

What You Need to Know About the Reformed HVCRE Rules

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On May 24, 2018, President Trump signed into law the “Economic Growth, Regulatory Relief, and Consumer Protection Act” (S. 2155), which reformed the widely unpopular rules relating to High Volatility Commercial Real Estate (“HVCRE”) loans. Below is a brief summary of some of the key changes to the HVCRE rules that will impact lending practices with respect to acquisition, development and construction loans.

1. Equity is no longer unreasonably trapped in the project.

Previously: All contributed capital, including all internally generated capital, had to remain in the project. The previous rules trapped any capital a borrower contributed to the project, even if in excess of its requirement to contribute capital of at least 15 percent of the real property’s appraised, as completed value (the “Borrower’s Minimum Capital Contribution Requirement”), which penalized over-capitalized projects. It also trapped all internally generated capital from the project, including all net operating income and any other distributable funds generated by the project, which penalized better-performing projects. So, while the purported goal of the previous rules was to ensure borrowers had skin in the game when dealing with risky highly volatile commercial real estate, the previous rules actually resulted in better capitalized and performing projects being forced to have more skin in the game, which was at best unfair and at worst antithetical to the purported goal.

Now: Only capital equal to 15 percent of the real property’s appraised, as completed value (tested at closing) is required to remain in the project, and this is only until the loan has been reclassified as a Non-HVCRE ADC Loan (see # 2 below for information on such reclassification). This change alone relieves much of the consternation associated with HVCRE, as it means that now, even prior to re-classification, borrower may make distributions so long as the 15 percent minimum equity rule continues to be satisfied. This is of great help for loans that may be classified as an HVCRE ADC Loan even though the financed project already may generate sufficient net operating income prior to completion of the contemplated improvements (e.g., a multi-phased project, a value-add project, etc.).

2. It is now much easier to reclassify a loan as a Non-HVCRE ADC Loan.

Previously: No distributions were permitted until the loan was either converted to permanent financing, sold or paid in full. The ambiguity around how a loan could be converted to a permanent loan created undue burdens on borrowers and lenders alike, with borrowers either being forced to refinance loans upon completion and stabilization or being subject to stringent conversion requirements built into the loan (effectively requiring a re-underwriting of the loan using the same criteria for a permanent loan). Even with this, lenders faced uncertainty as

to how the regulators would treat a loan so converted.

Now: A loan can be reclassified by a lender as a Non-HVCRE ADC Loan once the project has been substantially completed and has stabilized such that the cash flow generated by the project satisfies the minimum debt service requirements, in each case using the lender's underwriting criteria for permanent financing. This means that it is now much easier for a lender to determine when it can re-classify a loan by simply inserting a substantial completion and a debt service threshold condition into the loan agreement at closing which is consistent with the lender's substantial completion and debt service thresholds for permanent loans. Once those conditions are satisfied, the loan is then considered a permanent loan (without having to amend or restate the loan documents) and there are no further HVCRE related conditions or restrictions against distribution (i.e., the above described 15 percent equity rule no longer applies).

3. Borrowers can count the appraised value of property to satisfy Minimum Capital Contribution Requirement.

Previously: In order to satisfy Borrower's Minimum Capital Contribution Requirement, lenders could only count capital in the form of cash, unencumbered readily marketable assets, paid for, out-of-pocket development expenses and/or cash paid for the real property. This meant that only the actual cost of the project (acquisition, improvement costs etc. previously incurred by the borrower) could count toward satisfaction of the 15 percent contributed equity requirement. Lenders could not use the current, appraised value of that project. This appeared to be an artificial and unrealistic restriction and was also a source of frustration and challenge for borrowers and lenders alike.

Now: The reformed rule is identical to the previous rule; however, instead of only counting cash paid for the real property, lenders can count the appraised value of the real property toward borrower's satisfaction of the Borrower's Minimum Capital Contribution Requirement. This is a significant improvement in the rule and a better reflection of reality with respect to the amount of equity actually being contributed.

4. Loans made prior to January 1, 2015, are now excepted from the HVCRE rules.

Previously: HVCRE rules applied to loans that were made prior to January 1, 2015 (the effective date of the Final Rule). This was fundamentally unfair as it required lenders to suddenly categorize certain pre-existing loans as having HVCRE exposure and to assign such loans a heightened risk weight unless such loans met one of a handful of exemptions (which was unlikely given that such loans were negotiated and closed without any knowledge of the future HVCRE rules).

Now: Any loan made prior to January 1, 2015, is excluded from the definition of an HVCRE ADC Loan and lenders do not have to assign a heightened risk weight to the same.

5. Loans with tenant improvement holdbacks are no longer HVCRE ADC Loans.

Previously: A loan for minor capital or tenant improvements, where the project was cash flowing on day one, could still be required to be classified as having HVCRE exposure. Again, this required lenders and borrower to negotiate a myriad of terms and conditions in an effort to address HVCRE, many times for a loan that should never

have been classified as having HVCRE exposure but for the poorly drafted regulation.

Now: Loans for the acquisition, refinancing of existing income-producing real property “where 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” are expressly excepted from the definition of HVCRE ADC Loan. (This rule is similar to the reclassification rule set forth in paragraph 2 above, removing only the substantial completion requirement).

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