CONSTRUCTION AND LAND DEVELOPMENT LENDING

Core Analysis Procedures

Examiners are to consider these procedures but are not expected to perform every procedure at every institution. Examiners should complete only the procedures relevant for the institution's activities, business model, risk profile, and complexity. If needed, based on other identified risks, examiners can complete additional procedures not included below. References to laws, regulations, supervisory guidance, and other resources are not all-inclusive.

References

- *Interagency Guidelines Establishing Standards for Safety and Soundness (FRB: 12 CFR 208, Appendix D-1; FDIC: 12 CFR 364, Appendix A)*
- *Interagency Guidelines for Real Estate Lending Policies (FRB: 12 CFR Part 208, Appendix C; FDIC: 12 CFR Part 365, Appendix A)*
- *Appraisal regulations (FRB: 12 CFR 225.61-67; FDIC: 12 CFR Part 323)*
- *Interagency Appraisal and Valuation Guidelines (FRB: SR 10-16; FDIC: FIL-82-2010)*
- *Frequently Asked Questions on the Appraisal Regulations and the Interagency Appraisal and Evaluation Guidelines (FRB: SR 18-9; FDIC: FIL-62-2018)*
- *Statement on Prudent Risk Management for CRE Lending (FRB: SR 15-17; FDIC: FIL 62-2015)*
- *Policy Statement on Prudent Commercial Real Estate Loan Accommodations and Workouts (FRB: SR 23-5; FDIC: FIL-34-2023)*
- *Managing Commercial Real Estate Concentrations in a Challenging Environment (FDIC: FIL 64-2023)*
- *Interagency Guidance on Concentrations in Commercial Real Estate (FRB: SR 07-01; FDIC: FIL 104-2006)*
- *Frequently Asked Questions on Residential Tract Development Lending (FRB: SR 05-14; FDIC: FIL-90-2005*
- *Internal and Regulatory Guidelines for Managing Risks Associated with Acquisition, Development, and Construction Lending (FDIC: FIL-110-98)*
- *Acquisition, Development, and Construction Loan Concentration Study (FDIC OIG: Eval-13-001)*

Findings and Conclusions

Document findings and conclusions here, and include a summary of these findings and conclusions in the appropriate Primary or Supplemental modules.

Preliminary Review

1. Review documents that may identify issues relating to acquisition, development and construction (ADC) lending, such as:

- **Prior examination reports and work papers**
- **Exam planning memoranda and file correspondence**
- **Loan review reports**
- **Internal and external audit reports**
- **Loan committee minutes**
- **Documentation of action taken by management to address prior recommendations**

2. Obtain and analyze internal management reports relating to ADC lending, such as:
- **Lending activities (e.g., type, volume, location)**
- **Problem loans**
- **Workout strategies**

3. Assess the quality of market-analysis reports, considering:
- **Information provided in reports**
- **Reporting on specific market segments**
- **Economic developments in the markets served**
- **Variety in sources used**
- **Timeliness of information**

Policy Considerations

4. Determine whether policies and procedures promote prudent lending practices. Appropriate internal standards, within the context of ADC portfolio complexity, generally address issues such as:
- **Feasibility studies, risk analyses, and sensitivity of income projections to economic variables**
- **Minimum requirements for initial investment and equity maintained by the borrower**
- **Requirements for analysis of global cash flows of the borrower and guarantors, and identification of primary and secondary repayment sources**
- **Standards for using interest reserves or stipulations that interest reserves will not be used**
- **Standards for limiting the level of loans on speculative properties relative to capital**
- **Pre-sale and minimum unit-release requirements for non-income producing construction loans and developed lots**
- **Pre-leasing requirements on income producing properties**
- **Limits on lending with partial or no recourse to borrowers, if permitted**
- **Take-out commitment requirements that include an assessment of the availability and cost of permanent financing**
- **Minimum covenants for loan agreements, such as financial statement requirements**
- **Disbursement controls, including requirements for periodic inspections during construction and development**
- **Lien waivers from subcontractors**
- **Inventory control records of unreleased units and developed lots**
- **Curtailments when original projections are not met**
- **Certificates of occupancy**
- **Joint ventures, such as profit sharing or equity arrangements**
- **Equity withdrawals from loan proceeds**
- **Contractor's performance bonds for loans over a specified dollar amount**

