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Basel III's implications for commercial real estate

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After a lengthy comment period, the federal banking agencies released the US Basel III final rule on July 2, 2013. These rules revise regulatory capital requirements for all banks, savings associations, US bank holding companies with greater than $500 million in assets, and all savings and loan holdings companies. The rules implement the majority of the revisions of the global Basel III capital reforms, as well as relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act, in an effort to strengthen the quantity and quality of regulatory capital.

The new capital rules require banking organizations to maintain higher capital levels and enhance the definition of what can be included in the calculation of capital. The rules will have wide-reaching impacts on the banking industry, potentially altering the profitability and investment strategies for banking organizations and reassessing the allocation of capital. This paper focuses on the potential impact of the new regulatory capital rules on the commercial real estate industry, specifically for the borrowers of commercial mortgages who build, own and operate multifamily and commercial properties such as rental apartments, offices, shopping centers, hotels and warehouses.

Summary of the US Basel III final rule

The existing US general risk-based capital rules established under Basel I apply to all banking organizations.[1] At the same time, the largest US internationally active banks remain within the federal banking agencies' qualification process for the adoption of the advanced approaches under Basel II (i.e., advanced approach banks).[2] There are currently 12 bank holding companies that exceed the $250 billion advanced approach threshold in the US in addition to those that exceed the $10 billion foreign exposure threshold or that opt in. The US Basel III final rule will replace the existing general risk-based capital rules under Basel I and the advanced approaches rules under Basel II, affecting more than 8,000 US banking organizations.

[1] Banking organizations include all national banks, state member banks, state nonmember banks, state and federal savings associations, and top-tier holding companies domiciled in the United States, as well as top-tier savings and loan holding companies domiciled in the United States.

[2] Advanced approach banks refer to banking institutions with consolidated total assets of $250 billion or consolidated on-balance-sheet foreign exposure of at least $10 billion.

Building a better working world

The final rule increases bank capital requirements while tightening the definition of what can be included in the calculation of capital and revising the methodology of calculating risk-weighted assets, making them more risk sensitive.

According to the Federal Reserve, the banking sector has provided about half of the approximately $3 trillion of outstanding commercial real estate debt. Given the significance of this source of capital to the industry, the regulatory capital changes within the final rule could impact commercial real estate in numerous ways, including:

1. **Availability of capital to commercial real estate:** The final rule requires banks to maintain higher capital levels overall, while also contributing to higher capital levels for real estate assets due to changes in the risk weightings for these assets. These changes may influence banks' willingness to finance commercial real estate loans due to lower returns on capital and decreased profitability. If banks decide to reallocate capital away from commercial real estate to asset classes with more favorable treatment and a superior return on capital, there may be less liquidity for all types of real estate loans. This in turn may exacerbate the market's observed imbalance between the capital demanded by the industry to refinance existing properties and build new properties and the availability of capital in the banking system and other sources to supply those funds. To date, the commercial mortgage backed securities (CMBS) market and life insurance companies, while increasing production, have not provided sufficient capital to the market to close that gap.
2. **Higher cost of commercial mortgages:** Rather than reallocating away from commercial real estate, banks may instead choose to continue to lend to the sector but at a higher cost to retain profitability. Borrowing costs may also increase due to higher mortgage servicer fees resulting from less favorable capital treatment of retained mortgage servicing rights when selling or securitizing originated loans and higher overall capital charges resulting from increased risk weights for commercial mortgages. While mitigated in the short term by historically low interest rates, long-term higher borrowing costs will ultimately put upward pressure on capitalization rates, thereby causing property values to fall. Depending on supply and demand for space in each market, owners may be able to pass higher financing costs on to tenants through increased rents.
3. **Further shift away from relationship lending:** The final rule redefines how capital is calculated, placing specific constraints on mortgage servicing rights. These constraints not only impact capital but may deter banks from future involvement in the servicing industry. As a result, banks may be economically motivated to sell the servicing of a loan to a third party, and borrowers will have to deal with non-relationship servicers for requests during the term of the debt.

Availability and cost of commercial mortgage capital

What's changed:

The new US standardized approach modifies the calculation of risk weights applicable to commercial real estate loans held by all banking organizations. Specifically, the current general risk-based capital rules apply a risk weighting of 100% to all commercial real estate exposures regardless of the loan purpose or the asset class of the collateral, with the exception of multifamily properties. Under the existing rules, exposures for multifamily properties can be either 50% or 100% dependent upon the loan characteristics. The US standardized approach revises the risk weights applicable to commercial real estate loans to range from 50% to 150%, giving consideration to the purpose and characteristics of the loan, with the greatest weighting applicable to the inherently more risky construction and development loans. The new rules present a greater range of applicable risk weights to different loan types and asset classes that correspond to a greater range of capital requirements.

