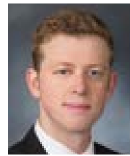
What's To Be Done about a Rule That Doesn't Work?

The CRE Finance Council Launches a High-Volatility CRE (HVCRE) Working Group



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CREFC's David McCarthy: We are happy to have you both co-chairing CREFC's HVCRE Working Group. Can you briefly explain what HVCRE is and why we need a working group?

Krystyna Blakeslee, Partner (effective as of January 1, 2017) at Dechert LLP/Marci Schmerler, Shareholder at Carlton Fields (KB/MS): Thanks David, let's take that in a few parts. Firstly, HVCRE is a classification under Basel III requirements for Risk-Based-Capital (RBC) rules. The intent behind the rule is presumably to reduce the volume of riskier exposures in the banking system by requiring larger capital requirements for loans classified as (or having elements of) Acquisition, Development or Construction (ADC) that are not permanent financing. This broad definition means that any ADC loan (including acquisition loans with no construction or development features) may be covered by the rule if not a "permanent loan".

As it stands, the industry has no consistent official guidance to square the difference between risk, which is generally interpreted as some sort of temporary, revolving or construction aspect to the deal, and the broad reach of the literal definition.

These inconsistencies, starting with the definition of HVCRE loans, between regulatory intent (the reduction of risk in the construction market) and the way the rule actually functions in real life, exist throughout the rule. Even two years after implementation (January 1, 2015), the industry is looking for ways to resolve the issues, whether they be through education or advocacy for clarifications and/or possibly revisions to the rule.

The HVCRE Working Group (WG) was initiated in response to requests from industry members to provide a platform upon which industry participants most affected could discuss their experiences and practical applications of the rule, in the face of an ambiguous rule with little or inconsistent official guidance.

DM: When you say more capital, how different is the current regime from the historical treatment of ADC loans?

KB/MS: For the loans that fall into this HVCRE bucket, and again, there is debate about what that universe is, the risk weight increased from 100% (which equates to 8% of the value of the loan) to 150% (or 12% of the value). We hear from lenders that this increase in capital costs translates into 20 to 150 additional basis points in the loan's coupon.

This particular capital rule is much more potent in many ways — not the least of which is that it applies retroactively. Most capital rules allow for a grandfathering phase, but this one forces bankers to apply the higher capital charge to all HVCRE loans on balance sheet, as of the implementation date. That means that, in effect, the collective balance sheet the banks had to put to work in the ADC markets was reduced materially and abruptly beginning in January 1, 2015. The administrative costs of compliance are also burdensome.

DM: What about exceptions? Most capital rules include those, but oftentimes they are limited.

KB/MS: There are four total exceptions or safe harbors under HVCRE. Three are clear: these apply to 1-4 family properties, community development properties and purchase and development of agricultural land. There is a fourth exception that is much harder to interpret and satisfy. The fourth safe harbor may be granted to ADC loans that meet the following conditions: loans that, at origination, have a stated (supervisory standard by property type) loan-to-value (LTV), an up-front cash equity contribution of 15% of the completed value of the project and a contractual provision prohibiting distributing contributed capital or internally generated capital. If a lender chooses not to classify the loan as HVCRE and the only applicable exception is this one, then compliance with all of these conditions is necessary. The conditions must be complied with for the life of the loan, or until it is converted to a permanent loan.

DM: It sounds like there are a number of options for lenders. What about these options do you think lenders are having trouble structuring?

KB/MS: There are all sorts of ambiguities in the rule (and the exceptions), which make the practical application of the exception conditions difficult. For example, the related terms — "permanent financing", "life of the loan" and "conversion" — are not defined in the rule, nor has any consistent official guidance as to the appropriate definitional parameters been provided (other than as it relates to the bank's internal policies).

If you consider the term "permanent financing" in conjunction with the fact that the HVCRE universe is some subset of ADC loans, you see there is a mixing of temporary/transitional assets and cash-flowing, stable assets. You could easily have an asset undergoing rehab or renovation that is also cash flowing at reasonable coverage levels.

Yet, if there is construction and development involved (whether ground up construction or renovation or rehab), and the ADC loan does not meet one of the three clear exceptions, then in order to meet the conditions for the fourth exception and be exempted from the HVCRE classification, distributions of "internally generated capital" must be contractually prohibited during the term of the loan. Among others, this raises a number of structural and cash management issues, including what is "internally generated capital" and how and when it can be used. This suggests perhaps that the rule makers didn't intend to include ADC loans secured primarily by stable cash-flowing assets as HVCRE and were instead concerned

about more risky ground-up construction projects. With that said, at a minimum, this ambiguity contributes to a structuring dilemma (think, for example, how and when are mezzanine lenders paid when there is a prohibition on distribution of cash?) if banks want to ensure compliance with the safe harbor exception.

