

# High Volatility Commercial Real Estate (HVCRE)

## *New Law Supplants Old Regulation on Construction Lending Rule*

Last updated: July 31, 2018

### **Executive Summary**

- **New Law; New Definition:** The President signed S. 2155 on May 24, 2018, which included a provision that rewrote the HVCRE definition. The risk weight remains at 150% and may only be applied if the loan meets the statutory definition of an HVCRE ADC) loan. The statute is now called the “Economic Growth, Regulatory Relief, and Consumer Protection Act” (EGRRCPA).
- **HVCRE ADC Loans:** The new definition allows exclusions for owner-occupied and permanent loans, preserves the borrower contributed capital exemption, and exempts loans made prior to January 1, 2015.
- **Key Exemption:** The borrower-contributed capital exemption ( $\geq 15\%$  equity) allows a normal risk weight (100% risk weight/8% of the loan value) if certain thresholds and limitations are met, but the exemption had been one of the sources of confusion. The new law allows for the appraised value of contributed land to count toward the requirement
- **Further Regulatory Action:** In light of EGRRCPA, CREFC registered its position with the regulators that the proposal, along with the old HVCRE regulations, should be withdrawn because they do not comport with the new statute. In July 2018, the federal banking regulators issued a brief statement confirming banks could begin applying the new definition. According to the statement, the agencies plans to promulgate regulatory revisions in the future.
- **The Old Rule:** The original rule went into effect on January 1, 2015, and applied a 150% risk weight to certain ADC loans unless certain exemptions were met. The rule broadly applied to banks with more than \$500 million in assets. A proposed fix, high volatility acquisition, development, and construction (HVADC) sought to lessen complexity, lower the risk weight, but expand the scope of loans. While the original risk weight remains, the passage of EGRRCPA makes the regulation, associated guidance obsolete, and the HVADC proposal obsolete.

### **HVCRE QUICK FACTS**

- HVCRE is a capital standard that applies a 150% risk weight to certain acquisition, development, and construction (ADC) loans unless certain exemptions are met. In effect, the rule required bank lenders to hold 12% of the ADC loan value to incentivize lower leverage in the higher risk category.
- A bipartisan legislative fix went into effect on May 24, 2018. The new law, its definitions and exemptions superseded existing regulation.
- Widespread variation in interpretation of the HVCRE rule had persisted across lenders since the original rule’s implementation in January 2015.
- The Basel Committee on Banking Supervision (BCBS) adopted standards on December 7, 2017, that comport with both HVCRE for advanced approaches (AA) banks and HVADC for SA banks.
- Despite the nine-year economic expansion, construction loans held on bank balance sheets have declined by 33% from an estimated \$370 billion at YE 2007 to \$249 billion at YE 2017, according to S&P Global.

## Potential Solutions

- **Congressional Revisions to HVCRE:** S. 2155, the “Economic Growth, Regulatory Relief, and Consumer Protection Act replaced the regulation – both HVCRE and any successor regulations (HVADC, if it were to be finalized) – for the purposes of clarifying key provisions of the original regulation. The bipartisan legislation became law on May 24, 2018. The legislation effectively replaces applicable features of the HVCRE regulation or any agency-generated alternatives (e.g., HVADC). Importantly, the risk weight assessment would remain within the purview of regulators.
- **New Law In Effect:** CREFC registered its position with the regulators that S. 2155/EGRRCPA is now the law and requires no additional rulemaking to effectuate. However, as a matter of good governance, CREFC urged the regulators to revise or conform HVCRE regulations and withdraw the HVADC because they do not comport with the new statute. CREFC urged regulators to work with the industry on any questions or clarifications, if necessary.

### CREFC Policy & Strategy

Nonbank lenders, and even some more conservative banks, would prefer that only minimal revisions be made to the standing rules, while many bank members strongly hold that revisions are needed. However, CREFC membership agrees on many of the recommendations, including:

- CREFC bank and nonbank members agree that requirements should be revised prudently and not encourage excessive ADC lending.
- Given the passage of S. 2155/EGRRCPA, regulators should align old HVCRE regulations with the new law and work with banks to resolve any outstanding questions. In June 2018, CREFC submitted a letter to regulators asserting the language in S. 2155/EGRRCPA is self-effectuating and does not require any action by the regulators to be implemented.
- CREFC submitted a comment letter on the HVADC proposal urging a single framework for all banks, maintaining a borrower-contributed capital exemption, and making clarifications to the existing rule. CREFC also signed onto a joint letter with other commercial real estate related trade associations. Furthermore CREFC asserts that S. 2155/EGRRCPA rescinds regulators’ authority to finalize HVADC.