- **A survey before construction and after the foundation is in place to ensure proper setbacks are maintained**
- **Procedures to ensure that projects comply with local codes and meet certificate of occupancy requirements (e.g., wetlands determination, zoning appraisals, and percolation results)**
- **Procedures to ensure that projects comply with required developer contributions to public infrastructure and common area improvements**
- **Maximum loan amount, pricing, and maturity by type of property**
- **Appraisal requirements (initial value) and processes for monitoring value and marketability of the property over the life of the credit**
- **Environmental implications and requirements for environmental inspections**
- **Volume limits, pre-purchase and ongoing due diligence requirements, and internal controls over out-of-territory or purchased ADC loans**

Administration

Market/Economic Assessment

5. Determine whether management monitors real estate markets and local economic conditions within the bank's trade and lending areas and ensures that real estate lending policies and practices are appropriate for market conditions. Consider the following items:

- **Demographic indicators, including population and employment trends**
- **Zoning requirements**
- **Current and projected vacancy, construction, and absorption rates**
- **Current and projected lease terms, rental rates, and sales prices, including concessions**
- **Current and projected operating expenses for different types of projects**
- **Trends in loan applications and originations**
- **Valuation trends, including discount and direct capitalization rates and**
- **Political considerations, such as:**
  - **Zoning and mapping approval process within subject area compared to surrounding counties or political units**
  - **Fees and other taxes as compared to other political units**
  - **Wetland, environmental, density, water sharing, and miscellaneous issues**
  - **Availability of public infrastructure**

Loan Agreements

6. Determine whether legal counsel or other experts (e.g., architect, supervising engineer) review building and loan agreements. Appropriate reviews typically determine whether improvement specifications conform with:

- **Building codes**
- **Subdivision regulations**
- **Zoning and ordinances**
- **Title and ground lease restrictions**

- **Federal and state laws governing access by individuals with disabilities**
- **Known or projected environmental protection considerations**
- **Specifications required under the National Flood Insurance Program**
- **Provisions in tenant leases**
- **Specifications approved by the permanent financier**
- **Specifications required by the completion bonding company or guarantors**

7. Determine whether significant changes to construction plans are approved, as needed, by:

- **An appropriate loan officer or committee**
- **Zoning authorities**
- **Permanent financing entity**
- **Architect or supervising engineer**
- **Prime tenants bound by firm leases or letters-of-intent to lease**
- **Completion bonding company**

8. Determine whether the building and loan agreement sets a date for project completion.

9. Determine whether the building and loan agreement requires:

- **The contractor to not start work until authorized by the lender**
- **On-site inspections**
- **Disbursement of funds as work progresses**
- **Withholding disbursements if work is not performed in accordance with approved specifications**
- **The contractor to submit appropriate lien waiver forms from subcontractors prior to disbursement**
- **A portion of the loan proceeds be retained pending satisfactory completion of the construction**
- **The lender to be allowed to assume prompt and complete control of the project and architectural and construction plans in the event of default**
- **The contractor to have adequate builder's risk and workmen's compensation insurance coverage**
- **Builder's risk insurance to be on a non-reporting form or a reporting form that requires periodic increases in the project's value to be reported to the insurance company**
- **Lender authorization for individual tract housing starts, including minimum requirements on earnest money deposits and proof of purchaser's availability of financing to recognize a start as pre-sold**
- **Tract developers to submit periodic sales reports**
- **Tract developers to submit periodic reports on tract houses occupied under rental or lease purchase option agreements**
- **A limit on the number of speculation and model homes that can be built ahead of sales**
- **Periodic reports on the status of any other projects in which the developer may be involved**

