# New HVCRE Rules May Allow Borrowers to Reduce Borrowing Expenses

By Alan Mark

Implemented by the Federal bank regulators in 2015 under the Dodd-Frank reform legislation, the original HVCRE Rules ("HCVRE I") imposed constraints on bank funded real estate loans. HVCRE I required commercial lenders to assign 150% risk weighting (i.e. 12% vs 8% for non-HVCRE loans)[1] to HVCRE loans which in turn resulted in increased borrowing costs (i.e. interest) charged to the borrower to offset the economic impact on lenders due to the increased reserve requirements. Under HCVRE I, a loan, other than "permanent loans"[2] would be treated as an HVCRE loan if it financed the acquisition, development or construction of real estate and once so classified would remain subject to HVCRE until maturity or conversion to permanent loan status. The HVCRE I rules did, however, provide exceptions for loans relating to:

- 1-4 family residential property;
- Agricultural land; and
- Commercial real estate where the loan to value ratio did not exceed regulatory standards, the borrower contributed capital (cash or property valued at its cost) before lender advances of at least 15% of the "as completed" value of the property, and all contributed capital (including capital in excess of the 15% level) and subsequent project earnings were not distributable to owners until and unless the loan converted to permanent financing.

HVCRE I also created reporting/classification problems for lenders due, to among other things, uncertainty as to the rules' pre-2015 retroactive applicability and uncertainty as to what would qualify as permanent financing. For borrowers, HVCRE meant either increased borrowing costs or "lock-up" of all project capital and earnings (generally reflected in loan agreement negative covenants) to maintain its HVCRE exception status so long as the loan otherwise remained subject to being classified as an HVCRE loan.

In late May 2018, Congress adopted and the President signed the Economic Growth, Regulatory Relief and Consumer Protection Act, which among other things, recast the HVCRE rules ("HVCRE II") to address some of the perceived shortcomings and overreach of HVCRE I.[3]

While the new law retained the 150% risk weighting, it fine-tuned the category of covered loans – now designated "HVCRE ADC loans." Covered HVCRE loans are now loans whose "primary purpose"[4] is to provide financing for acquisition, development or improvement of real estate into an income producing asset where loan repayment is dependent on <u>future</u> leasing/sale income or refinancing. Loans which are supported by <u>current</u> income generated from the financed project are not subject to the increased risk weighting. Additionally, the HVCRE exception conditions were also eased to provide that appreciated land value, as opposed to borrower cost, could be taken into account for the 15% capital contribution requirement and contributed capital in excess of the 15% minimum and project earnings could now be distributed to owners without losing HVCRE excepted status. HVCRE II also clarified that pre-2015 loans were not subject to HVCRE and that loans initially subject to HVCRE could be reclassified as no longer subject to HVCRE upon achieving substantial completion and positive cash flow.

HVCRE II may offer borrowers the opportunity to modify existing loan covenants restricting project distributions and may even allow borrowers the opportunity to seek interest rate adjustments once the financed project is substantially complete and achieves positive cash flow due to lower lender non-HVCRE reserve requirements.

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[1] - The 150% risk weighting was the same as required for delinquent loans.
[2] - Generally speaking loans with longer maturities and no future draw availability.

[3] - The Act's applicable section (214) was captioned "Promoting Construction and development on Main Street."
[4] - The definition of primary purpose remains to be flushed out.