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HVCRE Loans: Guidance for Developers and Lenders on New ADC Rules, Impact on Loan Covenants

Navigating Borrower Contributed Capital Rules, Maximum LTV Ratio, Conversion to Permanent Financing and More

WEDNESDAY, NOVEMBER 6, 2019

1pm Eastern | 12pm Central | 11am Mountain | 10am Pacific

Today's faculty features:

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Strafford Live CLE Webinar
Wednesday, November 6, 2019



From Basel III to Banking Regulation to Legislation to Conforming Regulation

Chronology

Final HVCRE Rule Issued October 11, 2013

Reporting to Commenced January 1, 2015

August 2014 MBA Organizes HVCRE Bank Working Group

First MBA Letter to federal banking regulators January 26, 2015

MBA Arranges Face-to-Face Meeting with federal banking regulators in DC March 17, 2015

Second MBA Letter to federal banking regulators April 1, 2015

Regulators Issue FAQs dated March 31, 2015 on April 1, 2015

First set of Call Reports with HVCRE reporting in May 2015 indicates inconsistent interpretation by banks

Real Estate Roundtable creates HVCRE Working Group May 11, 2015

Capitol Hill Talking Points document created by MBA, RER, CREFC, NAIOP on May 15, 2015

Real Estate Roundtable Letter to federal banking regulators July 27, 2015

Second MBA Face-to-Face Meeting with federal banking regulators March 2016

Rep. Pittenger (R-NC) contacts Real Estate Roundtable about HVCRE April 2016, asks for help in writing a letter to federal banking regulators

Letter from Rep. Pittenger and three other members of Congress to federal banking regulators June 8, 2016

Letter from federal banking regulators to Rep. Pittenger September 29, 2016 “Notwithstanding the higher risk weight for HVCRE loans, US banks have shown growth in ADC lending”

November 2016 Meeting in Rep. Pittenger’s office regarding a bill to clarify and rationalize HVCRE

From Basel III to Banking Regulation to Legislation to Conforming Regulation

Chronology (continued)

April 26, 2017, bill (HR 2148) entered in House Financial Services (HFS) Committee Rep David Scott (D-GA) Co-sponsors with Rep. Pittenger with Ranking Member Maxine Waters' (D- CA) permission

October 12, 2017, H.R. 2148 passes in HFS Committee 59-1

November 7, 2017, H.R. 2148 passes by voice vote in House (listed as unanimous)

S.2405 introduced in Senate February 2018

In February 2018 US Supreme Court in Digital Realty Trust v. Somers unanimously holds that regulators must follow an explicit statutory definition even if it is not its ordinary meaning

H.R. 2148 and S. 2405 incorporated into S. 2155 “, passes Senate 67-31 March 2018 after Sen. Schumer releases Democrats

Final MBA Face-to-Face meeting with federal banking regulators May 16, 2018

S. 2155 passes in House May 22, 2018

Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) signed into law May 24, 2018 (Section 214)

RER & MBA met with Federal banking Regulators and their counsel after enactment of EGRRCPA

Federal banking regulators' proposed HVCRE Rule 2.0 announced September 18, 2018 and published on September 28, 2019 to conform regulatory rule to superseding legislation (2018 NPR)

RER submitted its comment letter on 2018 NPR to the federal regulators on November 26, 2018

CREFC submitted its comment letter on 2018 NPR to the federal regulators on November 27, 2018

Federal banking regulators HVCRE Rule July 22, 2019 (2019 NPR) in response to comments to the 2018 regarding narrowing of 1- to 4 – for family exemption.

Portions of the 2018 NPR were effective October 1, 2019

Issue	Original HVCRE Rule
Applicability and Risk Weight	Banks – Same definition for both Advanced Approaches (AA) and Standard Approach (SA). SA risk weight is 150%; AA risk weight is variable.
Covered Loans	“a credit facility that, prior to conversion to permanent financing, finances or has financed the acquisition, development, or construction (ADC) of real property,” No definition of land, development or construction loans.
Exempt Loans	<ol style="list-style-type: none"> 1. 1-4 family residential 2. Community Development Investment 3. Agricultural land 4. CRE Projects with: <ol style="list-style-type: none"> A. Regulatory LTV ratio within applicable standards; B. 15% borrower contributed capital C. Capital contribution and internally generated funds required to remain in project until permanent conversion, sale, or paid in full.
Permanent Loans	Not Defined
Reclassification of Non-HVCRE	Not Defined
Contributed Capital	15% borrower contributed capital in form of cash, unencumbered readily marketable assets, out of pocket expenses (incurred and paid by borrower) or contributed real property or improvements. Contributed land value is borrower’s cost basis, not the current appreciated value.
Grandfathered	Existing loans made before January 1, 2015 not grandfathered. Applied to all past and future loans.
Proposed	HVADC Rule
Subsequent Exposure Proposal	The federal bank regulators published in response to industry efforts but failed to address any industry comments. Never became final rule.

