SQUIRE PATTON BOGGS

Regulatory and Legislative Developments Relating to Capital Requirements for Acquisition, Development and Construction Loans

On October 27, 2017, the US federal banking agencies published in the Federal Register a notice of proposed rulemaking (NPR) that would modify the Basel III capital rules for "non-advanced approach" banking organizations (banks, savings associations and depository institution holding companies with less than US$250 billion in consolidated assets and less than US$10 billion in foreign exposures), and would make technical and clarifying changes to the rules applicable to all institutions and their holding companies.[1] Comments on the NPR are due by December 26, 2017.

One of the more significant proposals made in the NPR would change the capital treatment afforded acquisition, construction and development loans, including lowering the risk-weight for these loans from 150% to 130%. These loans are referred to in the regulation as "High Volatility Commercial Real Estate" exposures, or HVCRE.

On the legislative front, on November 7, 2017, the House of Representatives passed H.R. 2148, the Clarifying Commercial Real Estate Loans Act. This bill would modify the existing regulatory treatment of HVCRE loans without changing the 150% risk-weight.

Below, we have prepared an overview chart that compares the provisions in H.R. 2148, the NPR and the current regulation at a high level.

	Current Rule	H.R. 2148	NPR
Definition of HVCRE	A loan[2] that finances the acquisition, development or construction (ADC) of real property. Loan does not have to be secured by real estate if its purpose is to finance ADC activities.	A loan *secured by land* or improved real estate that *primarily* finances the acquisition, development or construction with purpose of creating income-producing property *and* the loan is dependent upon future income of sales proceeds (or future refinancing) for the repayment of the loan.	Replaces HVCRE with new term: "High Volatility Acquisition, Development or Construction" (HVADC) exposure. HVADC is defined as a loan that "Primarily" finances the: • Acquisition of land • Development of land; or • Construction of buildings, including additions or alterations to existing structures
Mixed Use Loans	Not clear.	Loan must *primarily* finance the ADC activity.	Loan must "Primarily" finance the acquisition, construction or development of real estate. Primarily means 50% or more of the loan proceeds intended for ADC purposes.
Effect of Permanent Financing	HVCRE status terminates when replaced with "permanent financing."	Status terminates upon completion of the project and when cash flow generated by the project is sufficient to support the debt service and project expenses.	HVADC does not include a "permanent loan," defined as a prudently underwritten loan that has clearly identified ongoing sources of repayment aside from the sale of the property. Payment must be sufficient to support the debt service and project expenses.
Risk-Weight	150%	150%	130%

[1] 82 Fed. Reg. 49984 (Oct. 27, 2017). Basel III, and therefore this NPR, does not apply to savings and loan holding companies that engage in significant insurance underwriting activities. See 12 C.F.R. §217.2. However, the Basel rules do apply to the depository institution subsidiary.

[2] The term "loan" as used in this chart includes other credit facilities, such as a line of credit.

	Current Rule	H.R. 2148	NPR
One-to-Four Family Residential Housing	HVCRE does not include development of one-to-four family residential properties.	Same as current rule.	Same as current rule.
Agricultural Land	Does not include loans for the purchase or development of agricultural land, provided the sale of the land is based on its value for agricultural purposes and not potential commercial or residential development.	Does not include loans for the acquisition, development or construction on agricultural land.	Same as current rule.
Community Development	Excludes loans relating to community development projects under the CRA, except for certain small business loans.	Excludes loans for the ADC of real property that would qualify as an investment in community development. Community investment not defined.	Same as current rule but removes exception for certain small business loans and includes other technical changes.
Prudently Underwritten Loans With Borrower Capital Contribution	Excludes ADC loans where the loan-to-value ratio is below certain thresholds and the borrower has contributed capital equal to at least 15% of the completed value of the project, before any bank funds are advanced. Donated property can be used as capital contribution, but only up to the cash paid to purchase the property.	Similar to current rule except that this bill, unlike the current regulation, would allow the contributed capital to be equal to the *appraised market value* of contributed real property or improvements.	Deletes the exception for prudently underwritten loans with borrower capital contribution.

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