loans are now assigned a risk weighting of 150% for risk-based capital purposes. This change in risk weighting has a significant impact on institutions' risk-based capital ratios. There is no grandfathering of these rules, so loans made prior to implementation are subject to the HVCRE Rules. "*Conference of State Bank Examiners High Volatility Commercial Real Estate (HVCRE) Examiner Job Aid*", www.csbs.org/regulatory/resources/Documents/CSBS_HVCRE_JobAid.pdf.

3. **Capital Adequacy**. In order to operate, regulated financial institutions are required by their regulators to maintain a certain amount of capital. The amount required is expressed as a ratio of equity that must be held as a percentage of risk-weighted assets. As the ratios increase, activities of the financial institutions become more restricted. For example, if the ratios are too high, financial institutions cannot pay dividends, cannot engage in share buybacks, discretionary payments on preferred stock or discretionary bonus payments, and are subject to other regulatory restrictions.

4. **Implications of heightened risk weight**. HVCRE, with its 150 % risk weight, now shares the same risk category as 90 day past due delinquent loans. In order to appreciate the seismic effect that the HVCRE designation has on a bank's capital structure as opposed to other types of commercial real estate (CRE), the risk weight of various real estate assets is shown below:

	Risk Weight	
Commercial Real Estate	100%	
Owner Occupied Building	100%	
Manufacturing/Industrial Building	100%	
Acquisition, Development, and Construction: 1-4 family residential properties	100%	
Acquisition, Development, and Construction: non-1-4 family residential (HVCRE)		150%

Chart excerpted from *Notices of Proposed Rulemaking: Regulatory Capital Community Bank Informational Session FDIC* p. 28 http://docplayer.net/2931788-Notices-of-proposed-rulemaking-regulatory-capital-community-bank-informational-session.html

II. WHAT IS HVCRE?

A. Statutory Definition. "High volatility commercial real estate (HVCRE) exposure means a credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development, or construction (ADC) of real property." 12 CFR § 324.2

B. Exceptions.

An ADC loan is not treated as an HVCRE loan if the facility finances:

"(1) One- to four-family residential properties;

(2) Real property that:

(i) Would qualify as an investment in community development under 12 U.S.C. 338a *[Investments to promote public welfare and community development]* or 12 U.S.C. 24 (Eleventh) *[To make investments directly or indirectly, each of which is designed primarily to promote the public welfare, including the welfare of low- and moderate-income communities or families (such as by providing housing, services, or jobs)]*, as applicable, or as a "qualified investment" under 12 CFR part 345 *[Community Reinvestment Act (CRA)]*, and

(ii) Is not an ADC loan to any entity described in 12 CFR 345.12(g)(3) *[Activities that promote economic development by financing businesses or farms that meet the size eligibility standards of the Small Business Administration's Development Company or Small Business Investment Company programs (13 CFR 121.301) or have gross annual revenues of $1 million or less]*, unless it is otherwise described in paragraph (1), (2)(i), (3) or (4) of this definition;

(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 *[80 Percent for Commercial, multifamily and other non-residential]* in the FDIC's real estate lending standards at 12 CFR part 365, subpart A (state nonmember banks), 12 CFR § 390.264 (2015) and 12 CFR § 390.265 (2015) (state 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 FDIC-supervised institution 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 FDIC-supervised institution that provided the ADC facility as long as the permanent financing is subject to the FDIC-supervised institution's underwriting criteria for long-term mortgage loans." 12 CFR § 324.2 (2015) https://www.law.cornell.edu/cfr/text/12/324.2 (emp hasis added).

III. APPLICABILITY.

A. Affected Entities. The U.S. regulations implementing Basel III apply to all of the following regardless of size (with the exception of certain small bank holding companies):

1. National banks;

2. State member banks;

3. State nonmember banks;

4. State savings associations;

5. Federal savings associations;

6. Savings and loan holding companies (SLHCs) (other than certain types of SLHCs engaged in commercial activities or insurance underwriting activities);

7. U.S. bank holding companies (BHCs), other than small BHCs, but does apply to the BHCs' constituent banks;

8. Any of the above that are subsidiaries of foreign banks; and

9. Systemically Important Financial Institutions (SIFIs) (banks and nonbank financial institutions designated by the Financial Stability Oversight Counsel as being so important to the functioning of the economy that they require special rules and buffers).

