

Will the Banks Be Back Big?

Recent Federal Law Limits High Volatility Commercial Real Estate Regulations

by

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On May 24, 2018, new federal law ("Law") was enacted that substantially limits the effect of the High Volatility Commercial Real Estate ("HVCRE") rule ("Rule") adopted by the Federal Reserve Board, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation ("the Agencies") that became effective on January 1, 2015. The changes, widely sought by the banking industry since adoption of the Rule, offer relief to banks to whom the Rule applied.

The purpose of both the Rule and the Law is to address banks' capital adequacy requirements for certain commercial real estate loans that finance the acquisition, development or construction ("ADC") of real property.

Loans Covered; New Terminology

Under the Rule, if an ADC loan was classified as HVCRE, the bank would have to assign a risk rating of 150% to it (as compared to 100% for a non-HVCRE loan) and therefore had to retain 50% more risk-based capital on its balance sheet to cover that HVCRE exposure.

Under the Law, the risk rating percentage and the retention amounts remain the same but the Law creates a new term, "HVCRE ADC loan," as to which the requirements apply.

An "HVCRE ADC loan" is a loan that is secured by land or improved real property that:

- 1) primarily finances, financed or refinanced the acquisition, development or construction of real property;
- 2) is for the purpose of providing financing to acquire, develop or improve such real property into income-producing real property; and
- 3) is dependent upon future income or sales proceeds from, or refinancing of such real property for the repayment of such credit facility.

Thus, a "primary purpose" concept that was not in the Rule was added in the Law and subsections 2) and 3) are completely new. All of the elements of the new definition must be met.

Exemptions Under the Rule and the Law

The exemptions that existed in the Rule as to HVCRE loans primarily continue to apply to HVCRE ADC loans under the Law. In addition, more exemptions are added and the Law's applicability to commercial real property is limited.

Continued Exemptions

Similar to the Rule, the Law continues to exempt ADC loans that finance a) one-to-four family residential property; b)

community development investments; and c) agricultural land. The scope of the community development and agricultural exemptions are not defined as specifically as they were under the Rule.

New Exemptions

The Law adds new exemptions that essentially look to the bank's credit risk in making the loan. Thus, the term HVCRE ADC loan does not include a loan for the acquisition, refinance or improvement to existing income-producing real property secured by a mortgage on such property, if the cash flow being generated by the real property is sufficient to support the debt service and expenses of the real property, in accordance with the institution's applicable loan underwriting criteria for permanent financings.

Commercial Real Estate Exemption

Under the Rule, commercial real estate ADC loans that met three requirements (collectively, the "CRE Requirements") would be classified as an HVCRE exposure:

- 1) The loan-to-value ("LTV") ratio was less than or equal to the applicable maximum LTV ratios mandated by the Agencies (the "LTV Requirement");
- 2) The borrower must have contributed capital to the project in the form of cash or unencumbered readily

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marketable assets (or have paid development expenses out of pocket) of at least 15% of the property's appraised "as completed value" (the "Capital Contribution Requirement"); and

- 3) The borrower must have contributed the capital in 2) above before the bank advanced funds under the credit facility and that capital and all capital internally generated by the project must have been contractually required to remain in the project throughout its life, which life ended only when the credit facility was converted to permanent financing, was sold or was paid in full (the "Timing Requirements").

LTV Requirement Under the Law

The Law preserves the LTV Requirement under the Rule but changes each of the other two CRE Requirements.

Capital Contribution Requirement Under the Law

Under the Rule, only the portion of the purchase price of real property contributed to a project that was paid in cash would be considered in calculating the 15% capital contribution requirement.

A significant objection to the Rule arose out of the Agencies' interpretation that the value of contributed real property was determined as of the date of the borrower's purchase of the property and that only the amount of cash paid could be considered.¹ As such, any appreciated value as of the date of contribution could not be considered. The Law changes this and states that "contributed real property or improvements" are a permissible form of contributed capital for purposes of the 15% calculation and provides that the value of contributed real property is the appraised value as determined under FIRREA standards.

Timing Requirements Under the Law

The Rule's Timing Requirement had generated the most extensive comments. Under the Law, internally generated capital is no longer required to remain in the project until "the credit facility is

converted to permanent financing or is sold or paid in full." Rather, the capital must stay in the project until the credit facility has been reclassified by the institution as a non-HVCRE ADC. That reclassification may occur upon:

- 1) the substantial completion of the development or construction of the real property being financed by the credit facility; and
- 2) cash flow being generated by the real property being sufficient to support the debt service and expenses of the real property

in accordance with the institution's applicable loan underwriting criteria for permanent financings.

Effective Date

The Law was effective immediately on May 24, 2018, but requires conforming regulations to be adopted by the Agencies so that the Law and the regulations are not in conflict as they presently are since the Rule is presently the only regulation that is in effect. Prior to the introduction of the legislation that became the Law, the Agencies, in September, 2017, proposed new regulations which were not adopted and which are not now consistent with the Law as enacted. Thus, much of the activity since May 24, 2018 has been the urging to the Agencies by banking trade associations and others to promulgate new regulations that comply with the Law.

The Law provides that the Agencies may only require a depository institution to assign a heightened risk to an HVCRE exposure if the loan is an HVCRE ADC loan (the new definition under the Law). The Law also provides that it does not limit the authority of the Agencies to further the safe and sound operation of the financial institutions under their supervision.

Grandfathering of Pre-2015 Transactions

In another important timing-related change from the Rule, the Law grandfathers ADC loans made prior to Rule's January 1,

2015 effective date. The Rule had applied to all loans, even those made prior to its effective date. Thus, as a result of the Law, no ADC loan made prior to January 1, 2015 will have to meet the Law's HVCRE requirements.

Relevance To Private Lenders

While the Law is applicable to banks only, it is important that private lenders also understand it and the ways in which it changes the Rule since the marketplace forces impacted by the availability of bank financing often determine the extent to which borrowers will seek private financing. This has been borne out in the past several years when borrowers unable or unwilling to qualify for bank construction financing under the Rule's requirements have gravitated toward private lenders and other lending sources to meet their needs. The question now is the extent to which the relaxation of the restrictions on banks will drive borrowers back to banks with the possibility at least, of adversely affecting the volume of construction lending done by private lenders who had generally been positively affected by the existence of the Rule. ☺

Endnotes

- 1 Responses 7 and 8, Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Frequently Asked Questions on the Regulatory Capital Rule, March 31, 2015.

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