

## High Volatility Commercial Real Estate (HVCRE) Exposures<sup>4</sup>

**1. If a borrower contributes additional capital to an existing HVCRE loan to meet the 15 percent contributed capital requirement after the banking organization has already advanced funds to the borrower, can the loan be excluded from the definition of HVCRE as a loan to a commercial real estate (CRE) project that meets specified criteria?**

The loan remains an HVCRE loan because any contribution of cash or land must be contributed to the project before a banking organization advances funds for a loan to be considered a CRE loan, rather than an HVCRE loan.

**2. Are acquisition, development or construction (ADC) loans made prior to the effective date of the regulatory capital rule exempted from the HVCRE definition?**

The regulatory capital rule does not provide for the grandfathering of existing loans. Therefore, ADC loans made before the effective date of the regulatory capital rule are not automatically exempted from the definition of HVCRE. Unless such loans meet the criteria for exemption provided in the definition of HVCRE, they must be treated as HVCRE loans.

**3. If a borrower owns real estate (and has no mortgages or liens on that real estate) that is unrelated to a project, can the borrower pledge this real estate to the project as collateral and count the value of the real estate toward the 15 percent borrower contributed capital requirement and avoid the HVCRE classification?**

No, the definition of HVCRE requires that capital be contributed by the borrower to the project in the form of cash or unencumbered readily marketable assets. To the extent that an asset is merely pledged as collateral, it would not be considered to have been contributed to the project.

**4. For the purpose of determining whether a loan meets the definition of HVCRE, would various purchasers' deposits on units in a condominium project (that does not qualify as a one- to four-family property that is excluded from the definition of HVCRE) count toward the borrower's contributed capital?**

No. Purchasers' deposits on units in a condominium project do not qualify as capital contributed by the borrower. The purpose of contributed capital, or equity, is to ensure that the borrower maintains a sufficient economic interest in the property and to provide a margin between the loan amount and the value of the project to provide protection to the lender against loss due to overruns or an incomplete or otherwise failed project. Typically, a purchaser's deposit is not able to absorb losses on the project because the deposit must be returned to the purchaser in the event that the project is not completed.

**5. For the purpose of measuring capital contributed by the borrower under the HVCRE definition, if Bank A has a first mortgage secured by the real estate of the project and Bank B has a second mortgage on the same real estate collateral, does the second banking organization's funding count as cash contributed by the borrower?**

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<sup>4</sup> For HVCRE questions, see the definition of "HVCRE" in section 2 of the regulatory capital rule.

No. A second banking organization's funding of the project is not considered to be capital contributed by the borrower. Rather, it is another loan to the project, and both loans encumber the property.

**6. What is the “as completed” value? Can the “as stabilized” value be used for purposes of determining whether the loan is an HVCRE exposure?**

No, the “as stabilized” value cannot be used for purposes of determining whether the loan is an HVCRE exposure. The agencies' Interagency Appraisal and Evaluation Guidelines explain both the “as completed” value and “as stabilized” value as follows:

The prospective market value “as completed” reflects the property's market value as of the time that development is expected to be completed. The prospective market value “as stabilized” reflects the property's market value as of the time the property is projected to achieve stabilized occupancy. For an income-producing property, stabilized occupancy is the occupancy level that a property is expected to achieve after the property is exposed to the market for lease over a reasonable period of time and at comparable terms and conditions to other similar properties. (Refer to the interagency guidelines: The Board's SR letter 10-16 at <http://www.federalreserve.gov/boarddocs/srletters/2010/sr1016a1.pdf>; the OCC Bulletin 2010-42 at <http://www.occ.gov/news-issuances/bulletins/2010/bulletin-2010-42.html>; and the FDIC's FIL 82-2010 at <https://www.fdic.gov/news/news/financial/2010/fil10082a.pdf>.)

Of the three market value scenarios that are generally used by an appraiser (that is, the current [“as is”] market value, the prospective market value “as completed,” and the prospective market value “as stabilized”), a banking organization should consider only the prospective market value “as completed” for purposes of determining whether a project is an HVCRE exposure.

**7. If cash is used to buy land, and that land is subsequently contributed to a new development, can the land still count as contributed capital? Does the banking organization need to document when and how much the borrower paid for the land?**

Yes. If cash is used to purchase land that is subsequently contributed to an ADC project, the cash used to buy the land can count toward the 15 percent contributed capital amount. This 15 percent requirement must be met before the banking organization advances funds. The definition of HVCRE excludes CRE projects in which the borrower has contributed capital to the project in the form of cash or unencumbered readily marketable assets (or has paid development expenses out-of-pocket) of at least 15 percent of the real estate's “as completed” value. (See definition in question 6.) Consistent with the preamble to the regulatory capital rule, cash used to purchase land is a form of borrower-contributed capital under the HVCRE definition. The banking organization should document the details pertaining to the amount of cash paid for the land.

