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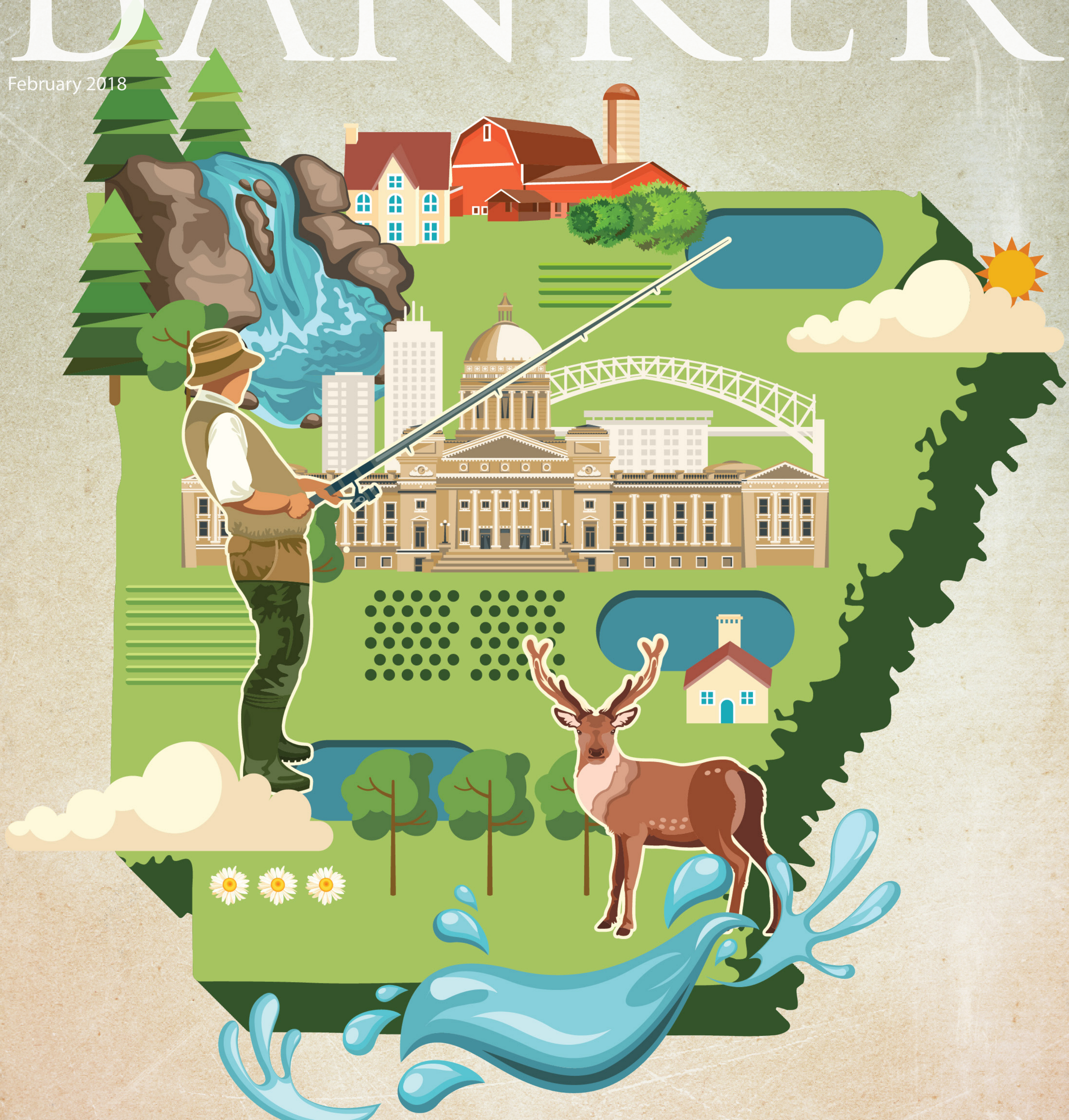

The Convention Issue

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HVCRE Lending:
Understanding the Regs & Upcoming Changes

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Changes may soon be made to the High Volatility Commercial Real Estate ("HVCRE") loan regulations that would ease borrower capital contribution requirements and allow exemptions for properties already producing income. There are competing proposals. One has passed in the House and is sitting in the Senate, the other has been proposed by the federal banking agencies but has not yet been adopted. Below is an overview of HVCRE rules today and the proposed changes that could occur.

WHERE DOES HVCRE STAND TODAY?

A loan is an HVCRE loan if "prior to conversion to permanent financing, [it] finances or has financed the acquisition, development, or construction ("ADC") of real property." If a loan is classified as an HVCRE loan, it will be assigned a risk weighting of 150%, instead of the normal risk weighting of 100%. The net effect is to lower a bank's return on capital. If a loan qualifies as HVCRE, a bank has to choose between requiring additional equity from the borrower or charging greater interest to offset the increased capital costs.

For an ADC loan to be excluded from HVCRE – the loan must satisfy each of the following:

- Loan-to-value ratio must be less than or equal to the applicable maximum ratio prescribed by bank regulators;
- Borrower must have contributed capital to the project of at least 15% of the real estate's "as completed" value, based on a current appraisal; and
- Borrower must contribute the capital prior to the bank funding the loan, and the capital contributed by the borrower, or internally generated by the project, must be contractually required to remain in the project until the loan is converted to permanent financing.

WHAT CAPITAL CONTRIBUTIONS QUALIFY?

