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Hunger Games: How Competing HVCRE Policy Proposals May Affect Competition Between Banks and Non-Bank Lenders

The federal banking agencies (the "Agencies") and the House Financial Services Committee (the "HFS Committee") have proposed competing revisions of the regulatory capital framework for high-volatility commercial real estate ("HVCRE") lending. These approaches will affect the cost of HVCRE exposures in different ways for small banks, large banks, non-bank lenders, and ultimately borrowers. This article explores how these alternative policy ideas may affect the lending market for acquisition, development and construction ("ADC") of commercial real estate ("CRE").

I. The Existing HVCRE Exposure Framework

Since 2015, U.S. standardized approach banks have been required to risk-weight HVCRE exposures at 150%.1 An "HVCRE exposure" is generally a loan secured by raw land or ADC projects that, prior to its take-out by a permanent facility, finances the ADC of certain categories of real property unless the project qualifies for an exemption. Single-family housing, agriculture loans, and some community development loans are exempt. Another exemption, known as the "contributed capital exemption," requires a regulatory loan-to-value ("LTV") test and the borrower contributed cash or readily marketable securities equal to at least 15% of the real estate's "as-completed" market value, and a commitment to retain any internally generated capital in the project for its life.

Standardized approach banks have long complained that ambiguities in the "contributed capital exemption",what constitutes permanent financing make the existing framework unworkable and effectively force them to over-classify as HVCRE certain CRE exposures that should properly be exempt.

II. The Agencies' Proposed HVADC Exposure Framework

In September, the Agencies issued a joint notice of proposed rulemaking (the "NPR") to simplify and enhance consistency in the treatment of ADC loans by standardized approach banks.[2] Capital for HVCRE exposures of advanced approach banks would still be determined by the banks' own methodologies.

A. New Purpose-Based HVADC Exposure Definition

The Agencies propose replacing the HVCRE exposure category as applied in the standardized approach with a new exposure category, termed "HVADC exposure." This is defined as a credit facility that "primarily" finances or refinances: (i) acquisition of vacant or developed land; (ii) development of land to prepare to erect new structures, including, but not limited to, laying of sewers or water pipes and demolishing existing structures; or (iii) construction of buildings or dwellings, or other improvements, including additions or alterations to existing structures. A CRE loan meets the "primarily finances" requirement if more than 50% of the loan proceeds are intended for ADC activities.

Significantly, the "primarily finances" test would supersede the current requirement that HVCRE loans be secured by real estate. Eliminating the "secured-by" requirement and adopting the "primarily finances" requirement will likely broaden the scope of coverage under the proposed HVADC framework and will require consideration of whether corporate financing transactions and warehouse lending facilities to non-bank lenders may constitute HVADC exposures.

B. Elimination of the Contributed Capital Exemption from the HVADC Exposure Definition Eliminates a Headache

The proposed HVADC exposure definition would remove the contributed capital exemption, thereby also removing the need to monitor compliance with supervisory LTV limits and with restrictions on the distribution of internally-generated capital. This is an attempt to address banks' concerns about the complexity and potential inconsistent application of the exemption, due to the multiple requirements to qualify for the exemption and the potential conflict between the borrower's organizational documents and the contractual limitations on distributions from the project that result from complying with the requirements.

C. A New Definition of "Permanent Financing" Would Provide Greater Certainty When HVADC Status Falls Away

As under the existing HVCRE framework, an ADC exposure would cease to be an HVADC exposure under the NPR when it is converted to "permanent financing." Under the existing HVCRE framework, the classification of a loan as permanent financing is based on each bank's subjective determination as to whether the loan meets the underwriting criteria for long-term mortgage loans. The HVADC framework would provide an objective standard by explicitly defining a "permanent loan" as "a prudently underwritten loan that has a clearly identified ongoing source of repayment sufficient to service amortizing principal and interest payments aside from the sale of the property." A loan need not be fully amortizing to satisfy the definition of "permanent loan."

D. New Risk-Weight; Grandfathering

The NPR would reduce the risk-weight for HVADC exposures from 150% to 130%. This proposed reduction is intended to counterbalance the anticipated greater inclusion under the proposed HVADC framework owing to the elimination of the contributed capital exemption and replacement of the "secured-by" requirement with the "primarily finances" test. Loans originated by standardized banks before the effective date of a final rule would continue under the existing HVCRE framework, including scope and risk-weighting.

