PRESENTED AT

50th Annual William W. Gibson, Jr.
Mortgage Lending Institute

September 29-30, 2016, AT&T Conference Center, Austin, TX
October 20-21, 2016, Cityplace Conference Center, Dallas, TX

High Volatility Commercial Real Estate Loans: New Federal Rules and the Impact on Loan Availability

Jonathan Thalheimer

Jonathan Thalheimer
McGuire, Craddock & Strother, P.C.
Dallas, TX

jthalheimer@mcslaw.com
214.954.6855

HIGH VOLATILITY COMMERCIAL REAL ESTATE LOANS: NEW FEDERAL RULES AND THEIR IMPACT ON LOAN AVAILABILITY

I. BACKGROUND.

A. BASEL III.

1. **What is Basel III?** Basel Committee on Banking Supervision is a committee of banking supervisory authorities that was established by the central bank governors of the Group of Ten countries in 1975. The Basel Committee formulates broad supervisory standards and guidelines and recommends statements of best practice in banking supervision in the expectation that member authorities and other nations' authorities will take steps to implement them through their own national systems. Basel III (or the Third Basel Accord) is a global, voluntary regulatory framework on bank capital adequacy, stress testing, and market liquidity risk and was developed in response to the deficiencies in financial regulation revealed by the financial crisis of 2007–2008. Basel III is intended to strengthen bank capital requirements by increasing bank liquidity and decreasing bank leverage (*Wikipedia*). The requirements and phase-in schedules for Basel III were approved by the 27 member jurisdictions and 44 central banks and supervisory authorities on September 12, 2010. Basel III compliance requires banks to satisfy the enhanced requirements by 2019. *US Implementation of the Basel Capital Regulatory Framework. Congressional Research Service* Darryl E. Getter 2014 (https://www.fas.org/sgp/crs/misc/R42744.pdf) ("**US Implementation**") p. 1.

2. The Basel Accords are standards, guidelines and recommendations but are not treaties. In order for these standards to have the force of law, the individual countries must implement them with such modifications as they see fit to suit their specific needs.

B. BASEL III Implementation.

1. **US Implementation.** In the United States, Congress mandated enhanced bank capital requirements as part of financial sector reform in the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (*Dodd-Frank Act; P.L. 111-203, 124 Stat.1376*). Specifically, the Collins Amendment to Dodd-Frank amends the definition of capital and establishes minimum capital and leverage requirements for banking subsidiaries, bank holding companies, and systemically important nonbank financial companies. The federal banking regulators issued a proposed rule on June 7, 2012; the final rule to implement most of the Basel III recommendations in the United States was approved by the Board of Governors of the Federal Reserve System and the Office of the Comptroller of the Currency (the "OCC") on July 2, 2013 and by the Federal Deposit Insurance Company (the "FDIC") on July 9, 2013. US Implementation p. 1.

2. **Reason for the US Implementation of Basel III**. According to the FDIC, "the proposed changes [contemplated by BASEL III and the implementing laws

and regulations] to the Federal banking agencies' current capital rules would strengthen the quality and loss-absorbance safeguards provided by regulatory capital and enhance banks' abilities to continue functioning as financial intermediaries, including during periods of financial stress." *Notices of Proposed Rule Making: Regulatory Capital Community Bank Informational Session (FDIC August3, 2012*). https://www.fdic.gov/regulations/capital/Presentation_on_Basel_III_and_Standardized_Approach_NPRs.pdf

C. Introduction of HVCRE.

1. **Prior to Basel III, all types of Commercial Real Estate were of equal risk weight.** Prior to the Basel III, all commercial real estate loans were treated the same and would have typically been assigned a risk weighting of 100% regardless of the loan purpose or asset class of the collateral. However, with Basel III, the "US standardized approach revise[d] the risk weights applicable to commercial real estate loans to range from 50% to 150%" and a new class of commercial real estate was introduced. See, *Basel III's implications for commercial real estate*. Rubin, Giczwewski and Olson, Ernst & Young (August 2013) ("**EY Implications**") p. 2. This new class of commercial real estate related to acquisition, development, or construction ("ADC") of real estate called High-Volatility Commercial Real Estate ("HVCRE"). (See, e.g. US Implementation p. 9).

2. **150% Risk Weight**. As of January 1, 2015, the regulatory capital rules implementing Basel III required that all loans that meet the definition of HVCRE be reported separately from other commercial real estate loans. HVCRE loans are now assigned a risk weighting of 150% for risk-based capital purposes. This change in risk weighting has a significant impact on institutions' risk-based capital ratios. There is no grandfathering of these rules, so loans made prior to implementation are subject to the HVCRE Rules. "*Conference of State Bank Examiners High Volatility Commercial Real Estate (HVCRE) Examiner Job Aid*", www.csbs.org/regulatory/resources/Documents/CSBS_HVCRE_JobAid.pdf.

3. **Capital Adequacy**. In order to operate, regulated financial institutions are required by their regulators to maintain a certain amount of capital. The amount required is expressed as a ratio of equity that must be held as a percentage of risk-weighted assets. As the ratios increase, activities of the financial institutions become more restricted. For example, if the ratios are too high, financial institutions cannot pay dividends, cannot engage in share buybacks, discretionary payments on preferred stock or discretionary bonus payments, and are subject to other regulatory restrictions.

4. **Implications of heightened risk weight**. HVCRE, with its 150% risk weight, now shares the same risk category as 90 day past due delinquent loans. The seismic effect that the HVCRE designation has on a bank's capital structure is demonstrated by the following risk weight chart of various types of commercial real estate ("CRE"):

Title search: High Volatility Commercial Real Estate Loans: New Federal Rules and the Impact on Loan Availability

Also available as part of the eCourse
2016 Mortgage Lending eConference

First appeared as part of the conference materials for the
50th Annual William W. Gibson, Jr. Mortgage Lending Institute session
"High Volatility Commercial Real Estate Loans: New Federal Rules and the Impact on Loan Availability"