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CLIENT ALERT

ECONOMIC GROWTH ACT PROVIDES SOME HVCRE RELIEF FOR REAL ESTATE LENDERS AND DEVELOPERS

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Since the implementation of regulations carrying out the 2010 Dodd-Frank reforms, U.S. banks have been subject to a heightened risk rating and certain "gold-plated" capital requirements for exposure to high volatility commercial real estate ("HVCRE") loans. President Trump recently signed the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Act") into law, and some less-publicized provisions of the Act provide guidance and relief from the onerous HVCRE capital requirements.

HVCRE PRIOR TO THE ACT

Under prior regulations, banks were required to hold 50% more capital against loans deemed HVCRE. Generally speaking, an HVCRE loan was any credit facility for the acquisition, development, or construction of real property (i.e., a construction loan as opposed to a permanent or standing loan). The breadth of this regulatory treatment led commercial lenders to consistently mandate that borrowers qualify for one of several exceptions to HVCRE status, such as (i) having a loan-to-value ratio under the standard provided for commercial real estate lending by the OCC (typically 80%); or (ii) more commonly, requiring that the borrower contribute (and maintain throughout the life of the loan) cash equity equal to at least 15% of the appraised "as-completed" value of the project, based on an appraisal performed prior to advancing loan proceeds.[1] This second exception was particularly restrictive because it did not permit inclusion of any appreciated value as evidenced by a later appraisal, and agencies interpreted it to prohibit distributing equity even if the equity percentage post-distribution remained above 15%.

CHANGES MADE BY THE ACT

The Act eases HVCRE regulations in three primary ways: (i) fewer loans will be subject to HVCRE treatment; (ii) it allows updates to the 15% cash equity calculation; and (iii) it provides for the conclusion of HVCRE status prior to a refinancing.

Specifically, Section 214 of the Act requires that, prior to receiving HVCRE treatment, the loan must be an "HVCRE ADC" ("ADC" standing for acquisition, development, and construction) facility. An HVCRE ADC loan is one that "(A) ***primarily*** finances, has financed, or refinances the acquisition, development, or construction of real property; (B) has the purpose of providing financing to acquire, develop, or improve such real property ***into*** income-producing real property; and (C) is ***dependent upon future income*** or sales proceeds from, or refinancing of, such real property for the repayment of such credit facility."[2] (emphasis added). By including the word "primarily", the Act excludes from HVCRE treatment an entire category of partial development or renovation credit facilities. Further, HVCRE treatment applies only if the project is singularly dependent on future, and not current, income.

Under the Act, a borrower may continue to qualify for the 15% cash equity exception even if it distributes revenue during the term of the credit facility, so long as the equity percentage remains above the 15% threshold. Further, by obtaining an updated appraisal, the parties may include appreciated land value in the equity calculation.

Finally, HVCRE status applied under the prior regulations until the ultimate refinancing or conversion of the credit facility into a permanent loan (i.e., a loan expected to be repaid from

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[1] Additional, but less utilized, exceptions to HVCRE treatment were available for one-to-four family residences, qualified "community development" investments, and agricultural land. *See* 12 C.F.R. § 3.2 (2017). These exceptions are unchanged under the Act.

[2] Pub. L. No. 115-174, § 214, 132 Stat. 1296, 1321 (2018).

existing, rather than future, cash flow). Now, the Act permits a change in status prior to such refinancing or conversion, upon "(1) the substantial completion of the [project]...; and (2) cash flow being generated by the real property being sufficient to support the debt service and expenses of the real property, [each] in accordance with the [lender's] applicable loan underwriting criteria for permanent financings.[3] In other words, so long as the lender determines that the project would qualify for permanent financing based on existing cash flow, it may be removed from HVCRE status before the permanent financing is actually obtained.

CONCLUSION

The Act's authors titled the HVCRE changes "Promoting construction and development on Main Street." Political spin aside, as commercial real estate lenders understand and implement the HVCRE provisions of the Act, developers will undoubtedly find capital for real estate projects somewhat easier to obtain with fewer covenants during the life of the loan.

ADDITIONAL INFORMATION

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[3] *Id*. At 1322.