High Volatility Acquisition, Development and Construction (HVADC): Simpler rules with implications for US real estate lenders

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Classifying ‘riskier’ commercial real estate (CRE) loans for US bank capital purposes would become simpler if a recent regulatory proposal proceeds.

However, what qualifies as ‘risky’ CRE expands. Under the proposal’s current form, we believe most lenders can expect overall CRE capital costs to rise.

- The September 2017 proposal to replace the high volatility commercial real estate (HVCRE) category under US bank capital rules with a newly defined HVADC category should substantially alleviate criticisms that the existing HVCRE rules are too complex, unclear and difficult to implement.
- The proposal also introduces a new 130% risk weight category for HVADC that would be lower than the current 150% risk weighting for HVCRE.
- The reduced risk weight should not be interpreted as an easing of capital rules. Rather, it is an offset to the higher volumes of CRE loans that would fall into the new HVADC category. The increased scope of CRE loans that would be categorized as HVADC may actually raise RWA totals for many banks lending in the CRE market, even with the lower risk weighting.
- The proposal underscores the importance of lenders having the capability to capture and analyze loan data to support accurate risk-weighting, portfolio analysis and regulatory reporting.

Building a better working world

In July 2013, the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (together the Agencies) released the US Basel III final rule, which defined a new category of loans called high volatility commercial real estate (HVCRE). The HVCRE classification attaches a 150% risk weighting in recognition of the 'riskier' aspects of financing the acquisition of land, land development and construction relative to other loans. A higher risk weighting has the effect of raising the required capital to be held by banks against these loans. At that time, we wrote that the rules for classifying HVCRE could be interpreted inconsistently, and many lenders subsequently sought further clarification of which loans should and should not be classified as HVCRE.

On September 27, 2017, the Agencies responded with a Notice of Proposed Rulemaking (NPR) titled Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996. In the NPR, the Agencies propose brighter lines to categorize higher risk CRE loans for banks using the standardized risk-weight approach, creating the new HVADC classification. Certain exemptions in the HVCRE definition may be eliminated, and the types of loans captured under HVADC would be expanded. The NPR states that "it is likely that more acquisition, development, or construction loans would be captured under the proposed HVADC exposure definition than under the current HVCRE exposure definition." As a counterbalance, the Agencies have proposed an HVADC risk weight of 130%, a level below the 150% risk weight currently applied to HVCRE.

The NPR states that the proposed rules would "not result in a significant change in the aggregate minimum capital required" while also noting that the Agencies "cannot estimate with precision the future impact of the proposed HVADC exposures at an individual banking organization level." CRE lenders need to understand the possible impact of the proposed rules on their portfolios and consider strategic options for lending in the real estate sector going forward.

Market participants have until December 26, 2017 to provide comments to the Agencies on the proposed rules.

Introducing HVADC

The new HVADC category is defined as a credit facility that primarily finances or refinances (i) the acquisition of vacant or developed land; (ii) the development of land to prepare to erect new structures, including, but not limited to, the laying of sewers or water pipes and demolishing existing structures; or (iii) the construction of buildings or dwellings, or other improvements including additions or alterations to existing structures[1]. The "primarily finances" clause provides that more than 50 percent of loan proceeds will be used for acquisition, development or construction activities. The new definition would only apply to newly originated loans, while existing loans would be grandfathered under the existing HVCRE definition.

