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Greater Clarity Needed For New HVCRE Regulations


By **Mitchell L. Berg**
And **Peter E. Fisch**

The 2008 financial crisis mandated that central banks and banking regulators work together to prevent another global financial meltdown. Many new regulations were proposed and implemented during the ensuing years, both domestically and internationally. In 2010, top bankers and regulators from 27 countries met in Basel, Switzerland, as part of the Basel Committee on Banking Supervision, and agreed on a new system of international regulatory rules known collectively as "Basel III."

One leading goal of the new framework, later amended at a subsequent meeting in 2013, was to make banks more capable of absorbing shocks to the global financial system by increasing capital reserve requirements. Although the Basel III rules were drafted by an international committee, it was up to individual member nations to implement rules that enforced the new regulatory scheme.[1]

PETER E. FISCH *and* MITCHELL L. BERG *are partners at Paul, Weiss, Rifkind, Wharton & Garrison.* XIANG SIOW, *a law clerk at the firm (not yet admitted), and legal consultant* COLLEEN CODEY, *assisted in the preparation of this article.*

In the United States, Basel III-compliant rules were finalized in 2013 and largely took effect in 2014 and 2015. One section of the new regulations addressed what is known as 'HVCRE', or high volatility commercial real estate.[2] The new HVCRE rules require banks to assign a 150 percent risk weight to any HVCRE exposure (up from the 100 percent risk weight assigned under general risk-based capital rules) and cover all acquisition, development, or construction (ADC) loans unless an exception applies. By increasing the risk weight, the applicable loan now counts for 1.5 times the principal amount in calculating the bank's required capital under applicable capital ratios.

> The full impact of the new high volatility commercial real estate (HVCRE) regulations on the commercial real estate industry is still unclear, with banks continuing to develop their positions on the issue and borrowers testing alternatives for their financing needs.

In practical terms, banks now have to hold significantly more capital in reserve for ADC loans than they were required to in the past. The applicability of the HVCRE rules is undesirable both to the banks, which have to retain more capital and thus are limited in making other loans, and to the borrowers, who are confronted either with more expensive debt (in the case where a loan is classified as HVCRE) or with more restrictive loan terms, and in some cases reduced loan proceeds in order to avoid HVCRE exposure.

The HVCRE Rules

The new HVCRE rules apply generally to all commercial ADC loans, with some exceptions. Three general classes of property are excused from the new requirements: (i) one- to four-family residential projects, (ii) investments in community development, and (iii) the purchase or development of agricultural land. In cases where different classes of property exist in one project—a mixed-use commercial and residential project, for example—only the component of the loan being used for HVCRE needs to be considered for the regulatory analysis.[3]

Other commercial real estate loans may still be exempt from the increased capital requirements if such loans are financing projects that meet certain loan-to-value (LTV) and capital contribution requirements. These new requirements were designed to provide protection to the lender by providing a greater margin between the loan amount and value of the project (in other words, a larger equity cushion) and to ensure that the borrower maintains a substantial economic stake in the project.

In order to qualify for this exemption, the LTV ratio of the loan must be less than or equal to the applicable maximum LTV ratio for the particular type of loan, based on current regulations. The LTV ratio for improved property, for example, cannot be greater than 85 percent, while the maximum is 80 percent for commercial and other non-residential construction and 75 percent for land development. In measuring LTV, the value used is the "as-completed value of the project," a value that will typically be lower than the project's "stabilized value," determined after initial lease-up. For HVCRE purposes, the LTV ratio is determined using the appraised value of a property at the time of origination of the loan, and the HVCRE classification will not change in the event the valuation increases during the term of the loan.

In addition, the borrower must make capital contributions equal to at least 15 percent of the "as completed" value. The capital must be in the form of cash or unencumbered marketable assets, including soft costs contributed to the project. Borrowed money, pledged loan collateral, third-party deposits, and governmental or non-profit grants are not considered contributed capital of the borrower. As discussed below, whether or not mezzanine debt or preferred equity will apply toward the 15 percent capital contribution requirement remains unclear. Cash equity that is used to acquire contributed land does count toward the capital contribution requirement, but any land value in excess of the cash investment at the time of the loan is not taken into account.

The new rules further condition the exemption on a two-part requirement. The 15 percent capital contribution rule must be satisfied at loan origination, and prior to the lender advancing any loan proceeds—a borrower cannot later add equity funding to a project to meet the 15 percent requirement. Consequently, a borrowers obligation to fund equity during the administration of the loan will not be taken into account in making the HVCRE determination.

