April 2017

Contacts

Jeff Adler
Vice President & General Manager of Yardi Matrix
Jeff.Adler@Yardi.com
(800) 866-1124 x2403

Jack Kern
Director of Research and Publications
Jack.Kern@Yardi.com
(800) 866-1124 x2444

Paul Fiorilla
Associate Director of Research
Paul.Fiorilla@Yardi.com
(800) 866-1124 x5764

Chris Nebenzahl
Senior Analyst
Chris.Nebenzahl@Yardi.com
(800) 866-1124 x2200

Justin Dean
Real Estate Market Analyst
Justin.Dean@Yardi.com
(800) 866-1124 x2071

Trade Groups in Effort to Fix Bank Lending Rules

To help banks struggling to deal with regulations on commercial mortgage lending that were enacted in 2015, a group of real estate trade organizations are working to introduce legislation that would clarify the rules.

The confusion involves so called high-volatility commercial real estate (HVCRE) loans originated by commercial banks, which encompass loans on acquisition, development and construction loans. The regulations went into effect in January 2015 and are interpreted by examiners at the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC) and Federal Reserve.

The regulations—part of new rules enacted via Basel III in the wake of the last financial crisis that are intended to de-risk bank balance sheets—require banks to set aside 50 percent more capital on loans deemed to be high-risk.

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>
> —Chip Rodgers Jr., Real Estate Roundtable

Banks say that the added costs makes them less competitive versus other lenders. Martin Schuh, head of government relations for trade group CRE Finance Council, said the HVCRE regulations add as much as 50 basis points to the cost of a loan. The diminished competitive position of banks has led to the rapid growth of non-regulated lenders such as private equity funds and foreign capital.

"Over the next three years, over $1 trillion—or approximately $1 billion a day—in commercial real estate debt is maturing. So, maintaining adequate credit capacity is vital for commercial real estate," said Chip Rodgers Jr., senior vice president of the Real Estate Roundtable (RER). "The HVCRE Rule is disproportionally affecting bank commercial real estate lending and contracting much needed credit to the sector."

What's more, from the time the rules were enacted, banks have complained that the HVCRE rules as written were unclear and that guidance from the various agencies in charge of compliance was often contradictory. Confusion was evident in early 2015 when banks reclassified loans already on their books to comply with HVCRE. Call reports from 1Q 2015 showed some banks classified as much as 90 percent of

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Hollie Zepke
Audience Development Specialist
Hollie.Zepke@Yardi.com
(800) 866-1124 x5389

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> —Bruce Oliver, Mortgage Bankers Association.

their existing ADC loans as HVCRE while others classified less than 10 percent, said Ashley Gunn, associate director of commercial/multifamily at the Mortgage Bankers Association (MBA).

“The lack of clarity … has negatively impacted ADC loan decisions for some banks, leaving some borrowers with fewer and potentially more costly sources of ADC loan capital. A slowdown in ADC lending has the potential for broader economic impact,” says a letter drafted by more than a dozen trade groups, including MBA, CREFC, RER, the National Apartment Association, the National Multifamily Housing Council, and NAIOP Commercial Real Estate Development Association.

In an attempt to get regulators to clarify the rules, the MBA and RER each formed HVCRE working groups in the fall of 2014. The regulators responded by issuing FAQ responses that didn’t address the groups’ concerns. MBA and RER then switched gears and began working toward a legislative solution. Congressman Robert Pittenger (R-NC) is sponsoring a bill in the House, for which Democratic co-sponsors are being recruited. Schuh said a bill with bi-partisan support is expected to be introduced by the end of April.

The proposed legislation would maintain HVCRE’s higher capital charges, but clarify which loans are subject to the rules. Key points of the legislation are:

- Grandfathering loans that were originated before 2015, which would save the banks the extra capital charges for those loans.

- Exempt acquisition/refinancing loans for performing income-producing properties. The rules were meant to require banks to set aside more capital for loans considered to be riskier. But the requirement to include acquisition loans means banks may have to set aside higher capital charges for low-leverage loans on properties with stable cash flows, although that is an area where interpretations differ.

- Allow sponsors to take internally generated capital out of properties, provided the required 15 percent equity contribution remains in place. As written, HVCRE requires all cash flow from a property to stay within the project. If there is excess cash flow in an HVCRE-classified mortgage, the money must remain in place until the loan is repaid. Such strict terms are unappealing to borrowers.

- Allow banks to withdraw HVCRE designation after the project meets the bank’s loan underwriting criteria for permanent financing. As it stands, HVCRE status extends for the life of a loan, even if the property becomes stable and meets prescribed standards for non-HVCRE status.

- Allow appreciated value of land to count versus the cash equity contribution. Currently, to avoid HVCRE status, the developer contribution on construction loans must be a minimum of 15 percent of “as completed” value. However, the value of the land as determined by the regulators for the developer equity contribution is the original purchase price, not the current value. That becomes problematic for construction loans in which the land was purchased in years past and has appreciated in value.

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>
> —Joe Forte, a partner at Kelley Drye

In addition, the trade groups are looking for clarity on issues such as tighter definitions of what constitutes a “redevelopment” loan or how to treat preferred equity and mezzanine debt in the capital structure. Banks interpret the rules to define construction or development as anything from a full-scale rehabilitation of a property to tenant improvements on a small portion of a property, says Bruce Oliver, associate vice president of commercial real estate policy at the Mortgage Bankers Association.

“The confusion comes from the vagueness of what’s in HVCRE,” Oliver said. “And we understand that, when bankers reached out to examiners, they have sometimes gotten conflicting advice.”

The differences in interpretation has serious consequences for banks. At a meeting sponsored by the MBA and RER recently held in the New York office of law firm Kelley Drye, a representative of Sun Trust Bank said it reclassified $1 billion of previously originated loans as HVCRE, which required it to set aside roughly $50 million of new capital and endangered the institution’s commitment to the commercial mortgage market.

“The purpose of the legislation is not to eliminate the regulatory agencies requirements to hold more capital, but rather to clarify by definition the loans that should not be classified as HVCRE,” said Joe Forte, a partner at Kelley Drye who moderated the recent banker’s panel. “And also to conform provisions of the rule to existing applicable federal banking regulations such as FIRREA (the Financial Institution Reform, Recovery and Enforcement Act of 1989).”

Prospects for the success of the legislation is unclear. The aims of the bill align with the public comments to reduce regulatory burden on banks by Congressional Republicans and President Donald Trump, so the path to passage theoretically is favorable. However, the legislative environment is clouded by disputes among Republican factions and non-cooperation among Democrats who are in no mood to compromise given the way they feel the GOP Congress stalled President Obama’s legislative agenda.

—**Paul Fiorilla**, *Associate Director of Research*

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