

BANK TRENDS

Analysis of Emerging Risks in Banking

WASHINGTON, D.C.

STEVEN K. BURTON

Recent Trends in Construction Lending Practices

A record number of insured institutions failed between 1989 and 1993. Studies of this period indicate that commercial real estate and construction loan concentrations, combined with relaxed underwriting standards, exposed a number of institutions to heavy loan losses when regional real estate values collapsed under the weight of excessive property supplies. A resurgence of construction activities in the latter half of the 1990s has renewed concerns about overbuilding and prompted questions regarding the prudence of recent underwriting practices. To answer these questions, the FDIC's Division of Insurance and Division of Supervision undertook a joint project to compare recent underwriting practices of insured depository institutions with those prevalent during the 1980s. The study relied on transaction-level underwriting data as well as interviews with lenders and regulatory supervisors. The study concludes that while current standards are generally more conservative than they were during the 1980s real estate boom, borrowers are nevertheless able to obtain concessions on pricing and terms due to intense competitive pressures. The study also finds a number of factors, with both positive and negative implications, that distinguish today's lending environment from that of the 1980s.

(The author would like to thank Senior Financial Analyst Diane Ellis and Examination Specialist Serena Owens for their significant contributions to this project.)

Loan Underwriting Project Target Markets



Recent Trends in Construction Lending Practices

Market volatility and economic decline offer the truest tests of business strategies. What may appear to be sound and profitable decisions in prosperous times can prove disastrous under more trying economic circumstances. In the banking business, loan pricing and underwriting are critical strategic decisions for achieving near-term market positioning, profitability, growth, and loan loss experience objectives. In conjunction with portfolio mix decisions, underwriting practices can also influence a bank's long-term viability, especially when market conditions deteriorate. Rather than using a static set of parameters, lenders monitor and adjust lending guidelines in response to changes in industry conditions and market expectations.

Adjusting loan pricing and terms to reflect changing market expectations is especially important for construction lenders, since loan repayment depends to a large extent on market drivers for real estate demand. Accurately predicting demand for proposed real estate is a challenging process, since there is often a long lag between a project's conception and its completion. Moreover, real estate forecasting has historically been difficult because of incomplete information. The experience of the 1980s is an example of how lenders sometimes failed to adjust lending terms in response to changing economic conditions and often failed to consider the possibility of cyclical swings in real estate values.

In August 1998, analysts from the FDIC's Division of Insurance and Division of Supervision undertook a study of construction loan underwriting practices, focusing on insured depository institutions that actively pursue construction lending business within selected markets experiencing rapid commercial

property development. The primary goal of the study was to provide additional context to regulatory survey results, which at the time suggested more aggressive practices and easing construction loan terms by many commercial banks. Using 1980s practices as a benchmark, the study attempted to gauge the extent of any easing in either loan pricing or loan terms. Another objective of the project was to compare and contrast the current lending environment with that of the 1980s. As discussed below, the current lending environment is unique in many respects with both positive and negative implications for commercial real estate¹ lending risks.

Commercial Real Estate Lending Has Historically Posed Higher Risks for Insured Institutions

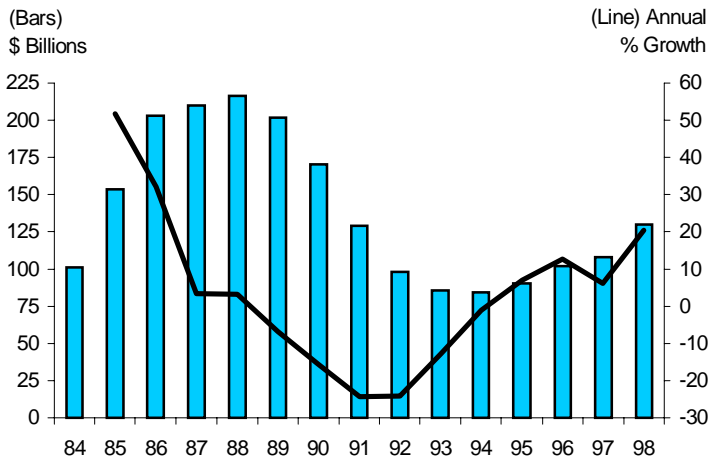
Commercial real estate risks are a perennial supervisory concern because of the experience of many insured institutions during the banking crisis of the 1980s and early 1990s. In 1997, the FDIC released results of its *History of the Eighties* project, which established a clear link between commercial real estate concentrations and bank failures from 1980 through 1993.² Specifically, banks that failed during this period tended to have higher levels of commercial real estate loans relative to total assets than banks that did not fail. The growth in commercial real estate loan concentrations for many insured institutions corresponded to a period of rampant development, which in turn led to severe imbalances between supply and demand, rising vacancy rates, and a sharp decline in property values in various major markets across the country.

The *History of the Eighties* study also concluded that commercial real estate loan losses recognized by banks were preceded by a period of loosened underwriting standards. This relaxation of standards was prompted in large part by competitive pressures. Some of the key changes to standards noted in the *History of the Eighties* study were an increase in “collateral-based” lending,³ higher loan-to-value limits often accompanied by inflated or overly optimistic appraisals, and inattention to secondary repayment sources.⁴ Because standards were eased, banks were less protected against the significant drop in property values that occurred in such areas as New England, Texas, and Southern California. The result was a record number of bank failures from 1989 to 1993.

