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Regulation of High Volatility Commercial Real Estate Loans

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Effective January 1, 2015, U.S. banks must comply with a Final Rule (the "Rule") adopted by the Federal Reserve Board, the Office of the Comptroller of the Currency and the Federal Deposit Insurance Corporation ("the Agencies"). The Rule affects commercial real estate loans that finance or have financed the acquisition, development or construction ("ADC") of real property. The Rule addresses banks' capital adequacy requirements for ADC loans classified as High Volatility Commercial Real Estate ("HVCRE") loans. The Rule is based on the standards of an international banking supervision committee of which the U.S. is a member ("BASEL III"), and was adopted to comply with requirements imposed on banks under the Dodd-Frank Wall Street Reform and Consumer Protection Act.

If an ADC loan is classified as HVCRE, the bank will have to assign a risk rating of 150% to it (as compared to 100% for a non-HVCRE loan) and must therefore retain 50% more risk-based capital on its balance sheet to cover that HVCRE exposure. While the Rule became effective on January 1, 2015, it also applies to loans that existed before that date.

An ADC loan will be classified as an HVCRE exposure unless, prior to conversion to permanent financing, it finances a) one-to-four family residential property; b) community development investments, as defined in the statutes; c) the purchase or development of agricultural land; or d) commercial real estate loans that meet each of the following requirements (collectively, the "Requirements"):

1) The loan-to-value ("LTV") ratio is less than

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or equal to the applicable maximum LTV ratios mandated by the Agencies, as follows:

a. Raw land – 65%;
b. Land Development – 75%
c. Construction - commercial, multifamily and other non-residential – 80%;
d. Construction - 1 to 4 family dwellings – 85%; and
e. Construction - improved property – 85%
(the "LTV Requirement");

2) The borrower must contribute capital to the project in the form of cash or unencumbered readily marketable assets (or have paid development expenses out of pocket) of at least 15% of the property's appraised "as completed value" ("Borrower Capital Contribution Requirement"); and

3) The borrower must contribute the capital in 2) above before the bank advances funds under the credit facility and that capital and all capital internally generated by the project must be contractually required to remain in the project throughout its life, which life ends only when the credit facility is converted to permanent financing, is sold or is paid in full ("Timing Requirements").

COMMENTS AND CLARIFICATION BY THE AGENCIES

LTV Requirement — Based on the perception and practices of banks which generally require LTV ratios equal to or greater than those mandated, the LTV Requirement has received the least comment. The LTV Requirement is satisfied (or not) at loan closing and subsequent changes in property value cannot change an HVCRE classification.

Borrower Capital Contribution Requirement — The Borrower Capital Contribution Requirement has generated extensive discussion. The Agencies responded in frequently asked questions ("FAQs")[1] in which they clarified that the borrower cannot use the following to satisfy the Borrower Capital Contribution Requirement: a) a pledge of other real property owned by the borrower (even if unencumbered); b) the amount of purchasers' deposits in a condominium project; c) the proceeds of a junior mortgage on the property; or d) cash received from grants. The FAQs stated that the borrower can use the following to meet the Requirement: a) cash used to acquire land; and b) soft costs paid by the borrower, such as brokerage fees, marketing expenses or costs of feasibility studies, including reasonable market based fees paid to borrower-related parties.

Timing Requirements — The Timing Requirements have perhaps generated the most extensive comments. In the FAQs, the Agencies clarified that a) the appreciated value of land cannot be used to remove an HVCRE classification; b) an HVCRE classification continues until a loan is converted to permanent financing in accordance with the bank's normal lending practices; and c) the Rule requires retention in the project of both the initial capital contribution and later generated internal capital.

OTHER CLARIFICATIONS IN THE FAQS

The FAQs also clarified that loans used solely to acquire land on which no construction is intended are HVCRE unless they qualify as permanent loans; that U.S. Small Business Administration 504 loans are not automatically exempt from HVCRE classification; and that a loan on a multi-purpose property that will contain both commercial real estate and exempt 1-4 family residential can be classified as HVCRE only to the

[1] 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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information.