For further information, visit CREFC’s Resource Center at: <https://www.crefc.org/library>

## ***Additional Background & History***

- The HVCRE rule was intended by the regulators to ensure that construction loan volume did not overheat, as was the case in the late 1980s and early 1990s, triggering in part the S&L crisis. According to regulators' data and research, ADC loans are both riskier than permanent loans and could lead to heightened macroeconomic stress conditions.
- The rule looked to dissuade banks from over lending by imposing higher risk-based capital charges on these financial institutions. For example, a non-ADC loan requires the financial institution to hold 100% of the 8% risk-based capital charge whereas loans categorized as ADC receive a 150% risk weight, a capital charge or 12% of the outstanding net present value of the loan.
- The old HVCRE rule contains four exemptions:
  - Loans secured by 1-4 family housing;
  - Certain community development loans;
  - Agriculture loans; and
  - Loans with at least 15% borrower-contributed capital, with additional restrictions around dividends and capital distributions.
- The US regulators released a set of FAQs in early 2015; however, confusion persisted with the application of the rule and its exemptions. With the passage of S. 2155, the FAQs are outdated and will need to be withdrawn or rewritten.
- **HVADC Proposal:** In September 2017, the Federal banking agencies proposed a rule, High Volatility Acquisition Development and Construction (HVADC), that would replace HVCRE for SA banks while leaving the then-current HVCRE rule in place for AA banks (>\$250 billion). The proposal attempted to remedy some of the complexity by removing the borrower-contributed capital exemption and lowering the overall risk weight to 130%. It proposed to establish a dualistic system wherein HVCRE and HVADC both exist and apply to different bank categories (although, the largest banks must use both regimes at different times). However, the HVADC proposal did not address the problems of HVCRE, and eliminating the 15% contributed capital rule suggests regulators have swapped borrower equity for bank capital (a move that is largely considered to be negative for the credit health of the sector). Most believed that the HVADC rule would require banks to add capital and would thereby slow bank lending even further. As of July 31, 2018, the HVADC rule is still pending, and regulators have not announced their plans in light of the passage of EGRRCPA, though it likely would have to be withdrawn or significantly rewritten to conform to the statute.
- **HVCRE versus HVADC:** The two capital regimes—HVCRE and HVADC—are materially different in their incentive structure and could influence underwriting practices differentially depending on the size of the bank, with the smaller banks having to hold less capital for each ADC loan.
- **H.R. 2148, "Clarifying Commercial Real Estate":** The bill, which passed the House of Representatives in mid-November 2017, sought to exempt income-producing property, allowed borrower distributions if the minimum-required capital is maintained, and allowed current appraised value of land to be counted in equity contributions and grandfather loans originated prior to January 1, 2015. In January 2018, an identical companion bill was introduced in the Senate (S. 2405). The language of H.R. 2148/S. 2405 was then included almost verbatim in the broad Senate regulatory relief package (S. 2155) and passed on March 14, 2018, also with strong Democratic support (67-31). The House subsequently passed S. 2155 and the President signed the bill into law on May 24,

2018. In light of EGRRCPA, CREFC registered its position with the regulators that the proposal, along with the old HVCRE regulations, should be withdrawn because they do not comport with the new statute.

- **Regulators Weigh-In:** On July 6, 2018, the Federal Reserve (Fed), Federal Insurance Deposit Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC) issued a statement providing high-level interpretations regarding the impact on existing statutory and regulatory requirements affected by the new law enacted on May 24. As it applies to HVCRE, the brief statement clarifies a few interpretative details regarding the overlay of S. 2155 onto existing requirements:
  - Statutory requirements related to HVCRE were immediately effective upon enactment on May 24, 2018.
  - Banks will be required to apply the higher HVCRE risk weight (150% versus 100% for permanent CRE loans) to only those loans that meet the statutory definition of an HVCRE Acquisition, Development and/or Construction (ADC) loan.
  - Banks are permitted to classify loans using the HVCRE ADC definition in the statute. In theory, this should constitute a smaller pool of loans since new exemptions and definition elements (e.g. owner occupied and other income producing properties) would not be subject to a higher risk weight.
- **Basel Approach:** The Basel Committee on Banking Supervision (BCBS) adopted standards on December 7, 2017 that comport with both HVCRE for advanced approaches (AA) banks and HVADC for SA banks. Because the BCBS adopted these measures, any revisions in the current HVCRE requirements should remain compliant with Basel standards, though the U.S. rule can be subject to some tailoring.

### CREFC Resources

- [CREFC Side-by-Side Comparison of Relevant Legislation and Regulation](#)
- [CREFC HVADC Comment Letter \(12/22/17\)](#)
- [Joint Associations Comment Letter\(12/22/17\)](#)
- [CREFC's letter regarding implementation of the HVCRE language in S. 2155 \(6/22/2018\)](#)
- [CREFC Alert on EGRRCPA Statement \(July 2018\)](#)

For further information, visit CREFC's Resource Center at: <https://www.crefc.org/library>

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