

Promoting Construction and Development on Main Street

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Publications

The Economic Growth, Regulatory Relief and Consumer Protection Act (the "Regulatory Relief Act"), enacted into law on May 24, 2018, clarifies under what circumstances a lender must retain additional capital for an acquisition, development or construction loans. Under the high volatility commercial real estate (HVCRE) regulations, an HVCRE exposure carries a 150% risk weight. The increased risk weight requires lenders to retain an additional 50% of capital for HVCRE loans which reduces the amount of capital lenders could deploy in the market and increases the cost of credit for construction borrowers.

The Regulatory Relief Act dispenses with the HVCRE definition under the regulations and replaces it with a HVCRE ADC loan exposure. A HVCRE ADC exposure is a credit facility that:

- primarily finances, has financed or refinances the acquisition development or construction of real property;
- has the purpose of providing financing to acquire, develop or improve such real property into income producing real property; and
- is dependent upon future income generated by the project, sale of the project, or refinancing for repayment of the loan.

The HVCRE regulations created a number of other issues in construction lending, not the least of which were:

- the value of the real property contributed by the borrower to a project was artificially suppressed by the regulations at the borrower's basis in the property.
- the borrower's contributed capital was required to remain in the project until the construction loan converted to permanent financing, was paid off, or the project was sold.
- whether improvements to existing, income producing projects would or could be HVCRE exposures.

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Fortunately, the Regulatory Relief Act rectifies these issues created by the HVCRE regulations.

Value of Contributed Real Property

Under the HVCRE regulations, the value of the project real estate contributed by the borrower as a capital contribution was the borrower's basis in the property, not its then-current fair market value. This illogically and artificially suppressed the value of the borrower's real property contributed to a project, meaning the borrower had to inject equity from other sources that the regulators deemed acceptable.

The Regulatory Relief Act now provides that the value of the real property contributed by a borrower to a project is its appraised value as determined under standards prescribed by Section 1110 of the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (12 U.S.C. § 3339), in connection extending the loan to the borrower. Borrowers will no longer be deprived of value in real property contributed to a project unless the property has declined in value since the date of acquisition.

Return of Borrower's Contributed Capital

Pursuant to the HVCRE regulations, a borrower's contributed capital was required to remain in the project until one of three events occurred: (a) conversion of the construction loan to a permanent loan, (b) sale of the project, or (c) refinance of the construction loan. Unless the borrower negotiated a mini-perm loan that converted to a permanent loan after completion and satisfaction of conversion covenants such project stabilization, minimum net operating income and/or a debt service coverage ratio, it was faced with refinancing the construction loan.

The Regulatory Relief Act now permits the construction lender to reclassify the HVCRE ADC loan to a non-HVCRE ADC loan in accordance with its applicable loan underwriting criteria for permanent financing upon (1) substantial completion of construction of the project, and (2) cash flow being generated by the project, sufficient to support debt service and expenses such as

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taxes and insurance. This will provide lenders with flexibility to reclassify a loan to non-HVCRE ADC, which will liberate the additional capital the lender retained while the loan was HVCRE-ADC and will relieve borrowers from pressure to refinance.

It should be noted that the Regulatory Relief Act did not mandate a capital retention requirement for a HVCRE ADC exposure. Until banking regulators act, the risk weight will remain 150%.

Additional Exclusions Provide Further Clarification and Relief

The Regulatory Relief Act includes the same exclusions as the HVCRE regulation, one-to-four family residential properties, agricultural land, and property that would qualify as investment in community development. The exclusion for commercial real property projects remain largely the same as the HVCRE regulations in that the loan-to-value ratio must be less than or equal to the applicable maximum supervisory loan-to-value ratio and borrower's minimum equity requirement remains 15% of the project's appraised "as completed" value.

Two new exclusions clarify to which ADC loans the heightened risk weight may apply. The exclusion are loans that finance:

- the acquisition or refinance of existing income producing property secured by a mortgage; or
- improvements to existing income producing property secured by a mortgage; and
- in both cases, the income produced by the real property is sufficient to support debt service and pay property expenses.

The Regulatory Relief Act provides much needed clarification to and correction of the HVCRE regulations and the issues unnecessarily created by the regulations. What remains to be seen is whether the regulators adjust the risk weight or leave it at 150% and how lender credit underwriting and loan documentation will change as a result.

For more information, please contact Steven M. Regan or any other attorney in Frost Brown Todd's Finance and Real Estate Practice

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