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Understanding the HVCRE regulation and its impact

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The High Volatility Commercial Real Estate (HVCRE) regulation is a Basel III reform aimed at strengthening risk management in the banking sector. Basel III regulations require banks to maintain enough capital to sustain themselves during economic downturns. The capital required depends on the level of risk a bank exposes itself to. Under Basel III, most loans are assigned a risk weight of 100%, but an HVCRE loan is assigned a risk weight of 150%. Essentially, the bank is required to maintain 50% more capital to protect itself due to the high-risk nature of the loan.

Subject to certain exceptions, the regulation defines an HVCRE loan as one that, "prior to conversion to permanent financing, finances or has financed the acquisition, development, or construction (ADC) of real property." An ADC loan can avoid HVCRE classification if all three of the following requirements are met:

1. The loan-to-value (LTV) ratio does not exceed the applicable regulator's maximum (e.g., 80% for commercial construction loans);
2. The borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development costs out-of-pocket) of at least 15% of the real estate's appraised "as completed" value; and
3. The borrower's 15% capital is contributed to the project before the bank advances any loan proceeds, and such capital is contractually required to remain in the project until the loan is converted to permanent financing, sold, or paid off.

Examining each requirement individually, the first requirement is typically satisfied because banks rarely extend credit at a ratio exceeding 65-70%. However, if a bank does extend credit at a high LTV ratio, the loan would retain HVCRE status even if a later increase in the property's value brought the ratio below 80%.

Turning to the second criterion, the borrower's contributed capital must be 15% of the property's "as-completed" value, meaning its expected market value as of the time development is completed. Land contributed to a new development counts toward the 15% contribution; however, its value is the amount the borrower paid for the land, not the land's value at time of the loan. The contribution may also consist of "soft costs" such as interest, brokerage fees, and marketing expenses. However, it may not include assets pledged as collateral, purchasers' deposits on condominium units, second mortgages, or government or nonprofit grants. These restrictions ensure that the borrower has a sufficient economic interest in the property and protect banks against loss due to overruns or a failed project.

The third criterion requires the borrower to contribute 15% capital before the bank advances funds.

Otherwise, the loan is an HVCRE loan and no subsequent contribution will reverse this classification. If the borrower makes the contribution on time, the contribution must also be "contractually required" to remain in the project. This means "the loan documentation must include terms requiring that all contributed or internally generated capital remain in the project throughout," and ensures that the borrower maintains an economic interest in the property. Finally, the issuance of a certificate of occupancy does not transform an HVCRE loan into permanent financing. The loan retains HVCRE status until it is converted to permanent financing in accordance with the bank's usual lending terms or is paid in full.

The regulation also affects existing bank loans. Previously issued ADC loans are not "grandfathered in," so banks must determine whether their existing loans pass the HVCRE test. Existing ADC loans that do not meet the exemption criteria must now be treated as HVCRE loans.

Overall, it is in both banks' and borrowers' best interest to avoid HVCRE classification whenever possible. Otherwise, the increased capital requirements impose a hefty burden on the bank. The loan documentation may authorize the bank to pass along its increased costs to the borrower. However, even if the bank is authorized to pass expenses along, doing so may adversely affect the bank's ability to compete with other lending institutions (e.g., nonbank lenders, to whom the HVCRE regulation does not apply). Consequently, the regulation may cause banks to reallocate capital away from ADCs, limiting the financing available for commercial real estate.

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