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High Volatility Commercial Real Estate Regulations Finalized

By: **Robert T. Smith**

Late last year the FDIC, the Federal Reserve and the OCC finalized regulations on High Volatility Commercial Real Estate (HVCRE) first proposed in 2018. The final rule conforms the regulatory definition of HVCRE exposure to the statutory definition implemented under section 214 of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA) effective May 24, 2018.

HVCRE is solely a risk-weighting, bank capital concept. HVCRE loans involve commercial real estate projects that regulators have determined to be high risk and, therefore, require a more robust capital buffer to mitigate the bank's risk with respect to the credit. The final rule maintains a risk weight of 150 percent for HVCRE loans.

Under the rule, "High volatility commercial real estate exposure" means any loan secured by real estate (improved or unimproved) that:

(1) primarily finances or refinances the acquisition, development or construction of real property;

(2) has the purpose of financing the acquisition, development or improvement of such real property into income-producing property; and

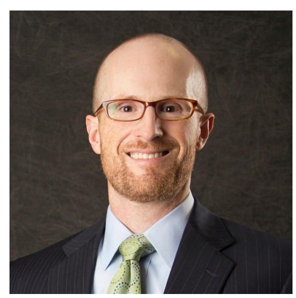
(3) depends on future income or sales proceeds from (or refinancing of) the real property for repayment of the loan.

<u>HVCRE exposure does not include the following:</u>

ATTORNEYS

Robert T. Smith
Regulatory Compliance, Securities & Corporate Transactions

Kael K. Bowling
Commercial Litigation



Jason N. Bramlett
Commercial Lending, Real Estate & Troubled Debt Restructuring & Bankruptcy

Bryan W. Duke
Commercial Lending & Corporate Transactions

1) Any loan financing the acquisition, development or construction of (i) one- to four-family residential properties, (ii) real property that would qualify as an investment in community development, or (iii) agricultural land;

2) Any loan financing the acquisition or refinance of existing income-producing real property if the cash flow from the property is sufficient to support debt service and expenses of the property (in accordance with the bank's applicable underwriting criteria for permanent financings);

3) Any loan financing improvements to existing income-producing improved real property if the cash flow from the property is sufficient to support debt service and expenses of the property (in accordance with the bank's applicable underwriting criteria for permanent financings);

4) Any loan financing a commercial real property project in which:

a. the loan-to-value ratio does not exceed the applicable maximum supervisory LTV ratio;

b. the borrower has contributed capital of at least 15% of the real property's "as completed" value to the project in the form of (i) cash, (ii) unencumbered readily marketable assets, (iii) paid out-of-pocket development expenses, or (iv) contributed real property or improvements; and

c. the borrower's capital contribution (of at least 15%) is (i) made prior to the lender advancing any amount under the credit facility, and (ii) contractually required to remain in the project until the HVCRE exposure has been reclassified to a non-HVCRE credit.

Key Components of the Final Rule:

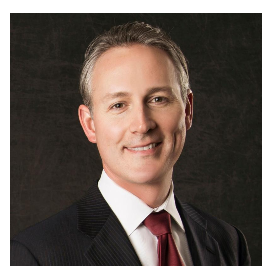
- ***Effective Date.*** The final rule is effective for all loans originated on or after April 1, 2020.
- ***Loans Originated Prior to January 1, 2015.*** Loans originated prior to 2015 are not subject to the revised HVCRE definition.
- ***Applicability.*** The final rule applies not only to regulated depository institutions but also to all related organizations subject to the agencies' capital rules including bank holding companies.
- ***Reclassification.*** A bank may reclassify a credit as non-HVCRE upon (i) substantial completion of the development or construction of the real property; and (ii) cash flow from the property being sufficient to support debt service and expenses of the property (in accordance with the bank's applicable underwriting criteria for permanent financings).
- ***Limit on Residential Exclusion.*** The exclusion of loans financing one- to four-family residential properties is not available for credits financing only improvements such as sewer lines, water pipes and similar improvements to land (as compared to construction of actual residential structures).
- ***Definitions.*** The agencies will interpret the phrase "a credit facility secured by land or improved property", as used in EGRRCPA, consistent with the Call Report

Lindsey Emerson Raines
Banking Litigation

David M. Graf
ERISA, Employee Benefits

Harry A. Light
Bankruptcy & Creditor's Rights

Michael S. Moore
Labor & Employment



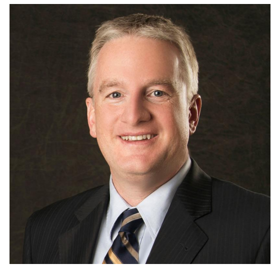
Jay T. Taylor
Commercial Lending, Tax Credit Financing & New Markets Tax Credits

definition of "a loan secured by real estate", meaning that the estimated value of the real estate collateral is not less than 50% of the principal amount of the loan at origination.

- ***Treatment of Capital in a Project.*** While the final rule requires that at least 15% of contributed capital remain in the project (for purposes of the exclusion of certain CRE projects), internally generated capital is not subject to that requirement. In addition, the rule clarifies that contributed real estate and improvements must be directly related to the project to count towards the 15% requirement.

The information was written by Attorney Robert T. Smith of the Banking and Finance Practice Group at Friday, Eldredge & Clark, LLP. This is not a substitute for legal advice and should be considered for general guidance only. For more information or if you have further questions, please contact one of our Bank and Finance Attorneys.

William A. Waddell Jr.
Banking Litigation



K. Coleman Westbrook
Trust & Estate Planning

HOT TOPIC IN LABOR & EMPLOYMENT

Employee Training You Should Be Doing

By **Daniel L. Herrington**

Recently a client asked me to come provide sexual harassment awareness and prevention training at their annual all employee training day. That is not only a best practice, but is fairly common training that most employers provide in some form or fashion (lawyer, HR, videos, or webinars). Surprisingly, however, the client also asked me to provide training to about 300 employees on the benefits provided to them under the Family Medical Leave Act and the Americans with Disabilities Act. This client understands work-life balance and wants employees to know that these two laws provide for time off, and in the case of the ADA, other accommodations to allow employees to succeed at work, even when life throws them a curveball.

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