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HVCR-What?: Managing Uncertainty Around HVCRE Loans

HVCRE regulations were implemented more than two years ago, but the scope and requirements of these rules are still unclear to many borrowers and lenders, note Pircher, Nichols & Meeks Partner Daniel Guggenheim and Associate Michael Seiden.

By Daniel Guggenheim and Michael Seiden

The regulations pertaining to "high volatility commercial real estate" (HVCRE) loans are more than two years old, but the scope and requirements of such regulations remain uncertain for both lenders and borrowers. As such, at the outset of any new financing, it is important for the borrower to confirm the lender's underwriting approach, project requirements and, if not a bank, any plans for a loan sale or syndication to a bank. Doing so may help identify any lurking disagreements regarding the impact of the HVCRE regulations on the contemplated financing.

Daniel Guggenheim (left) and Michael Seiden (right), of Pircher, Nichols & Meeks

At their core, the regulations provide that most acquisition, development or construction (ADC) loans are HVCRE, and thus carry a 50 percent higher capital charge for any bank with an interest in the loan, unless the requirements for exemption are satisfied. The threshold issues are whether the loan constitutes permanent financing or an ADC loan and, if it is an ADC loan, whether the loan is exempt.

There are conflicting views on how to determine whether a loan constitutes permanent financing. For example, some sources advocate deference to the lender's normal underwriting standards and its internal characterization of the loan. Others have suggested that any commercial loan with a future funding component constitutes HVCRE, regardless of whether the property is stabilized or the lender considers the loan to be permanent financing. Therefore, some banks with particular sensitivity to an increased capital charge may try to impose the requirements for the HVCRE exemption on nearly all of their loans.

For ADC loans that are subject to the HVCRE regulations, the two most notable requirements for exemption are:

1. Internally generated capital must remain in the project. There are many interpretations of this ambiguous concept—does it mean that rents may not be used to pay operating expenses prior to a refinance, or just that investors may not receive distributions until there is positive cash flow, or something in between?
2. The borrower must contribute equity representing at least 15 percent of the project's appraised "as completed" value (without credit for subsequent appreciation on land).

Unfortunately, the concerns regarding the substance of the regulations have been confounded by misunderstanding among market participants. Some borrowers continue to believe HVCRE regulations are only applicable to bank loans for new construction and, in any case, should not impair the typical administration of a project. Others fail to appreciate that non-bank lenders may not offer an escape from the regulations if they need the flexibility to sell or syndicate to a bank.

Rather than argue with the lender about whether a loan constitutes permanent financing, it may be more productive for the borrower to negotiate the restrictions the lender is seeking to impose to qualify for the HVCRE exemption and criteria for a post-closing conversion of the loan from an ADC loan to permanent financing, so the restrictions pertaining to the HVCRE exemption cease to apply.

Alternatively, the borrower may be in a position to simply reject the lender's HVCRE exemption requirements entirely and insist that the lender bear the risk of a higher capital charge as a cost of doing business. Similarly, a bank with less sensitivity to an increased capital charge may leverage its willingness to ignore the HVCRE requirements for a competitive advantage, just as a non-bank lender who does not sell or syndicate to banks may leverage its freedom from the HVCRE regulations.

Modifications to the HVCRE regulations are presently pending in Congress and seem likely to eventually improve relations between borrowers and lenders by reducing some of the uncertainty regarding the regulations. In the meantime, borrowers should continue to ask lenders about their underwriting approach, loan requirements, sale or syndication plans, and general HVCRE protocols, at the outset of any new financing, to flush out potential HVCRE issues that may pose a threat to the deal.

Danny Guggenheim is a transactional partner and Michael Seiden is a transactional associate with Pircher, Nichols & Meeks, a real estate law firm with offices in Los Angeles and Chicago. They can be reached at dguggenheim@pircher.com and mseiden@pircher.com, respectively.

A link to the original article can be found here.