Statutory Definitions Trump Regulatory Definitions

SUPREME COURT OF THE UNITED STATES

DIGITAL REALTY TRUST, INC. v. SOMERS

February 21, 2018

“When a statute includes an explicit definition, we must follow that definition,” even if it varies from a term’s ordinary meaning. *Burgess v. United States*, 553 U.S. 124, 130 (2008)

Because “Congress has directly spoken to the precise question at issue,”...we do not accord deference to the contrary view advanced by the SEC...The statute’s unambiguous ...definition, in short, precludes the Commission from more expansively interpreting that term.

Clarifying High Volatility Commercial Real Estate Loans (H.R. 2148)

- "Regulation is necessary for an orderly economy, but when regulators fail to provide clarity or address the real-world problems created by their rules, then Congress must act. This is a highly-technical bill, but it directly impacts the local economy. Without access to capital, entrepreneurs can't create jobs or build housing or generate economic activity. Representative Robert Pittenger (R, NC-9)
- "..with any law or regulation, nothing is perfect and we now have years of real-world experience that shows us what's working and what isn't. Mr. Pittenger's bill is exactly the type of technical fix our economy is hungry for, but moreover, this bill is carefully crafted so we aren't sending ourselves back to a time when financial regulation resembled the Wild West." Representative Scott Dixon (D, GA-13)

Issue	HVCRE ADC (PL 115-174)
Applicability and Risk Weight	Banks — Same definition and risk weight for both AA and SA. 150%
Covered Loans	<p>“A credit facility secured by land or improved real property that , prior to being reclassified by the depository institution as a Non-HVCRE ADC Loan ...”:</p> <p>(A) primarily finances, refinances or has financed the acquisition development, or construction of real property;</p> <p>(B) has the purpose of providing financing to acquire, develop, or improve such real property into income-producing real property; and</p> <p>(C) is dependent upon future income or sales proceeds from, or refinancing of, such real property for the repayment of such credit facility;</p>
Exempt Loans	<ol style="list-style-type: none"> 1. 1-4 family residential; 2. Community Development Investment; 3. Agricultural land; 4. Acquisition or refinancing of income-producing real property if cash flow is sufficient; 5. Improvements to existing income-producing real property if cash flow is sufficient; 6. CRE Projects with: <ol style="list-style-type: none"> A. Regulatory LTV ratio within applicable standards; B. 15% borrower contributed capital (clarifications) C. minimum 15% capital contribution required to remain in project until reclassification, but no prohibition on withdrawal of capital in excess of 15% or internal cash.
Permanent Loans	“institution’s applicable loan underwriting criteria for permanent financings”
Reclassification of Non-HVCRE	Reclassification upon (1) completion of development or construction of real property; and (2) cash flow is sufficient to support the debt service and expense of real property, to satisfaction of lender in accordance with institution’s permanent financing criteria.
Contributed Capital	15% borrower contributed capital in form of cash, unencumbered readily marketable assets, out of pocket expenses (incurred and paid by borrower) or contributed real property or improvements. Contributed land value shall be appraised value in accordance with a FIRREA compliant approval.
Grandfathered	Loans made prior to January 1, 2015 are excluded from HVCRE coverage.

Interagency statement regarding the impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)

High Volatility Commercial Real Estate (HVCRE) Exposures

EGRRCPA provides that, effective upon enactment, the agencies may only require a depository institution to assign a heightened risk weight to an HVCRE exposure if such exposure is an "HVCRE ADC Loan," as defined in section 214 of EGRRCPA. Accordingly, a depository institution is permitted to risk-weight at 150 percent only those commercial real estate exposures it believes meet the statutory definition of HVCRE ADC Loan.