Mid-1998 Market and Supervisory Indicators Raise Caution

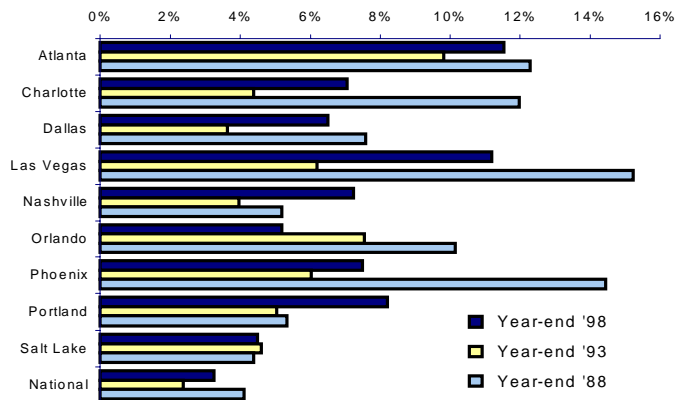
Some markets are experiencing a boom in construction activity. Real estate markets across the country have for the most part recovered from the decline in values during the late 1980s and early 1990s. Factors responsible for this recovery include strong employment gains, pent-up demand following a paucity of new construction through the first half of the decade, and low interest rates. With the resumption in development activities, construction and land development (C&D) loan growth at insured institutions has increased to levels not seen since the 1980s. Nationwide, however,

Chart 1
Construction Loan Growth Rebounds



Source: Bank Call and Thrift Financial Reports (Research Information System)

Chart 2
Rapidly Developing Markets Show Rising Community Institution C&D Loan Concentrations



Note: Average C&D loans as a percent of assets for insured institutions with under \$1 billion in assets. Source: Bank Call and Thrift Financial Reports (Research Information System)

C&D loan volumes remain well below those experienced during the mid- to late 1980s (see Chart 1). Still, there are selected markets where the rapid pace of construction has raised prospects for overbuilding. Metropolitan markets deemed most vulnerable to near-term overbuilding were highlighted in a recent issue of the FDIC’s *Regional Outlook*.⁵ This analysis was based on a review of supply and demand trends as well as the opinions and projections of various market analysts.

Community banks within rapidly developing real estate markets are experiencing higher C&D loan concentrations. Perhaps not surprisingly, community institutions within the most active development markets are experiencing rising exposure levels to construction lending.⁶ As shown in Chart 2, community banks within each of these rapidly developing areas have higher than average exposures to construction lending than community banks nationwide. In most cases, average concentration levels are rising in comparison to early 1990s levels but are below late 1980s levels.

Supervisory surveys from September 1997 to September 1998 suggested eased standards for C&D and commercial real estate lending. Regulatory surveys of commercial real estate and construction loan underwriting practices through mid-year 1998 also raised early warning signs that concessions on pricing and terms were increasing. For example, in the *Office of the Comptroller’s*

1998 Survey of Credit Underwriting Practices, examiners reported eased commercial real estate lending standards in 43 percent of banking companies surveyed. In comparison, surveys for 1997 and 1996 reported a 38 percent and a 16 percent incidence of easing, respectively.⁷ In both the 1998 and the 1997 survey, competition was cited as the overriding reason for eased standards. The September 1998 *FDIC's Report on Underwriting Practices* also suggested easing construction loan terms compared with the prior year's survey results. Specifically, this survey found higher incidences of speculative construction lending and failure to consider alternative repayment sources.⁸ Although more recent regulatory surveys suggest some tightening of commercial real estate loan standards, it is still informative to outline specific practices and recent trends observed during the course of this study and contrast them with practices commonly associated with the excesses of the 1980s.

Evidence of Recent Construction Loan Underwriting Criteria

This project focused on documenting current practices with respect to a limited number of key underwriting criteria: pricing, borrower cash equity requirements, recourse arrangements, loan-to-value requirements, tenors, and estimates of debt service coverage upon completion and lease-up of a project. While not an exhaustive list of terms and procedures critical to the construction loan underwriting process, the underwriting criteria reviewed for this study are sufficient to form some conclusions about recent industry practices.

Construction Loan Pricing and Fees. Loan pricing margins (including fees) documented during this study were found to be exceedingly thin even compared with the pricing prevalent during the height of the 1980s building cycle. Virtually every banker interviewed during the course of the project confirmed this observation. The pricing structures observed generally varied by developer/borrower size and scope of operations. C&D loans to large regional or national developers were commonly priced at some spread over the London Interbank

Offer Rate (LIBOR), with typical spreads ranging from 30/60/90 day LIBOR plus 175 to 275 basis points. Origination fees associated with these loans ranged from zero to 100 basis points. Banks usually assessed additional fees for extensions (typically 25 basis points) and conversions from the construction phase of a loan to "mini-perm"⁹ status (typically 25 to 50 basis points).

