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Replacing HVCRE with HVADC

On September 27, 2017, federal regulators proposed regulations that would replace the high volatility commercial real estate (HVCRE) regulations with a new and much simpler High Volatility Acquisition, Development and Construction (HVADC) exposure. The regulators admit that the new rules would likely capture more acquisition, development and construction (ADC) loans, but propose to lower the risk weight from 150% to 130% as an accommodation so that banking organizations using the standardized approach would realize little difference in the amount of capital required to be reserved and retained for HVADC exposures. Regulatory capital rules provide two methodologies for determining risk-weighted assets: the standardized approach and the advanced approach. The standardized approach applies to all financial institutions that are subject to the agencies' risk-based capital regulations. The advanced approaches apply only to certain large financial institutions (i.e. those with \$250 billion in total assets) or those that are internationally active (i.e. \$10 billion in foreign exposures). The HVADC exposure would apply to most banking organizations, but advanced approaches banking organizations would continue to be subject to the HVCRE exposure regulatory scheme. Loans that are entered into before the effective date of the new HVADC regulations will continue to be subject to the HVCRE regulations and rules. In other words, the HVADC regulations are not intended to be retroactive.

Under the proposed rule, a HVADC exposure would be "a credit facility that **primarily finances** or refinances: (i) the acquisition of vacant or undeveloped 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, dwelling or other improvements including additions or alterations to existing structures." (emphasis added). The "primarily finances" test means that more than 50% of the loan proceeds will be used for acquisition, development or construction of the project.

The exemptions from the HVADC rule are also much simpler than the HVCRE exemptions. HVCRE regulations require a borrower to contribute at least 15% of the as-completed value of the project in equity and all contributed capital must remain in the project until the loan is repaid in full or converted to permanent financing or the project is sold. The HVADC regulations specifically propose to eliminate this contributed capital requirement.

The other exemptions from the HVADC rule are proposed to include credit facilities that finance or refinance:

- One-to-four residential properties;
- Real property projects that would have the primary purpose of community development under applicable regulations;
- The purchase or development of agricultural land, which is broadly defined to include a broad array of agricultural projects such as timberland or fish farms, but excludes commercial manufacturing or processing plants such as a dairy processing plants; or
- A permanent loan defined as a prudently underwritten loan with an income stream to meet debt service obligations.

Within each exemption, the regulators offer some clarification as to what will or will not be subject to HVADC. For example, an ADC loan to an owner-occupied property that will be paid by owner revenue streams other than rent of the project and is prudently underwritten would be exempt as a permanent loan. The proposed rules are found [here](#).

Interested parties, including banks subject to the proposed new HVADC rules, have 60 days from the date the proposed rules are published in the Federal Register to submit comments. The proposed regulations also simplify, for non-advanced approaches banks, the capital treatment for (i) mortgage servicing assets (MSAs), (ii) tax deferred assets (TDAs), (iii) investments in the capital of unconsolidated financial institutions, and (iv) capital issued by a consolidated subsidiary of a banking organization and held by third parties. As of this date, the proposed rules have not been published in the Federal Register and are not available for review and comment on www.regulations.gov.

For more information, please contact [Steven Regan](#) or [Kim Mauer](#) on Frost Brown Todd's Lending and Finance Service Team.

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