BIPARTISAN CONGRESSIONAL SPONSORS' LETTER
Dated August 1, 2018

To: Vice Chair for Supervision Federal Reserve Board
Comptroller of Currency
Chair, Federal Deposit Insurance Corporation

Re: Enactment of S. 2155 and the HVCRE Rule

As you know, *The Economic Growth, Regulatory Relief, and Consumer Protection Act* was signed into law May 24, 2018 (Public Law No. 115-174). Section 214 of the Act amends the Federal Deposit Insurance Act (FDIA) in ways that have a direct impact on High Volatility Commercial Real Estate (HVCRE) risk-based capital rules issued by the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation.

Specifically, under Section 214, the appropriate Federal banking agencies may only require a depository institution to assign a 150 percent or other heightened risk weight to a credit facility that finances or has financed the acquisition, development, or construction (ADC) of real property -- if such credit facility is an "HVCRE ADC loan" as defined in Section 214. **The provisions of Section 214 supersede contrary provisions of the current HVCRE rules and any successor rule, and they became effective immediately upon enactment.**

We supported this legislative change to the HVCRE rule to provide clarity and relief to lenders in our communities. We therefore appreciate that the Federal banking agencies issued guidance July 6 to implement that clarity and relief on an interim basis. **We also would appreciate your assurance that you will fully implement the intended clarity and relief when you engage in a rulemaking to conform current agency regulations to the new law.**

Rep. David Scott (D-GA)
NC)

Rep. Robert Pittenger (R-

Sen. Doug Jones (D-AL)

Sen. Tom Cotton (R-AR)

Proposed HVRE Rule 2.0 - Purpose

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation . . . are proposing to

amend the regulatory capital rule to revise the definition of . . . (HVCRE) exposure” to conform to the statutory definition of . . . (HVCRE ADC) loan,” in accordance with section 214 of . . . (EGRRCPA);

facilitate the consistent application of the revised HVCRE exposure definition, the agencies propose to interpret certain terms in the revised HVCRE exposure definition generally consistent with their usage in other relevant regulations or the instructions to the (Call Report), where applicable;

request comment on whether any other terms in the revised definition would also require interpretation.

	HVCRE 2.0	2018 NPR & 2019 NPR
Issue	Incorporates EGRRCPA Language	Regulators' Supplemental and Clarifying Language
Applicability and Risk Weight	Conforms	
Covered Loans	Conforms	Vacant land is to be included in the definition of real property. HVCRE determination would only be made once, at the loan's origination.
Exempt Loans	Conforms	1-4 family residential aligned with Call Report Condos and coops are multifamily and are not exempt. Development loan made solely to finance preparing land for construction of one to four family residential structures are HVCRE Loans and not exempt if loan does not include provisions for financing the construction. Community Development Investment defined as primary purpose of community development, as defined in CRA regulations; Agricultural land defined as Call Report as "farmland."
Permanent Loans	Conforms	
Reclassification of Non-HVCRE	Conforms	
Contributed Capital	Conforms	Contributed real property or improvement "minus value of any liens on the real property" For purposes of 15% capital contribution, the use of "as is" appraisal is permitted, where applicable. Allows Evaluations in lieu of appraisals for lower-value lands (under \$500,000). In multiphase projects, each phase must have its own appraised "as completed" value in order to be deemed a separate project for the borrower contributed capital exemption.
Grandfathered	Conforms	Banks may apply a 100 % risk weight (or lower, if applicable) to ADC loans originated prior to January 1, 2015 that were classified as HVCRE, provided that the loans are not past due 90 days or more or on nonaccrual. For ADC loans after January 1, 2015, and before May 24, 2018, institutions may apply "best efforts" to align with the statute or classify under the old HVCRE regulations until the final rule is effective.

Sources

C.F.R. 12 § 324.2

Finalized October 11, 2013

Effective January 1, 2015-May 24, 2018

Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)

Public Law 115-174

Enacted May 24, 2018

Effective Immediately

Notice of Proposed Rulemaking

Announced September 18, 2018

Published in Federal Register Vol 83 No. 189

September 28, 2018

Notice of Proposed Rulemaking

Published in Federal Register

84 Fed. Reg. 35344 (2019), Tuesday, July 23, 2019 pages 35285 – 35514

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Thank You

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