

This document and any attachments are replaced by Comptroller's Handbook - Commercial Real Estate Lending

## Construction Lending

This Section of the Handbook discusses some of the general characteristics and major risk factors associated with construction lending and outlines some of the controls necessary to manage and contain related risks.

Construction lending provides funding for the development of residential and commercial properties and may also provide purchase money or working capital for the acquisition and development of land to be used for construction. Construction loans often serve as a form of interim financing until permanent financing is secured by the developer or buyer. Construction loans are generally secured by a first mortgage or deed of trust and may be backed by a purchase or take-out agreement from a permanent lender. With proper underwriting and controls, construction lending can offer significant profits in a short time. This high rate of return, however, is commensurate with the risks of this type of lending.

### Real Estate Lending Standards Rule

OTS regulation § 563.100-101, Real Estate Lending Standards Rule, was adopted by the Office of Thrift Supervision (OTS) in concert with the other federal banking agencies on December 31, 1992.

The rule requires each insured depository institution to adopt and maintain written internal real estate lending policies that are consistent with safe and sound banking practices and appropriate to the size of the institution and the nature and scope of its operations. It applies to extensions of credit secured by liens on or interests in real estate or made for the purpose of financing the construction of a building or other improvements to real estate, regardless of whether a lien has been taken on the property. The rule is more fully discussed in [Section 212, One- to Four-Family Residential Real Estate Lending](#).

Examiners assigned to the construction/development lending phase of the examination should determine that the institution's written construction lending policies: (1) are in writing, (2) have been approved by the board of directors, (3) promote safe and sound lending and are in compliance with § 563.100-101.

The Real Estate Lending guidelines establish the following standards that pertain to construction/development loans.

For development and construction projects, and completed commercial properties, the institution's policy should establish, commensurate with the size and type of project or property:

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- Requirements for feasibility studies and sensitivity and risk analysis (e.g., sensitivity of income projections to changes in economic variables, such as interest rates, vacancy rates, or operating expenses).
  - Minimum requirements for initial investment and the maintenance of hard equity by the borrower (e.g., cash or unencumbered investment in the underlying property).
  - Minimum standards for net worth, cash flow, and debt service coverage of the borrower or underlying property.
  - Standards for the acceptability and limits on nonamortizing loans.
  - Standards for the acceptability and limits on the use of interest reserves.
  - Preleasing and presale requirements for income-producing property.
  - Presale and minimum unit release requirements for non-income-producing property.
  - Limits on partial recourse or nonrecourse loans and requirements for guarantor support.
  - Requirements for take-out commitments.
  - Minimum covenants for loan agreements.

### *Construction Loan Risk Factors*

Construction loans are susceptible to a number of major risk factors, such as:

- Uncertainty associated with securing permanent financing for the project. Unknown future interest costs of permanent financing is a risk faced by any thrift engaged in construction lending, whether or not it is also the permanent lender;
- Insufficient experience or capacity of the contractor to meet the challenges of the specific construction project;
- Risk of diversion of progress payments or fraud; and
- The contractor's inability to complete construction within cost and time limitations.

Clear warning signs that indicate problems have been encountered with construction loans include:

- Delinquency in the payment of interest;

- Inspection reports citing departures from approved specifications or other adverse comments. They may reflect higher costs or, in the case of building to lesser specifications, the intent to divert loan proceeds;
- Draws requested and on schedule for work yet to be completed or draws not taken on schedule, indicating the possibility of slow sales where residential construction is concerned;
- Additional working capital loans to a troubled developer; and
- Restructuring take-out restrictions that could not be complied with.

### Risk Containment

The best method for limiting risks and avoiding cost overruns is to establish and implement sound policies and procedures. Although policies and procedures should be tailored to the different types of construction lending undertaken by the institution, the following major elements will typically be found in sound construction lending policies and programs:

- Construction loan application review and approval procedures that include a minimum:
  - Define acceptable types of construction loans, including limitations on aggregate construction loans and for particular types of construction projects;
  - Require borrowers to contribute and maintain equity in their project. Requiring land to be bought with funds from another source, limiting loan funds to be used for land acquisition, and requiring a first lien on land are all steps that provide protection to the lender. A common practice of prudent lenders is to loan no more than 50% to 65% for land acquisition costs or provide no more than 50% to 65% of current appraised value on land. The collateral margin provided by the borrower's equity serves to protect the lender from loss in the event of cost overruns or slow sales. Secondary market investors in income property construction loans typically set a maximum loan-to-value ratio of 70%;
  - Require limitations as to percentage of cost or value for construction loans that do not carry prearranged permanent financing and that are subject to the association's own take-out commitment; and
  - Provide for the satisfactory investigation of the character, expertise, and financial standing of all related parties in assuring that the developer, contractor, and subcontractors have demonstrated the capacity to successfully complete the type of project to be undertaken. The credit file should include background information on the developer (borrower) and any relevant third parties describing their experience on similar projects.

