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Loan-to-Value Tests in U.S. Real Estate Finance Transactions

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The financial test of the Loan to Value (LTV) ratio in U.S. syndicated lending continues to be used in underwriting and certain covenant conditions. While we have seen a shift from the use of Debt Service Coverage Ratios (DSCR) to Debt Yields (DY) since the 2008 recession, the LTV ratio continues to be used in certain circumstances.

First, an LTV test or LTV ratio is a test that is contingent upon a current FIRREA Appraisal. The test is not an ongoing test or covenant but a financial test calculated at a moment in time. It is the ratio of the outstanding principal amount of the applicable loan to the appraised value of the collateral property. Sometimes in a construction loan or a loan with a future advance or earnout there are negotiations concerning what is the outstanding principal amount. Is it the actual outstanding principal amount or the amount that is capable of being advanced since the lender has an obligation to advance such amount and has reserved such funds? Typically, most lenders will calculate an LTV on the total debt that is capable of being advanced unless the future advance is very tenuous or subject to conditions which are unlikely to be satisfied. It should be noted that sometimes lenders have an ongoing charge for reserving funds to be advanced, which is typically called an "unused commitment charge." It is in effect an interest charge (albeit a much lower rate) on the amount of unadvanced funds to compensate the lender for being obligated to advance such funds. This charge is not as common nowadays in syndicated and construction loans. The second prong of the test is the appraised value of the collateral property. The appraisal needs to be FIRREA compliant, current and reviewed and verified by the lender.

An LTV test is universally a part of the underwriting process but less likely a part of ongoing financial covenants since the test requires an appraisal rather than just a calculation based upon a borrower's financial statements. For this reason, it is rare to see an LTV test in a "Trigger" test which typically triggers the imposition of cash management or a cash sweep. For underwriting purposes, a loan will usually have in its term sheet an LTV test which is used to size the loan. Since this test is satisfied as part of the origination process, it is not contained in the loan documentation.

The two instances where an LTV test is typical are extension conditions and resizing or curtailment provisions. Sometimes, as a condition to a right of extension, the borrower will need to satisfy an LTV test as of the date of extension. Consequently, the borrower will need to obtain a current FIRREA appraisal, and the LTV test must be met as a condition to being able to extend the loan. In many instances, if the LTV test is not met, a borrower will still be able to extend the loan if it pays down the loan to comply with the LTV test or posts cash or a letter of credit as ongoing collateral to comply with the LTV test.

In addition, some loans will require periodic LTV tests during the term of the loan. Again, the borrower would need to obtain an appraisal and, to the extent that the LTV test is not satisfied, the borrower would then be required to resize or curtail the loan by prepaying an amount such that the loan would then satisfy the LTV test, or alternatively, post such amount, as ongoing, collateral cash or a letter of credit.

While not as common as DSCR or DY tests, LTV tests do continue to be used in real estate finance.