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Amendments to HVCRE Rules Give CRE Lenders and Borrowers Clarity, Relief

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Introduction

On May 24, 2018, the Economic Growth, Regulatory Relief, and Consumer Protection Act (Public Law No: 115-174) (the "Act") took effect. Among other things, the Act eases banking rules pertaining to so-called "high volatility commercial real estate" ("HVCRE") loans. Since January 1, 2015, lenders have been required to maintain significantly greater capital reserves for loans classified as HVCRE to hedge the increased threat to their capital adequacy posed by loans that finance real estate projects regulators consider riskier. Lenders, in turn, often seek to recoup some of the cost of maintaining greater reserves by increasing their interest rates on HVCRE loans. That makes their pricing less competitive. To avoid this situation, lenders and borrowers wish to classify a loan as non-HVCRE. That was difficult to do with construction or development loans before the Act. The definition of HVCRE loan was expansive. And excluding a loan from HVCRE classification almost always meant subjecting borrowers to stringent loan terms that, prior to the HVCRE rules being enacted, would have likely been unacceptable. This article summarizes the key ways in which the Act amended the HVCRE rules to provide lenders and borrowers clarity and relief.

1. The Act makes it easier to exclude a loan from HVCRE classification.

   Before the Act, a loan had to be classified as HVCRE if, prior to converting to

permanent financing, it financed the acquisition, development or construction of real property. A loan could, however, be excluded from HVCRE classification if the subject real property was a one- to four-family residential property, an investment in community development, or agricultural land. A loan could also be excluded under what this article refers to as the "Contribution Exclusion" if the loan met three criteria. First, it satisfied the prescribed loan-to-value ratio. Second, the borrower contributed capital to the project in an amount equal to at least 15 percent of the project's "as completed value" prior to any advance of loan proceeds. Third, all capital contributed to the project by the borrower or internally generated by the project was contractually required to remain in the project until the loan was sold, paid in full or converted to permanent financing. That broad definition and those narrow exclusions made it difficult to avoid classifying a construction or development loan as HVCRE.

The Act makes it easier. A new, tapered HVCRE loan definition, together with additional exclusions, clarifies that the HVCRE rules do not apply to loans that finance or refinance the acquisition, development, or improvement of real property if that property is already generating income sufficient to pay the contemplated debt and the property's expenses. Further, as discussed below, the Act broadens the Contribution Exclusion by loosening the exclusion's second and third criteria. The Act also exempts from HVCRE classification all loans made before January 1, 2015.

2. To satisfy the 15 percent capital contribution requirement, a borrower may use the appreciated value of land contributed to the project.

For a loan to be excluded from HVCRE classification under the Contribution Exclusion, before any loan proceeds are advanced, the borrower must have contributed capital to the project in amount equal to at least 15 percent of the project's "as completed value." Land contributed by a borrower to the project counts towards that 15 percent, but, prior to the Act, only what the borrower paid for the land counted, instead of what the land is worth.

Happily for borrowers, the Act provides that the value of contributed land should be determined by an appraisal. So appreciation counts toward the 15 percent. The Act also clarifies that a lender may advance a nominal amount of loan proceeds to secure its lien against the project before the borrower's 15 percent has been contributed without jeopardizing the Contributing Exclusion.

3. So long as a borrower maintains the 15% capital contribution, equity invested into the project may be returned and cash flow generated by project may be distributed.

Under the old HVCRE rules, for a loan to be excluded from HVCRE classification

under the Contribution Exclusion, all capital contributed to the project by the borrower or internally generated by the project had to be contractually required to remain in the project until the loan was sold, paid in full or converted to permanent financing. The rules did not elaborate on when a loan "converted to permanent financing," so lenders took a variety of positions. Some categorically prohibited distributions; others permitted them once amortization commenced or once certain financial covenants were met. This criteria imprisoned equity and profits much longer than borrowers forecasted—even while the project was generating cash flow more than sufficient to service the debt.

The Act clarifies that was never the intent. Instead, so long as a borrower maintains the 15% capital contribution, equity and cash flow may be withdrawn from the project. Once the loan has been reclassified as non-HVCRE, even the 15% capital contribution may be withdrawn.

4. An HVCRE loan may be reclassified as non-HVCRE when the project is substantially complete and generating income sufficient to support debt service and expenses.

Before the Act, a loan classified as HVCRE could not be reclassified until the loan was sold, paid in full or converted to permanent financing.

Now, an HVCRE loan may be reclassified earlier. Reclassification may occur when (a) the development or construction of the project financed by the loan is "substantially complete" and (b) the cash flow generated by the project is sufficient to support the debt service and expenses of the project.

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