Further to this definitional change, the NPR clarifies the types of lending activities under the HVADC umbrella, eliminates the exemption relating to borrower capital, and provides a definition of permanent commercial real estate lending to set a boundary for when a loan is no longer HVADC. These changes are summarized in the following table:

[1] All quotes are sourced from: Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996, https://www.occ.gov/news-issuances/news-releases/2017/nr-ia-2017-111a.pdf

	Existing HVCRE rules	Proposed HVADC rules
Definition/ scope	• Acquisition, development or construction loans secured by real property	• Primarily finances acquisition, development and construction using a "purpose-based" 50% threshold • Finances the acquisition of vacant/developed land • Finances land development in preparation for building • Finances the construction of/improvements on buildings
Contributed capital	• Exempt if loan-to-value (LTV) is below relevant supervisory LTV standard • Exempt if borrower contributes capital of 15% (property market value) before advancement of funds • Internally generated capital cannot be extricated throughout life of project	• Elimination of exemption for contributed capital
1 to 4 Family residential development	• Exempt from designation	• Exempt from designation, but with the clarification that this exemption does not apply to loans that finance condos and co-ops
Community development loans	• Exempt from designation	• Exempt from designation, but with simplified criteria for qualification as community development
Agricultural loans	• Exempt from designation • Specific criteria for qualification as agricultural	• Exempt from designation, but with simpler criteria • Clarification that manufacturing or processing agricultural products are not included in this exemption
Permanent loans	• Exempt from designation	• Exempt from designation • Better-defined criteria of what constitutes permanent loans • Clarification that bridge loans are not considered permanent loans and thus not exempt from HVADC designation
Risk weight	• HVCRE: 150% CRE: 100%	• HVADC 130% CRE: 100%

The HVADC challenge

While the NPR clearly achieves its purpose of clarifying the definition of HVADC, the number of loans swept into this new classification will likely be larger than the previous HVCRE bucket for the following reasons:

- The existing rules are unclear as to whether "mini-perms" or bridge loans – loans financing the period between the completion of a property and the property's stabilization – should be included in HVCRE. The Agencies recognize that risk lies in both construction and lease up, and specifically include bridge loans in the HVADC definition. The HVADC loan can be declassified when a loan could be considered permanent, that is, when the property is producing sufficient cash flow to cover debt service as if a newly created loan was prudently underwritten. In other words, all lending for commercial real estate activities, other than on cash-flowing properties with adequate coverage, is HVADC.
- Another impact of the permanent loan concept is the inclusion of financing of property rehabilitation and repositioning. While HVCRE generally focuses on newly constructed properties, HVADC captures an expanded the pool of loans, particularly because in today's market there is more in value-add rehab and re-lease activity than in construction activity in most classes of commercial real estate.
- The existing rules provide for a complex exemption when the borrower contributed capital of at least 15% of the 'as completed' value of the property before the first dollar of loan proceeds was funded, and did not reclaim that capital until the loan was fully repaid. This rule has elicited the greatest number of questions from market participants and the Agencies acknowledge in the NPR that considerations for clarifications to the exemption were "comparably complex and inconsistent with the goal of simplifying the capital rule." In the NPR, the exemption is proposed to be eliminated. Under the existing rules, lenders and borrowers structured loans to achieve the exemption despite its uncertainties. The elimination of this exemption will result in more loans classified as HVADC.
- Another exemption focuses on the financing of acquisition, development and construction of residential properties: loans to fund the building of condominiums and cooperative housing have been explicitly carved out of the one- to four-family residential property exemption in the NPR.
- The HVADC definition is "purpose-based," meaning it is based on the activities being financed rather than whether or not the loan is secured by real estate. Unsecured CRE lending will therefore be swept into the HVADC classification, potentially including: Certain owner-occupied properties where the purpose of the loan is for construction, mezzanine lending, unsecured REIT lending, and other instances where the funding is real estate purposed without the security of a mortgage.
- HVADC does not provide relief for loans with low loan-to-value ratios. The riskiness of the activities is not considered to be mitigated by the equity in the property or its value relative to the financing. The definition of permanent lending only relates to debt service coverage.

Congressional action on HVCRE

The clarification of HVCRE classification is also being addressed in Congress, where the House Financial Services Committee recently passed H.R. 2148, Clarifying Commercial Real Estate Loans Act, which would amend the Federal Deposit Insurance Act. The vote was bipartisan.

