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Recourse vs. Nonrecourse: Commercial Real Estate Financing—Which One Is Right for You?

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If you are considering an investment in commercial real estate, one of the most important decisions you will make is how to structure your borrowing and who you work with to obtain financing. The financing decision you make has the potential to have a significant impact on the investment's internal rate of return (annualized effective compounded return rate). It's important to note real estate investments carry unique risks, including lack of liquidity and potential complex tax consequences, and may not be suitable for all investors.

Recourse vs. Nonrecourse: Commercial Real Estate Financing—Which One Is Right for You?

Commercial real estate investors typically have two financing options—*loans with recourse* and *loans without recourse.* The primary difference between these two types of loans is as follows:

- Recourse loans: The lender has the ability to collect the difference between the sale price of the property and the amount owed to the lender from the borrowers should the property sell for less than the amount owed. In other words, there is a secondary source of repayment should the value of the property prove to be insufficient to repay the loan.
- Nonrecourse loans: The lender is prohibited from collecting any shortfall in the difference between the sale of the property and the amount owed the lender. The lender's only source of repayment is the property that was pledged as collateral.

Beyond this basic difference, there are other characteristics of recourse and nonrecourse loans that commercial real estate investors should carefully consider when making their financing decisions. Factors, such as flexibility, what kind of relationship you want to have with your lender, and personal liability, are all important considerations. In this report, we discuss the benefits and drawbacks of both options.

Commercial real estate lenders

Before exploring the differences between recourse and nonrecourse loans, it may help to get a sense of who lends to real estate investors and how they structure loans. This information can help you make an informed decision about the right type of loan for your specific circumstances.

There are three primary sources of loans for commercial real estate:

- Commercial banks
- Commercial mortgage-backed securities (CMBS) lenders
- Life insurance companies

Each type of lender has a different source of funding that they draw on to make the loan. Where they source their funding will greatly determine the limitations on the loan that they extend to the commercial real estate investors.

- Commercial banks obtain their funds from depositors.
- CMBS lenders securitize their loans by pooling a large number of the mortgages they extend to borrowers into a single security (bond) and selling pieces of that security to the public market. Borrowers must be a single-purpose entity, which is a limited liability company or corporation that holds title to real estate and owes money to a lender as the result of a mortgage on the property but which has no other assets or liabilities.
- Life insurance companies draw on money from policyholders.

Commercial banks generally extend recourse loans, and this type of loan accounts for almost half of the overall commercial real estate lending market. Nonrecourse loans are generally offered by CMBS lenders and life insurance companies, and they make up roughly 29% of the market. For multi-family properties, the government also serves as a lender through government-sponsored entities (GSE) such as Fannie Mae, Freddie Mac, and the Federal Housing Administration. Each of the U.S. government agencies such as the Government National Mortgage Association (Ginnie Mae) or GSE loan programs function much like the CMBS lenders in terms of benefits and drawbacks.

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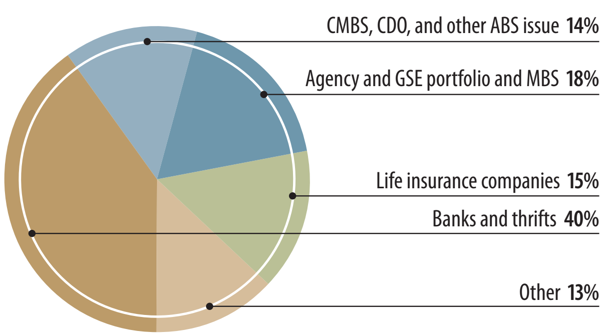
Outstanding commercial real estate leveraging/credit/financing



CMBS: Commercial mortgage-backed securities lenders
CDO: Collateralized debt obligations
ABS: Asset-backed securities
GSE: Government-sponsored enterprise
MBS: Mortgage-backed securities

Source: Federal Reserve Economic Research & Data, as of 9/31/17

Characteristics of recourse and nonrecourse loans

Your commercial real estate investment objectives and comfort level with certain loan characteristics are key considerations in determining which loan type is best suited to meet your needs.

The benefits of recourse loans include greater flexibility in pricing and loan structure and a personal and relationship-based process for ongoing management of the loan. A primary drawback for recourse loans is the personal liability associated with it.

