CSBS
SINCE 1902
CONFERENCE OF STATE BANK SUPERVISORS

High Volatility Commercial Real Estate (HVCRE) Examiner Job Aid

This job aid was created by the CSBS State Examiner Review Team to help state examiners understand important aspects of a new designation of commercial real estate loans, known as high-volatility commercial real estate (HVCRE). It summarizes existing guidance to aid in identifying these loans, understanding contributed capital and other exemptions, and ensuring that these loans are accurately reported. It is not confidential and may be shared with financial institutions.

Background

The regulatory capital rules (BASEL III) that went into effect January 1, 2015, introduced the concept of High-Volatility Commercial Real Estate (HVCRE), and require all loans that meet the definition of HVCRE to be reported separately from other commercial real estate (CRE) loans and assigned a risk weighting of 150% for risk-based capital purposes. Prior to January 1, 2015, these loans would have typically been assigned a risk weighting of 100%. Reporting requirements of the Consolidated Reports of Condition and Income (Call Report) for these assets took effect for the reporting period ending March 31, 2015.

This change in risk weighting may have a significant impact on certain institutions' risk-based capital ratios, which introduces an incentive to underreport HVCRE loans. Importantly, loans made prior to the implementation of these rules are subject to the new risk weighting; i.e., CRE loans that were made prior to the effective date of these rules that meet the definition of HVCRE must be reported and risk-weighted accordingly.

Identifying HVCRE and Understanding the Exemptions

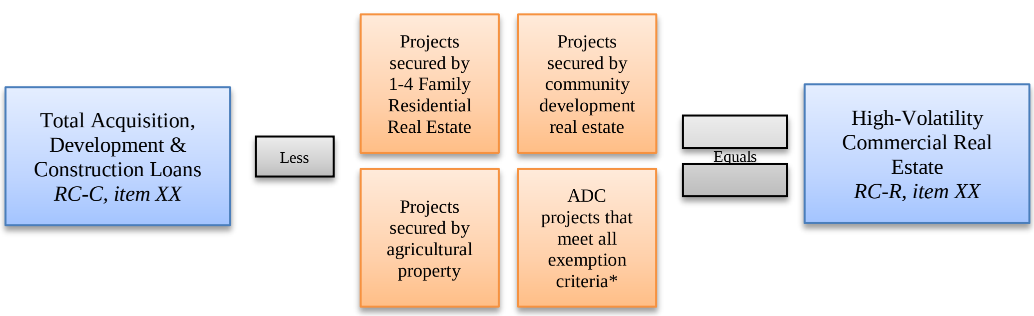
All loans and credit facilities used for acquisition, development, and construction (ADC) of real property prior to a conversion to permanent financing are to be reported as HVCRE unless one of the following criteria is met:

1. The loan finances one-to-four family residential projects.

2. The loan finances a property that would qualify as an investment in a community development project.

3. The loan finances purchase or development of agricultural land and is used for the purchase or development of land that will or can be used for agricultural purposes. The valuation of the land must be based on its use for agricultural purposes only and should not consider other development options.

4. The loan finances an acquisition, construction, or development project in which *all* of the following criteria are met:
    a. The project's loan-to-value is less than or equal to the maximum supervisory loan-to-value limits set forth in applicable regulations[1]; and,
    b. The borrower(s) has contributed capital to the project prior to the advancement of funds in the form of cash, unencumbered readily marketable assets, land to be contributed to the project purchased with cash, or certain out-of-pocket development expenses, where the aggregate of such capital contributions is at least 15 percent of the real estate project's "as completed" appraised value; and,
    c. Borrower-contributed capital is contractually required to remain throughout the life of the project, i.e., until the loan is converted to permanent financing or the debt is paid in full. A financial institution that provides the original ADC loan may permanently finance the project so long as the permanent financing meets underwriting criteria for similar loans with similar risk profiles at the financial institution.



*Exemption criteria to be excluded from HVCRE designation (all of the following must apply):

- LTV is at or below maximum supervisory LTV; and,
- Borrower has contributed at least 15% of the "as completed" appraised value in cash or unencumbered readily marketable assets (see below); and,
- Borrower contributed capital is contractually required to remain throughout the project life.

[1] Applicable regulations may include state statutes; 12 CFR part 208, subpart E (Federal Reserve Board); and 12 CFR part 365 (FDIC)

Contributed Capital

Of the allowable exemption criteria, the concept of contributed capital is perhaps the most subjective and, therefore, most at risk of misuse by borrowers and financial institutions attempting to avoid reporting of HVCRE loans. The following summarizes a 2015 Interagency Frequently Asked Questions guide on which types of borrower contributions may and which types may not be included in determining whether or not a particular loan is exempt from HVCRE designation.

Assets that are eligible to be counted toward contributed capital:

- Land, purchased with cash, that is contributed to the project prior to the advancement of funds
- Out-of-pocket development expenses paid by the borrower, including:
  - Brokerage fees
  - Marketing expenses
  - Cost feasibility studies
- Soft costs included in development expenses, provided that they are reasonable in comparison to similar services from third parties. Examples include:
  - Interest and fees related to pre-development expenses
  - Developer fees
  - Leasing expenses
  - Brokerage commissions
  - Management fees
- Cash expended by the borrower to acquire a site, including engineering or permitting expenses directly related to the project

Assets that are not eligible to be counted toward contributed capital:

- Borrower-owned real estate from an unrelated project pledged to the subject project
- Purchasers' deposits on units in a condominium project (that is not already exempt by virtue of its designation as a 1-4 family property)
- Financing from an external lienholder, such as a second mortgage
- Assets contributed to the project after the advancement of funds
- Cash received in the form of grants, regardless whether the grant is received from nonprofit organizations, municipalities, or government agencies
- Any contribution that may be withdrawn by the borrower prior to the borrower obtaining permanent financing, selling the project, or paying the loan in full
- Proceeds from a separate loan used to finance the project

Reporting HVCRE

Loans meeting the definition of HVCRE are to be reported in Schedule RC-R, Part II, items 4.b and 5.b, and assigned a risk weighting of 150% unless the loan, or a portion of the loan, meets certain criteria that allow for a lesser risk weighing.

Additional References

- Interagency Frequently Asked Questions on High Volatility Commercial Real Estate (HVCRE) Exposures

- Call Report Instructions for Schedule RC-R

- Refer to the Federal Reserve Rapid Response session dated 11/25/14 entitled *Basel III Update for Community Banks* for a narrated discussion of HVCRE and other changes with the new capital rules