New Bank Capital Rules Could Hurt Developers

BY JOSHUA STEIN | 6/08 3:36PM

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Recent changes in federal banking regulations could increase the cost to banks of making certain acquisition, development and construction loans. That could reduce such lending by banks, bring less regulated players into the market, tighten underwriting or increase spreads for these loans and change the development market in other ways. But exactly how remains to be seen.

The problems begin with the concept of "regulatory capital," the idea that a bank must maintain capital equal to a percentage of assets, including loans outstanding. Regulatory capital is expensive to maintain, so banks want to maintain less. But the federal government, as the all-purpose residual bagholder for the banking system, wants more. This is nothing new.

What's new is the idea that "high volatility commercial real estate loans" now require 50 percent more regulatory capital than most other commercial loans. So if a loan falls in that bad category, it costs the bank more to maintain. Thus the bank should demand a somewhat higher interest rate or go make other loans instead.

Any ordinary commercial real estate loan for acquisition, development or construction—i.e., the financing at the core of any real estate developer's business—will potentially constitute a "high volatility commercial real estate loan." Many such loans will avoid that stigma, but that requires satisfying three tests, some potentially troublesome.

First, the loan cannot exceed a certain percentage of the value of the project, typically 80 percent. That is a traditional element of commercial loan underwriting and not very interesting.

Second, before the bank makes any loan advances, the borrower must now invest capital in the project equal to at least 15 percent of the "as completed" value of the project.

The bank regulators interpret invested capital to mean cash. So if a developer bought a site 10 years ago, the invested capital means the purchase price, not the current value of the land. This represents a significant and burdensome deviation from ordinary underwriting standards for construction loans. And if the developer bought the site recently, but with borrowed money, that also probably won't count. Other forms of borrowed money also don't count, although preferred equity may do the trick.

These rules may, among other things, tempt developers to trade "old" sites among affiliates before any construction loan closing, if they can do it without breaking the rules.

Intuitively, one might expect the developer's required investment to equal some percentage of the project "cost." But the regulators require more—a percentage of "as completed" value, which is always a higher number for any project that makes financial sense. So the lender must figure out what the project will be worth on completion. The borrower must increase its 15 percent cash investment accordingly.

What if a developer takes over a failed project or buys into an existing one halfway through? The new rules don't say. One could argue that whatever the new developer pays is just like paying cash for land—it's just as much at risk in the project—even though the money might go to the old developer or a bank that foreclosed on the old developer. But the regulators could conceivably assert that these are funds are not the same as capital invested in the project itself. We don't have the answers yet.

Third, the borrower must put all its money into the project before the bank funds a dollar, and the borrower's investment must stay invested until the project converts to permanent financing. Usually, conversion will require a take out of the construction loan. Conversion to a "mini-perm" loan as part of the construction loan package won't qualify, unless the mini-perm could stand alone as a permanent loan under the lender's regular permanent loan underwriting standards. This could, for example, require the project to demonstrate a year of stabilized income.

Until the project has converted to bona fide permanent financing, the loan documents need to prohibit the borrower from withdrawing any of the borrower's invested capital. Once the project does convert, however, it no longer constitutes "high volatility commercial real estate" so the possible need to maintain extra regulatory capital goes away.

The new requirements don't apply to loans that finance residential projects with up to four units. Can we expect to see more such projects? Will developers break large multifamily projects into multiple four-family projects? Will suburban development become more attractive? The new rules also don't apply to agricultural loans or loans that finance community development projects.

Taken as a whole, the new rules on "high volatility commercial real estate" could give banks a disincentive to make certain types of loans, and encourage banks to tighten some of their terms and underwriting criteria. That was probably an intended consequence. The unintended consequences will unfold over time. They will probably arise mostly from the new rules on minimum invested capital.

In the worst case, they could significantly impair real estate development.

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