Conversely, one of the main benefits of a nonrecourse loan is the elimination of personal liability. Since nonrecourse lenders have only the property as a source of repayment, they impose certain restrictions on the property's cash flow and operation to ensure the property maintains its value. These restrictions often take the form of escrow and impound accounts as well as the establishment of lockbox arrangements for rent payments (discussed in further detail below).

There is limited flexibility in how nonrecourse loans are structured, as discussed more fully in the next section. Nonrecourse borrowers also need to be aware of provisions called "bad boy" carve outs. These provisions allow the lender to convert a nonrecourse loan into a full recourse loan in the event of borrower bankruptcy or illegal/unethical activities (such as fraud, failure to maintain insurance, etc.).

Flexibility in pricing and loan structure

There are differences between recourse and nonrecourse lenders when it comes to pricing, structuring, and prepayment restrictions, stemming from how the lenders fund their loans.

Recourse loans

One of the benefits of recourse loans is the flexibility in how the loan is structured and priced. As mentioned earlier, commercial banks fund most recourse loans. They hold the loans on their balance sheet. This direct connection between the lender and the borrowers sets the basis for a relationship as the bank gets to know and understand the borrowers' financial situation and borrowing needs.

Recourse loans typically require full financial disclosure and underwriting for each borrower. Having this complete picture of the borrowers' unique financial situation allows the lender to customize and tailor the loan to help meet its specific needs. In addition, the lender is able to work directly with the borrowers during the term of the loan to address restructuring requirements, capital improvements, and property maintenance.

Recourse loans from commercial banks typically are priced on a floating interest rate basis at a spread over an index rate, such as the London Interbank Offered Rate (LIBOR) or the prime rate (the rate at which banks lend to each other). The floating interest rate allows the bank to "match fund" the interest rate earned on the loan with the interest rate paid to depositors, which is also a floating rate. Borrowers also may consider asking their banker for a referral to an interest rate swap specialist to learn more about borrowing at a floating rate and using interest rate hedging strategies as alternatives to floating loans. Such an approach may potentially offer advantages not found with typical fixed-rate loans, but before entering such an agreement, you should ask for information about the interest rate risk associated with such hedging strategies.

The key to determining which loan type is best suited to your needs depends on your investment objectives and your comfort level with certain loan characteristics of recourse and nonrecourse loans:

- **Flexibility in pricing and loan structure**
- **Ongoing management**
- **Personal liability vs. property constraints**

Nonrecourse loans

Nonrecourse loans generally have much less flexibility in terms of loan structure and pricing. Where recourse loans are relationship-based, nonrecourse loans are generally more transactional since the lenders typically do not hold the loans on their balance sheets. As mentioned earlier, nonrecourse loans offered by CMBS lenders are aggregated with other loans that are similarly structured and then securitized into bonds. These bonds are then sold on the open market to fixed income investors. Thus, there is a need to have fairly standardized and consistent loan structures, which necessarily limits how customized a CMBS loan can be. This process is very similar to how mortgages on single-family residences are structured and sold.

Life insurance companies generally provide more flexible loan structures than CMBS since life insurance companies (like commercial bank lenders) hold their loans on their balance sheet. It is worth noting, however, that life insurance companies generally have a narrower scope of acceptable properties than CMBS lenders and commercial banks. They prefer to concentrate on properties that have low leverage, are high quality, and are located in major metropolitan areas. Projects that have unique characteristics, such as ground-up construction, renovation, or distressed properties, typically are difficult for nonrecourse lenders to finance due to their speculative nature and need for intense oversight. These types of projects are most often financed by recourse lenders.

Nonrecourse loans are generally offered on a fixed-rate basis, although floating rates are available. With CMBS lenders, the interest rate earned on the loan is transferred to the bond investors. With life insurance companies, the interest rate earned on the loan is used to manage the company's own balance sheet and pay life insurance claims. The actual loan pricing between the three different types of lenders will vary based on numerous factors.

Borrowers may encounter an issue if they wish to prepay a nonrecourse loan prior to maturity. CMBS bond investors expect to earn a set return for the life of the bond (or the life of the loan). Likewise, life insurance companies try to manage the expected return on their assets (the loans) accordingly, and early prepayment of a loan causes problems in how they manage their balance sheet. To compensate for early loan repayments, CMBS lenders and most life insurance companies usually require early termination fees or enforce "make whole"/"yield maintenance" provisions that attempt to make up the lost revenue the bondholders and life insurance companies expected to receive if the loan was repaid on the original term. Note, standard loan notes contain yield-maintenance prepayment provisions as well.

