Real Estate Finance and Bank Regulatory Capital: Will HVCRE be Replaced by HVADC?

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Real Estate and Finance Alert
10.4.17

Many banking organizations are challenged with the process of classifying a credit facility used to finance the acquisition, construction or development of real estate as an HVCRE (high volatility commercial real estate exposure) or a non-HVCRE. Particularly challenging has been the process of qualifying such credit facilities for an exemption from HVCRE status by, among other criteria, requiring the borrower to contribute capital to the project in the form of cash or unencumbered readily marketable assets (or as development expenses paid out-of-pocket) of at least 15% of the project's "as-completed" market value before any advance of funds under the credit facility. The goal of exempting a credit facility from HVCRE status is to assign the credit facility a lower risk weight with respect to the bank's regulatory capital treatment of the credit facility. Under the current capital rule for banks using the standardized approach, loans used to finance the acquisition, construction or development of real estate which are classified as an HVCRE receive a 150% risk weight while those classified as non-HVCRE receive a 100% risk weight.

Recently, the Office of the Comptroller of the Currency, Treasury; the Board of Governors of the Federal Reserve System and the Federal Deposit Insurance Corporation published a Notice of Proposed Rulemaking (NPR) entitled "Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996". If the regulation as written becomes effective, banking organizations which utilize the standardized approach for determining risk-weighted assets will no longer classify credit exposures as HVCRE's or non-HVCRE's, but, rather, will conduct a simpler evaluation to determine whether a credit exposure is an HVADC (high volatility acquisition, development, or construction exposure). The HVADC classification would apply to a credit facility if more than 50% of the loan proceeds are used for acquisition, development or construction (ADC) activities. The key factor which simplifies the analysis under the proposed HVADC definition is the elimination of the 15% capital contribution threshold exemption. Without this exemption, more commercial loans funding ADC of real estate would be classified under the newly-defined term HVADC; however, the associated risk weight for banking organizations utilizing the standardized approach would be 130%, rather than the 150% under current HVCRE requirements. For certain large or internationally active banking organizations which use the advanced approach in determining risk based capital, the NPR retains the HVCRE definition, the 15% capital contribution exemption and the risk weighting associated with that process.

Of all of the questions raised by the agencies seeking comment on the topic of HCVRE's, Question 8 appears to be the most challenging for those banking organizations subject to the advanced approaches for determination of risk based capital; i.e., those banking organizations having total consolidated assets greater than or equal to $250 billion and on-balance sheet foreign exposures of $10 billion or more. In short, that question asks for comment on whether it would be appropriate to replace the HVCRE definition with the proposed newly-defined category of credit exposures referred to as HVADC for banking organizations utilizing the advanced approach in addition to those utilizing the standardized approach for determining risk based capital (i.e., those banking organizations having total consolidated assets of less than $250 billion and on-balance sheet foreign exposures of less than $10 billion).

The NPR provides a grandfathering provision for ADC loans originated prior to the effective date of the final rule. Thus, an outstanding ADC loan will continue to be classified as an HVCRE exposure or non-HVCRE exposure until converted to permanent financing or until the property is sold or the loan paid in full.

To date, the NPR has not been posted for public comment on the Federal Register website. Comments to the proposal will be accepted on the Federal Register website for a period of 60 days from the date of publication. Until the final rule is in effect, banking organizations subject to either the standardized or the advanced approaches for determining risk-weighted assets, as well as their borrowers, should be cognizant of the potential changes to capital risk weighting for ADC loans, the proposed elimination of the 15% capital contribution exemption (with respect to banking organizations subject to the standardized approach, and possibly those subject to the advanced approaches), and prepare for the consequences of either classification.

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