Additionally, according to the rule, the contributed capital is "contractually required" to remain in the project through the "life of the project," either when the ADC loan is paid off or when the ADC loan converts to a permanent loan (the regulations generally provide that a loan can be converted to a permanent loan "when it is converted to permanent financing in accordance with the banking organization's normal lending terms."[4])

As a result of this requirement, covered loans typically include covenants requiring all capital to remain in the project for the life of the loan. As discussed below, this requirement may also cover any net cash flow internally generated by the property. Consequently, borrowers in these types of loans are typically restricted in their ability to make distributions during the life of the loan.

Effects of the HVCRE Rules

The new HVCRE rules have had a significant impact on the lending climate for commercial real estate projects. Borrowers and lenders both are heavily incentivized to avoid classification of their loans as HVCRE loans. However, the regulations lack clarity on certain issues, and insufficient time has passed for a defined market standard to emerge on some of these issues. Some lenders interpret the rules more conservatively than others, and for certain types of loans the lack of clarity in the regulations and the impact of HVCRE classification has been driving borrowers to lenders who are not subject to the Basel III regulations (such as private equity lenders and insurance companies).

Some lenders, burdened by increased capital requirements for loans that do not fall under the HVCRE exceptions, have passed on their increased costs to borrowers in the form of higher interest rates. In addition, the restrictions imposed by lenders in order to comply with the HVCRE exceptions, coupled with the lack of clear authority behind the restrictions, can result in contentious negotiations between lenders and borrowers as they attempt to narrow and define the restrictions.

One area of continuing uncertainty in the regulations is whether mezzanine debt and/or preferred equity counts toward the HVCRE capital contribution requirement. Even though a mezzanine loan technically is contributed to a mortgage borrower as equity vis-à-vis a mortgage lender, many lenders interpret the regulations as meaning that mezzanine loan proceeds do not apply toward the capital contribution requirement.

Preferred equity can be structured to look more like equity and less like debt, and some practitioners believe that preferred equity that is structured more like equity should be treated similar to common equity in determining whether the 15 percent capital contribution requirement is met. However, without any clear guidance from regulators, many lenders will have difficulty making that determination.

Similarly, the requirement that all equity stay in the project for the life of the loan has created uncertainties. The language of the regulation requires that "capital contributed by the borrower, or internally generated by the project, is contractually required" to remain in the project.[5] Under the language of the regulation, net operating income generated by the property is not explicitly required to remain in the project. Nevertheless, it appears that most banks are requiring borrowers to keep both capital and net cash flow in the property. In general, it is not entirely clear the extent to which lenders are required to restrict distributions on account of this requirement, and more specific guidance has not been provided. For example, would a distribution to a mezzanine borrower to pay debt service be restricted? What about the payment of a market development fee or management fee to a principal of the buyer? Different lenders may take varying positions on these issues.

Occasionally, these restrictions on distributing cash are drafted by prohibiting distributions only to the extent they would violate the HVCRE regulations, which allows the lender and the borrower to benefit from a change in the regulations or any clarifications provided from time to time but does not create clarity in the first instance. Note that the consequence of a distribution in violation of the loan covenant need not be a borrower default, but can instead be limited to an obligation to compensate the lender for its loss of profit on the loan resulting from the increased capital requirements (such as an increase in the loan spread).

An additional effect that the HVCRE rules may have on the market is to encourage borrowers contributing appreciated land to look elsewhere for financing. A borrower holding a development parcel for a long period of time may have very little cash invested, and under normal circumstances, the appreciated value of the land might be sufficient from an underwriting standpoint to constitute most or all of a borrower's equity. However, without 15 percent cash equity, the loan would be subject to HVCRE restrictions. Given the limited universe of lenders active at any given time in providing construction financing, this can be highly problematic for developers.

Conclusion

The full impact of the new HVCRE regulations on the commercial real estate industry is still unclear, with banks continuing to develop their positions on the issue and borrowers testing alternatives for their financing needs. This lack of clarity should dissipate over time as market practice develops and if regulators issue guidelines and clarifications that provide more direction to lenders and borrowers.

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2. Department of the Treasury & Federal Reserve System, "Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Capital Adequacy, Transition Provisions, Prompt Corrective Action, Standardized Approach for Risk-weighted Assets, Market Discipline and Disclosure Requirements, Advanced Approaches Risk-Based Capital Rule, and Market Risk Capital Rule" (Federal Register, Vol. 78, No. 198) (Oct. 11, 2013) ("Regulatory Capital Rules") (https://www.gpo.gov/fdsys/pkg/FR-2013-10-11/pdf/2013-21653.pdf).
3. Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Regulatory Capital: Frequently Asked Questions—High Volatility Commercial Real Estate (HVCRE) Exposures (April 6, 2015) (https://www.fdic.gov/regulations/capital/capital/faq-hvcre.html.
4. Ibid.
5. Regulatory Capital Rules.