Although similar in intent to the Agencies' HVADC proposal, the Committee's proposed HVCRE ADC classification diverges in several ways: (i) the bill does not distinguish between banks using the standardized or advanced approach under Basel III, (ii) unlike the NPR's purpose-based definition, H.R. 2148 retains language relating to credit facilities secured by land or improved real property, (iii) the bill retains parts of the borrower capital exclusion, and (iv) there is no carve-out for condo-co-op ADC loans in the one- to four-family exemption. H.R. 2148 is still early in the legislative process and may undergo significant changes, including convergence with the Agencies' final rule.

The proposed rules will pose different operational requirements for lenders. The data to be captured on each loan will necessarily change based on the final HVADC definition, requiring the adaptation of bank MIS systems. And rather than the data being collected only at origination, it will need to be collected periodically during the life of the loan to determine when the loan achieves permanent status and can be declassified from the HVADC category. Further, the proposed rule states that the lender must document the intended use of funds (i.e., the ADC activities) and also document that the funds are primarily used for those activities.

Similar to 2013, lenders will now need to determine the impact of the new capital requirements on their anticipated real estate lending activities, the likely change in the profitability of these activities, and the incremental operating costs of ADC lending. In so doing, banks are faced with the following choices:

- Accept the NPR changes and absorb the potentially higher cost of capital as the "cost of doing business"
- Modify their anticipated targeted lending activities to avoid higher cost of capital loans
- Adjust loan pricing and/or employ additional fees to pass on the higher cost of capital to their customers

The resulting strategic direction of banks will have an impact on the real estate industry, potentially further increasing the cost of debt capital (and therefore reducing real estate returns) and possibly reducing overall liquidity in the sector. Similar to 2013, the rules may further drive ADC lending out of banks to unregulated private real estate debt providers.

Assessing the magnitude of impact on bank capital

In the analysis on the following page, we assume a lender currently has $1 billion of HVCRE loans, $10 billion in CRE (not HVCRE), $12 billion in commercial and industrial (C&I) loans and $8 billion in other loans. The bank's current total loan exposure is $31.0 billion and total assets $41.3 billion. The bank's common equity Tier 1 (CET1) ratio is assumed to be 12.0%[2]. After application of current US bank capital risk weightings across the bank's $41.3 billion in assets, its total RWA is assumed to be $30.0 billion.

Over the next several years, loans that resemble today's HVCRE loans will be originated or renewed as HVADC. The new HVADC value will be higher, lower or nearly the same over this period. In the table below, we lay out four scenarios: a) 100% increase: The $1 billion of HVCRE becomes $2 billion under HVADC, b) 50% increase: The $1 billon of HVCRE becomes $1.5 billion under HVADC, c) No increase: The $1 billion of HVCRE remains flat, and d) 25% decline: The $1 billion of HVCRE shrinks by 25% to $750 million.

[2] The ratio value of 12.0% represents the bank's current common equity (meeting Tier 1 capital requirements) divided by the bank's total risk weighted assets. We assume the bank aims to hold this ratio near constant.

The diagram below shows a base CET1 held against the current $1 billion of HVCRE exposures ($195 million) and the resulting differences for each of the four cases in overall CET1 allocated against assumed HVADC pools:

Current rule (150% risk weight):

CET1 ratio (%) and CET1 capital held ($mm)

$1,000 mm HVCRE → $1,500 mm RWA → x 12% = $195 million

Proposed rule (130% risk weight):

	Change from base level of HVCRE ($ millions):			
	100% increase	50% increase	No increase	25% decline
HVADC exposure:	$2,000	$1,500	$1,000	$750
RWA of HVADC exposure: (at 130% risk weight)	2,600	1,950	1,300	975
Multiply: (CET1 target ratio)	x 12%	x 12%	x 12%	x 12%
CET1 (to hold for HVADC)	$312	$234	$156	$117
net CET1 (currently held for HVCRE)	-195	-195	-195	-195
Difference	+$117	+$39	-$39	-$78
Difference/RWA (bps)	+39 bps	+13 bps	-13 bps	-26 bps