A related issue is the "life-of-the-loan" reference. Again, it is difficult to understand what the regulators intended here particularly in the context of the distribution prohibition. Did they consider that larger-scale projects typically have multiple components? Even ground-up construction projects (whether or not phased) function differently at the point the projects becomes income producing. Or again were regulators focused solely on the construction phase not the cash-flowing phase? Or was something else entirely going on? In any event, all we know for certain is that there is still no certainty on this point.

"Conversion" too is a hot topic of debate within the industry. There is little to no guidance on what conditions satisfy the "conversion" point (e.g., Do lenders actually need to make a whole new loan? Can they build in the conversion conditions like you would build in loan extension or assumption conditions or frankly, as more traditional, convert from construction to perm? Can "conversion" be automatically triggered on some sort of LTV, DSCR or DY test that must be satisfied in order for a loan to be successfully converted from an HVCRE loan to a non-HVCRE loan and if so, how and by whom is satisfactory criteria determined?)

We have found that even those banks that simply elect to classify all ADC loans as HVCRE (e.g. to avoid the structural and administrative costs surrounding interpreting and complying with the safe harbor exceptions) and to accept the higher capital charges (or pass them on to borrowers) still have to answer the question about when to reclassify those loans as a permanent facility. It is not clear that the regulators (who we understand anecdotally are not consistent in their application among regulatory agencies or even within individual regulators) are even achieving their presumed intended outcome of better credit underwriting or mitigation of riskier loans, though they seemingly have been successful in forcing some of the more subordinated interests outside of the banking system.

Because of the ambiguities and issues already mentioned (and many more…we could probably talk for hours about this and have), we see an opportunity for the WG to help crystallize how or why many of these loans could or should be treated differently than riskier loans. In other words, an important question is should many of the loans that fall literally within the broad ADC category be classified as HVCRE loans?

DM: Why is it important to establish a working group now, two years after implementation?

KB/MS: We are at the beginning stages of the WG, and, in fact, are still taking names of interested parties. In broad brushstrokes, we plan to build on the work of other trade associations (Mortgage Bankers Association and The Real Estate Roundtable). As a base-line goal, we plan to develop educational materials to assist stake-holders of all types with a practical understanding of the rules and the range of interpretations. If our membership is in agreement, we could move to develop some kind of advocacy campaign to again try to extract clarifications, if not revisions to the rule. That could be effectuated through a legislative and/or an administrative approach (going directly to the regulators). In fact, we believe we will have an opportunity to provide feedback to a draft bill that Rep Robert Pittinger (R-NC) has been working on for some time now.

DM: As one of the CREFC staff liaisons to the HVCRE WG, I know that the membership is varied. Can you describe what that means for the agenda?

KB/MS: This is an interesting rule, because, while the bank port-folio lenders are the only group that is directly impacted, nonbank lenders are also interested in similar outcomes (think, for example, non-bank lenders with repo/warehouse lines provided by regulated banks and non-bank mezzanine lenders). Banks (and non-banks) need to know how to interpret the rule in order to remain compliant and/or to optimize their lending strategies and pricing. Part of that equation is knowing what structures fit neatly under the rule. One of the keys to that determination is in how to count preferred equity and sub-debt, a topic which remains a subject of debate today.

Additionally, there are so many other confusing aspects of the rule's exceptions (or application) that are critical drivers of the economics of these deals. One of the more critical of these, which comes into play when calculating the amount of contributed capital — is how contributed land is valued. The rule (together with the only official guidance) only allows the value at the time of purchase to be counted as eligible contributed equity and would preclude use of current appraisals for land if previously owned. This we understand deviates from customary underwriting and raises a host of other issues depending on how and when the land is acquired.

DM: Does the election change the WG's agenda?

KB/MS: It does not necessarily impact the direction of the WG. It may impact the success of advocacy efforts, though. The early skepticism expressed by President-Elect Trump and the nominee for Secretary of the Treasury, Steve Mnuchin, toward regulation in general, and more particularly, those requirements developed by global governance groups, such as the Basel Committee on Banking Supervision, suggests that Congress may have an opportunity to successfully force clarifications of and even possibly revisions to capital rules, like HVCRE.

DM: One last question….Do you foresee construction lending volumes rising or falling next year based on the pipeline of deals you are seeing?

KB/MS: It is difficult to say, and there is a myriad of other issues in play, but the HVCRE rule is creating serious headwinds not just for banks but for nonbanks working with banks and borrowers and equity stakeholders. Whether banks treat construction loans as HVCRE or try to structure around it, construction loans from banks will likely be more expensive, which means borrowers will need additional capital to fill the gap. Even if non-banks step in, costs of funds will likely be higher as well. Construction projects are generally very time sensitive and delays typically result in higher costs. That means, at a minimum, real costs (overall construction budgets) will increase. That potential increase in overall cost combined with the confusion over application, structuring delays (and existing backlog on banks' balance sheets) caused by the rule may play some role in slowing down the volume and pace…. Only time will tell. ■