According to bankers interviewed, the implementation of LIBOR-based pricing for construction lending is a fairly recent phenomenon that owes its existence to the proliferation of alternative funding sources and the increasing access of larger development companies to the capital markets. The choice of LIBOR as a reference rate is usually more favorable to the borrower than prime-based loans. For example, in mid-May 1999, a loan priced at a spread of 90-day LIBOR plus 250 basis points (a commonly observed LIBOR-based spread) would carry an interest rate of approximately 7.5 percent, whereas a loan priced at prime plus 0.5 percent (a commonly observed prime-based spread) would carry a rate of 8.5 percent. Interestingly, a number of LIBOR-based loans would offer the borrower the option of selecting the lower of two or more reference rate options whenever the loan rate reset. Some of the lenders and supervisors interviewed for this project observed that many banks have attempted to offset declining C&D loan margins by promoting ancillary services to the borrower (relationship banking). However, such strategies provide little benefit to downstream participant banks, which frequently purchase portions of the largest credits.

For smaller, local developers, prime-based lending

Table 1

Loan Pricing: Observed Reference Rates

Reference Rate	Percent of Loans		
	Commercial Construction	Residential A&D	Single-Family Construction
LIBOR	31	7	5
Prime	68	93	82
Other or Fixed	1	-	13

Percentage of loans within each property category where pricing information was documented (A&D = acquisition and development).

Sources of Information for the Study Range from Supervisory Reports to Decision-Level Lending Criteria

To understand more fully industry practices in active construction lending markets, this study drew from a wide range of analytical and supervisory resources. Following is a brief outline of the sequence of activities and information gathered during the project.

Selecting the Target Markets. The first stage of this project involved identifying a limited number of markets for further investigation. Markets were selected on the basis of previous Division of Insurance analyses of development activities within major commercial real estate markets throughout the country as well as regional analyses of specific local market conditions and trends.¹⁰ On the basis of these analyses, three primary focus markets were chosen: Atlanta, Dallas, and Las Vegas. Charlotte, Phoenix, and San Jose were also investigated on a more limited basis.

Selecting Institutions. The second stage of this project involved identifying institutions actively engaged in construction and development lending within the primary focus markets. The screening criteria used for these purposes considered the following factors: headquarters of operations,¹¹ construction lending in excess of 25 percent of loans, and annual loan growth in

excess of 10 percent. This screening process identified approximately 170 banks for further review.

Reviewing Examination-Based Information. In this third stage, supervisory information was reviewed. In addition to recent underwriting survey data, analysts reviewed supervisory and examination comments from approximately 150 of the 170 banks identified as active construction lenders. To obtain information about specific underwriting practices, analysts reviewed workpapers¹² from recent examinations and participated in ongoing bank examinations. Table 2 shows the number and volume of loans that were reviewed for this study broken down by target market and by broad project type. Although the banks reviewed for this project were primarily engaged in local area lending, a relatively small number of loans among those reviewed were secured by projects outside the target markets listed in Table 2.

Interviews and Bankers Meetings. The final stage of the project involved roundtable discussions with local area bank lenders and interviews with supervisory staff within each of the three primary focus markets.

Table 2

Construction and Development Loan Review Activity

Target Market	Number of Banks	Number of Loans	\$ Volume All Loans (000s)	Number of Residential Loans	\$ Volume Residential (000s)	Number of Commercial Loans	\$ Volume Commercial (000s)
Atlanta	5	119	277,144	79	129,074	40	148,070
Charlotte	4	56	173,189	33	89,739	23	83,450
Dallas	6	117	698,958	74	345,110	43	353,848
Las Vegas	7	116	193,992	57	81,101	59	112,891
Phoenix	3	22	25,935	12	12,516	10	13,419
San Jose	4	26	113,973	13	31,422	13	82,551
Total	29	456	\$ 1,483,191	268	\$ 688,962	188	\$ 794,229

was the norm. Here, the typical spread over prime ranged from 0.25 percent to 2 percent.¹³ According to bankers interviewed, current prime-based C&D loan interest rate spreads are lower than those granted during the 1980s, which usually ranged in excess of prime plus 3 percent. For most of the banks involved in this study, it was observed that loan rates had trended lower over the past several years.¹⁴ Again, this observation was universally confirmed by bankers, who pointed to intense competitive pressures as the underlying reason for the reduced interest rate spreads. Some bankers indicated that this pressure has eased somewhat following the financial market turmoil in the latter part of 1998, especially for larger commercial development projects. For single-family development projects, however, most bankers felt that the trend toward thin loan pricing margins is not likely to be reversed and may narrow even further given the increased availability of alternative funding sources.

Borrower Cash Equity. One of the more positive findings of this project was a nearly universal agreement among bankers that borrowers should have a significant financial stake in commercial development projects. In many cases, lenders ranked this factor as one of the more important variables in the underwriting process. The rationale behind minimum cash equity requirements is that the borrower will be more motivated to see a project through to completion if personal funds are at risk. Bank lending policies reviewed for this project typically required a minimum equity contribution of 15 percent on commercial development projects, where the numerator is equal to cash (or land cost) contributed by the borrower and the denominator is equal to the sum of total hard and soft project costs¹⁵ (including land costs). Although most banks

in the study paid close attention to cash equity requirements, many bankers acknowledged that once pricing margins are eroded by competition, cash equity and personal recourse requirements are the next most likely terms to be negotiated away. In fact, loans reviewed did include some instances, mostly involving loans to larger developers, where the borrower had minimal, if any, cash equity at risk.¹⁶

In contrast to commercial construction loans, many banks placed less emphasis on cash equity requirements for residential acquisition and development (A&D) and single-family housing construction loans (see Table 3). In the case of residential A&D loans, most banks had equity requirements, but it was not unusual to see internal policy exceptions in this area, particularly when the bank felt it had sufficient collateral coverage (i.e., a low loan-to-value) or strong secondary repayment sources or guarantors.¹⁷ In a number of cases, the borrower was allowed to recoup personal contributions as new phases in a multiple-phase project were started (even when the initial equity contribution consisted solely of land equity). In the case of single-family home construction, advancing up to 100 percent of project costs to seasoned developers was a common practice. According to bankers and examiners interviewed, advancing 100 percent of costs on single-family construction is a standard industry practice that has not changed from prior cycles.

