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Off Balance

Do commercial borrowers benefit from bank relationships?

by Steve Zorich

"We are looking for a relationship."

"We are a relationship bank."

Often borrowers hear these phrases when requesting a commercial mortgage loan from a bank; however, in these circumstances, *relationship* is really just a marketing-friendly code word for compensating balance.

Compensating balances are funds that a borrower is required to keep on deposit in a bank to satisfy the terms of the commercial real estate loan agreement. Depending upon the stipulated agreement, the deposit may be held in a checking account, savings account, or certificate of deposit. These are cash-restricted funds, and the balance required is usually a percentage of the committed loan amount. The amount is negotiable and can vary widely.

Who Benefits?

The common belief in commercial real estate finance — especially espoused by bank loan officers to their clients — is that if the commercial real estate borrower enters into a compensating balance arrangement with the bank, the borrower will benefit from a lower interest rate on the loan.

While this certainly sounds like a good idea, keeping liquidity on deposit with the lender in exchange for a lower rate is in fact just the opposite. As we see in the example below, agreeing to a compensating balance arrangement significantly increases the effective rate on the loan.

Let's take the following example: A borrower obtains a $5 million loan at an interest rate of 4.5 percent. The annual interest payments are $225,000. The bank's compensating balance requirement is $2 million. In actuality, the borrower is borrowing $3 million ($5 million loan less $2 million compensating balance). Thus, the effective interest rate is 7.5 percent.

The two most prevalent types of compensating balance arrangements banks use are the average balance and minimum fixed amount. The average balance arrangement is most commonly used in commercial banking lines of credit and is calculated on the average maintained account balance over a set period of time, typically a 30-day average. Normally when insufficient balances go below the agreed-upon average balance, the interest rate on the loan will increase.

Oftentimes compensating balance requirements are buried in standard loan agreements.

The minimum fixed balance amount is most typically used in commercial real estate loans. This agreement requires a predetermined minimum balance amount be kept on account at all times. When banks require a set minimum — rather than an average balance — the level of inequity is substantially greater.

With single-asset entities being the most prevalent borrowing structure for commercial real estate, cash held on the balance sheet of these borrowers is often limited. Because of this, banks most often will look to the financial strength of the deep-pocket sponsor behind the borrowing entity to satisfy their compensating balance requirements.

The implementation of the agreement is simplified if the sponsor has an existing depository relationship with the bank. Since the agreement is binding and the liquidity is restricted, disclosure must occur in the borrower's financial statements and the sponsor's personal financial statement. Oftentimes, the bank's compensating balance requirement becomes higher if the amount of liquidity available is higher, thus further driving up the effective cost of borrowing.

Risks and Challenges

Oftentimes compensating balance requirements are buried in standard loan agreements. Many borrowers and principals are unaware that, when signing, they agreed to a compensating balance arrangement.

The effect of entering into a compensating balance agreement in conjunction with a commercial mortgage can be far reaching and is very risky to the borrower and its principals. The risk is that compensating balances give the bank the right of offset. In the event of default on the commercial mortgage, it becomes simple for the bank to freeze or set aside the agreed-upon compensating balance amount. Once done, this cash now becomes restricted and is unable to be accessed or used. The restricted cash held by the bank may be applied to reduce the outstanding loan balance.

Because of the higher effective cost and the risk of having accounts frozen in an event of default, many sophisticated commercial real estate investors often choose to borrow from non-depositary commercial mortgage lenders rather than from their relationship bank. Keeping a commercial mortgage loan separate from deposits is prudent from both a cost and risk management perspective.

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