Relax! Navigating High Volatility Commercial Real Estate Exposure Just Got Easier

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In analyzing the causes and effects of the 2008 financial crisis, banking regulators concluded that banks were not adequately capitalized to support many of their lending practices, including making high volatility commercial real estate (HVCRE) loans. In response, regulations required banks to carry a heightened risk weight of 150% for HVCRE loans; increasing capital reserves ensured that banks were adequately capitalized. While the intentions of the regulations were to protect both banks and borrowers, many banks reacted by reducing the number of HVCRE loans in their portfolios because they felt the regulations were too restrictive.

2018 brought reform to the HVCRE loan regulations by way of the enactment of the Economic Growth, Regulatory Relief, and Consumer Protection Act (the "Act"). The Act loosened restrictions on HVCRE loans and provided some relief for those banks making HVCRE loans. Additional changes to HVCRE loan regulations are on the horizon. On November 20, 2019, the Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Company (FDIC) jointly issued a final rule to amend the definition of an HVCRE exposure under Section 214 of the Act. The revised definition aims to clarify certain terms generally consistent with their usage in the Call Report instructions, and to clarify the capital treatment of loans which finance one to four family residential properties and the development of land.

<u>HVCRE Exposure</u>

The preceding definition of HVCRE exposure applied to loans that financed the acquisition, development, or construction of real property. However, the new definition is applicable only to loans that *primarily* finance the acquisition, development, or construction of real property. Under the final rule, classification as an HVCRE exposure requires satisfaction of three criteria: (1) the loan "must primarily finance or refinance the acquisition, development, or construction of real property"; (2) the purpose of the loan "must be to provide financing to acquire, develop, or improve such real property into income-producing real property"; and (3) the repayment of the loan "must depend on future income or

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sales proceeds from, or refinancing of, such real property." According to regulators, loans that finance land development projects should be assigned a higher risk weight because these types of loans, in some cases, do not generate cash flow and require cash for debt service from other sources. Thus, loans classified as an HVCRE exposure carry a heightened risk weight of 150%.

HVCRE Exposure Exclusion

Exclusion from an HVCRE exposure may be permitted if the loan is made to finance the acquisition, development, or construction of: (1) one to four family residential properties; (2) community development projects pursuant to the Community Reinvestment Act (CRA) regulations; (3) agricultural land, which has the same meaning as "farmland" in the Call Report instructions; (4) existing income-producing real properties qualifying as permanent financings; and (5) certain commercial real property projects. Loans financing a commercial real property project must satisfy four specific criteria to be eligible for exclusion from the amended HVCRE exposure definition. First, the loan-to-value ratio must be equal to or less than the applicable supervisory maximum. Second, the borrower must make a capital contribution equal to at least 15% of the subject property's appraised "as completed" value. Third, the borrower's 15% capital contribution must be made prior to the advancement of funds. Finally, the loan documentation must require the borrower's 15% capital contribution to remain in the project until the loan qualifies as a non-HVCRE exposure. Importantly, loans that meet the amended HVCRE exposure definition and qualify for HVCRE exposure exclusion will receive a 100% risk weight while those loans that meet the amended HVCRE exposure definition but do not qualify for HVCRE exposure exclusion will receive a heightened risk weight of 150%. Additionally, the revised definition of HVCRE exposure excludes any HVCRE loan made before January 1, 2015.

The final rule becomes effective on April 1, 2020, at which time all outstanding HVCRE exposure-related FAQs will be rescinded.