Borrower Recourse Arrangements. Instances of nonrecourse construction lending were rare in the loans reviewed for this study. Recourse arrangements and practices varied widely, however, particularly for larger developers. Here, a distinction is made between personal recourse arrangements that obligate an individual to repay the loan in the event of default and other types of recourse arrangements. In a few cases, analysts observed commercial development loans that were guaranteed solely by the underlying development partnership or corporation (see Table 4). These types of recourse arrangements often have little value when projects encounter financial difficulties, since the financial fortunes of the guarantor are usually closely tied to the project in question.

Table 3

Observed Borrower Equity Requirements

Required Equity Coverage of Costs*	Percent of Loans		
	Commercial Construction	Residential A&D	Single-Family Construction
> 10 percent	19	29	42
≥ 10 percent	81	71	58

*Hard and soft costs (land costs included). Percentage of loans within each property category where information was documented.

Table 4**Observed Borrower Recourse Requirements**

Type of Recourse	Percent of Loans		
	Commercial Construction	Residential A&D	Single-Family Construction
Limited or No Personal Recourse	9	11	15
Business Recourse Only	2	-	-
Full Personal Recourse	88	89	85

Percentage of loans within each property category where recourse arrangements were documented.

Recourse requirements among community banks¹⁸ in the study were fairly standard; they generally required unconditional personal guarantees for construction lending regardless of project type or loan size. Moreover, when guarantees were required, most banks attempted to verify the financial capacity of the guarantor through current financial statements. Larger banks, on the other hand, tended to have a tiered approach to guarantee requirements. For example, larger developers could in some instances obtain funding on a limited or non-personal-recourse basis. Developers with a nationwide or regionwide scope of operations were often able to obtain recourse “burn-off” provisions, in which recourse (both personal and corporate) was phased out in percentage terms upon completion or attainment of specified debt service coverage ratios. For local builders, on the other hand, a full personal guarantee is almost always required.

Another less frequent recourse variation was a requirement to guarantee completion of a project but not performance on the loan. In instances where banks extended revolving credit lines¹⁹ for development purposes, nonrecourse arrangements were fairly common. These types of arrangements

Table 5**Supervisory Loan-to-Value Limits**

Loan Category	Loan-to-Value Limit
Raw Land	65%
Land Development	75%
Commercial Development	80%
1 to 4 Family Residential Development	85%

Source: Part 365, Appendix A of FDIC Rules and Regulations

were usually available only to larger developers.

Loan-to-Value Requirements. Section 304 of the Federal Deposit Insurance Corporation Act of 1991 (FDICIA), 12 U.S.C. 1828(o), required the federal banking agencies to establish standards for real estate lending. The resulting standards and related guidelines include supervisory loan-to-value limits for land, land development, and construction loans as shown in Table 5. Most of the banks whose loans were reviewed for this study had adopted the loan-to-value limits shown in Table 5 into their own internal loan policies. In some cases, bank policies had more conservative ratios than supervisory loan-to-value limits. Banks are allowed to exceed these loan-to-value limits as long as the bank documents why the loan is still a good business decision despite the low collateral margin, and as long as the total amount of nonconforming loans does not exceed 100 percent of a bank’s total capital.

This study did reveal a number of construction loans that exceeded banks’ internal policy limits. However, relatively few of the loans reviewed exceeded the above supervisory guidelines. Once again, loans with the highest loan-to-value ratios (some approaching 100 percent) were typically made to larger, more seasoned developers. Although exceptions to internal policy and supervisory lending limits generally were well documented in the initial presentation of credits to the bank’s board or credit committee, few banks in the study maintained an aggregate running list of such exceptions, as recommended by the supervisory guidelines. Moreover, how a property’s value was determined was often inconsistent between lenders, particularly with respect to residential A&D loans. Specifically, some lenders based valuations on a gross retail basis, while others used a discounted sell-out basis to value projects.²⁰

Unsecured Lending. A number of loans reviewed during the study were granted on an unsecured basis. These facilities were generally extended to large real estate investment trusts (REITs) and large corporate developers to support existing inventories and development. In place of collateral protection, these unsecured lines contained various loan covenants designed mainly to protect the bank

Table 6**Observed Loan-to-Value (LTV) Requirements**

Approved LTV	Percent of Loans		
	Commercial Construction	Residential A&D	Single-Family Construction
≤ 85 percent	91	88	97
> 85 percent	9	12	3

Percentage of loans within each property category where information was documented.

against excessive leverage. Common covenants observed included maximum leverage ratios, minimum equity requirements, and limits on encumbered assets through recourse or cross-collateralization arrangements with third parties. Some covenants also limited funds that would be advanced against speculative development or within certain geographic locations.

