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Non-bank lenders unfazed by HVCRE clarifications

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Despite efforts to clarify construction lending rules for banks in 2017, non-bank lenders are expected to continue their domination of the commercial real estate construction market this year. Market players had hoped that clarifying HVCRE rules within Basel III would help banks regain their competitive edge, but alternative lenders are still expected to be the go-to for sponsors that aren't traditionally looked after by banks.

Due in part to the costs imposed on banks by HVCRE – which was adopted to decrease traditional bank exposure to riskier assets – banks have largely restricted post-financial crisis construction financing to low-leverage projects for their relationship borrowers.

Non-bank lenders have largely benefited from that shift; this year, private funds deployed a massive amount of capital in the construction lending space, most of which they raised from private investors like pension and endowment funds that sought exposure to real estate at higher yields.

Since it became effective in 2015, HVCRE has layered on an additional cost for bank lenders, and market players allege that the rule has muddied the definition of exactly which loans require banks to hold additional capital.

As they currently stand, the regulations state that bank construction lenders must meet at 15% equity requirement and that the leverage on their construction loans can't exceed 80% of the estimated value of the project once completed. If the requirements aren't met, banks must hold a 150% risk weight requirement against the loans and continue to hold the capital until the loan is converted to permanent financing, sold or paid in full.

Industry groups, including the **Commercial Real Estate Finance Council** and **Mortgage Bankers Association**, have been advocating for the clarification of the HVCRE rules. Earlier this year, Congressman Robert Pittenger (R-NC) and Congressman David Scott (D-GA) introduced bipartisan legislation that provides a more specific definition for the HVCRE category; lets borrowers claim equity against the appraised value of the land rather than the purchase price; eliminates the all-cash equity requirement; clarifies when a loan on a completed development can exit HVCRE requirements; and adds an exemption for refinancing or acquiring an existing, income-producing development.

"The general sentiment is that this [issue] got swept up in a much larger piece of legislation and that [HVCRE] has flaws operationally," said **David Blatt**, CEO at **Capstack Partners**, an investment bank. "Now that the market has been as strong as it has, the sentiment of loosening regulations overall makes this, in particular, something that could be tackled."

Market pros do note that, once HVCRE is clarified, current market makers will face increased competition from banks. But non-bank lenders are brushing that worry off, saying that banking culture and risk appetite will keep market participation low.

Since the financial crisis, most banks have stayed conservative when making loans and have scaled back considerably in the inherently riskier construction financing space. Market pros argue that while regulation does play a part, banks are also making this choice on their own. "Our thinking is that banks don't really turn on a dime," said **Jonathan Chassin**, managing director at **Moinian Capital Partners**, a non-bank lender that launched its operations this year. "They don't want to take additional risks if they don't need to and I don't see them becoming significantly more aggressive because of changes [to HVCRE]."

Private capital is also able to lend on projects with higher loan-to-cost values. “A clarification of the domestic policies might make it easier for banks to play in the 0% to 50% LTC space, but I think it’s highly unlikely that clarifications would enable banks to lend at the slightly higher LTCs that we lend at,” said **Boyd Fellows**, managing partner at **ACORE Capital**, a CRE finance company that lends on transitional assets. Non-bank lenders like ACORE, in comparison, are making loans between 60% and 70% LTC.

Gregg Gerken, head of commercial real estate at **TD Bank**, told *REFI*, “Banks aren’t wholly opposed to doing construction loans but instead are asking the following important questions: Can they get their heads wrapped around the supply/demand equation? Is it cost effective, and do you want to take that form of risk on your balance sheet?”

While banks continue to pick off the loans that work best for their balance sheets, non-bank lenders will look for projects that require higher leverage or are more complicated, according to lenders who spoke to *REFI*. So far, that bifurcation has been working well for banks, who have adapted their strategies to fit the regulatory framework – instead of originating a construction loan, more banks are buying off the A-note participation in an HVCRE-compliant deal that was originated by a non-bank lender. “Banks may not have the capacity or desire to originate, but they’re pleased to take the A-notes, so they’re still participating,” said **Wayne Heicklen**, co-chair of **Pryor Cashman LLP**’s real estate group.

The bigger challenge for non-bank lenders is that the influx of new funds in the market has created more competition for deals. So far, market players haven’t noticed a significant slide in credit quality, but are seeing pricing for the last dollar of risk become cheaper and cheaper, according to Chassin.

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