Congress Introduces Bill to Clarify HVCRE Loans

Last week, Congressmen Robert Pittenger (R-NC) and David Scott (D-GA) introduced proposed amendments to the Federal Deposit Insurance Act (H.R. 2148) to clarify banks' capital requirements for certain acquisition, development and construction loans. As part of the rules implementing Basel III, commercial banks with over $50 billion in assets are required to reserve 50% more of their capital for commercial real estate loans constituting "High Volatility Commercial Real Estate" ("HVCRE") than they are required to reserve for non-HVCRE loans. This requirement, in effect since January 1, 2015, has translated into banks charging borrowers higher interest rates for loans classified as HVCRE. The problem for the finance industry the last two years has been the difficulty in determining which loans are deemed HVCRE. Under the regulations, any loan used for the acquisition, development or construction of real property is deemed HVCRE unless it falls under one of a handful of enumerated exclusions. Unfortunately, the breadth of the reach of the regulations – any acquisition, development or construction loan – combined with the ambiguity in the language of the enumerated exclusions, has led many commercial banks to pull back significantly (or in some cases altogether) on their origination of new construction loans.

The bill aims to alleviate some of this ambiguity in three significant ways:

1. Exempting from the HVCRE regulatory regime the following loans:

   A. All loans made prior to January 1, 2015;

   B. Loans used for the acquisition or refinance of existing income-producing real property;

   C. Loans used to fund renovations to existing income-producing real property;

2. Allowing borrowers to apply a property's appraised value toward the requirement that a borrower contribute capital of at least 15% of a property's "as completed" value;

3. Allowing loans to exit the HVCRE regulatory framework upon completion of construction and the commencement of cash flow sufficient to support the debt service and other property expenses rather than having to wait until the construction loan is refinanced with a permanent loan.

The bill has been widely welcomed within commercial real estate circles (thirteen real estate and finance trade organizations signed a letter to Pittenger supporting the bill), especially the language allowing borrowers to use a land's appreciated value toward the 15% equity requirement.

However, the bill does not address a number of other aspects of the regulatory framework that have been frequent targets of criticism from both lenders and borrowers. For instance, the bill does not address whether mezzanine loans or preferred equity count toward the 15% borrower equity requirement. In addition, the bill continues to base the 15% borrower equity requirement on the "as-completed" value of the property. This is a one-time test that does not allow for the possibility of loans to exit the HVCRE framework upon a post-closing reappraisal. Perhaps more importantly, and as many banks and commentators have noted, the "as-completed" leads to the inconsistent outcome of a borrower having to contribute more equity for a property pre-leased to a creditworthy tenant than for a ground-up development with no pre-leasing.

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Eric D. Lemont is a partner in the Real Estate Department of our Boston office. Mr. Lemont's practice focuses on a wide variety of commercial real estate transactions, including acquisitions and sales across various property types (office, retail, industrial, multi-family and hospitality), joint ventures, and mezzanine, construction and permanent financings. His clients include developers, real estate funds, REITs, insurance companies, institutional investors, and owner/operators.

The author can be reached at elemont@sandw.com.