Loan Tenors. The stated maturity of most construction loans reviewed fell within reasonable time frames considering the type and size of the project. Typical maturities by project type were 12 months for single-family construction; one to two years for lot development, office, retail, and industrial projects; two to three years for large-scale apartment projects; and one to five years for hotel development. Tenors of revolving lines for development purposes ranged from one to four years.

Take-out Financing. Among those loans observed, banks commonly approved mini-perm loans concurrently with the origination of the construction loan. Pricing and terms on these mini-perm loans varied widely, but most maturities fell within five years, and repayment schedules were based on 25-year or less amortization. Thirty-year amortization terms were observed in only a few instances. Few loans reviewed had take-out arrangements by third parties, with most institutions opting to provide intermediate-term financing themselves.

Debt Service Coverage. A debt service coverage (DSC) ratio measures how many times a project's net cash flow covers debt service payments. In a construction lending context, lenders view the DSC ratio as one measure of a project's feasibility.²¹ The

ratio is also used as an indicator of cash flow cushion available to the permanent lender in case rental rate, absorption, and interest rate projections fail to materialize (the higher the ratio, the more attractive the loan will be to a permanent lender). Of course, these ratios are subject to a number of assumptions, particularly when the project is in the construction phase. One potentially troublesome assumption is the application of today's relatively low interest rates to projected debt servicing requirements. A more prudent practice is to subject projections to various adverse scenarios to determine how sensitive a project's feasibility is to changes in market conditions and interest rates.²²

Most of the commercial development loans reviewed contained estimates of debt serviceability upon completion of the project. This finding suggests that bankers are paying closer attention to the economic viability of projects that they fund. Moreover, in some (but not all) cases, banks were subjecting these ratios to some form of sensitivity analysis, which recognizes the inherent market uncertainties related to these projects. The DSC ratios observed were typically in excess of 1.25 to 1.0. The lowest DSC ratio observed was 1.1 to 1.0.

Speculative Development. Development risks can be substantially reduced by securing leases for planned space before breaking ground on the project. Without substantial preleasing (or presales in the case of single-family development), the developer is "speculating" that market conditions will generate sufficient demand to absorb the project. Approximately 50 percent of the commercial construction loans reviewed could be classified as purely speculative (see Table 7).²³ The remaining projects were split evenly between those that were partially preleased and those that were fully preleased (including owner-occupied and build-to-suit). A higher percentage of residential A&D loans were funded on a purely speculative basis. Single-family construction loans observed were mixed between purely speculative, partially sold (partial presales on multiple-unit tract developments), and pre-sold projects. In the case of residential properties, it was fairly common for banks to place limits on either the number of or the funding volume supporting speculative lots or

Table 7

Observed Instances of Speculative Development

Extent of Preleasing or Presales*	Percent of Loans		
	Commercial Construction	Residential A&D	Single-Family Construction
Fully Speculative	48	62	43
Partially Leased/Sold	26	36	42
Build-to-suit or Fully Leased/Sold	26	3	16

*At the time of loan approval. Percentage of each property category where preleasing or presales activity could be determined

homes. As evidence of the vibrancy of the markets reviewed, speculative single-family construction and development projects often sold out before the end of the construction period. Still, many lenders recognized the risks inherent in speculative residential development by placing various limits on the volume or number of speculative homes or lots within a given project or a given credit line.

Summary of Underwriting Criteria Findings.

The construction loan underwriting practices observed for this study do not appear to approach the aggressiveness of practices exhibited during the real estate boom years of the last cycle. Because of intense competitive pressures evident in today's financing markets, borrowers appear capable of obtaining concessions from lenders, but these have primarily taken the form of pricing concessions. Structural concessions were also observed but were generally associated with a limited number of larger developers, who typically have greater access to financial markets and therefore have more financial flexibility with which to weather adverse conditions. Among the most aggressive structures found during the study were long-term (from three to four years) unsecured lines to REITs and large corporate developers, limited or nonrecourse loans, loans with no or nominal borrower-contributed equity, and loans with thin projected collateral value protection. These aggressive structures were usually observed in conjunction with large, seasoned developers. Perhaps more important, most of the bankers interviewed expressed a shift in underwriting focus from the "collateral-based" lending philosophy that guided many credit decisions during the 1980s to a greater emphasis on

project feasibility, the impact of competitor projects, completed project cash flows, and borrower cash equity requirements. Still, competitive pressures are a major influence on current underwriting practices as borrowers take advantage of a wider range of funding alternatives available in both public and private debt and equity markets to secure the most favorable price and terms.

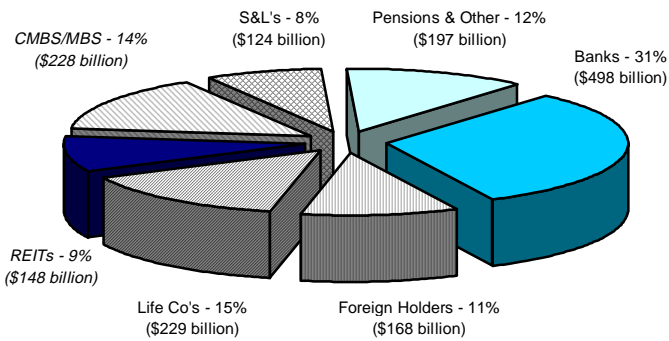
Comparing the Present Lending Environment with the 1980s

Any discussion of industry underwriting practices should be placed in the context of the competitive, market, regulatory, and industry conditions in which they are observed. To this end, this project attempted to contrast the recent construction lending environment with that of the 1980s. Many of the following observations were drawn directly from roundtable discussions with bankers and bank regulators.

