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What is a "High Volatility Commercial Real Estate" Loan, and How Does it Affect Your Ability to Lend?

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More and more, bankers are becoming familiar with the term "High Volatility Commercial Real Estate," or HVCRE for short. These bankers may sense that HVCRE has a dampening effect on their ability to lend to commercial real estate borrowers. But many bankers do not know (i) why we have the term HVCRE, (ii) what an HVCRE Loan is, and (ii) what effect HVCRE has on their ability to lend.

Why Do We Have the Term HVCRE?

The concept of High Volatility Commercial Real Estate started gaining traction shortly after the financial crisis of 2007-2008. Around that same time, the Basel Committee on Banking Supervision was in the process of updating its bank capital requirements. The Basel Committee on Banking Supervision is an international committee of the banking regulators of the world's largest economies focused on the importance of adequate capitalization in a stable international banking system. In 2011, the committee completed its third iteration of capital standards for banks, which is commonly referred to as Basel III. Because Basel III was developed around the time of the financial crisis, the standards, in many ways, constitute a response to that crisis.

Because Basel III does not have the force of law, countries signing on to Basel III require national laws or regulations for implementation. In the United States, these laws came in part through Dodd Frank and its implementing regulations. Pursuant to Dodd Frank, the OCC, Federal Reserve and FDIC all published capital rules in July, 2013, which apply to all banks regardless of size.

In developing those regulations, the regulators deemed certain commercial real estate loans to be riskier than other types of commercial loans. These particular commercial real estate loans were designated by the regulators as "High Volatility Commercial Real Estate Loans," or "HVCRE."

What is an HVCRE Loan?

An HVCRE loan is any loan used for acquisition, development or construction of real estate, unless the loan finances: (i) 1-4 family residential properties; (ii) real property that would qualify as a "qualified investment" in community development (generally, any loan which would qualify as a permissible investment for the Community Reinvestment Act should meet this test); (iii) the purchase or development of agricultural land; (iv) commercial real estate projects where (A) the loan-to-value ratio is less than or equal to the applicable regulator's maximum permitted amount (depending on the type of loan and such bank's applicable regulator-typically 80%), and (B) the borrower contributes capital to the project in the form of cash or unencumbered readily marketable assets (which can include certain development costs out of pocket) of at least 15% of the real estate project's "as completed" appraised value.

Loans for permanent financing would not be considered HVCRE loans. These are loans where the underlying project is complete and no future advances will be made. Some examples of other loans that would not be considered HVCRE loans include: (i) affordable housing (including multifamily rental housing) for low or moderate income individuals; (ii) community services targeted to low or moderate income individuals; and (iii) activities that revitalize or stabilize low or moderate income geographies, designated disaster areas, or distressed or underserved nonmetropolitan middle-income geographies designated by the federal banking regulators.

What Effect Do HVCRE Loans Have on a Bank's Ability to Lend?

Basel III and the Dodd Frank implementing regulations require banks to reserve more capital when a loan is categorized as HVCRE. As a general rule, most corporate loans carry a risk weight of 100%. By contrast, because regulators view them as more risky to the financial stability of a bank, HVCRE loans carry a risk weight of 150%. In other words, a bank must now reserve $6 million in capital to make a $50 million HVCRE loan, rather than the $4 million it would be required to reserve for a typical commercial real estate loan.

One would anticipate that the natural consequence of these increased capital requirements would include increased pricing on construction loans and banks less willing to provide financing for development projects. At this point, there is no clear data on how much pricing and credit have been affected by the HVCRE requirements. Anecdotally, however, we are hearing from our clients that they are not, at least purposely, limiting their exposure to HVCRE loans, but are instead just pricing these loans to reflect the increased capital requirements.