Bonding Requirements

10. Assess the processes related to completion bonding requirements for construction loans. Consider the following:

- **Reviews by counsel of completion insurance bonds for acceptability**
- **Bank established minimum financial standards for borrowers who are not required to obtain completion bonding and requirements that the standards are followed in all cases**

11. Determine whether the construction loan amount and the project's estimated completion date correspond to the amounts and expiration dates of the take-out commitment and completion bonds, if any.

Insurance and Tax Requirements

12. Evaluate the processes regarding insurance coverage and tax payment. When applicable, consider:

- **Mortgage errors and omission policies**
- **Hazard, builder's risk, and worker's compensation policies, with the bank named as loss payee where appropriate)**
- **Procedures for determining whether insurance premiums are current on properties securing loans, with the bank named as loss payee where appropriate**
- **Procedures for ensuring that taxes and insurance premiums are being paid**

Environmental Hazards

13. Assess the processes designed to minimize risks associated with environmental hazards.

- **Determine whether management takes the appropriate steps to identify any environmental hazards associated with the collateral. Additionally, consider whether management ensures that the borrowing entity has conducted an environmental evaluation that meets the standards and practices of the EPA's All Appropriate Inquiry Rule.**
- **When there is reason to believe that there may be serious environmental problems associated with the collateral:**
  - **Consider whether management takes steps to monitor the situation to minimize potential liability to the bank**
  - **Consider whether management seeks the advice of experts, particularly in situations where management may be considering foreclosure on a contaminated property**

Validity of Cost Estimates

14. Assess practices for ensuring reliable cost estimates. Consider whether:

- **Cost estimates include:**
  - **Land and site improvement costs**
  - **Building construction costs**
  - **Contractor and developer profits**
  - **Legal and other professional fees**
  - **Loan interest, insurance, and tax expenses**
- **Cost breakdowns are required for each phase of development and construction rather than on a total project basis**
- **Qualified architects, construction engineers, or other third parties review cost estimates for complex projects**
- **Cost budgets include the amount and source of a borrower's equity contribution and expected profit**

15. Determine whether management has established processes to mitigate exposure of front loading by a builder or borrower.[1]

Project Monitoring

16. Determine whether the undisbursed loan balance is sufficient to complete the project. Consider the following:

- **Reports used to monitor construction progress, advances, sales, and other pertinent factors**
- **Inspection reports**
- **Comparisons of budget projections to actual costs**
- **Comparisons of draws to degree of completion**

17. Determine whether undisbursed loan proceeds and contingency or escrow accounts are independently validated, generally at least monthly. Determine whether statements on such accounts are regularly mailed to customers.

Inspections and Disbursements

18. Assess the processes designed to ensure reliable inspections. Appropriate processes generally identify inspection authorities in:

- **Construction loan commitments**
- **Building and loan agreements**
- **Tri-party buy and sell agreements**
- **Take-out commitments**

[1] **The practice of front loading deliberately overstates the cost of work completed in the early stages of construction. If it is not detected early, there may be insufficient loan proceeds available for completing construction in the event of default.**

19. Assess the quality and effectiveness of property inspections. Consider whether:

- **Individuals conducting the inspection are sufficiently qualified**
- **Inspections are conducted on an irregular schedule and before draw requests**
- **Inspection reports are sufficiently detailed to support disbursements**
- **Individuals conducting the inspection are rotated or independent of the lending function**
- **Spot checks are made of the inspectors' work**
- **Inspectors assess overall compliance with plans, specifications, and progress of work**
- **Inspectors assess the status of outstanding entitlements as well as the expiration date of those entitlements**
- **Inspectors assess the progress of work for required developer contributions to public infrastructure and common area improvements**

