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High Volatility Commercial Real Estate: Loan Document Considerations

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As of January 1, 2015, global Basel III regulations and the Dodd-Frank Wall Street Reform Consumer Protection Act required banks in the United States to comply with certain new capital rules and regulations.

Among other requirements, these rules and regulations added High Volatility Commercial Real Estate (HVCRE) as a new risk-weight category, requiring banks to hold more capital for loans meeting the definition of HVCRE. HVCRE loans must be reported separately from other commercial real estate loans and require a risk-weight of 150 percent, which is 50 percent higher than other commercial real estate loans.

Although the regulations have been in place for more than a year, we are finding that many of our bank clients have not taken the necessary steps to reduce the capital impact that would otherwise be imposed by HVCRE loans.

Generally speaking, the HVCRE designation applies to any credit facility that, prior to the conversion to permanent financing, finances or has financed the acquisition, development or construction (ADC) of real property. If an ADC loan is exempt from the HVCRE designation, the new 150 percent risk-weight does not apply. Therefore, it becomes important to structure ADC loans so that they satisfy an available exemption.

An ADC loan can be exempt from the HVCRE designation in four primary ways. The loan is exempt if (1) it is secured by one-to-four family residential projects; (2) it is secured by a property that would qualify as an investment in a community development project; (3) it is secured by agricultural land and is used for the purchase or development of land that will or can be used for agricultural purposes; or (4) it meets all aspects of the three-prong test below.

If a commercial real estate loan fails to satisfy another exemption but meets all of the following requirements, it is not considered an HVCRE loan and is therefore not subject to the 150 percent risk-weight:

1. The project's loan-to-value ratio must be less than or equal to the maximum supervisory limits set forth in applicable regulations. Note: This ratio varies by loan category.
2. The borrower must have contributed capital to the project <u>prior to the advancement of funds</u> in an amount that is at least 15 percent of the project's "as completed" appraised value. Note: Certain assets are not eligible to count as contributed capital.
3. Borrower-contributed capital must be <u>contractually required</u> to remain throughout the life of the project.

To ensure that an ADC loan does not become an HVCRE loan, the loan agreement should include certain provisions addressing the above exemption requirements. The loan agreement should be clear that no funds will be advanced unless and until the required 15 percent capital investment has been made. Further, it should include a provision requiring borrower-contributed capital to remain in the project for the applicable time period. Finally, the loan agreement should also include a covenant prohibiting the borrower from taking any action that would cause the loan to fail to meet the exception criteria.

If you have any questions regarding HVCRE issues or any other commercial real estate or secured lending issue, or need assistance in updating your loan agreement provisions, please contact the authors of this alert, your regular Baker Donelson attorney or any of our Real Estate Finance attorneys.