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Federal Banking Agencies Propose New Approach to Capital Treatment for Acquisition, Development, and Construction Loans

By Henry M. Fields, Oliver I. Ireland, and Mark Sobin

On September 27, 2017, the three federal banking agencies[1] (the "Agencies") released a Notice of Proposed Rulemaking ("NPR"), which proposes changes to certain aspects of the bank capital rules under the "standardized approach."[2] Of keen interest to many banks will be the proposal to modify the approach to the capital treatment of acquisition, development, and construction ("ADC") loans characterized under the current capital rules as high volatility commercial real estate ("HVCRE") exposures.[3] Under current rules, banks are required to apply a 150% risk-weight to HVCRE exposures under the standardized approach. Since the introduction of the HVCRE definition under the standardized approach, banks have criticized the complexity of the HVCRE definition and its uncertain application. The proposed modifications are described as a simplification of the capital treatment of ADC loans. However, while attempting to simplify the capital treatment of ADC loans, the proposal generally broadens the ADC loans subject to a higher capital charge, while reducing the size of the capital charge for covered loans from 150% to 130%. Despite the lower capital charge, some banks may be required to carry more capital for ADC loans than under the current regime. Also, whether the new approach will be simpler remains to be seen.

The Agencies are soliciting comments on whether the new approach is workable and appropriate. The comment period will end 60 days after the NPR is published in the *Federal Register*.

Below are highlights of the NPR as it pertains to ADC loans.

NEW "PURPOSE-BASED" DEFINITION FOR HIGH VOLATILITY ACQUISITION, DEVELOPMENT, OR CONSTRUCTION ("HVADC") EXPOSURES

Under the proposal, a HVADC exposure will be defined as a credit facility (whether or not real estate secured) that primarily finances or refinances (i) the acquisition of vacant or developed land; (ii) the development of land to prepare for new structures; or (iii) the construction of buildings or other improvements, including additions or alteration to existing structure.[4] The proposal includes four exemptions from this definition, which we describe below.

[1] The Office of the Comptroller of the Currency ("OCC"), the Board of Governors of the Federal Reserve System ("Board"), and the Federal Deposit Insurance Corporation ("FDIC").

[2] The NPR has not yet been published in the *Federal Register*. Citations to the NPR in this Client Alert are to the unpublished NPR, which is available here: https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170927a1.pdf [hereinafter "Unpublished NPR"]. A summary of the NPR prepared by the Agencies is available here: https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170927a2.pdf.

[3] The NPR also addresses the regulatory capital treatment of mortgage servicing assets, certain deferred tax assets, investment in the capital of unconsolidated financial institutions, and capital issued by a consolidated subsidiary of a banking organization and held by third parties (minority interest).

[4] *See proposed rule* 12 C.F.R. § 324.2 (FDIC); 12 C.F.R. § 217.2 (Board); 12 C.F.R. § 3.2 (OCC). If the "purpose test" embedded in the definition is met, the exposure will be an HVADC exposure, even if not real estate secured. Unpublished NPR at 10.

Unlike the existing HVCRE definition, a credit facility will be an HVADC exposure regardless of the amount of capital contributed to the project or the distribution of internally generated capital to sponsors or developers.[5] Accordingly, banks that have successfully structured around the HVCRE definition by requiring an appropriate amount of contributed capital and prohibiting distributions during construction will not be able to use this technique to avoid the higher capital charge.

HVADC exposures are those “primarily” financing or refinancing the ADC activities described in the rule. The use of the term “primarily” is intended to address multi-purpose loans. A credit facility would be deemed to be primarily financing ADC activities if more than half of the loan proceeds are used for the ADC activities. A bank would need to make this determination at the outset by reviewing the proposed use of funds. The Agencies will expect each ADC transaction to be supported by documentation of sources and uses of funds tailored to the specific project and to have a process in place to review the intended use of funds in this connection.[6]

EXEMPTIONS FROM THE DEFINITION OF HVADC EXPOSURES

The NPR includes four exemptions from the definition of an HVADC exposure:

ADC loans for residential properties. A credit facility that finances or refinances one-to-four family residential properties will not be deemed to be an HVADC exposure.[7] This is a carry-over from the HVCRE definition. In the NPR, the Agencies provide some clarification of interpretive issues that have arisen under the HVCRE exclusion for such credit facilities. For example, ADC loans for the development or construction of condominiums or cooperatives would not qualify for the exclusion unless the project contains fewer than five individual units. Row houses or townhouses with dividing walls extending from ground to roof would be treated as single family residential property, as would tract development of individual homes. Loans to finance the acquisition of undeveloped land would not qualify for this exclusion.[8]

Community development projects. As under the existing HVCRE definition, the HVADC definition exempts community development projects. However, the scope of the community development exemption under the proposed HVADC definition is broader.[9]

Financing for the purchase or development of agricultural land. As under the HVCRE regime, credit facilities that finance or refinance the purchase or development of agricultural land are exempt from the definition of an HVADC exposure.[10] However, the exemption would not apply to ADC loans for manufacturing or processing plants related to agricultural products, such as a dairy processing plant.[11]

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

[6] Unpublished NPR at 10-11.