As part of the standardized approach, the final rule requires banking organizations to assign a higher risk weight of 150% to any high-volatility commercial real estate (HVCRE) exposure, defined as "a credit facility that finances or has financed the acquisition, development, or construction (ADC) of real property." Exempt from the HVCRE classification are loans that finance the acquisition, development or construction of one- to four-family residential properties, real property that would qualify as community development investments, or loans to business or farms with gross revenues of $1 million or more. Other ADC loans may be exempt from the HVCRE classification if they meet three specific criteria: the loan must have a loan-to-value ratio (LTV) of less than or equal to 80%, the borrower must contribute capital to the project in the form of cash or unencumbered marketable assets of at least 15% of the appraised "as complete" value, and the borrower's capital must be contributed prior to bank funding and remain in the project throughout the life of the project. The life of the project concludes when the credit facility is converted to permanent financing, sold or repaid in full.

The risk weighting for HVCRE exposures is the greatest for all commercial real estate loans, as the agencies note "supervisory experience has demonstrated that certain acquisition, development, and construction loan exposures present unique risks for which the agencies believe banking organizations should hold additional capital."

Conversely, multifamily loans[3] are eligible for a reduced risk weight of 50% one year after origination if there is evidence of timely principal and interest payments and if the loan meets specific credit criteria.[4] All other commercial real estate loans that do not meet the characteristics of an HVCRE exposure or a qualifying multifamily loan are assigned a risk weight of 100%.

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[3] Multifamily mortgages are defined as mortgages for residential properties with more than four units.

[4] A multifamily loan will be eligible for 50% risk weighting if the following criteria are met: (i) LTV is less than 80% on fixed-rate loans or 75% for adjustable rate loans, (ii) amortization is not greater than 30 years and repayment of principal is not less than 7 years, and (iii) annual NOI must exceed debt service by 20% for fixed rate loans and 15% for adjustable rate loans.

Table 1 – Commercial real estate risk weightings

Category	Risk weighting	Qualifications
Multifamily loans	50%–100%	50% if specific requirements are met; all newly originated multifamily loans are weighted 100% regardless of borrower history or credit score
Non-HVCRE/ non-multifamily loans	100%	All CRE loans not associated with multifamily and ADC
HVCRE loans	100%–150%	ADC loans are primarily 150% unless specific requirements are met

Potential impact:

Given that multifamily loans will have the lowest capital requirements with a potential risk weight of 50% relative to a weight of 150% for HVCRE loans, banking organizations may be motivated to originate loans secured by existing multifamily properties under the revised capital requirements. Such a reallocation of capital toward the multifamily sector would benefit apartment owners by increasing liquidity and potentially lowering their cost of capital. This capital is much needed in light of the recent trend away from homeownership toward rental units. Incremental, lower-cost multifamily lending will also be required as Fannie Mae and Freddie Mac lower their multifamily origination volumes per the mandate from the Federal Housing Finance Agency (FHFA). However, the lower risk weighting does not apply to multifamily construction loans; allocation of capital away from multifamily construction could result in a shortage of units and ultimately higher pricing to tenants.

Any redirection of funds toward the multifamily sector could reduce the capital available to other property types. The real estate industry greatly relies on the banking sector for this capital, as other sources of capital, including the CMBS market, have proven unreliable through the cycles. Alternatively, banks could maintain their profitability by passing the higher capital costs through to borrowers. A higher cost of capital would put upward pressure on capitalization rates, which drive the value of stabilized properties, and discount rates, which drive the value of new and transitional properties. Accordingly, higher mortgage rates negatively impact both the profitability and asset values of property owners. The resulting lower collateral values would raise LTV ratios and ultimately reduce loan proceeds to real estate borrowers.

The final rule rightly recognizes that different types of real estate loans have different levels of risk that should be priced accordingly, particularly those loans where the collateral has construction or lease-up risk, such as ADC loans. However, the risk-weighting categories are based on broad classifications by asset and loan type, without direct consideration of the credit characteristics of a particular loan or borrower. Loan structures, reserves and other credit enhancements that mitigate these risks are not consistently factored into the capital requirements.

While there has been much discussion about the newly branded HVCRE loans and their 150% risk weighting, most ADC loans are unlikely to fall into the HVCRE definition due to the exemptions noted above. The first exemption is leverage; most ADC lenders are more conservative than the 80% threshold required in the final rule.

The second exemption is that the borrower contributes equity to the project before the bank; this is a cornerstone credit structure of prudent ADC lending that most banks employ.