III. The HFS Committee's Proposed HVCRE ADC Loan Framework

In October, the HFS Committee reported out a bill, H.R. 2148, (the "Bill") that would amend the Federal Deposit Insurance Act to redefine the scope of HVCRE. The Bill is closer to the existing HVCRE framework than to the proposed HVADC framework in the NPR but has important differences from both.

A. Narrowed HVCRE ADC Loan Definition

The Bill would replace the current HVCRE exposure definition with a new term, "HVCRE ADC loan." This is a credit facility "secured by land or improved real property" that (i) "primarily" finances, has financed, or refinances the acquisition, development, or construction of real property; (ii) has the "purpose" of providing financing to acquire, develop, or improve such real property into income-producing real property"; and (iii) is "dependent upon future income or sales proceeds from, or refinancing of, such real property for the repayment of such credit facility.

Retaining the "secured-by" requirement may eliminate some concerns about whether the "primarily" finances test and the "purpose" test may expand the scope of coverage. However, including refinancing loans may blur the line between ADC loans and permanent take-out financing and may create particular ambiguity with respect to bridge loans.

B. Preservation of the Contributed Capital Exemption with Changes

Unlike the NPR, the Bill seeks to preserve the current 15% contributed capital exemption. However, it would apply that exemption differently from existing law. Notably, instead of measuring land contributed as capital based on cost basis, the Bill would base that measurement on the "appraised value" of the property in accordance with the Financial Institutions Reform, Recovery, and Enforcement Act of 1989.[3]

C. Simpler Definition of "Permanent Loans"; Same Risk-Weight; Grandfathering

Under the Bill, a loan that was originated as an HVCRE ADC loan would be converted to non-HVCRE ADC status upon (i) completion of development or construction of real property being financed by the credit facility; and (ii) cash flow being generated by the real property being sufficient to support the debt service and expense of real property, in either case to the satisfaction of the lender in accordance with the institution's applicable loan underwriting criteria for "permanent financing." The Bill does not prescribe a risk-weight for HVCRE ADC loans, leaving it to the Agencies to apply a risk-weighting framework to the revised definition. The Bill would not apply to loans originated before January 1, 2015.

D. All Banks Covered

The Bill would apply equally to standardized approach banks and advanced approach banks. This is different from the NPR, which covers only banks that use the standardized approach.

IV. Implications for Players in the ADC Financing Market

Like dueling gladiators in the arena, each of whom brandishes a different type of weapon, the Bill and the NPR apply different tools whose very differences may impact the outcome of the battle. The NPR requires a weighing of the competing forces of greater inclusion on one hand and lower capital cost on the other. The Bill is more straightforward and, in some ways, has a more evident impact on the market, but it too contains ambiguities that may lead to unintended results and is silent on capital cost. This section analyzes the implications of the NPR and the Bill for bank lenders, their borrowers, and non-bank lenders.

A. Implications for Bank Lenders and Their Borrowers

A key trade-off in the Bill and the NPR is the balance between the breadth of the relevant exposure definition and the regulatory capital for covered loans. The proposed HVADC exposure definition in the NPR would likely capture more ADC exposures than are currently captured by the HVCRE exposure definition as a cost of a mechanism that purports to be simpler to administer. This may be offset (at least for standardized approach banks) by reducing the risk-weights for HVCRE exposures to 130%, and may indeed result in a net equivalent retention of capital among that cohort. Whether that would be true for any particular bank would largely depend on that particular bank's lending activities going forward. On the other hand, the Bill would likely capture fewer loans than under existing law or under the NPR, but because it does not purport to affect the corresponding risk-weights, the regulatory capital position of banks with HVCRE ADC loans would depend on whether and how the Agencies modify the 150% risk-weight to accommodate the new definition.

The purpose requirements of the NPR and the Bill are key issues that will affect the scope of coverage of each. To take the NPR first, the "primarily finances" test represents a significant expansion of the scope because it replaces the current requirement that an HVCRE loan be "secured by" real property. Eliminating an objective standard that intuitively applies only to CRE loans may effectively expand the definition of HVADC loans to include corporate credit facilities for general corporate purposes that may incidentally include refurbishment of office facilities and the like. This may impose new due diligence and compliance burdens on both bank lenders and borrowers, similar in general terms to the compliance burdens imposed by margin lending regulations. As a result, bank lenders may seek to cover HVADC compliance in covenants regarding the use of proceeds or perhaps request corresponding legal opinions even in loans that do not appear to involve CRE. As to the Bill, including the "primarily finances" purpose test and the "source of repayment" requirement will reduce loan coverage for both individual banks and the market as a whole, particularly since the Bill preserves the "secured-by" requirement in its HVCRE ADC loan definition.