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

[8] Unpublished NPR at 12.

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

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

[11] Unpublished NPR at 13.

"*Permanent Loans*." HVADC loans would not include a "prudently underwritten loan[12] that has a clearly identified ongoing source of repayment sufficient to service amortizing principal and interest payments[13] aside from the sale of the property. For purposes of this section, a permanent loan does not include a loan that finances or refinances a stabilization period or unsold lots or units of for-sale projects."[14]

The current HVCRE definition also embraces the notion of "permanent financing."[15] However, it is not a specific exemption from the definition of an HVCRE exposure. Rather, under the current HVCRE definition, an HVCRE exposure is an ADC loan "prior to conversion to permanent financing."[16] In other words, an HVCRE exposure contemplates conversion of a credit facility to permanent financing once a project is complete but does not contemplate (explicitly) the idea that a loan to finance the acquisition, development, or construction of a project might be permanent financing from the outset. In this connection, the NPR contains the following helpful commentary:

> [T]he agencies recognize that for loans financing owner-occupied [ADC] projects, the owner may have sufficient capacity at origination to repay the loan from ongoing operations, without relying on proceeds from the sale or lease of the property, in which case the loan would be considered a permanent loan and thus excluded from the HVADC exposure definition, assuming it was prudently underwritten. For example, a prudently underwritten loan to a company that obtains financing to construct an additional facility that does not rely on the lease income from the facility to repay the loan, and instead relies on cash flows from other sources to cover amortizing principal and interest payments, may be considered a permanent loan and excluded from HVADC.[17]

The HVADC commentary also indicates that a HVADC exposure could subsequently meet the definition of a "permanent financing" as the property generates additional revenue sufficient to service amortizing principal and interest payments, provided that the loan was "prudently underwritten at origination."[18]

EFFECTIVE DATE; GRANDFATHERING

The HVADC category and associated 130% risk weight would take effect with respect to any loans originated on or after the effective date of the proposal when it is adopted. Loans originated before that date would be subject to the current HVCRE regime, including the 150% risk weight. This means, for example, that such loans could continue to benefit from the exemption for ADC loans with sufficient contributed capital and constraints on distributions of internally generated capital. Also, HVCRE exposures originated before the effective date could convert into permanent financing under the criteria for such conversion contained in existing interpretations, which would permit them to drop back from a 150% risk

[12] In explaining when a loan will be deemed to be "prudently underwritten," the NPR refers to the Interagency Guidelines for Real Estate Lending Policies. 12 CFR part 208, Subpart J, Appendix C (Board), 12 CFR part 34, Subpart D, Appendix A (OCC); 12 CFR part 365, Subpart A, Appendix A (FDIC). Unpublished NPR at 13 n. 17.

[13] The proposal would not require that current loan payments be amortizing for the loan to be a "permanent loan." Unpublished NPR at 13.

[14] *See proposed rule* 12 C.F.R. § 324.2 (FDIC); 12 C.F.R. § 217.2 (Board); 12 C.F.R. § 3.2 (OCC).
The Agencies comment in the NPR that bridge loans generally would not qualify as permanent loans as the property would not be generating sufficient revenue to meet the definition. Unpublished NPR at 14.

[15] *See* Interagency Frequently Asked Questions on the Regulatory Capital Rule, FAQs 9 and 17 (March 31, 2015), https://www.fdic.gov/regulations/capital/capital/faq.pdf.

[16] 12 C.F.R. § 324.2 (FDIC); 12 C.F.R. § 217.2 (Board); 12 C.F.R. § 3.2 (OCC).

[17] Unpublished NPR at 13-14.

[18] Unpublished NPR at 14.

weight to a 100% risk weight. A benefit of this grandfathering approach would be that banks would not need to re-evaluate all of their existing ADC loans under the new standard.[19]

ADVANCED APPROACHES BANKS

Advanced approaches banks currently calculate their risk-weight capital ratios under two regimes: (i) the advanced approach of Basel II (under which, generally speaking, the banks risk-weigh assets under the internal ratings-based approach and the advanced measurement approach) and (ii) the standardized approach of Basel III (which pre-determines risk weights for various categories of assets). They are then required to maintain risk-based capital ratios based on whichever method results in the greater amount of risk-weighted assets.

In the NPR, the Agencies have not proposed to change the HVCRE definition embedded in the advanced approaches regime. This would mean that advanced approaches banks would, under the proposal, continue to use the HVCRE definition for the advanced approaches calculation, while converting over to the HVADC definition for the standardized approach calculation. The Agencies have solicited comment on whether this dual regime will present special challenges to advanced approaches banks and whether the HVADC definition should also be used under the advanced approaches regime.

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[19] *See* Unpublished NPR at 14-15.

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