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Bill Clarifying HVCRE Rule Passes House, Goes to Senate

December 2017 • Kyle R. Blackmer

The U.S. House of Representatives has passed a bill to clarify the rule regarding high volatility commercial real estate loans, commonly referred to as “HVCRE loans.” This alert summarizes the major clarifications contained in that bill, H.R. 2148, the Clarifying Commercial Real Estate Loans Act. For the background and basics of the HVCRE rule and the implications of HVCRE classification, please see our September 2015 Client Alert, which can be found here.

The key takeaways of H.R. 2148 are the following:

1. By delineating a three-part definition, the bill more clearly defines what loans are classified as HVCRE and what loans are exempted from HVCRE classification, including exempting loans financing the acquisition, refinance, or improvement of a property generating cash flow sufficient to support the contemplated debt service and the property’s expenses.
2. The bill states that the value of contributed land will be based on a recent appraisal rather than its purchase price.
3. The bill indicates that only an amount equal to 15 percent of the property’s appraised, “as completed” value must be contractually obligated to remain in the project until the loan is reclassified as a non-HVCRE loan.
4. The bill provides that a HVCRE loan may be reclassified as a non-HVCRE loan when (1) completion of the development or construction occurs, and (2) cash flow generated by the real property is sufficient to support the debt service and the project’s expenses.

These key takeaways are discussed more fully below.

In sum, while certain questions regarding the HVCRE rule would remain, H.R. 2148 offers needed guidance on how to navigate and comply with the HVCRE rule and affords lenders and borrowers more latitude in negotiating credit facilities. H.R. 2148 is now before the U.S. Senate.

1. **H.R. 2148 more clearly defines what loans would be classified as HVCRE and what loans would be exempted from HVCRE classification.**

   Fundamentally, H.R. 2148 delineates that a loan is a HVCRE loan if it meets the criteria enumerated in the chart below.

Current HVCRE Rule	Proposed HVCRE Rule (H.R. 2148)
A loan is an HVCRE loan if, prior to conversion to permanent financing, it finances or has financed the acquisition, development, or construction of real property.	A loan is an HVCRE loan if it is secured by land or improved real property and the loan 1. primarily finances, has financed, or refinances the acquisition, development, or construction of real property; 2. has the purpose of providing financing to acquire, develop, or improve such real property into income-producing real property; and 3. depends upon future income or sales proceeds from, or refinancing of, such real property for the repayment.

   The current HVCRE rule also exempts certain loans from HVCRE classification. One such exemption—and the one that is encountered most often and is the subject of the most analysis and negotiation—is a loan that satisfies each of the following three criteria: (1) the loan-to-value ratio is less than or equal to the prescribed applicable maximum ratio; (2) the borrower has contributed capital to the project of at least 15 percent of the real estate's "as completed" value; and (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 (collectively, the "15% Contribution Exemption").

   H.R. 2148 generally maintains the existing exemptions, with the modifications to the 15% Contribution Exemption discussed below. But the bill also goes further by expressly exempting from HVCRE classification loans that finance the acquisition or refinance of, or improvements to, real property producing cash flow sufficient to service the contemplated debt and the property's expenses.

2. **The value of contributed land would be based on recent appraisal rather than its purchase price.**

   Under the existing 15% Contribution Exemption, contributed land is valuated at its historical cost—i.e., its purchase price. By contrast, under H.R. 2148, the value of contributed land would be based upon a recent appraisal.

3. **Only an amount equal to 15 percent of the property's appraised, "as completed" value must be contractually obligated to remain in the project.**

   Currently, for a loan to be exempted under the 15% Contribution Exemption, "capital contributed by the borrower, or internally generated by the project," must be "contractually required to remain in the project until the loan is converted to permanent financing or is sold or paid in full." This requirement has been particularly problematic for borrowers and has been the source of much negotiation. Read strictly, this requirement prohibits both the return of any equity and distribution of any income generated by a project until the loan is converted to permanent financing, sold or paid in full.

   H.R. 2148 grants borrowers relief. It provides that only an amount equal to the 15 percent contribution must stay in the project; in other words, any equity in excess of that 15 percent amount could be withdrawn by the borrower, and income generated by the project could be distributed. When the loan is reclassified as non-HVCRE (discussed below), even that 15 percent amount may be withdrawn.

4. **A HVCRE loan could be reclassified as a non-HVCRE loan when completion occurs.**

   H.R. 2148 prescribes that a HVCRE loan may be reclassified as a non-HVCRE loan when (1) the development or construction of the real property being financed by the credit facility is completed, and (2) the real property is generating cash flow sufficient to support the debt service and real property's expenses. Importantly, the bill provides that the depository institution is to determine whether these two conditions have been satisfied in accordance with the institution's applicable loan underwriting criteria for permanent financings.

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