The fate of the contributed capital exemption under the NPR and the Bill will affect the respective competitive positions of standardized approach and advanced approach banks in ADC lending. Eliminating the contributed capital exemption may increase classifications of loans as HVADC loans by bank lenders using the standardized approach since lenders would not be able to control classification of ADC loans by requiring borrowers to contribute a certain amount of capital and prohibiting distributions during construction. This may be problematic from a risk perspective as it shifts the capital risk of projects from the borrower to the bank lender.

Risk-weight modification further complicates the assessment with respect to banks' regulatory capital requirements under both the NPR and the Bill, but in different ways. Although the NPR proposes a 20% risk-weight reduction to counterbalance the expected increased loan coverage, the effect on particular institutions may be hard to assess to the extent new loans that would not be considered HVCRE (as it currently exists) exposures under the existing definition might receive a risk-weight of 130% instead of the 100% they would otherwise have received. The net effect will vary between standardized approach banks and advanced approach banks and among individual banks within each group.

The Bill's effect on regulatory capital requirements is more difficult to analyze because the Bill changes the definition but leaves it to the Agencies to prescribe the regulatory capital for banks with HVCRE ADC loans. Therefore, the actual cost would depend on whether and how the Agencies modify the 150% risk-weight to accommodate the new definition.

The considerations described above may also have implications for financial system stability. If risk-weighted regulatory capital levels for banks are too high, ADC lending may flee to unregulated financial institutions in a manner analogous to what has been seen in corporate lending following introduction of the Federal Reserve's leveraged lending guidance in 2013. If capital levels are set too low, the risk of bank insolvency may be increased, with concomitant pressure on the Federal Deposit Insurance Corporation's insurance fund and the resolution mechanisms put in place since 2010. To the extent that advanced approach and standardized approach banks are required to use the same regulatory approach to risk-weight ADC exposures, the large banks may be disincentivized to invest in robust risk management protocols in this area.

B. Implications for Non-Bank Lenders

If it becomes more costly to finance ADC activities through bank lenders that must retain capital in accordance with the NPR or the Bill, borrowers may turn to non-bank lenders for alternative financing options. This may affect not just classic CRE finance but also non-real estate secured facilities in certain cases. To the extent warehouse loans by banks to those non-bank lenders may themselves be considered as HVADC exposures under the NPR or HVCRE ADC loans under the Bill, there may be an effect on liquidity to the non-bank lender sector. For the reasons discussed above, under the NPR, the competitive position will depend in part on whether the lowering of the risk-weight is offset by the broadening of the scope of coverage. Under the Bill, the competitive position will largely depend on how the Agencies assign a risk-weight to the revised definition.

V. Conclusion

The Bill and the NPR each promises to change the face of CRE finance in different ways. Their potential impact is a multi-dimensional puzzle that requires an assessment of how each may affect big banks and small banks differently and may change the cost of general corporate lending. The effect of certain proposed changes may be difficult to model, particularly in relation to the tradeoff in the NPR between an expanded definition and a lowered risk-weight and in relation to the Bill how the Agencies might adjust capital charges to the Bill's narrower definition of HVCRE exposures and whether the Agencies will be able to withstand political pressure not to take away the proverbial punch bowl by raising capital costs.

1 The U.S. regulatory capital rules detail two approaches for determining risk-weighted regulatory capital requirements under Basel III. Under the "standardized approach," banks apply standard risk weightings to different categories of exposures without distinguishing among different levels of risk within a single asset category based on the relative creditworthiness of the obligor and the tenor of the obligation. A small number of large, internationally active U.S. banks must, and other institutions may elect – with the consent of their primary regulators – to use one of two advanced approaches for measuring operational risk and credit risk based on their own experience and internal credit scoring methodologies. See 78 Fed. Reg. 62018 (Oct. 11, 2013).

2 The deadline for comments is December 26, 2017. The NPR does not propose material changes to the exclusion for one-to-four family residential, agricultural or community development projects.

3 12 U.S.C. 3339.