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Basics of Reserves

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Reserves are amounts deposited with a lender as security for an obligation expected to occur at a future date, and can serve various functions. The following is an overview of typical reserves in a real estate finance transaction.

Required Repairs

Lenders typically commission property condition reports in connection with a financing which detail immediate repairs anticipated to be required in the short-term for a property. The time frame ranges from work needed immediately to work which should be accomplished over the next 6-12 months. Work beyond that time frame would typically be characterized as a capital expenditure project, which would be addressed in another potential reserve. The anticipated cost of required repairs would be held back from the loan proceeds at closing and funded into a reserve account for such work. Such funds are then released either as progress payments to fund such work or in a lump sum as such work is completed.

Real Estate Taxes

Since most real estate taxes, if not paid, are a lien on real property which is senior to the lien of a first mortgage, many lenders require that a borrower maintain a reserve for real estate taxes. Typically, a borrower would make deposits into such reserve on a monthly basis in an amount equal to one-twelfth of the annual real estate taxes such that when real estate tax payments (usually semi-annual payments) are due, the appropriate amount is on deposit. Disbursements from these reserves are either made directly to the taxing authority or to the borrower against evidence of the payment of the real estate tax obligation.

Insurance

Since most real estate financing is structured as non-recourse, whereby upon a default the lender's remedy is to foreclose and obtain title to the real estate without recourse to a creditworthy entity for any deficiency, the maintenance of insurance on the property is critical. If the building is destroyed and there are no insurance proceeds available, then the lender's recourse is limited to a piece of land with a partially or totally demolished building. Consequently, it is typical for a borrower to make monthly deposits into a reserve equal to one-twelfth of the premium anticipated to be due on the insurance policy such that the lender has a sufficient amount to pay such premium when due. Disbursement of the premium payment is either made directly to the insurer by the lender or to the borrower against evidence of payment of the premium.

Capital Expenditures

Similar to immediate repairs, over the long-term, properties require repairs and maintenance which are capital in nature. To ensure that funds are available to pay for such significant items as they come due, lenders will typically require that a certain amount (usually codified as an amount per square foot) be deposited in a reserve for future capital improvements. Mechanisms and requirements for disbursements from this reserve, while similar to that for immediate repairs, tend to be a bit more robust given that these items tend to be more significant and are in larger sums. Consequently, the requirements for disbursement are more consistent with slimmed-down requirements for disbursements which are typical for a construction loan.

Tenant Improvements and Leasing Commissions

In order to lease vacant space, landlords have to expend significant sums in order to pay brokerage commissions and costs of tenant improvements. In order to be competitive in the leasing market, landlords must expend such sums to induce tenants to rent space in their buildings. Consequently, in order to anticipate the amounts that will be needed to re-lease existing vacant space and space anticipated to be vacant during the term of a loan due to the “roll-over” of existing tenants (*i.e.*, the renewal of an existing lease or the reletting of such space to a new tenant), lenders will require amounts to be deposited into a reserve which will typically include a lump sum amount at closing, together with monthly deposits to accumulate sufficient amounts to pay such sums. Disbursements are made after a new lease is signed to pay such brokerage commissions and to fund required payments of the reimbursement to tenants of tenant improvement work in the form of a tenant allowance or to fund work which a landlord performs to induce such tenant to rent such space.

Ground Rent

To the extent that a property is not owned in fee, but is owned pursuant to a long-term ground lease, the efficacy of such ground lease is critical to the lender since, should the ground lease terminate, the lender’s collateral disappears since its mortgage lien is limited to the ground leasehold interest, not the fee. In addition to the numerous protections afforded the lender in a ground lease to make it a “financeable” ground lease, such as notice and cure rights in the event of a default, lenders will require that a reserve for the payment of the anticipated ground rent be established. The reserve held by the lender will be funded with monthly amounts such that an amount equal to the required ground rent payments are always available to pay such rent directly to the ground landlord.

FF+E

In financings of hotels, it is customary to reserve funds for FF+E or furniture, fixtures and equipment. Hotels, in general, refurbish and update their entire property on a periodic basis. This practice is driven mainly by requirements of the manager or “flag” running the hotel. Management contracts require that hotels are refreshed and updated periodically so they are consistent with the franchise requirements and, theoretically, will attract customers to a newly refurbished property. Consequently, lenders will require that a percentage of gross revenues, usually 4%, is deposited into a reserve to pay for such refurbishment. Many management contracts with the major flags will require that this reserve is maintained by the manager, but if not, the lender will maintain same. Disbursements from the reserve are typically made against evidence of completed work or purchase.

Free Rent

Many tenants, as part of their economic deal or package of inducements to lease their space, may receive a certain amount of rent abatement or free rent. Many times, this is just reflected in the lease as the tenant having no obligation to pay rent over the first 1, 3, 6, 9 months or longer of the lease term. In certain cases, the abated rent may be spread out over longer periods of the lease term on a periodic basis such that the tenant receives the abatement during the first 3 months of each of the first, fifth and seventh year of the lease term, for example. Regardless of the arrangement, many lenders are concerned about the interruption of the cash flow of the property and may require an upfront or periodic deposit of sums equivalent to this free rent such that the cash flow of the property does not have significant shortfalls. Disbursements from this reserve would mirror the applicable free rent periods.

Conclusion

The foregoing outlines some of the more typical reserves seen in real estate financing. It should be noted, however, that there are many other reserves that are used in real estate financings to address deal-specific or property-specific issues. As outlined, reserves are a useful way for lenders to address property-specific issues, smooth out cash flow and protect against various issues.