COMMERCIAL

HVCRE Banking Rule

What Does It Mean for CRE Lending?

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BACKGROUND

On January 1, 2015, federal banking regulators implemented new rules under the Basel III international banking accords, in order to increase the quality and quantity of bank capital. One of these rules defines High Volatility Commercial Real Estate, or HVCRE, and requires banks to increase their capital reserves by 50% for certain commercial real estate loans, thus making those loans more expensive to the lender. Since banks now have a higher reserve requirement for HVCRE loans, their cost of funds is higher, resulting in higher loan pricing to the borrower.

WHICH CRE LOANS ARE CONSIDERED HVCRE?

Bank loans used for acquisition, development and construction (ADC) of real property, prior to a conversion to permanent financing, must now be classified as HVCRE, unless they meet the exemption requirements. Banks making these loans now have the higher reserve requirement. Private lenders who intend to sell their non-regulated loans to a regulated bank also need to be aware of this requirement, since their loans will fall under this rule when a bank acquires them.

HVCRE EXEMPTIONS

A bank ADC loan may be exempted from HVCRE classification only if it meets one of the following criteria:

1. The loan is secured by a one-to-four unit residential project.
2. The loan is secured by property that would qualify as an investment in a community development project.
3. The loan is secured by agricultural land and is used for purchase or development of property that can and will be used for agricultural purposes.
4. The loan finances acquisition, development or construction of a project in which all of the following criteria are met:
    a. The project's loan-to-value is below the maximum supervisory loan-to-value limits set forth in applicable regulations[1]; and,
    a. The borrower has contributed capital to the project of at least 15 percent of the project's Prospective "As Completed" appraised value prior to the advancement of funds; and,
    a. Borrower-contributed capital is contractually required to remain throughout the life of the project, i.e., until the loan is converted to permanent financing, the property is sold or the debt is paid in full.

WHAT QUALIFIES AS CONTRIBUTED CAPITAL?

The exemption component related to contributed capital (#4b. above) is somewhat subjective and subject to misuse by borrowers and/or financial institutions who are attempting to avoid HVCRE classifications.

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Assets that are eligible to be counted toward contributed capital include:

- cash
- unencumbered marketable assets
- land purchased with cash, that will be contributed to the project
- certain defined out-of-pocket development expenses
- certain defined soft costs included in the development expenses
- cash expended by the borrower to acquire a site including engineering or permitting expenses directly related to the project

Assets that are not eligible to be counted toward contributed capital include:

- Borrower-owned real estate from an unrelated project
- Buyers' deposits on units in a condominium development
- Secondary financing from an external lender
- Assets contributed to the project after the advancement of loan funds
- Cash received in the form of grants from non-profits, municipalities or government agencies
- Any contribution that may be withdrawn by the borrower prior to the borrower obtaining permanent financing, selling the project or paying the loan in full
- Proceeds from a separate loan used to finance the project

OTHER CONSIDERATIONS

The HVCRE rule does not provide for grandfathering of existing loans, so loans made prior to the adoption date of the HVCRE rule are subject to these rules and must be categorized and reported as HVCRE if they fit the definition.

If the property is a mixed-use development with commercial and one-to-four unit residential components, then the HVCRE rule only applies to the commercial component.

If the project is classified at origination as HVCRE for not meeting the LTV requirement, and based on a subsequent appraisal it does meet the LTV requirement, the loan is still classified as HVCRE since the classification is based on the appraisal at the time of the origination. Once a loan is classified as HVCRE, it remains classified as HVCRE throughout the life of the loan.

CONCLUSION

The HVCRE rule is already impacting the way banks underwrite and price their ADC loans. A clear understanding of this rule can help lenders help their borrowers avoid confusion and frustration when applying for an ADC loan. Lenders can also gain a competitive edge if they can work with their borrower to meet the exemption criteria in order to avoid the HVCRE classification. As always, the best response to a new rule is to stay informed.

1 Including statutes: 12 CFR part 208, subpart E (Federal Reserve Board); and 12 CFR part 365 (FDIC).