20. Assess the processes designed to ensure legitimate loan disbursements. Verify that disbursements are:

- **Advanced on a prearranged disbursement plan**
- **Made only after management reviews written inspection reports, requisite lien searches, and title updates**
- **Subject to advance with written authorization by the:**
  - **Contractor**
  - **Borrower**
  - **Inspector**
  - **Lending officer**
- **Reviewed by a bank employee who had no part in granting the loan**
- **Compared to original cost estimates**
- **Checked against previous disbursements**
- **Made directly to subcontractors**
- **Made after appropriate releases (lien waivers) have been signed**
- **Supported by receipted bills describing the work performed and the materials furnished**

21. Determine whether management obtains waivers of subcontractors and mechanics' or materialmen's liens as work is completed and before disbursements are made.

22. Determine whether management confirms that a certificate of occupancy is obtained before final disbursement.

Interest Reserves

23. If the bank uses interest reserves, determine whether the conditions for use and rationale are appropriate to the project being financed. Consider the reasonableness of the assumptions in the project's feasibility study and the time allotted for completion and lease-up of the property.

24. Determine whether extensions or increases in interest reserves are supported by a reasonable and realistic assessment of the underlying project's continued feasibility, the timeframe for project completion, and guarantor capacity.

25. Determine whether controls prevent unsecured lines of credit or any unrelated borrowing facilities to contractors or developers from being used to keep construction or development loans current.

Takeout Commitments

26. If the bank provides permanent financing, determine whether credit terms are consistent with the bank's normal underwriting standards.

27. Assess the processes designed to ensure the validity and reliability of take-out commitments by third parties. Consider the following:

- **Review by counsel for acceptability**
- **Review of financial statements of the permanent lender to assess capacity to fulfill the underlying commitment**
- **The completion of a tri-party buy and sell agreement before the construction loan is closed**
- **Whether take-out agreements include a clause that provides for an automatic extension of the completion date in the event construction is delayed for reasons beyond the builder's control**

External/Internal Loan Review and Audit

28. Assess loan reviews and internal and external audit activities performed on the ADC portfolio. Consider the following:

- **Scope of the reviews**
- **Frequency of the reviews**
- **Qualifications of staff conducting the reviews**
- **Results of the reviews**
- **Ability to allow management to identify emerging problem loans and weakening projects and borrowers**

Borrower Default[2]

29. Evaluate the loan staff's workout experience and skills relative to ADC credits and foreclosures. Consider whether:

- **The bank would benefit from a special-assets department or similar function given the volume and complexity of problem or workout loans**
- **The credit skills and experience of workout personnel are commensurate with the complexity of problem credits**
- **The reporting structure of the workout unit promotes independence from the credit department and other undue influences**

Underwriting Standards (Borrower Assessment)

30. Determine whether ADC credit decisions consider the following factors:

- **Feasibility studies that assess, if applicable, the following items:**
  - **Economic and environmental issues**
  - **Engineering surveys and tests**
  - **Soil borings**
  - **Character of adjacent properties**
  - **Flood plain and water table concerns**
  - **Zoning**
  - **Jurisdiction of state and federal agencies**
  - **Water availability**
- **Assessing borrower, developer, and contractor qualifications and reputation, such as:**
  - **Construction experience of the borrower, developer, and contractor**
  - **Payment history to suppliers, trade creditors, and major subcontractors**
  - **Credit reports**
- **Take-out commitments, including financial capacity of the take-out lender**
- **Marketability of properties without take-out commitments**

31. Determine whether ADC credit decisions consider the following credit evaluation factors:

- **Requirements for initial investments and maintenance of appropriate equity by the borrower (cash or unencumbered investment in underlying property)**
- **Minimum standards for net worth, cash flow, and debt service coverage of the borrower or underlying property**
- **Borrower's outside repayment sources**
- **Standards for the acceptability of and limits on non-amortizing loans**