B. Exceptions.

1. **Small Bank Holding Companies**. The regulations do not apply to BHCs with less than $500 million in consolidated assets unless the holding company:

(a) is engaged in significant nonbanking activities either directly or through a nonbank subsidiary; or

(b) conducts significant off-balance sheet activities (including securitization and asset management or administration) either directly or through a nonbank subsidiary; or

(c) has a material amount of debt or equity securities outstanding (other than trust preferred securities) that are registered with the Securities and Exchange Commission (SEC); or

(d) The Federal Reserve decides in its discretion that applying the risk-based guidelines is warranted for supervisory purposes. 12 CFR Part 225, Appendix A to Part 225 - *Capital Adequacy Guidelines for Bank Holding Companies: Risk-Based Measure*. https://www.law.cornell.edu/cfr/text/12/part-225/appendix-A

2. **Non-regulated entities.** The regulations do not apply to non-regulated entities such as:

(a) private funds;

(b) insurance companies; or,

(c) HB-5 lenders.

IV. WHY PICK ON ADC LOANS?

A. OCC Definition Recognizes the Special Nature of ADC Underwriting. The OCC, states that "ADC lending may finance the land acquisition, land preparation, and construction of a single residential or commercial building. Often, however, ADC lending finances a single- or multiple-phase development of many units. ADC is highly specialized lending that requires a thorough understanding of its inherent risks." *The Office of the Comptroller of the Currency August 2013 Comptroller's Handbook*, p 16 https://www.occ.gov/publications/publications-by-type/comptrollers-handbook/cre.pdf "*OCC Handbook*"

B. Examples of lending qualifying as ADC lending.

1. unsecured working capital loans to finance real estate;
2. land acquisition loans;
3. land development loans;
4. tract development loans;
5. construction loans for commercial properties;
6. bridge loans;
7. permanent loan commitments;
8. stand-by commitment providing back-up financing should other permanent financing not be found; and
9. a forward commitment for permanent financing.

C. Unique Risks inherent in ADC Lending – lacks objective performance criteria. "ADC lending presents unique risks not encountered in the term financing of existing real estate. Assessing performance on a development or construction loan can be challenging because most are underwritten without required amortization or project-generated interest payments. Absent such objective performance measures, examiners must fully evaluate the projected cash flow of the project, compare actual progress to the initial plan, and when applicable, analyze guarantor support. This analysis must consider the feasibility of the project, given current conditions, planned construction, and the level of fully funded debt." *OCC Handbook* p. 16

V. FREQUENTLY ASKED QUESTIONS.

A. FAQs. In response to industry questions regarding the HVCRE rules, various federal regulatory bodies have provided interpretive guidance. The OCC, the Board of Governors of the Federal Reserve System and the FDIC have published interpretive guidance in the form of questions and responses. "*Frequently Asked Questions on the Regulatory Capital Rule*, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, and Federal Deposit Insurance Corporation (April 6, 2015) https://www.federalreserve.gov/bankinforeg/srletters/sr1506a1.pdf, [the **OCC FAQ**]. In addition, the Federal Reserve Board of Atlanta also published interpretive guidance in the form of questions and responses. *ViewPoint: Spotlight: High-Volatility CRE*, Federal Reserve Bank of Atlanta, Robert Canova, https://www.frbatlanta.org/banking/publications/financial-update/2015/q3/viewpoint/spotlight-high-volatility-cre.aspx (Vol. 28, No. 2 Second Quarter 2015) [the **FRBA FAQ**]. The following sections review a selected set of miscellaneous FAQs.

B. Will previously booked loans be grandfathered? Already booked ADC loans will not be grandfathered but will be reviewed by the examiners as an HVCRE Loan unless it is exempt.

1. **Question:** Are acquisition, development or construction (ADC) loans made prior to the effective date of the regulatory capital rule exempted from the HVCRE definition?

2. **Response:** The regulatory capital rule does not provide for the grandfathering of existing loans. Therefore, ADC loans made before the effective date of the regulatory capital rule are not automatically exempted from the definition of HVCRE. Unless such loans meet the criteria for exemption provided in the definition of HVCRE, they must be treated as HVCRE loans. **OCC FAQ 2, see also FRBA FAQ**

C. Is a facility on raw land without development plans an HVCRE loan?

1. **Question:** Is a credit facility used to purchase a commercial lot (land only with no site improvements) an HVCRE exposure? The proceeds are used to acquire the land, however, there is no plan to develop, construct, or make improvements. At this time the borrower intends to hold the land.