**8. For purposes of determining the amount of a borrower's contributed capital and whether a loan would be classified as an HVCRE loan, would “soft costs” (such as brokerage fees, marketing expenses, or costs of feasibility studies) qualify as “development expenses”?**

Under the regulatory capital rule, contributed capital may include out-of-pocket development expenses paid by the borrower. “Soft costs” that contribute to the completion and value of the project can count as development expenses for purposes of the HVCRE definition. Such soft costs include interest and other development costs such as fees and related pre-development

expenses. Project costs paid to related parties such as developer fees, leasing expenses, brokerage commissions, and management fees may be included in the soft costs provided the costs are reasonable in comparison to the cost of similar services from third parties. Acceptable contributed capital includes actual cash expended by a developer for the purchase of a site and initial costs paid, such as engineering or permits related directly to the project.

**9. Does an interest-only loan to purchase an existing building under renovation with tenants qualify as HVCRE?**

The terms of financing (for example, interest-only loans) are not a relevant criterion for HVCRE determination. Rather, the classification of the loan depends primarily on whether it is permanent financing. A loan cannot be classified as permanent financing if (1) the loan is based on the “as completed” value of the project (i.e., the project has not yet been completed) and (2) there will be any future advances on the loan. Other characteristics of the loan should also be considered in the context of the regulatory capital rule’s HVCRE definition.

**10. Are Small Business Administration (SBA) 504 loans considered community development loans under the definition of HVCRE and, therefore, not subject to the HVCRE treatment?**

SBA 504 loans are used for fixed assets (for example, the purchase of land and buildings, site and building improvements, newly constructed facilities, and long-term machinery and equipment) as well as to refinance existing debt and are not automatically excluded from the definition of HVCRE. SBA 504 loans that meet the criteria in paragraphs (2)(i) and (2)(ii) under the HVCRE definition are exempt from treatment as an HVCRE exposure. SBA 504 loans that are not community development investments may be exempt from the HVCRE treatment if the loan satisfies the other exemption criteria in the definition of HVCRE.

**11. Projects may receive cash in the form of grants from nonprofit organizations, municipalities, state agencies, or federal agencies. Can a banking organization providing ADC financing to a project (that does not otherwise qualify as a community development investment with regard to the HVCRE exemption) consider the cash from such grants as part of the 15 percent contributed capital requirement?**

No, to the extent a project receives a grant, a banking organization may not consider the cash from the grant as a capital contribution because the cash did not come from the borrower. Although a third-party grant would increase the capital invested in the project, because it does not come from the borrower, it does not affect the borrower’s level of investment and therefore does not ensure that the borrower maintains a sufficient economic interest in the project.

**12. Is a credit facility used to purchase a commercial lot (land only with no site improvements) an HVCRE exposure? The proceeds are used to acquire the land, however, there is no plan to develop, construct, or make improvements. At this time the borrower intends to hold the land.**

An acquisition loan to purchase CRE (including land) would qualify as an HVCRE exposure, unless the loan is permanent financing in accordance with the banking organization’s normal lending terms or meets the exemption criteria described in the HVCRE definition.

**13. Does an ADC loan on a multipurpose property that will contain both CRE and one- to four-family residential real estate meet the HVCRE definition?**

Only the portion of the loan applicable to the property's CRE could be subject to the HVCRE treatment. The banking organization should consider the contribution of the CRE portion of the project to the total "as completed" value of the project when determining the portion of the loan applicable to the property's CRE.

**14. Subsequent to loan origination, if an updated appraisal or valuation on an HVCRE exposure results in a loan-to-value (LTV) ratio that no longer exceeds the maximum LTV ratio in the relevant supervisor's real estate lending standards, could the exposure then be removed from the HVCRE classification (if the exposure meets the other exemption criteria in paragraph (4) of the HVCRE definition)?**

No. A banking organization must consider the LTV ratio at origination when evaluating a loan against the HVCRE exemption criteria. A loan with an LTV ratio that exceeded the maximum supervisory LTV ratio at origination would remain an HVCRE exposure until it converts to permanent financing. Refer to the agencies' real estate lending standards regulations: 12 CFR part 34, subpart C (OCC); 12 CFR part 208, subpart E (Board); and 12 CFR part 365 (FDIC).

**15. The definition of HVCRE includes a provision that "the capital contributed by the borrower, or internally generated by the project, is contractually required to remain in the project throughout the life of the project." What does "contractually required" mean in this context?**

In order to meet this criterion in paragraph (4)(iii) of the HVCRE definition, the loan documentation must include terms requiring that all contributed or internally generated capital remain in the project throughout the life of the project. The borrower must not have the ability to withdraw either the capital contribution or the capital generated internally by the project prior to obtaining permanent financing, selling the project, or paying the loan in full.

**16. If a banking organization lends a borrower 15 percent against the property, independent of the project, can the proceeds from the loan count towards the obligor's 15 percent capital contribution to the project?**

No. Proceeds from a loan from the banking organization that is financing the ADC project does not count toward the 15 percent contributed capital amount.

**17. Would the issuance of a certificate of occupancy qualify the loan as having reached the stage of permanent financing? There is usually a remaining loan duration extending past the issuance of the certificate of occupancy in either the initial loan term and/or through extension options.**

A certificate of occupancy does not transform an HVCRE loan into permanent financing. The HVCRE exposure ceases to be an HVCRE exposure when it is converted to permanent financing in accordance with the banking organization's normal lending terms, or is paid in full.

Generally, this would involve a new credit facility in the form of a term loan replacing the ADC facility.