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ACQUISITION FINANCING

Changes Needed to Protect the Banking Sector When Dealing with the Marijuana Industry

Understanding, Negotiating, and Drafting Purchase Price Provisions

FINANCE
Special Edition 2016

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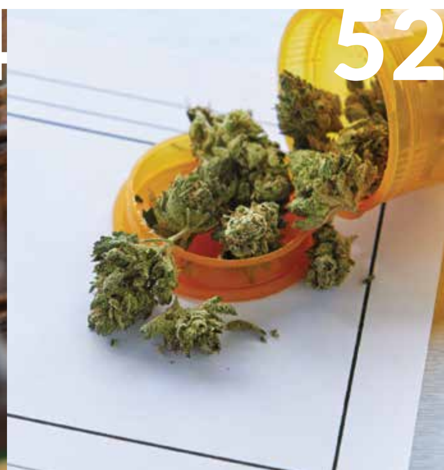

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Dwight Smith NELSON MULLINS RILEY & SCARBOROUGH LLP

The Impact of Dodd-Frank and Capital Requirements on **Commercial Lending**

THE DODD-FRANK WALL STREET REFORM AND CONSUMER Protection Act (Dodd-Frank), 111 P.L. 203, addresses commercial lending in two of its titles. First, and most prominently, Title I of the statute deals with risks to the stability of the financial system through more stringent regulation of bank holding companies with more than $50 billion in assets. As something of a shorthand, these companies are referred to as "systemically important." The more stringent regulations are known as "enhanced prudential standards" and cover a variety of bank operations including commercial lending. Second, Title VI makes a number of changes to bank-level regulations that cover commercial loans. The discussion below first focuses on the Title I provisions and then Title VI.

Single counterparty credit exposures. Title I of Dodd-Frank requires the Board of Governors to cap credit exposures to a single counterparty by bank holding companies with assets of more than $50 billion at 25% of a bank holding company's total capital and authorizes the Board to set more stringent standards. This provision on its face covers credit exposures to any third party, regardless of its business, but as a practical matter the standards will affect primarily inter-bank holding company relationships. In a broad sense, the provision lifts the bank-level ceilings on loans to a single borrower to the holding company level (for systemically important bank holding companies). In another sense, this Dodd-Frank provision lifts the inter-bank financing limits in Regulation F to the holding company level. Exposures that will be subject to the cap include (in addition to loans and other traditional extensions of credit):

- Repurchase and reverse repurchase agreements and securities borrowing and lending transactions with another company
- Guarantees, acceptances, and letters of credit issued on behalf of the company
- Purchases of or investments in securities issued by the company
- Derivative transactions with another company that result in credit exposure to the bank holding company

In 2013, the Board proposed caps and other requirements for single counterparty credit exposures as part of a broad set of enhanced prudential standards. The single counterparty provisions would have included the statutory 25% ceiling with a lower ceiling of 10% for credit exposures between bank holding

companies with more than $500 billion in assets. The Board issued most of the enhanced prudential standards in final form in February 2014. However, the Board held off finalization of the single counterparty credit limits in order to assess forthcoming standards on this issue from the Basel Committee on Bank Supervision.

The Basel committee issued its standards in April 2014. See http://www.bis.org/publ/bcbs283.pdf. The Basel standards also adopt a 25% rule, but the denominator is tier 1 capital rather than total capital. These standards also impose a more stringent 15% ceiling for the single-party credit exposures between globally systemically important banks (G-SIBs). G-SIBs are identified annually by the Financial Stability Board and the Basel committee. As of November 2014, there were 30 G-SIBs worldwide, of which eight were based in the United States. As of October 2015, the Board has not yet proposed a rule to implement the April 2014 Basel standards.

Credit exposure reports. Title I of Dodd-Frank also calls on the Board to include in the enhanced prudential standards for systemically important banks a requirement for periodic reports on credit exposures. These reports are intended in part to facilitate the review of resolution plans, and the FDIC and the Board included requirements for quarterly reports in their proposed rule on resolution planning. The agencies ultimately determined, however, that a final rule on reports hinged on the completion of the regulations on single counterparty credit exposures. Given the uncertainty about the timing of a regulation on those exposures, the timing of a rule on credit exposure reports is up in the air. As of this writing, no regulation is on the horizon.

Title VI of Dodd-Frank contains several provisions amending laws that apply to all banks and bank holding companies. Among other changes, provisions in Title VI expand the definition of an extension of credit for the purpose of lending limits and the restrictions on affiliate and insider transactions. In all cases, the expansions add derivative transactions and securities borrowing and lending activities to the definition.