- Minimum standards of documentation, including:
  - Specific, reasonable, and supportable cost estimates. Regulators should at all times be able to determine the nature of project costs and the extent to which these costs contribute to collateral value.
  - Clearly identified sources of repayment. Such sources as contracted anchor tenants in a mall, a primary tenant in an office development, or sales of housing units would be appropriate. Although the use of interest reserves is common, it is preferable to ensure loan servicing from known funding sources, such as other investments of the borrower or cash provided by initial investors, until the project is producing a positive cash flow. A feasibility study should project cash flow adequate to service debt and ensure orderly liquidation of principal. A projected debt service coverage of anywhere from 110% when tenants are financially stable and under contract to 150% for speculative properties, is a reasonable underwriting requirement;
  - Specific plans for permanent financing. The plans should include requirements and standards for take-out commitments, tri-party (buy/sell) agreements, and “completion” or corporate bonds. The take-out commitment supports the source of repayments and is issued by the lender that provides the permanent financing. The amount of the take-out commitment should be adequate to cover principal and interest that has not otherwise been planned from other sources. The expiration date and restrictions in the take-out commitment should be reasonable.

All requirements should be met and approved by the permanent lender prior to construction and the institution should ensure that the issuer is financially capable of honoring its commitment. The building and loan agreement, which is entered into by the institution, the builder, and the property owner, outlines the performance responsibilities of each party and generally contains certifications that plans and specifications conform to all applicable laws and are approved by appropriate interested parties. It also contains certain covenants that protect the lender’s interest during the term of construction.

The tri-party (buy/sell) agreement is entered into by the borrower and the construction and permanent lenders. It contains provisions protecting the interest of each lender, such as preventing the permanent lender from withdrawing the take-out commitment because of unacceptable documentation or unforeseen developments such as the death of a principal before permanent loan documents are signed.

The “completion” or corporate bond, which is written by an insurance company, guarantees that all loan proceeds will be expended on the construction property. It does not warrant completion in the event of cost overruns. Some institutions are reluctant to require a completion or corporate bond because performance by the surety may involve litigation, and any change in plans or specifications or a failure to notify the bonding company of default or exception may nullify the protection of the bond;

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- Appropriate insurance. The lender should assure that the project is at all times protected from liability and various hazards through builder's risk and hazard insurance protection, if not otherwise provided. Title protection should ensure perfected liens, preferably through insurance from before the start of construction through completion. All liens should be paid or otherwise cleared to the satisfaction of the title insurer.
- A formal system of loan administration, inspection, and disbursements. Loan administration should have definite control procedures to prevent overpayment and ensure that liens are paid and released. Controls should involve segregation of duties, site inspections, budget comparisons, and dual approval of disbursements. Records should be kept that can show that remaining funds in LIP are adequate for completion. Records of expenses should be complete and subject to audit, independent of the loan administration staff. The percentage of completion of the project and the percentage of funds expended should be easily determinable at any time. If regulators are not comfortable with the control procedures on a major project, an additional site inspection should be done to ensure that progress is as reported in the credit files.
- Inspections. For major projects, architect or engineering inspection reports, independent of the borrower, should be required with each draw to ensure work is done to specifications. A representative of the lender should at least occasionally inspect the site to ensure work is done as reported. The loan administration staff should compare site inspection reports to construction plans and specifications preferably prior to disbursement. Inspection reports should state compliance with plans and specifications, support disbursements, and state whether or not the project is progressing as anticipated.
- Disbursements. Disbursements are generally prearranged and are based upon either a standard payment plan that calls for fixed payments at the end of specified stages of construction or a progress payment plan, which is usually based on monthly disbursements up to a stated percentage of value with a stated percentage held back until the project is completed. Under each plan, a percentage of the loan is usually retained until a notice of completion has been filed and the stipulated period under which liens may be filed has lapsed. Disbursements should be properly authorized and supported by the inspection report. Receipted bills of work performed and materials furnished, and lien waivers should be obtained as disbursements are made. A release of mechanic's liens should also be obtained from the general contractor at the time construction is completed and before final disbursement. Appropriate institution personnel should compare draws with cost estimates to ensure that budgets are met or cost overruns are provided for. Prudent lenders often will hold back part of loan advances, requiring the developer to put equity into each phase of construction. This may be done by holding 10% or 20% of construction costs until the project is finished. Such holdbacks can be started with the initial draw, so that funds are paid out at the rate of, for example, 80% of expenses, resulting in a delay for full loan funding until correction of errors, completion, and final disposition of the project is ensured to the satisfaction of the end user or permanent lender.

