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The National Law Review

CHANGES TO HIGH VOLATILITY COMMERCIAL REAL ESTATE CAPITAL REQUIREMENTS

Monday, June 25, 2018

The Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Act"), signed into law on May 24, 2018, with immediate effect, amended multiple provisions of Dodd-Frank, including the capital requirements for loans secured by High Volatility Commercial Real Estate ("HVCRE"). The higher capital requirements for HVCRE are part of the post- crisis financial market reforms and were implemented by U.S. bank regulators in 2015. While the Act does not remove the HVCRE heightened capital requirement, it amends the approach in several important ways that limit the scope of its application and relieve some of the burdens of the requirements on lenders and borrowers.

HVCRE heightened capital requirements in effect under U.S. banking regulation require that a 150 percent risk weight be assigned to loans that finance the acquisition, development or construction of real property. The requirement generally excludes certain enumerated categories, including 1-4 family residential loans, agricultural loans, community development and commercial real property projects that meet specified loan-to-value and borrower contribution requirements. The result for covered loans is 1.5 times the capital requirement that would otherwise be applicable to the lending bank for a non-HVCRE loan, and the accompanying cost and credit availability effects on commercial real estate borrowers. The Act features several important changes and clarifications to the HVCRE requirements, including:

- The prior requirement, implemented in 2015, was not explicitly limited to loans made after it became effective. The Act includes an explicit exclusion for any loan made prior to January 1, 2015.
- The Act creates a new defined term "HVCRE ADC Loan" (High Volatility Commercial Real Estate Acquisition, Development or Construction loan), which is narrower than the pre-existing HVCRE category, in that the loan must also "primarily" finance the acquisition, development or construction of real property, have the purpose of financing the conversion to income-producing real property and be dependent on future income (versus in place income) or proceeds from the real property. Improvements to existing income-producing real property would not be covered if the cash flow already generated by the existing real property is able to cover debt service and expenses.
- Under the existing requirement, the Act limits the types of borrower contributions that can be considered for satisfying the 15 percent threshold for exclusion from HVCRE heightened capital. Significantly, the Act allows the use of the appraised value of any land contributed to the project, meaning that borrowers can now get credit for appreciation of contributed land above the purchase price paid.
- Finally, the Act creates a more flexible off ramp from HVCRE treatment. Under the previous regime, the heightened requirement would remain in place until replacement with permanent financing. The Act allows "reclassification" to a non-HVCRE loan upon substantial completion of

the project or the point at which cash flow from the real property becomes sufficient to cover the debt service and expenses.

While the HVCRE requirements are still an important potential financing difficulty to consider when evaluating a project, the changes accomplished by the Act are a helpful development to limit the scope and duration of application of the heightened capital requirements.