[2] **Additional information may be found in the Policy Statement on Prudent Commercial Real Estate Loan Workouts (FRB: SR 09-7, FDIC: FIL 61-2009).**

- **Standards for the acceptability of and limits on the financing of the borrower's soft costs**
- **Pre-leasing and pre-sale requirements for income-producing property**
- **Pre-sale and minimum unit release requirements for non-income-producing property**
- **Limits on partial recourse or nonrecourse loans and requirements for guarantor support**
- **Minimum covenants for loan agreements**
- **Global cash flow analysis of principals and guarantors and assessment of contingency debt**

Appraisals and Evaluations (Assessment of Collateral)

The Real Estate Valuation Programs Reference module provides additional perspective on assessing the effectiveness of the appraisal process and establishing collateral values.

32. Determine whether appraisals comply with appraisal regulations and contain sufficient information and analysis to support management's credit decision. Appropriate appraisals:

- **Conform with the Uniform Standards of Professional Appraisal Practice (USPAP) and provide an opinion of the property's market value**
- **Reflect an appropriate scope of work**
- **Consider the risk and complexity of the transaction and property**
- **Analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units[3]**
- **Provide, if applicable, prospective market value opinions based upon current and reasonably expected market conditions.[4]**
- **Consider the prospective market value that corresponds to the credit decision and the phase of the project being funded, if applicable**

33. Determine whether loans are based on inflated collateral values caused by rapid turnover of ownership without any corresponding property improvements (e.g., land flips).[5]

Documentation Standards

34. Assess the loan file documentation. Typical ADC loan documents include the following:

- **Mortgage or deed of trust**
- **Note, building and loan agreement, and construction agreement**
- **Attorney's opinion or title insurance**

[3] For such transactions, per appraisal regulations (FDIC: 12 CFR 323.4(e); FRB: 12 CFR 225.64(e)) and the Uniform Standards of Appraisal Practice (USPAP) standard 1-2(e), an appraisal must include the market value of the property, which should reflect the property's actual physical condition, use, and zoning designation (referred to as the *as is* value of the property), as of the effective date of the appraisal.

[4] Per USPAP standard 1-2(d), when an appraisal includes the prospective market value opinions, there should be a point of reference to the market conditions and time frame on which the appraiser based the analysis.

[5] USPAP standard 1-5(b) requires a discussion of the property's recent sales history.

- **Appraisal or collateral evaluation, as well as documentation of the subsequent review**
- **Evidence of appropriate insurance (i.e., property, liability, flood)**
- **Feasibility study**
- **Business plan for the development**
- **Take-out commitment(s)**
- **Signed commitment letter**
- **Plans for common area improvements and required developer contribution to public infrastructure**
- **Governing documents for condominium and homeowners associations**

35. Determine whether the bank's documentation standards require:

- **Evidence of the contractor's payment of:**
  - **Employee withholding taxes**
  - **Builder's risk insurance**
  - **Workmen's compensation insurance**
  - **Public liability insurance**
- **Evidence of the property owner's payment of:**
  - **Real estate taxes**
  - **Hazard insurance premiums**
- **Loan applications**
- **Financial statements for the borrower, builder, proposed prime tenant, take-out lender, and guarantors**
- **Credit and trade checks on the borrower, builder, major sub-contractor, and proposed tenants**
- **A copy of architectural and construction plans and specifications**
- **A copy of the building permit**
- **A survey of the property**
- **Building and loan agreement or construction agreement**
- **Up-to-date preliminary title search**
- **Ground leases**
- **Assigned tenant leases or letters of intent to lease, as well as copies of other legally binding agreements between the borrower and tenants and reports of past due leases, including delinquent expense reimbursements**
- **Tri-party buy and sell agreement**
- **Inspection reports**
- **Disbursement authorizations**
- **Undisbursed loan proceeds and contingency or escrow account reconcilements**
- **Insurance policies**

End of Core Analysis.