The Volcker Rule

Section 619 of Dodd-Frank is the so-called Volcker Rule, a highly publicized provision that is intended to force banks and their holding companies and affiliates (each a covered banking entity or CBE) out of much of the proprietary trading and private equity business. Although not directed generally at commercial loans, the rule bars loans to certain private equity funds or hedge funds. The rules on proprietary trading do not implicate commercial lending.

A CBE is generally prohibited from taking an ownership interest in (as principal) or sponsoring a private equity fund or a hedge fund. An ownership interest includes the right to participate in the selection or removal of a managing member or directors of a fund and the right to receive a share of the income, gains, or profits of a fund. A fund subject to Volcker Rule restrictions is one that claims an exemption from registration with the Securities and Exchange Commission as an investment company because it either has fewer than 100 investors or accepts investments from individuals only if the individuals qualify as high net worth. (If a fund can find another exemption, its relationships with banks are not covered by the Volcker Rule).

A bank may lend to a private equity fund or a hedge fund without triggering the Volcker Rule prohibition, provided that the loan does not provide any sort of equity interest. For example, an equity kicker or a rate tied to the performance of the fund's investments would be problematic.

Under certain conditions, notwithstanding the general prohibition, a CBE may sponsor such a hedge fund or private equity fund for its customers; may serve as an investment manager, investment adviser, or commodity trading adviser for such a fund; and may make a de minimis investment in such a fund. If a CBE undertakes any of these actions, two restrictions modeled on affiliate transaction rules in Sections 23A and 23B and Regulation W apply. Indeed, the restrictions are popularly known as "Super" 23A and 23B.

First, if the CBE takes one of these actions or serves in one of these roles above, neither the CBE nor any of its affiliates may extend credit to such a fund that would be a covered transaction under Section 23A, if the CBE were regarded as a bank and the

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For information on structural changes to the U.S. financial regulatory framework, see

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> **SUMMARY OF THE DODD-FRANK ACT BANK CAPITAL REQUIREMENTS**

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fund as an affiliate. This prohibition goes beyond Section 23A in reaching all bank affiliates (not simply the bank) as a complete prohibition, whereas Section 23A allows loans subject to certain conditions.

Second, the Section 23B market terms requirement has been adopted in the Volcker Rule for relationships by a CBE with private equity and hedge funds. Whenever a CBE serves as investment manager, investment adviser, or sponsor to such a fund or organizes and offers a fund, the terms of this relationship must adhere to Section 23B requirements.

ALTHOUGH CAPITAL IS COMMONLY THOUGHT OF AS A PROTECTION FOR BANKS, THERE IS NO SEPARATE AMOUNT OF FUNDS THAT A BANK PUTS ASIDE FOR A RAINY DAY.

Basel III and Capital Requirements

The economics of bank lending are circumscribed by regulatory capital requirements. Increasingly, the federal banking regulators have been using these requirements to discourage some forms of lending and, indirectly, to encourage others. Residential mortgage lending is a good example of the latter.

The concept of bank capital may be somewhat unusual for practitioners not regularly involved in bank regulatory matters. Although capital is commonly thought of as a protection for banks, there is no separate amount of funds that a bank puts aside for a rainy day. Rather, capital is akin to the net equity entry on a bank's balance sheet. The amount of a bank's capital will expand or contract as the fortunes of a bank rise or fall. A write-off of a nonperforming loan will shrink the asset side of the balance sheet and thus reduce a bank's capital.

The regulatory capital rules in the United States are based largely (although not exclusively) on international capital standards. The Basel Committee on Banking Supervision, an international group of regulators including those in the United States, sets these standards. The Basel Committee first created capital standards in 1988. In 2011, the committee completed the third iteration of the standards, referred to as Basel III. See http://www.bis.org/publ/bcbs189.pdf.

Meaningful work on Basel III began just as the financial crisis broke, and the standards accordingly constitute a response to that crisis. Basel III raised minimum capital thresholds significantly, particularly for what are known as G-SIBs. The standards include more complex rules for determining capital adequacy in respect of derivatives and asset-backed securities, two types of instruments thought to lie at the core of the crisis. Basel III also includes liquidity requirements; such requirements are new to the Basel process, which previously had focused almost entirely on credit risk. In addition, the standards changed the risk weighting of some assets, including certain commercial loans.