2. **Response:** An acquisition loan to purchase CRE (including land) would qualify as an HVCRE exposure, unless the loan is permanent financing in accordance with the banking organization's normal lending terms or meets the exemption criteria described in the HVCRE definition. **OCC FAQ 12, see also FRBA FAQ**

D. Once a construction loan has converted to permanent financing, does it cease to be an HVCRE loan?

1. **Question:** Any loans during the construction phase would be considered HVCRE if they meet three criteria: (1) the LTV is above the maximum supervisory LTV; (2) the borrower does not contribute 15 percent of the "as-completed" appraised value; and (3) the borrower's equity is not contractually obligated to remain throughout the project life. Therefore, HVCRE applies only to those loans that would be considered as construction loans as defined by the call report. Is the correct interpretation of the

guidance that once projects are converted to permanent financing, they are no longer considered to be HVCRE?

2. **Response**: Under the final rule's HVCRE definition, HVCRE applies only to a specific subset of acquisition, development and construction (ADC) loans and is, therefore, not applicable to all commercial real estate loans. The banking agencies noted that when the life of the ADC project concludes and the credit facility is converted to permanent financing in accordance with the banking organization's normal lending terms, the permanent financing is not an HVCRE exposure. Thus, a loan permanently financing owner-occupied commercial real estate is not an HVCRE exposure. Typically, a new credit facility in the form of a term loan replaces ADC facility. The rule does not grandfather existing ADC loans. **FRBA FAQ**

E. Do the financing terms play a role in determining whether a loan is a permanent loan?

1. **Question:** Does an interest only loan to purchase an existing building under renovation with tenants qualify as HVCRE?

2. **Response:** The terms of financing (for example, interest-only loans) are not a relevant criterion for HVCRE determination. Rather, the classification of the loan depends primarily on whether it is permanent financing. A loan cannot be classified as permanent financing if (1) the loan is based on the "as completed" value of the project (i.e., the project has not yet been completed) and (2) there will be any future advances on the loan. Other characteristics of the loan should also be considered in the context of the regulatory capital rule's HVCRE definition. **OCC FAQ 9, see also FRBA FAQ, VIII B below** "The interest-only feature has no relevance to HVCRE designation."

F. If a construction loan has a mini-perm feature will the conversion to a mini-perm loan suffice to remove the facility from the HVCRE designation?

1. **Question**: If a construction loan does not meet the equity requirement (say it's 14 percent cash equity) but is Regulation H compliant at the outset (no new appraisal "needed"), and the loan is structured with a "mini-perm" after construction (would have to meet debt service coverage (DSC) and loan-to-value (LTV) requirements and would have been converted to permanent financing with a shorter term than typical in the permanent market), would the loan then be eligible for removal from HVCRE?

2. **Response**: Permanent financing is achieved only when HVCRE is converted to permanent financing in accordance with the bank's normal lending terms or is paid in full. Typically, a new credit facility in the form of a term loan replaces the construction loan. **FRBA FAQ**

G. How will the one to four-family residential property exemption be applied to a mixed use project?

1. **Question:** Does an ADC loan on a multipurpose property that will contain both CRE and one-to four-family residential real estate meet the HVCRE definition?

2. **Response:** Only the portion of the loan applicable to the property's CRE could be subject to the HVCRE treatment. The banking organization should consider the contribution of the CRE 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 CRE. **OCC FAQ 13**

H. In determining the loan-to-value ratio, can the "as stabilized" value be used or must the "as completed" value be used?

1. **Question**: What is the "**as completed**" value? Can the "**as stabilized**" value be used for purposes of determining whether the loan is an HVCRE exposure?