Ongoing loan management

Recourse loan ongoing management

Once the recourse loan is in place, the relationship between the lender and the borrower serves as the foundation for how the property is managed and maintained. Since recourse lenders have a secondary source of repayment, they typically do not require the establishment of escrow/impound accounts or lock boxes. The relationship between the lender and borrower determines the timing and flexibility of what kinds of capital improvements are needed.

Nonrecourse loan ongoing management

Once CMBS loans are securitized and sold, the oversight and management of the loan is handled by a third-party servicer that acts on behalf of the bondholders. The servicing company is bound by a servicing agreement that expressly details the servicer's fiduciary duty and abilities. In contrast to the more personal model offered by a recourse loan, the servicing agreement significantly limits the amount of flexibility.

As previously mentioned, life insurance companies, like commercial banks, generally have more flexibility in terms of loan oversight since the loans are held on their own balance sheet and not transferred to a third party. That being said, life insurance companies are generally less flexible than commercial banks since they have only one source of repayment—the underlying property.

Personal liability vs. property constraints

As mentioned earlier, the benefit to the borrower for nonrecourse loans is the elimination of personal liability if the loan defaults. This feature provides significant protection to the borrowers. In exchange for this benefit, however, nonrecourse lenders typically impose various restrictions on the property's cash flow and property maintenance schedule to help protect their only source of repayment. These restrictions often take the form of escrow and impound accounts specifically dedicated to the property and held by the lender as well as a set schedule for when capital improvements are needed and performed. The escrow and impound accounts protect the lender by making sure funds are available to pay taxes and perform needed maintenance and improvements and restricting the borrower's ability to defer those items. These escrow or impound accounts are established at loan closing.

Thereafter, a portion of the property's cash flow is directed to these accounts on a regular basis. At times, nonrecourse lenders also require that the property's tenants send their rent payments directly to a lock box controlled by the lender. From this lock box, the lender makes the loan payments and deposits into the various escrow accounts and then distributes the remaining cash flow to the property owner.

As previously noted, nonrecourse loans have claw backs and "bad boy" carve out provisions that allow the lender to convert a nonrecourse loan into a full recourse loan. Such provisions can potentially increase the borrower's liability. Examples of the application of these carve outs can include situations where the borrower is accused of fraud and misrepresentation, rent skimming, diversion of insurance proceeds, and undisclosed environmental contamination, or has filed for bankruptcy.

Conclusion

If you are considering investing in commercial real estate, many factors will influence your decision about whether a particular property is likely to be a good investment. These factors will include building location, its mix of tenants, and the amount you are prepared to invest in upgrades over time, among other considerations. We also encourage you to pay equal attention to the type of relationship you wish to have with your lender and the type of loan that is most appropriate for your needs. As this paper has outlined, the decisions you make about your lender and loan can have a significant impact on the flexibility, management, and personal liability associated with your commercial real estate investment.

And keep in mind, each loan has its own risk considerations. With recourse loans, the primary drawback is the personal liability associated with it. Conversely, with nonrecourse loans, the primary drawback is the lack of flexibility in terms of structure and ongoing management. In addition to less flexibility, nonrecourse loans offered by CMBS lenders and life insurance companies generally have early prepayment fees or defeasance costs if the loan is paid prior to maturity.

Given the complexities and the importance of these decisions, we recommend you discuss potential commercial real estate investments with your financial and tax professionals so that you can weigh the benefits of the investment in the context of your overall financial plan and determine an appropriate financing approach to meet your individual needs.

In general, the following are some points to consider when you're making a decision regarding the financing of your commercial real estate property with a recourse or nonrecourse loan.

You may want to consider a recourse loan if you:

- Want the flexibility to customize the loan structure and pricing
- Want the potential to modify or restructure the loan post closing
- Want to limit prepayment issues
- Do not want to divert cash flow to escrow or impound accounts
- Are investing in distressed properties or new construction

You may want to consider a nonrecourse loan if you:

- Do not want to provide personal recourse for repayment
- Plan on holding the property for the length of the loan
- Don't expect to change or modify the loan during the term
- Are comfortable with diverting property cash flow to escrow or impound accounts

The decisions you make about your lender and loan can have a significant impact on the flexibility, management, and personal liability associated with your commercial real estate investment.

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