Navigating Improved Rules for HVCRE Loans – What You Need to Know

On May 24, 2018, the Economic Growth, Regulatory Relief and Consumer Protection Act (the Economic Growth Act or the Act, as applicable) was signed into law. Section 214 of the Economic Growth Act contains provisions that modify capital treatment of High Volatility Commercial Real Estate (HVCRE) loans, changing the interpretation of the Basel III capital rules. The recently enacted Economic Growth Act reforms certain aspects of HVCRE regulation, adding new exceptions to the general HVCRE rule, reforming key aspects of the Fifteen Percent Contributed Capital rule (hereinafter discussed), and clarifying the issue of HVCRE loan reclassification. Both borrowers and lenders should benefit from the implementation of the Act.

Basel III (or the Third Basel Accord) is a regulatory framework that was developed in response to the 2008 financial crisis. Such regulations were promulgated by the Basel Committee on Banking Supervision, a forum comprising member countries working to establish best practices in banking oversight for the purpose of increasing the stability of the global banking system. Any recommendations made by the Basel Committee are non-binding until a member nation adopts said recommendations through legislation. Through the Dodd-Frank Wall Street Reform and Consumer Protection Act, the United States adopted Basel Committee recommendations concerning the implementation of risk-based capital requirements for banks, bank holding companies, and significant nonbank financial institutions.

One of the adopted recommendations calls for bank lenders to meet certain capital retention requirements when making loans for the acquisition, construction, and development of certain commercial real estate projects that are deemed to be riskier than normal. Such loans are referred to as High Volatility Commercial Real Estate loans, or HVCRE loans. Non-regulated lenders (non-banks, generally) are not subject to HVCRE restrictions.

In order to understand the changes mandated by the Economic Growth Act, we first need to review the status of HVCRE loans prior to its enactment. An HVCE loan was any loan for the acquisition, construction, and development of real estate that did not fall within any of the statutory exceptions.[1]

A commercial mortgage loan that received HVCRE treatment was assigned a risk weight of 150 percent of normal, requiring a bank lender to retain 12 percent of the loan's value in capital instead of the usual 8 percent. As such, funding an HVCRE loan was less cost-effective for a bank, and such increased costs were passed on to borrowers in the form of increased interest rates.

For most development projects, in order to avoid HVCRE classification, a borrower had to contribute at least 15 percent of the project's "as completed" value (i.e., the property's market value as of the time that development is expected to be completed) prior to the lender's advancement of funds. The tricky part, however, was often the calculation of what could be counted towards the borrower's required capital contribution. A borrower's contribution was solely permitted to come in the form of cash or unencumbered, readily marketable assets "that came exclusively from the borrower," meaning that any grants received from nonprofit organizations, municipalities, state agencies, or federal agencies, as well as any capital advanced pursuant to another loan taken out by the borrower (for example, a mezzanine loan) would not be considered equity when determining whether a borrower has met the requirement.

In addition to cash, a borrower may also contribute land for the purposes of fulfilling the contribution requirement. However, prior to the enactment of the Economic Growth Act, only the value of said land **at the time of its purchase** could be counted towards the contribution (even if the initial purchase of the property occurred a decade or more prior to the making of the loan and

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such land had increased dramatically in value), as opposed to the land's actual market value at the time of contribution.

Another facet of the Fifteen Percent Contributed Capital Rule that served to cause difficulty for borrowers was the requirement that the required capital contribution, as well as all capital internally generated by the subject property, was mandated to remain in the property for the duration of the HVCRE loan. Therefore, if a project generated revenue during the term of an HVCRE loan, such revenue could not be accessed by the borrower, nor distributed in the form of dividends to investors, until the HVCRE loan was paid off or converted to a permanent financing in accordance with the bank's normal lending policies. Given that a bank's own underwriting criteria are the determinant for whether a project is subject to permanent financing, lenders were unsure when a reclassification was appropriate or permitted, if at all, during the term of the loan.

The real estate and banking community objected to many of the requirements of the original HVCRE regulations in part because they were clearly costly to both lender and borrower and partly because they were unclear and often left interpretation to the bank itself. In response to the objections, the Economic Growth Act was enacted.