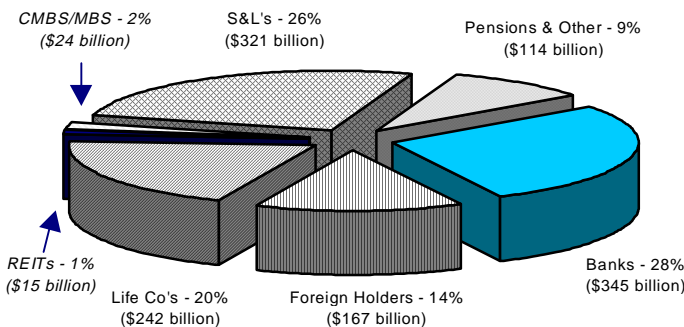
Public funding and intensifying competition have been significant drivers of underwriting practices. According to most of the lenders interviewed during this study, competition within the commercial real estate funding area has not diminished in comparison with the 1980s. Rather, most lenders felt that competition has intensified in recent years. This sentiment seems to be confirmed by the rapid market-share growth of public funding vehicles such as commercial mortgage-backed securities (CMBS) and REITs (see Chart 3). For the most part, REITs and CMBS provide permanent capital flows rather than development funds to commercial real estate projects. Nevertheless, these sources have an indirect influence on construction financing, since they provide much of the take-out financing for completed projects. Construction lenders may be more aggressive (lending on a speculative basis, for instance) if they believe abundant funding (by REITs, CMBS, or other sources) is available to "take out" the C&D loan.

Competition also has been influenced by the relaxation of interstate banking restrictions. Eliminating barriers to interstate branching, for example, has allowed regional and nationwide

Chart 3
REITs & CMBS Hold More Commercial Real Estate (CRE)
3Q98 Debt & Equity CRE Outstandings by Holder



1988 Debt & Equity CRE Outstandings by Holder



Sources: Money Market Directory, NAREIT, FDIC, ACLI, Dept. of Commerce, Lend Lease Investment Research

banks to establish a greater presence in many of the markets focused on for this study. Even though banks tend to focus on loan sizes commensurate with their asset size, it was not unusual to see community banks competing with nonlocal regional banks for their larger clients' business. Likewise, regional banks often compete directly with nationwide banks for lending relationships. Evidence of the intensity of competition between banks could often be found in loan files, where borrowers used loan proposals from other lenders to negotiate terms with the bank that ultimately extended credit.

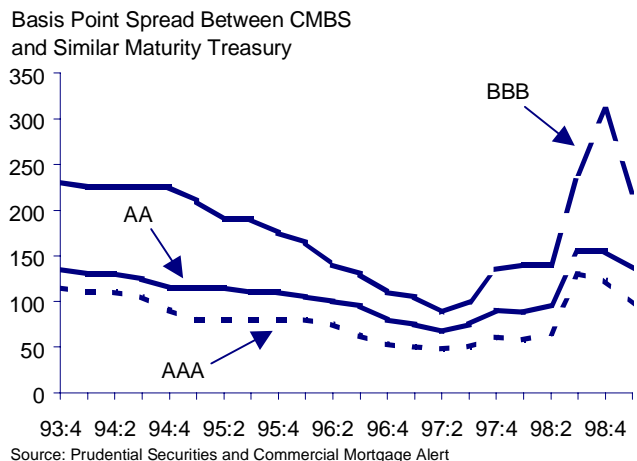
The upside of greater capital availability is increased market liquidity and potentially lower disposition losses in the event of a downturn. Public funding has also raised the level of property-specific performance information available in the marketplace. The downside of greater capital availability is that it has placed tremendous

downward pressure on loan pricing and in some cases lending standards. Many lenders interviewed for this study openly expressed increasing discomfort with the risk and expected return characteristics of some construction loans.

Capital market volatility alters the near-term outlook but public funding is likely to remain a significant competitive force in the industry. Since this construction loan underwriting study was begun, funding market conditions have changed. Pricing volatility in the CMBS market in the latter part of 1998 dampened many lenders' enthusiasm for commercial real estate development. However, last fall's financial market volatility may have provided only a temporary respite in the pace of development as CMBS spreads begin to narrow once again (see Chart 4).

REITs have had a significant influence on market prices in some areas. From 1995 to 1997, REITs were aggressive purchasers of commercial property in many of the most rapidly developing U.S. markets, making them an influential factor in establishing current market values. Until early 1998, when falling stock prices effectively cut REITs off from the equity markets, some analysts had expressed concern that REIT activity was driving commercial property values to unsustainable levels, thereby encouraging excessive development. However, recent trends in equity flows to commercial real estate suggest that REIT acquisition activity has slowed in response to falling

Chart 4
CMBS Spreads Gradually Improving



share prices. To maintain their acquisition programs, REITs have been forced to turn to other methods of raising capital, such as joint ventures and increased borrowings. Although their acquisition activity may have been curtailed, REITs remain a formidable competitive force in the real estate industry.

