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Otten Johnson Alert -

The ABC's of HVCRE: A Synopsis of High Volatility Commercial Real Estate Loans for Borrowers

If your business involves obtaining commercial real estate loans, you have likely either heard references to your loan being "HVCRE" or seen new provisions in your loan documents that are a result of "HVCRE." HVCRE stands for High Volatility Commercial Real Estate and refers to a complex new rule promulgated by U.S. banking regulators concerning commercial real estate loans that took effect on January 1, 2015. Although the rule has been effective for 9 months, it persists as a sticking point in many commercial real estate loan negotiations in part because it remains somewhat nebulous and foreign, especially to borrowers. In an effort to foster more efficient and successful negotiations between borrowers and banks, this article provides the basics—the ABC's—of HVCRE.

A Loan is Classified as HVCRE if...

A loan is classified as HVCRE if, "prior to conversion to permanent financing, [it] finances or has financed the acquisition, development, or construction (ADC) of real property." These are widely referred to as "ADC loans."

Two categories of ADC loans, however, are exempt from HVCRE classification. The first are for one- to four- family residential properties, real property that qualifies as community development investments, or loans to business or farms with gross revenues of $1 million or more.

The second are loans that satisfy each of the following three criteria:

(1) – The loan-to-value ratio is less than or equal to the applicable maximum ratio prescribed by bank regulators. The ratio for raw land is 65 percent; land development is 75 percent; and construction of commercial, multifamily, and other non-residential is 80 percent;

(2) – 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 "as completed" value;

(3) – The borrower contributed its capital prior to bank funding, and the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project until the loan is converted to permanent financing or is sold or paid in full.

Background of HVCRE

The HVCRE rule is part of the broader "Basel III" capital regime. Basel III was introduced by U.S. bank regulators on the heels of recession, in July 2013, to address what they perceived to be banks that were inadequately capitalized to withstand turbulence to the world's financial system. To this end, the HVCRE rule is designed to increase the quality and quantity of bank capital by increasing the risk weighting assigned to HVCRE loans. And a loan's risk weighting is tied to the amount of capital a bank must maintain.

Prior to the implementation of the HVCRE rules, all commercial real estate loans, except multifamily properties, were assigned a risk weighting of 100 percent regardless of the purpose of the loan or the type of collateral. This is the same risk weighting assigned to an unsecured loan to a corporate entity. By contrast, the HVCRE rule now assigns a risk weighting of 150 percent to HVCRE loans. Non-HVCRE loans are still assigned the 100 percent risk rating.

Consequences of HVCRE Classification

For banks, the consequences of HVCRE classification are significant. This is because a loan's risk weighting is positively correlated with the amount of capital a bank must maintain against that loan. If a loan is classified as HVCRE, then a bank must maintain 1.5 times more capital than if the loan was non-HVCRE. This erodes a bank's return on capital by requiring it to hold capital that could otherwise be deployed. The additional costs of HVCRE compliance could also increase the cost of debt. It is not surprising, then, that banks want their loans exempted from HVCRE classification. Unless the loan falls into the first exempt category, the only way to achieve that is by fitting it into the second category. To do so, banks are incorporating the three criteria discussed above into their loan documents.

This is where the tension between banks and borrowers arises because exempting a loan from HVCRE classification has consequences for borrowers. One consequence is that borrowers must contribute more equity. Equity is traditionally calculated as a percentage of the project's cost. Banks also usually count the current value of the developable land towards that equity. Now, though, to achieve exemption, equity must instead be a percentage of the project's "as completed value." Furthermore, banks can count only what borrowers paid for the developable land. Another consequence of exemption is that the capital borrowers have contributed, or the capital internally generated by the project, must remain in the project until the loan is converted to permanent financing or is sold or paid in full. This implicates a borrower's ability to make distributions, a key term in any deal. As many borrowers can probably attest, banks are interpreting this language and incorporating it into their loan documents in numerous ways.

The quagmire of the HVCRE rule is this: To maintain their returns and lower costs, banks want to avoid HVCRE classification. That risks losing business due to less desirable loan terms. At the same time, borrowers would prefer to remain unfettered by the requirements for non-HVCRE classification—namely, contributing more equity and inhibiting distributions. In the short-term, this is advantageous. But in the long-term, the costs of HVCRE classification make other, non-real estate investment options more appealing to banks. This, in turn, could diminish the supply of capital for commercial real estate loan borrowers.

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