2. **Response**: No, the "as stabilized" value cannot be used for purposes of determining whether the loan is an HVCRE exposure. The agencies' Interagency Appraisal and Evaluation Guidelines explain both the "as completed" value and "as stabilized" value as follows:

(a) The prospective market value "**as completed**" reflects the property's market value as of the time that development is expected to be completed;

(b) The prospective market value "**as stabilized**" reflects the property's market value as of the time the property is projected to achieve stabilized occupancy. 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. (Refer to the interagency guidelines: The Board's SR letter 10-16 at http://www.federalreserve.gov/boarddocs/srletters/2010/sr1016a1.pdf ; the OCC Bulletin 2010-42 at http://www.occ.gov/news-issuances/bulletins/2010/bulletin-2010-42.html);

(c) Of the three market value scenarios that are generally used by an appraiser (that is, the current ["as is"] market value, the prospective market value "as completed," and the prospective market value "as stabilized"), a banking organization should consider only the prospective market value "as completed" for purposes of determining whether a project is an HVCRE exposure. **OCC FAQ 6.**

I. If the property appreciates in value after the loan has funded, can the new appraisal be used for the loan-to-value ratio calculation?

1. **Question**: Subsequent to loan origination, if an updated appraisal or valuation on an HVCRE exposure results in a loan-to-value (LTV) ratio that no longer exceeds the maximum LTV ratio (80%) in the relevant supervisor's real estate lending standards, could the exposure then be removed from the HVCRE classification (if the exposure meets the other exemption criteria in paragraph (4) of the HVCRE definition)?

2. **Response**: No. A banking organization must consider the LTV ratio at origination when evaluating a loan against the HVCRE exemption criteria. A loan with an LTV ratio that exceeded the maximum supervisory LTV ratio at origination would remain an HVCRE exposure until it converts to permanent financing. Refer to the agencies' real estate lending standards regulations: 12 CFR part 34, subpart C (OCC); 12 CFR part 208, subpart E (Board); and 12 CFR part 365 (FDIC). **OCC FAQ 14, FRBA FAQ**.

VI. FIFTEEN PERCENT CONTRIBUTED CAPITAL.

A. Questions Related to the Fifteen Percent Contributed Capital Rule. Of all the rules with respect to the HVCRE Exceptions, the rule regarding the requirement of 15% contributed capital has generated the most uncertainty.

B. Statutory Re-Cap.

1. **Statutory Requirement.** The 15% contributed capital rule requires that the borrower has contributed capital to the project:

(a) in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket);

(b) of at least 15 percent of the real estate's appraised "**as completed**" value;

(c) before the institution advances funds under the credit facility; and

(d) 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.** 12 CFR § 324.2 (2015) (emphasis added).

VII. SELECTED FAQS – FIFTEEN PERCENT CONTRIBUTED CAPITAL.

A. The appreciated value of acquired land does not count toward the 15% contributed capital requirement.

1. **Effect on financing of long-held appreciated assets.** The regulation requires that 15% of the “as completed” value of the project must be contributed in cash or unencumbered readily marketable assets. This has been read to mean that the appreciated value of the project (the Borrower’s skin in the game), is not the amount used in the determination, but rather the cash used to purchase the project. This does not affect

a loan on a newly acquired property but will have a massive effect on a property that was purchased long ago and has since substantially appreciated in value. EY Implications, p. 2.

2. **Related FAQ Question:** If cash is used to buy land, and that land is subsequently contributed to a new development, can the land still count as contributed capital? Does the banking organization need to document when and how much the borrower paid for the land?

3. **Response:** Yes. If cash is used to purchase land that is subsequently contributed to an ADC project, **the cash used to buy the land** can count toward the 15 percent contributed capital amount. This 15 percent requirement must be met before the banking organization advances funds. The definition of HVCRE excludes CRE projects in which 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 "as completed" value. (See definition in question 6. [V-H above]) Consistent with the preamble to the regulatory capital rule, cash used to purchase land is a form of borrower-contributed capital under the HVCRE definition. The banking organization should document the details pertaining to the amount of cash paid for the land. **OCC FAQ 7** (emphasis added)**.**

4. **Notes.**

(a) **Tracing**. The financial institution must be able to trace and document the actual cash used to purchase the real estate.

B. Can the Borrower cure the 15% deficiency by contributing additional cash after loan funds have been advanced?

1. **Question:** If a borrower contributes additional capital to an existing HVCRE loan to meet the 15 percent contributed capital requirement after the banking organization has already advanced funds to the borrower, can the loan be excluded from the definition of HVCRE as a loan to a commercial real estate (CRE) project that meets specified criteria?

