

# HVCRE Reform Under the Dodd-Frank Deregulation Legislation (2018)

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**PRACTICES** Commercial Real Estate Leasing, Real Estate

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In the past decade, regulated banking organizations under the Federal Deposit Insurance Act seeking to establish acquisition, development, and construction (“ADC”) credit facilities with high volatility commercial real estate (“HVCRE”) exposure (collectively, “HVCRE ADC Loans”) have run up against a rather enigmatic regulatory scheme. The banking community has heavily criticized the post-2008 Financial Crisis reforms, modeled in part after the Basel III Accord (“Basel III”) framework developed by the Basel Committee on Banking Supervision, as it relates to HVCRE ADC Loans for being vague, overly-complex, and burdensome to implement. On May 24, 2018, President Donald Trump signed into law the Economic Growth, Regulatory Relief, and Consumer Protection Act (the “Regulatory Relief Act”).<sup>1</sup> The Regulatory Relief Act seeks to clarify the existing regulatory framework and provide banking organizations with a simpler set of rules for HVCRE ADC Loans.

## Background on Original HVCRE Regulations

Basel III is a regulatory framework that aims to bolster the stability of banking organizations by increasing certain capital requirements based on the Risk-Weighting of Assets (known as “RWA”). Under the RWA model, different asset classes are assigned a particular risk weight. The amount of capital a bank is required to maintain depends on the varied risk weights of its asset portfolio, which is amalgamated and expressed as a capital adequacy ratio. In the United States, substantial elements of Basel III were implemented in the Collins Amendment to the Dodd-Frank Act, and in regulations adopted by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively, the “Original HVCRE Regulations”). The Original HVCRE Regulations created heightened capital reserve requirements of 150 percent for HVCRE ADC Loans. Due to the ostensible vagueness of the Original HVCRE Regulations overall, banking organizations struggled to determine when and if the requirements applied to any given loan. The result was widely varied policies on HVCRE ADC Loans across the banking sector.

## The Regulatory Relief Act

The Regulatory Relief Act attempts to alleviate some of the uncertainty created by the Original HVCRE Regulations. While it leaves the heightened capital requirements at 150 percent for HVCRE ADC Loans, the Regulatory Relief Act amends the Original HVCRE Regulations in four significant ways.

### I. New Exemptions for Income Producing Properties

In response to industry criticism that the Original HVCRE Regulations captured loans on stabilized properties, the Regulatory Relief Act creates two new exemptions from the increased capital reserve requirements for HVCRE ADC Loans. First, a credit facility financing the *acquisition* of an existing income producing property, or refinance an existing income producing property secured by a mortgage, is exempt from HVCRE status if the income produced by the real property is sufficient

to support debt service and pay property expenses.<sup>2</sup> This new exemption allows lenders to avoid HVCRE exposure for loans made to acquire or refinance property with existing rental income. Second, a credit facility financing *improvements* to an existing income producing property is exempt from HVCRE status if the income produced by the real property is sufficient to support debt service and property expenses.<sup>3</sup> This new exemption allows lenders to avoid HVCRE exposure for loans made to perform capital improvements and other upgrades.

## II. Use of Appreciated Value for 15 Percent Exemption

Under the Original HVCRE Regulations, a loan that would otherwise be classified as an HVCRE ADC Loan, could obtain an exemption from the additional capital reserve requirements if the borrower contributed 15 percent or more of the real estate project's appraised "as completed" value prior to the bank advancing any funds (the "15 Percent Exemption"), among other requirements outside the scope of this article. However, only the cash or readily marketable assets the borrower paid for the land or paid toward development costs were considered in the calculation, and the current fair market value of the land was not considered. This cost-based calculation suppressed the true value of the borrower's contribution to a project, and the borrower was forced to inject equity from other sources in order to meet the 15 Percent Exemption. The Regulatory Relief Act now provides that the value of the real property contributed by a borrower to a project is its current appraised value. As such, the new rule permits the borrower to capture the *appreciated* value of the real property in order to meet the 15 Percent Exemption.

## III. Return of Borrower's Equity

The Original HVCRE Regulations created uncertainty about whether income generated by a project utilizing the 15 percent Exemption could be distributed prior to the maturity or the refinance of the loan. The Original HVCRE Regulations appeared to require that both a borrower's 15 percent minimum contributed capital (the basis for the exemption), as well as all of the income internally generated by the project, must remain in the project. The Regulatory Relief Act clarifies that the borrower's minimum 15 percent of capital must be "contractually required to remain in the project..."<sup>4</sup> Under this new rule, income generated by the project may be distributed prior to maturity or refinance provided that the 15 percent minimum capital contribution remains with the project until the project has otherwise been reclassified as a non-HVCRE ADC Loan.

## IV. Removal of HVCRE Designation Prior to Maturity

Under the Original HVCRE Regulations, it was unclear whether lenders had the discretion to reclassify an existing HVCRE ADC Loan as a non-HVCRE ADC Loan after the initial funding. Thus, if using the 15 percent Exemption, a borrower's contributed capital was required to remain in the project until one of three events occurred: (1) conversion of the construction loan to a permanent loan; (2) sale of the project; or (3) refinance of the construction loan. This forced borrowers to refinance the construction loan if they wanted to retrieve their 15 percent contribution prior to one of the aforementioned events. By contrast, the Regulatory Relief Act now clarifies that lenders have the ability to reclassify the HVCRE ADC Loan to non-HVCRE ADC status upon the lender's determination that (i) substantial completion of construction of the project has occurred and (ii) that the cash flow being generated by the project is sufficient to support debt service and property expenses.<sup>5</sup> This new two-prong test provides lenders with the flexibility to terminate the HVCRE ADC designation and release the borrower's additional capital without the need for refinancing. The Regulatory Relief Act also makes it clear that lenders have discretion to determine when and if the two-prong test has been satisfied based on their own underwriting criteria.

It will be interesting to see whether the changes brought about by the Regulatory Relief Act will result in greater consistency across banking organizations in their policies with respect to HVCRE ADC Loans. Regardless, the changes to the Original HVCRE Regulations represent a move by lawmakers in the right direction.

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<sup>1</sup> Economic Growth, Regulatory Relief, and Consumer Protection Act, Sec. 214, § 2155, P.L. 115-174.

<sup>2</sup> *Id.* at §51(b)(2)(C).

<sup>3</sup> *Id.* at §51(c).

<sup>4</sup> *Id.* at §51(b)(2)(D)(iii).

<sup>5</sup> *Id.* at §51(d).