The Basel III-based rules as issued by the U.S. regulators reflect complementary provisions of the Dodd-Frank Act that are intended to strengthen capital requirements. Dodd-Frank did not, however, affect the rules insofar as commercial lending is concerned.

The capital rules include two types of ratios for measuring capital adequacy: a leverage ratio and three risk-based ratios. The leverage ratio is almost intuitive and is the total capital of a bank or bank holding company divided by total consolidated assets. The latter is a generally accepted accounting principles (GAAP) determination, but total capital for the purpose of the ratios incorporates several supervisory decisions of the bank regulators.

The three risk-based ratios all have the same denominator: total assets, all of which have been reviewed and whose values (for the purpose of these ratios) have been adjusted to reflect their relative credit risk. Most commercial loans are risk-weighted at 100%, that is, they have the same value at which they are held on the balance sheet under GAAP, but higher risk loans such as certain commercial real estate loans and certain past-due loans are risk-weighted at 150%. By contrast, most residential mortgage loans, still thought to be lower risk, are risk-weighted below 100%. For a bank's internal planning purposes, the risk weighting allows the bank to determine the capital charge for each asset class. As a rule of thumb, 8% is the charge for a 100% risk-weighted asset. If the risk weight is 150%, then the charge is 12%.

The three risk-based ratios are differentiated by their numerators: either (i) common equity tier 1 capital, (ii) tier 1 capital, or (iii) total capital. As its name suggests, common equity tier 1 consists almost solely of common stock with a small handful of other instruments in which the holders are the first to be wiped out if a bank fails. Tier 1 capital consists of common equity tier 1 and other instruments from which a holder is unlikely to derive any value if the bank is failing. Total capital is the sum of tier 1 capital and a group of other

instruments referred to as tier 2, with respect to which a holder may be able to gain some return, such as subordinated debt.

Basel III includes certain threshold levels for these ratios. Under the U.S. Basel III-based rules, a bank must maintain a common equity tier 1 risk-based capital ratio of 4.5%, a tier 1 risk-based capital ratio of 6%, a total risk-based capital ratio of 8%, and a leverage ratio of 4%. In 2016, an additional capital conservation buffer will begin to phase in, ultimately reaching 2.5% in 2019. Separately from Basel III, the U.S. regulators have issued higher thresholds for "well capitalized" status: tier 1 risk-based capital of 6%, total risk-based capital of 10%, and a leverage ratio of 5%. (There is no threshold for common equity tier 1.) These thresholds have become the expectation for all banks.

As this discussion indicates, the critical issue for commercial loans (and any other asset class) is the appropriate risk weight. The starting point for commercial loans is 100%. The weight may increase for certain loans.

- Commercial real estate loans that are deemed "high volatility" commercial real estate loans are risk-weighted at 150%. A loan is highly volatile if either the loan-to-value ratio exceeds the supervisory ratios (set forth above), the capital contribution of the borrower in the form of cash or unencumbered assets is less than 15%, the contribution is not made until after the bank advances funds, or the contribution is not contractually required to remain in the project through the life of the project. Construction loans that finance one- to four-family residential properties, property deemed "community development" (and that meets other requirements), and agricultural land are exempt from these requirements.
- Past-due loans, those that are 90 days or more past due or that are on non-accrual status, are weighted at 150% as well.
- A pre-sold loan to construct one- to four-family housing may be risk-weighted at 50% if the loan meets several conditions. Among other requirements, the purchaser of the housing must reside in it, the purchaser must already have entered into a contract and made an earnest money deposit of at least 3%, the builder must incur at least the first 10% of the direct costs, and the loan to sale price must not exceed 80%. If at any time a pre-sold loan fails to meet any of these requirements, its risk weight re-sets to 100%.

Credit enhancements may reduce the risk weight on any commercial loan. A qualifying guarantee from an entity to which loans would be made at a lower risk weight (i.e., a U.S. government entity) would cause the risk weight on the original loan to decrease to that lower weight. A guarantee from another commercial entity therefore would not help. Financial collateral (but not other collateral) may also reduce

the risk weight. Such collateral includes investment grade debt securities, publicly traded equity securities and convertible bonds, and certain money market or other mutual fund shares. A bank must have a perfected first-priority security interest in such collateral. A bank may substitute the risk weight of the collateral for the risk weight of the original loan to the extent that the fair value of the collateral covers the outstanding principal amount. Note that not all qualifying financial collateral necessarily will have a risk weight better than the presumptive 100% risk weight for commercial loans. L

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