2. **Response:** The loan remains an HVCRE loan because any contribution of cash or land must be contributed to the project before a banking organization advances funds for a loan to be considered a CRE loan, rather than an HVCRE loan**. OCC FAQ 1**

C. If the bank's existing portfolio contains construction loans without equity withdrawal restrictions, will these be retroactively designated HVCRE loans?

1. **Question**: Does bank management have to look at their existing portfolio—in other words, loans that would not restrict the borrower from removing equity—when determining its level of HVCRE, or is this to be applied on a go-forward basis?

2. **Response**: Existing ADC loans are treated as HVCRE exposures if they do not meet any of the exemption criteria. **FRBA FAQ**

D. Can the borrower pledge other unencumbered real estate in lieu of cash?

1. **Question:** If a borrower owns real estate (and has no mortgages or liens on that real estate) that is unrelated to a project, can the borrower pledge this real estate to the project as collateral and count the value of the real estate toward the 15 percent borrower contributed capital requirement and avoid the HVCRE classification?

2. **Response**: No, the definition of HVCRE requires that capital be contributed by the borrower to the project in the form of cash or unencumbered readily marketable assets. To the extent that an asset is merely pledged as collateral, it would not be considered to have been contributed to the project. **OCC FAQ 3**

E. Can a condominium development count purchasers' deposits toward the 15%?

1. **Question:** For the purpose of determining whether a loan meets the definition of HVCRE, would various purchasers' deposits on units in a condominium project (that does not qualify as a one- to four-family property that is excluded from the definition of HVCRE) count toward the borrower's contributed capital?

2. **Response:** No. Purchasers' deposits on units in a condominium project do not qualify as capital contributed by the borrower. The purpose of contributed capital, or equity, is to **ensure that the borrower maintains a sufficient economic interest in the property** and to provide a margin between the loan amount and the value of the project **to provide protection to the lender** against loss due to overruns or an incomplete or otherwise failed project. Typically, a purchaser's deposit is not able to absorb losses on the project because the deposit must be returned to the purchaser in the event that the project is not completed. **OCC FAQ 4** (emphasis added).

F. Can the Borrower count a second lien on the property by a different bank toward the 15%?

1. **Question:** For the purpose of measuring capital contributed by the borrower under the HVCRE definition, if Bank A has a first mortgage secured by the real estate of the project and Bank B has a second mortgage on the same real estate collateral, does the second banking organization's funding count as cash contributed by the borrower?

2. **Response:** No. A second banking organization's funding of the project is not considered to be capital contributed by the borrower. Rather, it is another loan to the project, and both loans encumber the property. **OCC FAQ 5**

G. Does cash contributed to the project in the form of grants count toward the 15%?

1. **Question:** Projects may receive cash in the form of grants from nonprofit organizations, municipalities, state agencies, or federal agencies. Can a banking organization providing ADC financing to a project (that does not otherwise qualify as a community development investment with regard to the HVCRE exemption) consider the cash from such grants as part of the 15 percent contributed capital requirement?

2. **Response:** No, to the extent a project receives a grant, a banking organization may not consider the cash from the grant as a capital contribution because the cash did not come from the borrower. Although a third-party grant would increase the capital invested in the project, because it does not come from the borrower, it does not affect the borrower's level of investment and therefore does not ensure that the borrower maintains a sufficient economic interest in the project. **OCC FAQ 11**

H. Can a lender count any amounts loaned to borrower and subsequently contributed by borrower to the project against the 15%?

1. **Question:** If a banking organization lends a borrower 15 percent against the property, independent of the project, can the proceeds from the loan count towards the obligor's 15 percent capital contribution to the project?

2. **Response:** No. Proceeds from a loan from the banking organization that is financing the ADC project does not count toward the 15 percent contributed capital amount. **OCC FAQ 16**

VIII. SELECTED SET OF FAQS WITH RESPECT TO THE REQUIREMENT THAT THE CONTRIBUTED CAPITAL REMAIN IN THE PROJECT.

A. What does it mean that the contributed capital must stay in the project for the life of the project?

1. **Question:** The definition of HVCRE includes a provision 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." What does "contractually required" mean in this context?