Tax law changes have restored proper economic incentives. Before the Tax Reform Act of 1986, borrowers could use real-estate-generated losses to shield income against taxes. This tax shelter vehicle often created improper incentives to buy, develop, and hold real estate. After this shelter was eliminated, development activities became more closely aligned with economic feasibility.

Today's construction differs in terms of type, geography, and completion times. The resurgence in development that began in 1996 has been centered primarily in suburban areas (see Chart 5). In contrast, much of the development during the 1980s occurred in downtown areas and therefore involved a substantial volume of high-rise commercial office space. According to most bankers interviewed, office and residential projects today tend to be smaller in scale than in the 1980s and therefore pose less risk when viewed in conjunction with surrounding competitive space. Some bankers also noted a shift in emphasis on the part of lenders toward collateral with shorter construction time frames, thereby reducing the

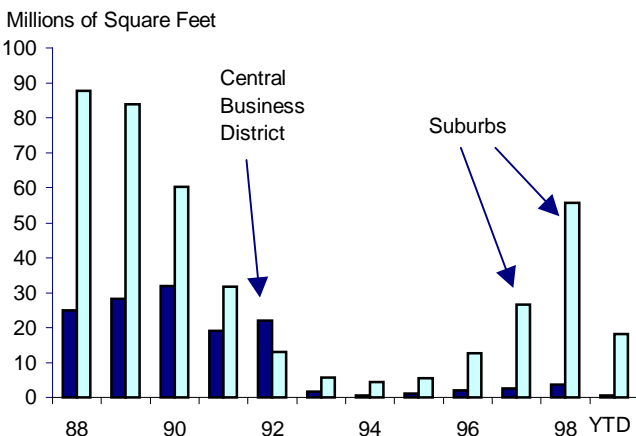
uncertainties inherent in longer-term projects. These observations do not necessarily hold across all property types, as recent years have seen a substantial volume of development related to large-scale luxury hotels, hotels and casinos, big-box retail, and mega-malls.

Rapid suburban development poses another kind of risk: suburban sprawl that heavily taxes existing transportation routes, water and sewer resources, and other supporting infrastructure such as schools, police, and fire protection. Increasingly, analysts and urban planners are warning of a potential backlash against overcrowding, traffic congestion, and unrestrained growth.²⁴

Supply of labor, materials, and land is tight. Despite a surge in construction activity for those markets targeted in this study, several factors may act as constraints to rapid development. Lenders interviewed generally agreed that shortages in construction workers and basic housing materials were slowing the pace of development from what it might otherwise be, particularly in higher demand markets. The scarcity of land in and around central business areas also constrains growth in downtown areas and may partially explain the shift toward suburban development during this cycle. Despite these constraining factors, however, lenders interviewed generally agree that there is no shortage of developers within the markets they serve.

Market information has improved. Coincidental with the expansion in credit availability by public funding sources such as REITs and CMBS, there has been a significant increase in the volume of information on real estate supply, demand, and project performance. In addition, numerous private companies have emerged in recent years whose main purpose is to track and analyze market supply and demand trends. As a result, it is becoming much easier for lenders and developers to evaluate the feasibility of proposed projects using both public and private information sources on existing competing space and planned space. Many lenders indicated that their own communication networks are much improved, giving them a better sense for the total exposures of their clients and the existence of competing projects. Finally, the growing ranks

Chart 5
Suburbs are Driving Current Office Development*



*Based on completions for 54 metropolitan markets
Source: Torto Wheaton Research

of analysts, bankers, and supervisors focusing on real estate markets and underwriting lead to a greater awareness of underwriting practices and the risks associated with lax standards.

Developer sophistication has improved. Armed with better information and cognizant of the lessons of the 1980s, many bankers suggested that today's developer is more sophisticated and better managed than in the past. While developers are thought to be more capable of managing their financial obligations, the rise in sophistication also implies that developers are more likely to actively shop for the cheapest and most favorable loan terms.

Appraisal processes have improved. Insured institutions became subject to appraisal standards following the adoption of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA). Transactions covered by these standards must now conform with uniform appraisal guidelines,²⁵ and appraisals must be prepared by individuals with demonstrated levels of competency. While these guidelines do not ensure the elimination of optimistic evaluations, they have facilitated a more thorough analysis of competing space and local market conditions.

Positive Implications. Differences between today's construction lending practices and those of the 1980s have a number of positive implications for construction and real estate lending risks. A number of factors suggest that banks may be exposed to a lower degree of real estate-related risk in the current cycle. First, smaller-scale development combined with improved diversification practices decrease the likelihood that one or two projects will impair an insured institution's capital should there be a sharp downturn in real estate values.

Second, improvements in real estate market information and efficiency coupled with natural resource constraints on building have the potential to smooth cyclical swings in real estate values.

Third, better information about the availability of competitive space combined with more thorough analyses of the economic viability of proposed

projects should improve developers' decision processes.

Finally, improved appraisal processes and increased communication about industry underwriting practices should help improve the quality of construction lenders' decisions.

Negative Implications. Several negative implications also stem from changes in today's lending environment. First, improvements in market efficiency do not come without cost to those who supply funding. This project found that lenders today are compensated less for bearing construction lending risks than they were during the prior cycle.