- Lien Releases. The principal balance of an acquisition-and-development loan is generally repaid through lien release payments. Depending on the type of project (development of single-family lots, condominium conversion, or tract home building), as each unit is sold, the proceeds are used to (1) pay interest on the outstanding balance, (2) repay a portion of the principal, (3) cover the developer's overhead and expenses, and (4) provide the developer a profit.

Section 545.6(c) requires that "the principal balance of the loan shall be reduced by an amount at least equal to that portion of the outstanding loan balance attributable to the value of the property to be released" (i.e., the lien release must be at least 100% of the unit's proportional share of the loan balance).

Prudent lenders, however, often require the developer to pay lien releases greater than the proportional share of the loan value of the unit sold (often 110% to 125%). Otherwise, the loan will not be repaid until the last unit is sold. The latter is undesirable because the most marketable units often sell first, leaving the loan secured by less desirable, hard to sell units.

For example, assume Lot Development, Inc. (LDI) is developing 100 single-family lots that are projected to sell (on average) for \$50,000 each. The project was appraised for \$2 million, based on the discounted net cash flows from the lot sales. Prudent Federal agreed to loan LDI \$1.5 million (75% of the appraised value of the project). As part of its construction loan agreement with LDI, Prudent required a lien release payment for each lot sold and released equal to 125% of the loan amount proportional to the lot. If the lots are sold equal in value, the lien release would be calculated as follows:

$$\$1,500,000/100 = \$15,000 \times 125\% = \$18,750.$$

With a 125% lien release, the loan will be fully repaid at the sale of the 80th lot (\$1.5 million/\$18,750=80). If a 110% lien payment were required instead, the release would be \$16,500 and the loan would be repaid at the sale of the 91st lot (\$1.5 million/\$16,500=91).

The Construction Loan Review line sheet is intended as a tool for examiners to use in reviewing these underwriting and classification criteria for major construction loans. This work sheet provides general questions on loan underwriting, a review guide for disbursement procedures and controls, comparisons of funds available with funds needed for completion, a review of interest reserves, and space for a summary of a site inspection. Some examination procedures require its use.

### Developer's Profit and Interest Reserves

Developer's profit and interest expense, from the inception of a project until sell-out or break-even leasing, are legitimate development costs. As such, they should be budgeted along with all other development costs when determining the adequacy of loan and equity funds to cover all expenses associated with a development.

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Because developer's profit and interest expense are recognized costs of developing a project, construction lenders should control the funding of these expenses through the Loans in Process (LIP) account.

#### *Developer's Profit*

Developer profit is the Funding of a Loan. Developer profit and overhead costs should be funded by investor equity, sales, or rents, and not construction loan funds. Such expenses do not contribute to collateral value unless the project is successful, meaning the project has been completed and the properties sold or leased up. Paying a developer a profit for an incomplete project removes his/her incentive to complete and sell the units in a real estate project and has in the past led to financial problems for some institutions.

Developer Profit and REO. The institution must always ensure that it has sufficient funds (or borrower equity) in a project to complete construction. This includes all hard costs as well as amounts for interest reserves, overhead and developer's profit. If the institution should have to foreclose on the project, it would incur such items in its own development costs because it would either have to sell the project (and usually provide the financing) at a amount that would allow the new developer to cover all costs and earn a profit, or it would have to hire a developer to take over and complete the project and pay for the developer's services.

#### *Interest Reserves*

LIP proceeds allocated to interest, whether generated from loan funds or deposits from the borrower, should be clearly designated for payment of interest.

Construction lenders should analyze the adequacy of the estimated interest expense as projected by the borrower/developer to cover completion of the project. Projected timing of loan draws should be provided by the applicant. The lender should analyze the timing of principal repayments/projected income in concert with the projections. The adequacy of remaining interest reserves should be continually monitored in an effort to determine whether they are sufficient. Delays in construction and slower-than- anticipated selling or leasing progress can adversely affect the sufficiency of interest reserves. Any deficiency in interest reserves is a matter of serious concern and should be cause for protective measures by the lender to control costs and to secure additional funds to cover the shortfall. The requirement on the borrower to cover any LIP shortfall should be incorporated in the loan documents.