2. **Response:** In order to meet this criterion in paragraph (4)(iii) of the HVCRE definition, the loan documentation must include terms requiring that all contributed or internally generated capital remain in the project throughout the life of the project. The borrower must not have the ability to withdraw either the capital contribution or the capital generated internally by the project prior to obtaining permanent financing, selling the project, or paying the loan in full. **OCC FAQ 15**

B. What about retention of cash generated by a third party?

1. **Question**: Assuming a borrower has a construction loan that is "interest only" for an extended period to allow for stabilization, would the bank violate the exception if the borrower were allowed to receive cash from the operation of the lease prior to the loan converting to permanent? This would be typical for a single-entity building where the tenant moves in and begins paying rent prior to conversion to permanent financing or payoff from a nonrecourse lender.

2. **Response**: The interest-only feature has no relevance to HVCRE designation. As long as the cash is coming from a third party under a property rental agreement, it would not violate the exemption. **FRBA FAQ**

(a) This seems to conflict with **OCC FAQ 15** above as it would seem that all capital accretion by definition would seem that capital generated by a third party would fall under the definition of capital generated internally by the project.

C. How long is the "life of the project"? Is it until a final certificate of occupancy is issued, or perhaps when cash generation occurs?

1. **Question:** Would the issuance of a certificate of occupancy qualify the loan as having reached the stage of permanent financing? There is usually a remaining loan duration extending past the issuance of the certificate of occupancy in either the initial loan term and/or through extension options.

2. **Response:** A certificate of occupancy does not transform an HVCRE loan into permanent financing. The HVCRE exposure ceases to be an HVCRE exposure when it is converted to permanent financing in accordance with the banking organization's normal lending terms, or is paid in full. Generally, this would involve a new credit facility in the form of a term loan replacing the ADC facility. **OCC FAQ 17**

D. Can excess capital be distributed upon the sale of lots in a lot development loan or units in a condominium loan?

1. **Question:** How does the bank compute the 15 percent capital contribution on an "as-completed" basis when a borrower begins selling lots in a development project even as the loan remains a "construction loan"? As lots or parcels of the property are sold, does the amount of the 15 percent reduce proportionally with the reduction in collateral? How would it be viewed if the borrower were allowed to retain a portion of the sales proceeds?

2. **Response:** The prospective market value "as completed" reflects the property's market value as of the time that development is expected to be completed. The "as-completed" value does not change if a developer sells parcels (or units) of the project while it is still in the construction phase. The purpose of contributed capital, or equity, is to ensure that the borrower maintains a sufficient economic interest in the property and to provide a margin between the loan amount and the value of the project to provide protection to the lender against loss due to overruns or an incomplete or otherwise failed

project. The capital required to be contributed to the project has to be contractually required to stay in the project throughout the life of the project (per the HVCRE definition) to meet the HVCRE exemption for commercial real estate. **FRBA FAQ.**

IX. SOME UNANSWERED QUESTIONS.

A. Mezzanine Loans.

1. **Mezzanine loans and skin in the game**.

(a) **Mezzanine loans by senior lender**. The regulations only apply to the capital to be contributed by the borrower and not borrower's owners, but it appears that the regulators are also indicating that a financial institution must pick its spot in the debt stack and cannot make a mezzanine loan to the owners of the borrower. This result is based on OCC FAQ 16 stating that "proceeds from a loan from the banking organization that is financing the ADC project does not count toward the 15 percent contributed capital amount".

(b) **Mezzanine loans by a third party lender**. For purposes of the contribution requirement, the regulators are quite clear that they require that the borrower have skin in the game. To the extent that the borrower, or its owners have borrowed money, it would appear that they have not contributed the requisite equity. **OCC FAQ 4, OCC FAQ 5, OCC FAQ 7, OCC FAQ 11** and **OCC FAQ 16.**

(c) **If the regulators take the position that mezzanine debt is prohibited, where does this stop.**

(i) If a mezzanine loan is prohibited to the owners of the Borrower, what about a loan to the owners of the owners of the Borrower?

(ii) How far up the food chain would a financial institution go to determine debt on the project?

(iii) Does this same analysis apply to preferred equity?

(iv) If not, why not, what is the structural difference?

2. **If the regulators do not take the position that mezzanine debt is prohibited but allow mezzanine debt at some level how can the debt be serviced?**

(a) If the regulators allow mezzanine debt but the borrower is not allowed to withdraw either the capital contribution or the capital generated internally by the project prior to obtaining permanent financing, how can the borrower service the mezzanine debt?