The third exemption is that the borrower provides 15% cash equity to the project, measured against the "as completed" value of the project. This test departs from traditional bank credit practice in two important ways: (i) typically the equity is 15% or more of the project's cost and (ii) banks usually consider the current value of developable land to count as the borrower's "skin in the game." While the third exemption will not significantly impact a real estate developer purchasing the property at the time of the financing, it may be problematic for a developer who wants to build on land previously invested and held for the right market circumstances. These borrowers may not only find capital harder to source from banks, but the amount and timing of additional equity will have a direct impact on the project's feasibility. Finding construction capital at nontraditional lenders may eliminate the equity issue, but the cost of capital from private equity and other non-bank lenders is typically more expensive than bank loans. As such, the equity rule may negatively impact development, including multifamily development. While there has been limited construction in the US during the past five years, population growth and other demographic shifts over the next decade necessitate significant commercial development.

Banks seek the highest return on capital when determining how to allocate capital among various investment options. Higher capital requirements for commercial real estate, particularly HVCRE loans, could cause the banking system, including the smaller banks that provide critical liquidity to the sector, to redirect funds from commercial real estate lending or charge more for their loans to maintain profitability. Moreover, the additional costs of compliance with these new requirements may drive up the cost of debt. In the current low-interest-rate environment, the impact of more expensive borrowing may be mitigated; however, as interest rates return to historical norms, the changes could significantly impact real estate sector liquidity.

Relationship lending

What's changed:

The Basel III final rule modifies the definition and calculation of capital when estimating the tier 1 capital ratio and common equity tier 1 ratio, placing specific restrictions on the inclusion of mortgage servicing rights (MSRs) in the calculation of capital.

Under the existing general risk-based capital rules, MSRs are included in capital up to 90% of their fair value or book value, whichever is lower. The amount of MSRs not included in the calculation of capital is treated as an asset and subject to a 100% risk weight.

In contrast, Basel III removes the 90% fair value restriction and caps the recognition of MSRs at 10% of the common equity component of tier 1 capital, along with a similar 10% cap on significant investments in common shares of unconsolidated financial institutions and deferred tax assets (DTAs). Basel III also requires a bank to deduct the amount by which the aggregate of these three items exceeds 15% of its common equity component of tier 1 capital. The amount of MSRs not included in the calculation of capital would continue to be subject to a 100% risk weight through the phase-in period of Basel III, ending in 1 January 2018. After the phase-in period, the risk weight would increase to 250%.

Potential impact:

When a commercial mortgage is originated, the process also creates a second asset: the right to service the loan. This second asset represents the lender's right to collect servicing fees with each monthly mortgage payment; such servicing fees are embedded in the interest rate of the loan. The bank has the choice of retaining the servicing function or selling the servicing to third party. Many banks prefer retaining servicing to maintain the relationship with the borrower and to be in a better position to control the workout of the loan in the event a collateral or borrower issue causes a delinquency. The borrower typically benefits from the access and flexibility of working within a relationship if borrowing needs change or problems arise during the loan's term. This flexibility is not always possible when the restructure is managed by a third-party servicer.

By increasing capital charges on MSRs for which a bank does not retain the associated loan, banks may be more likely to sell servicing and lose the benefit of the borrower relationship. Additionally, the borrower will no longer have the ability to continually work with its lender. However, selling the MSRs may be more difficult since the typical buyers are often other banks. Hence, the unintended outcome of the new requirements under Basel III is that commercial mortgage servicing may move to third-party non-bank servicers outside the regulatory environment.

If banks decide to retain servicing, it is likely that servicing fees will be greater, translating into higher loan rates for commercial mortgage borrowers. Moreover, non-bank servicers could take advantage of the situation by raising servicing costs, creating a permanent change in commercial mortgage pricing.

Conclusion

Through both up and down cycles, banks have been the greatest source of debt capital to the commercial real estate sector. The new regulatory capital rules under Basel III will increase the capital that banks must hold against their commercial mortgage exposures. The result will either be more expensive mortgage rates or less capital allocated to commercial real estate. Less favorable treatment of mortgage servicing rights may make retaining servicing less attractive, impeding the desired relationship between lender and borrower.

In aggregate, the changes may have the unintended consequence of moving more commercial mortgage lending out of the banking system to the commercial mortgage backed securities market or to a nonregulated environment with non-bank lenders. While these capital sources can be very efficient, they provide less reliable long-term liquidity.

The recent downturn demonstrated the need for banks to hold more capital against credits in all economic sectors. The new rules reflect the need to better differentiate risk among types of commercial mortgages. Such differentiation and the resulting higher capital requirements are intended to enable banks to absorb losses in times of economic stress and to help prevent future systemic banking catastrophes. However, these changes may negatively impact the availability and cost of debt capital in the commercial real estate sector, making the business of developing and owning real estate less profitable and curtailing development and real estate transactions.

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