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Basel III and commercial real estate valuation

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Basel III implements the revisions of the global Basel capital reforms and relevant provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act. Appraisers should be aware of Basel III and the potential effect the rule could have on commercial real estate valuation.

The U.S. Basel III rules were released by the federal banking agencies in July 2013 and apply to all banks, savings associations, U.S. bank holding companies with greater than $500 million in assets, and all savings and loan holding companies. The complex rules of Basel III focus on strengthening capital requirements, implementing new liquidity standards, and reducing the leverage of banks. Basel III rules require banks to maintain higher capital levels which will force banks to reevaluate their capital allocation strategies. The higher capital levels are tied to the riskiness of the assets. The application of these new rules is expected to impact commercial real estate and construction loans.

Excessive construction lending contributed significant losses to financial institutions during the global financial crisis. In Basel III, regulators attempt to address the risks that arise with construction loans compared with other loans. Previously all commercial real estate loans were given a one hundred percent risk weight, regardless of the underlying collateral, with the exception of some multifamily properties.

The new rules under Basel III will impose a higher risk weight to any loans identified as high-volatility commercial real estate exposure (HVCRE), defined as "a credit facility that finances or has financed the acquisition, development, or construction (ADC) of real property, unless the facility finances one- to four-family residential mortgage property, or commercial real estate projects that meet certain prudential criteria." HVCRE loans are assigned a risk weight of one hundred and fifty percent and require financial institutions to maintain a higher capital ratio. Basel III will also give certain multifamily loans a fifty percent risk weight, if specific conditions are met. All other commercial real estate loans will be assigned a risk weight of one hundred percent.

Commercial real estate ADC loans may be exempt from HVCRE classification if they meet three criteria: (1) The loan has a loan-to-value ratio (LTV) less than or equal to certain supervisory standards which are currently eighty percent or less, (2) The borrower's capital is contributed before bank funding and remains in the project until the loan is paid off or converted to a permanent loan and, (3) The borrower contributes an equity portion to the project in the form of cash (or unencumbered marketable assets) or has paid development expenses out of pocket of at least fifteen percent of the appraised "as complete" value of the project.

While the criteria to avoid HVCRE status were developed with good intentions, there have been issues from a financing perspective. The first requirement of a maximum LTV is not a concern because lenders are usually more conservative with acquisition, development, or construction loans. Lenders typically require a LTV ratio less than seventy-five percent.

The second requirement regarding up front equity is standard practice for lenders.

The third requirement, which forces the borrower to contribute fifteen percent of the "as complete" value, differs from typical underwriting procedures. Traditionally, banks based the required equity percentage on the project's cost, which, at times, also included the land value based upon market value. For Basel III purposes, the land is included at the dollar cost of acquisition and not at market value. In situations where the original cost of the land is less than market value, a developer will be required to provide more cash equity up front than pre- Basel III or the bank will have to classify the loan as HVCRE exposure

The impact of Basel III is apparent in the financing of pre-leased properties and properties with fast absorption because the "as complete" value is close to the "as stabilized" value and normally higher than the project's construction cost. The fifteen percent equity requirement will be based upon the higher "As Complete" value versus the construction cost. Therefore, in certain situations, Basel III will require the developer to provide additional equity.

At this point, Basel III has no real estate appraisal requirements. Appraisers should comply with the requirements of the Uniform Standards of Professional Appraisal Practice for the valuation of real estate for regulated financial institutions.

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