Courts have not limited disclosure obligations in residential (and even commercial) transactions to the presence of physical defects. The duty to disclose has been extended to include nonphysical defects that detrimentally affect property values. For example, in a widely discussed and analyzed case, *Stambovsky v. Ackley*, 572 N.Y.S. 2d 672 (N.Y. App. Div. 1991), the court held that the seller had a duty to disclose that the house was reputed to be haunted. According to the court, the buyer had no reason to inquire about the apparition and could not have discovered its presence through a reasonable inspection. The court reasoned that because both local and national publications had reported the alleged hauntings at the house, the defendant was estopped to deny the existence of the apparitions. The court concluded that "as a matter of law, the house [was] haunted." Id. at 256. The court noted that the reported haunting lowered the resale value of the property, and ruled that while the doctrine of caveat emptor prevented an action for damages, an action for rescission was appropriate because the seller had taken advantage of the buyer's lack of knowledge regarding the house's reputation, and had in fact "created and perpetuated a condition about which he [was] unlikely to even inquire." Id. at 260.

See generally Ronald Benton Brown and Thomas H. Thurlow III, Buyers Beware: Statutes Shield Real Estate Brokers and Sellers Who Do Not Disclose That Properties Are Psychologically Tainted, 49 OKLA. L. REV. (1996), wherein the authors note that: In 1995, the New York Legislature passed its statute protecting transferors of psychologically impacted property and their agents who fail to disclose the fact . . . Around the time of the law's passage, news stories reported that New York was passing a "haunted house" statute. However, nothing in the statute refers to haunted houses. The law is simply a psychologically impacted property statute that is similar to statutes in other jurisdictions Some states, not including New York, have borrowed the language of Stambovsky for their psychologically impacted property statutes. They specifically include any "act or occurrence which had no effect on the physical structure of the real property." The New York statute does not include this language. Id. at 640.

The author has been informed of a situation in Wisconsin that was reported to the Wisconsin Board of Realtors, where the broker was told that the walls of the listed house "bled." As is common in most states, Wisconsin's real-estate license law requires brokers to disclose a "haunting" only if it has an effect on the physical condition of the property. Given the alleged "physical" effect on the house, that particular "haunting" was required to be disclosed.

The California Association of Realtors is bound by the disclosure requirements of CAL. CIV. CODE § 1710.2, which states that the death or manner of death of an occupant of real property need not be disclosed if it occurred more than three years prior to the date the transferee offers to purchase, lease, or rent the real property, or that an occupant of that property was infected with the AIDS virus, unless the transferee or prospective transferee makes a direct inquiry regarding deaths on the property. Many brokerage firms have disclosure forms that specifically inquire about deaths on the real property.

Some states even require home sellers to disclose "stigmas" affecting a property, including, e.g., proximity to homeless shelters and the scene of a

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extent of the commercial real estate.

LOAN DOCUMENTATION

While contractual requirements are mentioned only in connection with the Timing Requirements, loan document provisions addressing all of the Requirements is recommended and it has become a best practice to include them. The Rule's requirements would be covered in representations and warranties, covenants, closing conditions, cost recovery, events of default, and other appropriate provisions.

DISCUSSION SUBSEQUENT TO THE FAQS/COMMUNITY BANKS

While the FAQs resolved a number of questions, others still exist including the scope of construction activity, the definition of cash and readily marketable assets and whether mezzanine debt or preferred equity can satisfy the Capital Contribution Requirement. Further clarification regarding the allowability of appreciated land value to satisfy the Capital Contribution Requirement and reconsideration of the Rule's requirement for retention of all internally generated capital have also been requested in discussions between the Agencies and groups including the Mortgage Bankers Association, the group whose inquiries led to the FAQs, and others. Congressional hearings on Bank Capital and Liquidity Regulations were held in June, 2016. Additional revisions and guidance on the Rule should be expected.

While much of the discussion on the Rule has been with regard to its applicability, community banks have largely taken the position that they should be entirely exempt on the grounds that a) BASEL III was intended to apply only to the largest banks; b) community banks play an important role in providing capital to local communities; and c) the Rule reduces credit availability and increases costs for potentially job-creating projects. Several pieces of legislation that purports to mitigate the effect of BASEL III on smaller banks have been introduced and should be watched.

CONCLUSION

An ongoing topic of discussion with significant implications for commercial real estate lending, the risk-based capital rules deserve the commercial real estate industry's full attention, especially as ADC lending needs have continued to grow in many parts of the country. ◂