Qualifying capital contributions may include, unencumbered land, cash expended to acquire a site (including engineering or permitting expenses directly related to the project), and soft costs that contribute to the "completion and value of the project" as long as they are commercially reasonable and paid by the borrower. Examples of soft costs include interest and fees related to pre-development expenses, developer fees, leasing expenses, feasibility studies, brokerage commissions, and management fees. While cash equity used to acquire contributed land counts toward the capital contribution requirement, any land value in excess of the cash investment at the time of the loan is not taken into account. A bank should document the details pertaining to the amount of cash paid for the land and the soft costs used to meet the capital contribution requirement.

In order to meet the capital contribution requirement, the loan documents must include terms requiring that all contributed or internally generated capital remain in the project throughout the life of the project. The borrower must not have the ability to withdraw either the capital contribution or the capital generated internally by the project prior to obtaining permanent financing.

WHAT IS NOT CONSIDERED AN ELIGIBLE CAPITAL CONTRIBUTION?

Eligible capital contributions do not include borrower-owned real estate from an unrelated project pledged to the subject project; purchasers' deposits on units in a condominium project; financing from an external lienholder, such as a second mortgage; assets contributed to the project after the advancement of funds; cash received in the form of grants, regardless of whether the grant is received from nonprofit organizations, municipalities, or government agencies; any contribution that may be withdrawn by the borrower prior to the borrower obtaining permanent financing; and proceeds from a separate loan used to finance the project.

ARE THERE OTHER EXEMPTIONS TO HVCRE?

In addition to the capital contribution exemption, other HVCRE exemptions include loans for 1-4 family residential properties; the purchase or development of agricultural land for agricultural purposes provided the valuation of the agricultural land is based on its value for agricultural purposes and the valuation does not take into consideration any potential use of the land for non-agricultural commercial development or residential development; and qualified investments in community development.

WHAT ARE THE PROPOSED CHANGES TO HVCRE REGULATIONS?

On November 8, 2017, the House passed H.R. 2148. If the Bill passes the Senate unchanged and is signed into law, loans will not be classified as HVCRE if the property is producing enough income to satisfy the bank's debt service requirements and pay expenses related to the property, regardless of whether the loan meets the bank's standards for permanent financing. This exemption would exclude several loans that are used to renovate or improve existing income producing property. Banks could also reclassify an existing HVCRE

loan to non-HVCRE if the property can cover the debt service and the expenses related to the property. The Bill would ease capital requirements by allowing a borrower to use the appreciated value of the real property in calculating the 15% capital contribution requirement for an exemption to HVCRE. Finally, the proposed Bill would exempt loans made prior to January 1, 2015.

If H.R. 2148 does not pass, the federal banking agencies have another proposal which can be found in Simplifications to the Capital Rule Pursuant to the Economic Growth and Regulatory Paperwork Reduction Act of 1996. The proposed regulation would reduce the current HVCRE risk weight requirement from 150% to 130%, but it would also remove the capital contribution exemption. Removing the capital contribution exemption could increase the number of loans subject to the new High Volatility Acquisition, Development and Construction ("HVADC") loan definition. HVADC would apply to new loans that "primarily finance" the acquisition of vacant or developed land, the development of land to erect new structures (including infrastructure), or the construction of buildings or dwellings. Fifty percent (50%) of the loan proceeds would need to be used for acquisition, development, or construction to be classified as HVADC. An HVADC loan would switch to "permanent financing" if the loan is prudently underwritten and the property has sufficient income to pay the debt service.

We will have to wait and see if either of the new regulations are passed, but if they are, there should be some relief to the current HVCRE restrictions.

Daniel Beck is a transactional attorney with Quattlebaum, Grooms & Tull PLLC, who primarily practices in the areas of banking law and real estate.

Hear about HVCRE Lending & more at the half-day CRE Lending Legal Due Diligence Workshop on March 15!

MILLENNIAL MINUTE

ZAC PRICE

Bank

First National Bank of Wynne, Harrisburg

Position

Loan Officer

How Long Have You Been with First National Bank?

5 1/2 Years

Family

Wife Megan & 4 Year Old Cavalier King Charles Spaniel, Charlie

What is the most interesting thing about working in a small town bank?
The most interesting thing, to me, about working in a small town bank is the fact that you're always a Banker. Small town banking is not Monday – Friday, it's more than that... It's Wednesday night after church in the parking lot, and Saturday afternoon in the local grocery store. The relationships you are able to build in a small town are unlike any other. In a small town, people try to take care of each other and the small town bank plays a big role in that. Being able to make a difference in the community and knowing that you have an opportunity to have a direct impact on helping your neighbors achieve their financial goals and dreams is a special feeling.

We've seen you on Twitter…. What is the importance of social media for both banking and young professionals?
The impact of Social Media on both Banking and young professionals is huge. For the most part, people begin and end their day with some form of social media. Young professionals can take advantage of this by marketing themselves online and by connecting and developing relationships with experts in their industries. As a bank, we are able to utilize social media platforms in marketing strategies to promote our brand and products to consumers that we otherwise may never see face to face. Additionally, the ability to be able to, for example, follow industry changes on Twitter and even tweet out directly to law-makers in support of or in opposition to a bill that could have a major impact on the banking industry is unparalleled.

What movie character are you most similar to (and why)?
This is a tough one, but I would have to go with Ferris Bueller. I try to enjoy life to the fullest and have been known to occasionally lip sync a song or two.