Under the proposed rules with a 130% risk weight, but a hypothetical new level of HVADC assets of $2 billion, the capital demand jumps to $312 million. Such a jump against $30 billion of total RWA would mean a 39 bps shortfall against the bank's target 12% CET1 ratio, requiring an approximate $117 million of additional common equity. If the level of HVADC rises by 50% over current HVCRE, the capital impact is 13 bps; a lower but not immaterial amount. If the HVADC levels hold steady or decline, obviously, some relief in capital burden occurs. The breakeven point where the RWA difference is neutral is dependent on each bank's target CET1 ratio. In the illustration above, the breakeven is about a 25% increase in exposure to the high volatility classifications.

The illustrative analysis above heavily depends on the assumed delta of HVADC over the current HVCRE volume, as well as the starting loan composition and related RWA of the bank. The actual increases in "riskier" CRE levels can only become known through bank-by-bank examination and analysis.

CRE lender next steps

CRE lenders need to rapidly gain an understanding of how the proposals could affect their capital requirements given their portfolio allocations. Below is an approach that banks can use to respond to the NPR and prepare for change:

Perform diagnostic assessment → **Perform deep-dive impact assessment** → **Define / plan for business changes**

Step 1: Perform diagnostic assessment

Performing a diagnostic impact assessment helps an organization understand the implications of the NPR on its current CRE lending business and helps ground its position on the proposed terms of the NPR. Some key questions to consider in this assessment are as follows:

- How much of the bank's total portfolio is currently categorized as CRE? HVCRE?
- What is the current process for identifying and categorizing CRE loans?
- How are new and existing CRE loans tracked for HVCRE compliance?
- What additional CRE loans would likely fall into the HVADC category? Are there existing commercial loans that would meet the purpose-based test of the proposed HVADC definition and how can they be readily identified?
- What is the approximate overall change in capital requirement if the bank's existing portfolio was not grandfathered?
- The current proposal only applies to banks using the standardized approach for capital. Banks that use the advanced approach may want to consider whether this disparate treatment creates a competitive advantage or disadvantage.

Once an organization understands the business impact of the NPR, it will be better positioned to provide comments to the Agencies on its proposed terms.

Step 2: Perform deep-dive impact assessment

After the initial impact assessment has been performed to assess the NPR's impact on its business, banks should review their CRE lending terms and structures to better understand the impact of the NPR on their existing operations and processes, and identify potential areas of enhancement to be ready to comply with the guidance. Some key questions to consider in this assessment are as follows:

- What additional data is required to identify HVADC loans? How will data be managed across legacy grandfathered loans versus newly qualifying originations?
- How can Comprehensive Capital Assessment and Review (CCAR) data requirements (FR Y-14Q) be leveraged in this process?
- How will the bank document each loan's purpose?
- How will unsecured CRE lending and commercial loans be identified as HVADC?
- What operating changes are required for the ongoing classification of HVADC loans?
- What modifications to existing policies, procedures, reporting capabilities and controls are needed to accommodate the new HVADC inclusion (and exemption) criteria, and to ensure they are properly applied?
- What user populations are affected by the new guidance, and how can they most effectively be trained to implement the new requirements?

Step 3: Implementation and strategic implications

Once the organization gains a detailed understanding of the potential capital impact and required operational enhancements, bank management will have to consider the strategic options for continued CRE lending as described above. The strategy must consider the necessary steps for compliance with the new rules, as finalized, and plan for the various activities to allow changes to its loan offerings, pricing, data governance and capture, and customer relationships. The bank can then prioritize efforts accordingly, taking into account its short-term and long-term goals and objectives.

Any changes contemplated by the organization should be weighed in tandem with its capability and willingness to implement such enhancements versus other strategic options (e.g., acceptance, portfolio modification, pricing adjustments).

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