Second, from a purely economic standpoint, lower loan pricing coupled with the rise in funding alternatives could encourage more development, all other things equal, which could lead to overbuilding. However, it seems unlikely that pricing factors alone will completely offset the development constraints mentioned above or the benefits of increased scrutiny of commercial real estate risks by public investors. Prudent underwriting standards serve as an additional and necessary constraint to excessive development.

Third, a number of industry analysts have raised concerns about the ramifications of unrestrained suburban development without proper planning for supporting infrastructure.

Finally, despite attempts to control risks through loan covenants, the lack of collateral protection observed on a number of long-term lines to REITs and large corporate developers raises concerns about the prospect for higher loan loss rates in the event of a severe downturn in real estate prices.

Summary

The purpose of this project was to study C&D lending practices in banks serving active development markets. A review of loans made by insured institutions reveals that current construction loan underwriting standards are for the most part

prudent in comparison to the more aggressive structures prevalent during the 1980s. Still, intense competition has eroded pricing margins and has led to some isolated instances of concessions on various loan terms such as personal guarantees, borrower cash equity requirements, and loan collateral margins. Moreover, fundamental differences distinguish today's real estate lending environment from the prior cycle. While these distinguishing features are generally positive for the commercial real estate industry, some of these changes also have negative implications.

Endnotes

¹ Commercial real estate includes loans for construction and land development, loans secured by nonfarm, nonresidential properties, and loans secured by multifamily properties.

² *History of the Eighties, Lessons for the Future*, pp. 159-160.

³ Collateral-based lending refers to situations where estimated collateral values become the primary, if not sole, justification for extending credit. In these cases, projected cash flow and alternative repayment sources become secondary concerns if they are considered at all.

⁴ *History of the Eighties, Lessons for the Future*, pp. 155-156.

⁵ See *Regional Outlook*, first quarter 1999. The markets identified as most vulnerable to overbuilding are Las Vegas, Atlanta, Nashville, Charlotte, Salt Lake City, Portland, Phoenix, Dallas, and Orlando.

⁶ The term "community institution" here refers to insured institutions with less than \$1 billion in assets. Larger institutions are less reliable sources of geographic lending trends since their loan portfolios often span multiple markets.

⁷ Ranked in order, the most frequent methods of easing in the 1998 survey were reduced loan fees and pricing, eased guarantor requirements, extended maturities, lower collateral margins, and relaxed loan covenants.

⁸ See reports for April through September 1998 and April through September 1997.

⁹ Mini-perm loans typically have maturities ranging from three to seven years. Principal payments on these loans are usually based on 25-year or 30-year amortization periods.

¹⁰ See, for example, "Ranking the Risk of Overbuilding in Commercial Real Estate Markets," *Bank Trends*, October 1998; "Metropolitan Atlanta Construction and Development Lending Trends," *Bank Trends*, October 1998; and "Regional Banking," *Regional Outlook* for the San Francisco Region, fourth quarter 1997.

¹¹ Some banks outside the primary and secondary focus markets were also considered if they had substantial loan production facilities within these markets.

¹² Examination workpapers, some of which detail information about loans reviewed during the examination, are maintained as part of the examination process. The types of information documented include a loan's purpose, repayment source,

nature of collateral (if any), maturity, pricing, and other substantive loan terms and conditions.

¹³ Among the prime-based loans reviewed, there was an inverse relationship between pricing spreads and loan size.

¹⁴ Most of the loans reviewed were originated over the two-year period from January 1997 to January 1999.

¹⁵ Hard costs include the direct costs of materials and labor involved in a construction project. Soft costs include various indirect costs related to construction including architecture fees, appraisal fees, financing costs, marketing and leasing expenses, and any developer fees.

¹⁶ A common practice for commercial development loans is to include developer fees in the construction budget. Any cash equity contribution is effectively offset if the developer is allowed to draw these fees from loan proceeds without limitation. To ensure the developers' continuing equity commitment to a project, lenders often stagger developer fee draws to coincide with verified stages of completion.

¹⁷ The *estimated value* of acquired land instead of the more conservative measure of the land's *cost* was commonly used in the calculation of borrower equity.

¹⁸ The term "community bank" is not used here to denote banks of any particular size, but rather banks whose construction lending focused almost exclusively on local area developers.

¹⁹ In a typical construction loan, the outstanding balance grows as loan draws are used to complete the project. At completion of the project, the outstanding loan is replaced or "taken out" by a permanent financing arrangement. With a revolving line of credit, loan advances are used to support the construction of many units within one or more project plans. Here, the outstanding loan amount fluctuates depending on the level of inventory in progress and the speed with which completed units are sold or financed by third parties. Revolving lines are generally renewed at maturity after a review of the appropriateness of the line size and the continued desirability of the lending relationship.

²⁰ Using a discounted valuation is the more conservative option, since it takes into account the time required to sell all the lots in a project. A gross retail valuation simply sums the expected sales prices of each lot with no discounting for timing of sales.

²¹ For construction loans, the DSC ratio is measured assuming completion and lease-up.

²² Sensitivity analysis is particularly important for projects with lengthy construction periods.

²³ This excludes a number of hotel C&D loans, which by their very nature can be considered speculative.

²⁴ See, for example, Price Waterhouse/Lend Lease Investment Research, *Emerging Trends in Real Estate 1999*, p. 22 (), and Urban Land, *Atlanta at the Crossroads*, p. 39.

²⁵ The Uniform Standards of Professional Appraisal Practice (USPAP).