"High Volatility" - How Can Banks Avoid Having Loans Classified as HVCRE?

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09.13.2016

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I?m very good at the past. It?s the present I can?t understand. ? Nick Hornby, *High Fidelity*

Where did the HVCRE rules come from?

In the wake of the 2008 financial crisis, international banking regulators determined that banks were not sufficiently well-capitalized and published the Basel III Capital Accords in 2010, which required increased capital reserves. In July 2013, U.S. bank regulators issued the final rules implementing ?Basel III?, which rules went into effect on January 1, 2015 for the Call Report reporting period ending March 31, 2015.

?Basel III? provided for two methods of assigning capital requirements to bank assets: the Standardized Approach and the Advanced Approach. The Standardized Approach uses set rules to assign bank assets particular risk weights, and is utilized across the board among U.S. banks to calculate capital requirements. Under this approach, loans designated as high volatility commercial real estate, or ?HVCRE?, require the lending bank to maintain additional capital reserves for such loan ? therefore, banks generally want to minimize the number of loans on their books that fall into the HVCRE classification.

How can banks avoid having a loan being labeled as HVCRE?

The regulations define an HVCRE loan as ?a credit facility that, *prior to conversion to permanent financing*, finances or has financed the acquisition, development, or construction (ADC) of real property,? subject to certain critical exclusions. HVCRE loans carry a heightened risk weight of 150%, and banks must reserve capital for such loans at a rate of $1.50 per $1.00 of credit (compared to traditional loans with a $1.00 to $1.00 capital requirement). Due to this increased reserve requirement, it is important to understand the exclusions and exemptions to keep a loan from falling into the HVCRE

classification.

1. <u>Permanent Financing</u> ? The HVCRE rules only apply during the construction phase. Once a project is converted to permanent financing under the subject bank?s normal lending practices, the HVCRE exposure terminates (and so does the increased capital requirement). Note that permanent financing is evaluated based on the loan terms rather than the status of the project. So, for example, just getting a certificate of occupancy won?t convert a construction loan to permanent; there can be no availability for future advances and loan-to-value (?LTV?) requirements cannot be calculated based on a future ?as completed? value for the project.

2. <u>1-to-4 Family Residential Properties; Agricultural Land</u> ? Loans for one-to-four family residential properties are excluded from the HVCRE rules. For mixed-use projects, only the commercial portion would be subject to HVCRE compliance. Loans against agricultural land are also exempt (as long as the financing is based solely on the property?s agricultural value).

3. <u>Community Development</u> ? Loans with respect to property that would qualify as an investment in community development, public welfare, or economic development under 12 U.S.C. 338a or 12 U.S.C. 24, as applicable, or as a ?qualified investment? under 12 CFR part 228, are exempt from the HVCRE regulations.

4. <u>Satisfaction of Certain Equity Requirements</u> **?** Loans in which the following three conditions precedent are satisfied will also avoid an HVCRE designation: (i) the LTV is less than or equal to the maximum LTV figures prescribed in the Interagency Guidelines for Real Estate Lending (as set forth below), (ii) the borrower has contributed at least 15% of the ?as completed? value of the property in cash or unencumbered readily marketable assets prior to the first construction advance, and (iii) the capital contributed to and generated by the project is contractually required to remain in the project for the duration of the project life. The LTV figures prescribed in the Interagency Guidelines for Real Estate Lending are as follows:

    - Raw land ? 65%
    - Land under development ? 75%
    - Construction (commercial, multifamily, other non-residential) ? 80%
    - Construction (1-to-4 family residential) ? 85%
    - Construction (improved property) ? 85%

The timing of the requisite capital contribution is of paramount importance ? it must occur *before* any funds are advanced under the loan, and any later injection of capital will not be sufficient to change an HVCRE designation. Further, the upfront capital contributed, as well as any additional capital internally generated by the project, must remain in the project through the project life (in other words, conversion to permanent, payoff of the loan or sale of the project), and must be unencumbered; a separate and

independent loan from the same institution, or from a second mortgage issued by a different bank, used to make the 15% contribution will not satisfy the exemption.

The contributed capital can take a variety of forms, including land purchased with cash that is contributed before the first advance or cash used to purchase land that is subsequently contributed to an ADC project. Certain out-of-pocket development expenses (such as brokerage commissions, feasibility studies, marketing expenses, developer fees, leasing expenses, management fees, permit fees and other similar expenses), or soft costs included as development expenses that contribute to the ?completion and value of the project,? will also qualify, as long as they are reasonable and paid by the borrower. However, if any of these payments are made to a related third party, the fee must be commercially reasonable when compared to such third party?s regular fee schedule.

The underlying intent of the 15% capital requirement is to encourage borrowers to have invested significant ?skin in the game,? so third party funds ? such as loans or government or non-profit grants ? will not be sufficient to avoid the designation, nor will real estate assets pledged as collateral that are not directly put into the project. Further, purchaser deposits cannot be included since those deposits must be returned if the project is not completed.

How is HVCRE changing bank practices?

Banks are required to report all HVCRE loans in their Schedule RC-R, Part II report and assign them a 150% risk weight. There is no exception for small banks and all loans in existence are subject to the regulations (there is no ?grandfathering? of pre-existing loans). Once a loan is characterized as a HVCRE at origination it maintains that designation until it is converted to a permanent loan, paid off, or the property is sold. No change after origination ? such as cures of an LTV deficiency through rising real estate values or an updated appraisal, additional capital contributions that meet the threshold or early completion of construction ? will remove the designation as a HVCRE loan.

In order for loan documents to be in compliance with the regulations, it is important to keep a few things in mind. First, all LTV and capital contribution requirements should be in the commitment letter and loan documents. The loan documents should require the 15% capital contribution as a condition precedent to the first loan disbursement, and expressly require all contributed or internally generated capital to remain in the project throughout the ?project life?. Further, it may be prudent to add any increased costs borne by the bank as a result of an HVCRE classification to the indemnification provisions of the loan documents. Bear in mind that contractual limitations on distributions from the project set forth in the loan documents may conflict with the borrower?s organization documents, and any discrepancies will need to be analyzed and addressed before loan closing.

The statutes and regulations surrounding HVCRE have been difficult to decipher. In response, the regulators have posted a FAQ page at https://fdic.gov/regulations/capital/capital/faq-hvcre.html regarding the application of HVCRE rules. It is also important to remember that, due to attempts to clear up confusion, regulations and guidance may continue to be updated from time to time. Therefore, they should be referenced regularly in order to account for any changes. In addition, be aware that

banking practices may change as a result, as banks adopt new policies and procedures to conform to the HVCRE requirements. Please feel free to contact a member of Williams Mullen to discuss how these rules impact you or your clients.

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