Pursuant to the Economic Growth Act, in order for a loan to receive HVCRE treatment and be assigned a 150 percent risk weight, the characteristics of the loan must now meet both the original definition of an HVCRE loan as stated above, and the newly created definition for HVCRE ADC loans contained in Section 214 of the Act. Any commercial real estate loan for a project that does not meet both definitions is assigned a risk weight of 100 percent (prompting banks to retain the standard 8 percent capital, as opposed to 12 percent).

According to Section 214 of the Economic Growth, Regulatory Relief, and Consumer Protection Act, an HVCRE ADC loan is defined as follows:

A credit facility secured by land or improved real property that, prior to being reclassified by the depository institution as a non-HVCRE ADC loan pursuant to subsection (d):

A. Primarily finances, has financed, or refinances the acquisition, development or construction of real property;
B. Has the purpose of providing financing to acquire, develop, or improve such real property into income-producing real property, and
C. Is dependent upon future income or sales proceeds from, or refinancing of, such real property for the repayment of such credit facility.

In addition to the above definition, the new legislation provides additional exceptions to the HVCRE rule. Currently, a commercial real estate loan will be exempt from HVCRE treatment if it falls under one of the exceptions in 12 CFR 324.2 (outlined in the previous section), or if it is used to:

- Acquire income producing property, secured by a mortgage, so long as the internally generated revenue is enough to support the property's debt service and expenses in accordance with the lending institution's applicable loan underwriting criteria for permanent financings, or
- Make improvements on an existing income producing property, secured by a mortgage, so long as the internally generated revenue is enough to support the property's debt service and expenses in accordance with the lending institution's applicable loan underwriting criteria for permanent financings.

In addition to establishing new exemptions, the Act modifies key aspects of the Fifteen Percent Contributed Capital Rule. Previously, if a borrower contributed land for the purposes of satisfying the contribution requirement, only the value of said land at the time of purchase would be counted towards the requirement, as opposed to the land's market value at the time of contribution. Under the current HVCRE regulation, as modified by the Act, lenders may now consider the appraised value of the land at the time of contribution for the purposes of determining whether a borrower has satisfied the Fifteen Percent Contributed Capital rule.

The new legislation also allows for the distribution of internally generated capital so long as the amount of capital maintained by the borrower amounts to not less than 15 percent.

The Economic Growth Act additionally removes the previous uncertainty surrounding HVCRE loan reclassification. Previously, loan reclassification was only appropriate upon the loan's conversion to permanent financing. According to the Act, such conversion is no longer required. Under current HVCRE regulation, reclassification may take place upon the relevant project's substantial completion, and generation of funds sufficient to support the property's debt service and expenses in a manner that complies with the relevant lender's permanent financing standards.

In addition to the changes to some of basic HVCRE rules that were limiting applicable mortgage loans by bank lenders, the implementation of the Economic Growth Act has also served to clarify several aspects of the old regulation that were causing confusion and a reluctance to enter into HVCRE loans or loan that could potentially be reclassified as such. Borrowers and lenders should both be in better positions as a result of the enactment of the Economic Growth Act.

To discuss any questions you may have regarding the issues discussed in this Alert, please contact a member of the Cozen O'Connor's Real Estate Practice.

Iris Valasquez contributed to this article.

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[1] Exceptions include:

1. One to four family residential properties;
2. Real property that: (i) Would qualify as an investment in community development under 12 U.S.C. 338a or 12 U.S.C. 24 (Eleventh), as applicable, or as a "qualified investment" under 12 CFR prt 345, and (ii) Is not an ADC loan to any entity described in 12 CFR 345.12(g)(3), unless it is otherwise described in paragraph (1), (2)(i), (3) or (4) of this definition;
3. The purchase or development of agricultural land, which includes all land known to be used or usable for agricultural purposes (such as crop or livestock production), provided that the valuation of the agricultural land is based on its value for agricultural purposes and the valuation does not take into consideration any potential use of the land for non-agricultural commercial development or residential development; or
4. Commercial real estate projects in which:
   a. The loan to value ratio is less than or equal to the applicable maximum supervisory loan to value ratio in the FDIC's real estate lending standards at 12 CFR part 365, subpart A (state nonmember banks), 12 CFR 390.264 and 390.265 (state savings associations);
   b. The borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out of pocket) of at least 15 percent of the real estate's appraised "as completed" value; and
   c. The borrower contributed the required amount of capital before the FDIC supervised institution advances funds under the credit facility and the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project. The life of a project concludes only when the facility is converted to permanent financing or is sold or paid in full.