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Risk-based capital requirements: Impact of rules on commercial real estate loans - by Michael Chase

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Two popular sources of commercial real estate financing are banks and insurance companies. According to the Mortgage Bankers Association, banks and insurance companies combined hold 54% of the nearly $4.7 trillion in outstanding commercial mortgages as of the end of 2023. Both of these lender groups are subject to regulations from various local, state, and federal bodies. These regulations include risk-based capital requirements – funds that institutions must hold against certain assets in order to be able to sustain losses and maintain an efficient market. Holding risk-based capital reserves creates an opportunity cost for lenders unable to invest those funds. While rules governing risk-based capital are not new, they are currently having an even greater impact on commercial lending and borrowing.

The Federal Reserve’s actions to increase interest rates in order to tame inflation has put stress on the balance sheets of many banks. This contributed to the collapse of Signature Bank, Silicon Valley Bank, and First Republic in 2023 and more recently to the distress at New York Community Bank. Higher short-term interest rates have increased the cost of capital for banks while also leading to a flight of depositors seeking higher yields generally offered by online banks and money market funds. How does this impact commercial real estate lending? In addition to higher interest rates for commercial real estate loans, many banks are requiring additional deposits beyond the typical ask to simply open an operating account for the financed property. These deposit requests are generally around 10% of the loan amount. Coincidently the standard risk-based capital requirement for commercial loans at banks is 8%. By requesting these extra deposits, the banks are effectively asking the borrowers to self-fund the risk-based capital requirement for the loan. If a borrower does not have an existing deposit relationship, offering deposits can now mean the difference between getting a bank to offer terms.

Life insurance companies have their own sets of guidelines for risk-based capital. Understanding these can help borrowers achieve a significantly lower cost of capital. Insurance companies are regulated at the state level, and many follow the guidelines set by the National Association of Insurance Commissioners (NAIC). The NAIC standards allow insurance companies to set aside the lowest levels of risk-based capital for loans that qualify as CM1. Setting aside less risk-based capital allows lenders to pass savings from lower opportunity costs along to the borrower.

The most important metric in determining if a loan qualifies for a CM1 rating is if it will underwrite to a minimum debt service coverage ratio of 1.50 using the proposed loan rate on a stressed 25-year amortization schedule.

Loans with a lower debt service coverage ratio will get a risk rating of CM2 or higher. For some lenders, qualifying for the lowest risk rating could mean the difference of about 30 basis points in rate. In addition, borrowers with requests for loans rated at the lowest risk level are more likely to be able to negotiate other favorable terms.

Understanding the risk-based capital requirements for lenders is just one of many hidden elements that can help borrowers achieve the best available terms in a challenging environment.

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