#### *Acquisition, Development, and Construction (ADC) Arrangements*

Loans for the purpose of acquiring, developing, and constructing improvements to real estate can be treated three different ways for accounting purposes, depending on the specific circumstances of the transaction. Significant accounting differences as to the recognition and timing of interest and fee income occur, depending on whether the transaction is a loan, a joint venture in real estate, or an investment in real estate. Refer also to [Examination Handbook Section 230, Equity Investments](#).

Beginning January 1, 1989, all savings associations and their affiliates should classify and account for ADC loans and arrangements in accordance with generally accepted accounting procedures (GAAP). (GAAP on ADC arrangements is currently set forth in the American Institute of Certified Public Accountants' Practice Bulletin 1, Exhibit I, "ADC Arrangement," published in the February 10, 1986 issue of the CPA Letter.)

Because some ADC transactions are treated by associations as loans when in fact they should be treated as investments, income and capital can be overstated. Transactions containing the additional risk associated with an investment involve more risk to the lender than a loan does. These transactions typically involve speculative projects and, because the borrower cannot yet demonstrate the ability to completely repay the loan, it is inappropriate to recognize market interest rates and portions of loan fees as income before the project's success has been proven.

If the association will receive a majority of the project's profits, the transaction should be treated as an investment in real estate, and interest fees, and profits in excess of the association's cost of funds should be deferred and offset against the investment in the loan. See Statement of Financial Accounting Standards (SFAS) Nos. 67 and 66.

If the lender's profit participation is 50% or less, the entire arrangement is accounted for as a loan or a real estate joint venture, depending on the circumstances. At least one of the characteristics of a loan, as outlined below, or a qualifying personal guarantee should be present for the arrangement to be accounted for as a loan. Otherwise, real estate joint venture accounting would be appropriate. See Standards of Practice No. 78-9 and SFAS No. 34 as modified by APB No. 58.

ADC loans that are more properly treated as joint ventures or investments in real estate typically contain substantially more risk than loans do. The difference between a transaction properly treated as a loan versus one properly treated as a joint venture or investment is that for a loan, the following generally occur:

- The borrower has a substantive equity investment in the project from its inception;
- The lender has recourse to substantive assets of the borrower other than the ADC projects or the borrower has provided an irrevocable letter of credit from a creditworthy, independent third party to the lender for a substantial amount of the loan over the entire term of the loan;
- A reasonably conditioned full take-out commitment has been obtained from a creditworthy, independent third party; or
- Noncancellable sales contracts or lease commitments are in effect.

A joint venture or investment transaction typically involves the following in addition to a profit participation:

- The lender provides all or substantially all of the funds to acquire and complete the project, including loan and commitment fees;

- The lender funds all interest due during the development and construction by adding interest to the loan balance;
- The lender has no recourse to any assets of the borrower other than the ADC project or has a personal guaranty from the borrower of little or questionable value; or
- The loan is structured so that during project development, the loan is unlikely to go into default and therefore be foreclosed because no payments are required until the improvements are finished.

## REFERENCES

Code of Federal Regulations (12 CFR)

*Subchapter C: Regulations for Federal Savings Associations*

- § 545.32 Real Estate Loans
- § 545.36 Loans to Acquire or to Improve Real Estate
- § 545.37 Combination Loans

*Subchapter D: Regulations Applicable to All Savings Associations*

- § 561.30 Nonresidential Construction Loan
- § 563.93 Loans to One Borrower
- § 563.100-101 Real Estate Lending Standards
- § 563.170(c) Establishment and Maintenance of Records
- § 567.5(c) Total Capital (Assets Required to be Deducted)
- § 567.6(a)(1)(iv) 100 Percent Risk Weight

Office of Thrift Supervision Bulletins

- TB 16 Environmental Risk and Liability

Financial Accounting Standards Board, Statement of Financial Accounting Standards

- No. 34 Capitalization of Interest Cost
- No. 58 Capitalization of Interest Cost in Financial Statements That Include Investments Accounted for by the Equity Method
- No. 66 Accounting for Sale of Real Estate
- No. 67 Accounting for Costs of Initial Rental Operations of Real Estate Projects

American Institute of Certified Public Accountants Pronouncement  
Practice Bulletin 1, Exhibit I, "ADC Arrangement"

**RESCINDED**