B. In determining the appropriate LTV will subordinate debt negatively impact the LTV or will it be, at worst, neutral since it is subordinate to the senior loan?

1. It seems that the regulators would take the position that since both loans encumber the property they should both be considered as the "loan" for the purposes of that ratio. See **OCC FAQ 5** above in the context of the 15% equity requirement stating that "a second banking organization's funding of the project is not considered to be capital contributed by the borrower. Rather, it is another loan to the project" and **OCC FAQ 16** "Proceeds from a loan from the banking organization that is financing the ADC project does not count toward the 15 percent contributed capital amount."

C. How does a condominium development loan or a lot development loan ever become a permanent loan?

1. Deference is paid to the financial institution determination as to when a HVCRE loan has converted to permanent financing. "The HVCRE exposure ceases to be an HVCRE exposure when it is converted to permanent financing in accordance with the banking organization's normal lending terms, or is paid in full." **OCC FAQ 17**. The deference is not, however unlimited as:

(a) A certificate of occupancy is insufficient to transform an HVCRE loan. **OCC FAQ 17.**

(b) Generally, this [permanent financing] would involve issuing a new credit facility in the form of a term loan replacing the ADC..." **OCC FAQ 17.**

(i) What about a mini-perm, i.e. a loan that has components of a construction loan and then a short term permanent loan?

(ii) Can a loan that never amortizes or a property that never has a stabilized value such as a condominium development or a lot development ever be a permanent loan?

(c) If a lot development loan or a condominium loan can never be permanent does the borrower have to keep its capital in until the loan is paid off?

(i) If so, how will the borrower have the money to pay its taxes on the sale of its condominiums or lots?

X. HVCRE Unintended Consequences.

A. Appraisal Works Against Borrower.

1. **Higher Value Works Against Borrower.** Counterintuitively, a higher appraised value works against the Borrower. Because the Borrower must contribute 15% of the "as completed" value regardless of cost or appreciation, the higher the appraised value, the greater the contributed capital required.

(a) **Example 1 – Low Basis.** Suppose a borrower purchased property for $10,000.00 in 1950 in North Texas. The property is now worth

$10,000,000.00 and the “as completed” value is $50,000,000.00. The Borrower would have to contribute $7,500,000.00 and would only get credit for the cash portion of $10,000.00.

(b) **Example 2 – Low cost to develop.** Suppose the total cost to develop a commercial office building is $10,000,000 and the borrower is willing to invest cash in the amount of $2,000,000 (20% of the loan amount). This credit facility should pass the 80% LTV test and the 15% capital contribution test, as the borrower has contributed 20% of the total capitalization of the project. If, however, the completed project appraises for $13,333,334 or greater, the lending facility will fail the 15% requirement unless the borrower invests additional capital.

B. Cash Flow Issues. The requirement that capital contributed to the project as well as any capital generated from the project must stay in the project causes at least two problems.

1. **Incentive to Minimize Contributions.** The Borrower will have an incentive to contribute the minimum amount to the project to avoid having capital trapped.

2. **No Distributions.** The Borrower may have a harder time finding investors since they will not be allowed to receive distributions or dividends of income generated by the project.

C. May drive banks to make riskier long term loans.

1. **Incentive to make long term loans.** Construction loans are short term loans which have a lower risk of adverse changes in the interest environment than do long term permanent loans.

2. **Downward pressure on interest charged.** Because of the risk to the Bank’s capital structure of a loan being classified as an HVCRE, Banks will be inclined to allocate more resources to permanent loans and will be competing against CMBS, life insurance companies and other markets to provide ever lower interest rates on long term permanent loans.

D. May drive quality borrowers out of the regulated system.

1. **Quality borrowers may have an incentive to seek alternate financing.**

The HVCRE rules militate against financing in the regulated system:

(a) highly appreciated property (increases the capital requirements);

(b) a property with great cash flow (capital must be retained in the project);

(c) efficient Borrowers that are able to operate at low costs (capital must be retained in the project);

(d) Borrowers who want low leverage and want to contribute more than 15% to the project (capital must be retained in the project).

XI. IS IT WORTH IT – DO INCREASED CAPITAL REQUIREMENTS NECESSARILY MITIGATE INDIVIDUAL AND SYSTEMIC RISKS?

A. Increased capital requirements should mitigate individual and systemic risk. It seems intuitively obvious that increasing the capital requirement should increase the capacity of the banking system to absorb losses, reduce the vulnerability of banks to failure and reduce the size of the claims against the deposit insurance fund, but in practice the correlation between higher capital requirements and these results is not clear. See US Implementation p. 12.

B. Increased risk of bank failure.

(a) Capital comes from investors and the cost to obtain such capital is greater than funding loans via the short-term interbank loan markets. Because of the premium over short-term loans that must be paid for capital, banks are reluctant to hold more capital than necessary.

(b) During periods of economic uncertainty when the bank needs additional capital, investors could possibly interpret a bank's decision to raise capital as a sign that its default or funding risks may be increasing. This negative interpretation might cause a fall in the bank's share price and could lead to an increase in the risk of bank failure. See US Implementation p. 13

C. Dampens credit expansion and slow the pace of economic recovery.

1. In order to avoid raising new capital and diluting shareholder equity, a bank may:

(a) decide to sell some existing assets (loans) or reduce future lending, or

(b) pass its higher funding costs on to borrowers by increasing lending rates.

(c) The balance between how the bank decides whether its borrowers or its shareholders shoulder the burden of the increased capital requirements could dampen credit expansion and slow the pace of economic recovery. See US Implementation p. 13

D. Do higher capital requirements decrease systemic risks?

1. **The “paradox of financial instability”.**

(a) Prior to the recent financial crisis, many banks held more than enough capital to be considered well capitalized by regulatory standards; yet holding precautionary capital did not necessarily restrain lending by the covered institutions.

(b) The “**paradox of financial instability**” states that the financial system appears at its most robust when it is actually most at risk.

(i) The evidence for the paradox is linked to the observation that bank capital is *procyclical*, meaning that it rises during healthy economic periods, when there are fewer defaults, and declines during financial downturns when defaults increase. Procyclical implies that bank capital levels may be a **lagging indicator** of distress **rather than a predictor** of a systemic event.

(ii) Excessive lending activity may arise when banking institutions grow overconfident (1) as a result of being well-capitalized and (2) as optimism grows with the exceptional performance of an asset used as collateral for loans.

(c) **Higher capital requirements may not actually mitigate systemic risk and may not be as good an indicator of systemic financial stability as the pace of aggregate lending activity.**

(i) Since banking crises may be attributed to the bursting of asset bubbles, which has been difficult to predict, a rise in the pace of aggregate lending activity may arguably serve as a better indicator of vulnerability to a systemic risk event than higher capital requirements. <u>US Implementation</u> pp 12-13.

2. **Bank capital levels may be a misleading indicator of systemic strength when assets are financed outside of the regulated system.**

(a) Many loans that were originated prior to the financial crisis were originated outside of the financial regulatory system (e.g., securitizers, nondepository institutions, and nonbank subsidiaries of bank holding companies). In addition, financial institutions warehoused loans or otherwise sponsored financial conduits that allowed mortgages to be financed off the balance sheets of supervised banks.

(b) “When large amounts of lending activity occur in parts of the financial system that are not regulated for safety and soundness, raising capital requirements for depository institutions would not necessarily address the rise in the various types of financial risks in the economy.” <u>Implementation</u> p 14.

(c) "Conversely, if nonbank lending activities substantially decline, then the influence of higher bank capital requirements on overall lending activity may increase, causing credit availability in the economy to become more contingent on (or sensitive to) changes in bank capitalization levels." Id, pp 12-13.

XII. CONCLUSION.

The capital requirement rules, in general, and the HVCRE rules, in particular, create a complex system designed to decrease the risk of institutional and systemic failure. Unfortunately, regulatory capital rules are a blunt instrument to achieve these goals. While it may seem intuitively obvious that an increase in capital requirements with the concomitant systemic deleveraging would help to achieve stability, it is questionable whether, in the case of HVCRE lending, the focus on a particular asset category will have the desired effect of stabilizing banks or the system. Of one thing we can be certain: These rules will have a number of unintended consequences with respect to bank safety, availability of credit, and systemic risk. Whatever efficacy these rules may ultimately have, their interpretation is unclear and banks will be seeking guidance for some time to come. This uncertainty will lead to some interesting times for the construction industry, which will have to grapple with an increased reluctance of regulated financial institutions to make construction loans.