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In This Issue

On My Mind...

CEIS' President, Joe Hill, shares his thoughts

We've been SOC'ed!! That's right, CEIS Review has been successfully SOC 1 Type 2 audited and has passed with flying colors. While it was a most pleasurable experience, we are happy to have our auditor friends gone. In today's day and age, it is critical that as a business your institutions are dealing with vendors that are not only experts in their respective fields, but also that they have their house in order and have the wherewithal to be there for you in the future.

Years ago, hiring a former banker would suffice for whichever need you were seeking expertise in. It made sense, and it was an economical choice. In the 1980's CEIS was in fact one of those types of organizations, but how have we grown. Today CEIS employs over 50 professionals & support staff, has offices in NYC and Miami, and serves over 130 commercial lending institutions.

We have all seen the headlines, "Security Breach", "Hacked", etc. and have been shown the extent to which these events can affect people and organizations. In today's environment you not only have to have insurance plans in place to protect against damages from any unforeseen incidents, but you also need to have the systems and process in place to decrease the likelihood of any unforeseen incident ever happening. With that, we are proud to announce that we have been SOC'ed, and have come out with flying colors.

Joseph J. Hill

Construction Lending - Structuring your Program

By: Mr. Frank Ziella & Mr. Daniel Horan

Among Community Banks, Commercial Real Estate Construction is back in full swing thus opening additional potential for institutions to gain income and drive profits from participating in these activities. Although this type of lending can be lucrative when performed correctly, before engaging or re-engaging in commercial construction lending an institution should carefully examine several aspects of said lending activity and from such examination should be able to gain an honest and fair assessment of their respective institutions capabilities in the commercial construction lending arena.

The areas that should be examined to gain an assessment of are; regulatory - an institutions current standing as well as ones capabilities to maintaining compliance to the guidelines in this specific type of lending, expertise - in-house as well as vendors and potential participating parties, historical, and institutional risk tolerance - establishing levels of risk that are acceptable and then determining methods of implementing measures to track those risk tolerance levels.

Within CRE construction lending there are then subcategories which in themselves hold their own specific risks to be considered and these should be thoroughly evaluated before an institution engages in the CRE construction lending of these niche types of lending. Within this article we will explore several of these topics and provide the reader with some thoughtful considerations which should be evaluated when an institution is considering being active within CRE construction lending which should assist one in determining if Commercial Real Estate Construction Lending is an appropriate fit for ones institution.

Today's commercial lending environment has seen many regulatory changes and some of which specifically pertain to construction lending. Regulatory agencies now require institutions engaging in CRE construction lending to have performed a comprehensive and thorough review of an institution's critical expertise in this specialized area. This should be in conjunction with enhancements to the institution's Credit Policy and a clear "Strategic Plan" before continuing or re-engaging in any construction lending. Additionally, reductions in the levels of CRE construction/renovation/improvement loans as a percentage of capital and the loan portfolio have also been implemented.

The regulatory guidelines really set the stage for what a lender may or may not engage in, and should always be the first element of the evaluation which a lender should consider.

The next element to explore is the internal and external experience level of all the people involved in such projects in the past.

Questions that may assist in uncovering areas of concern internally may be:

- Was there a lack of staff experience in this type of lending that was unrecognized and thus caused inadequate underwriting and monitoring while problems were occurring?
- Were there documentation issues evident including lack of Title Insurance, inadequate monitoring of liens filed, no updated title policy, or were there weak covenants?

This may show itself to be evident by questioning if there were underwriting weaknesses related to inadequate cash equity by developer or sponsors at origination or were the developers not fully experienced with the type of project (size; cost; budget and timeframe).

When looking at the external expertise involved in these transactions some probing questions may be:

- Was there an experienced engineering / inspection firm hired or was this waived to save costs?
- Was the General Contractor (GC) adequate for the project (experienced as to type and scale of the project)?
- Was the GC replaced during construction and was the institution not immediately notified or notified well after the fact, with a replacement GC not approved and perhaps not as experienced?
- Why was the GC replaced?

When looking at historical performance and or losses some general considerations a banker should ask themselves are:

- What has been your institutions prior experience in construction or renovation lending?
- When and if losses were sustained, what were the reasons and has the institution performed "post-mortems" to fully identify the reasons, including common threads or elements?

Analysis of the reasons for losses would contribute to a stronger underwriting and improved monitoring when new projects are approved.

After a lender has determined the regulatory guidelines appropriate for their institution, the expertise involved in past construction lending, historical experience regarding losses, then identifying the risk tolerance for these types of transactions should be addressed. Consideration should definitively include a tempered portfolio growth rate taking into account a lenders level of capital and its current loan portfolio mix, what are acceptable Loan to Value limits (considering Supervisory LTV limits), as well as Debt Service Coverage Ratios by type of property which should be outlined in the current Credit Policies.

From a risk management standpoint, there should be periodic reporting to the BOD with updates on the various construction projects. Diligent monitoring and reporting is an absolute necessity to assure a successful project completion and then a subsequent performing loan. The basis of this monitoring would come from the Bank's independent engineer's ongoing status reports and validations for each construction draw request. If there are any problems which have developed they should be evaluated to determine their severity and their potential impact on the project. A reporting structure of this design assists the bank in protecting against a project not arriving at completion, which could play a part in a financial loss for the bank.

The two types of projects most often funded are as follows:

1. Apartment and Multifamily Projects

Apartment projects are perceived as being lower risk, although there are still areas of concern which must be evaluated and questioned specific to this type of lending. Be sure to always ensure that underwriting analysis determines whether a number of projects in the area are being started either at the same time or separately and will those projects be coming to completion at the same time, which in turn would increase the leasing risk and further potentially jeopardize the borrower's DSC ability. Also evaluate what is the unit mix is, the amenities, and what the proximity is to local employers.

As with all real estate construction projects there should be pre-established minimum equity contributions, maximum LTVs based on value of the completed project, appropriate maturity commensurate with the size and scope of the project, a budget of total project costs, a plan and cost review by an independent construction consultant, an interest reserve appropriate for the duration of the loan and a business plan demonstrating feasibility of the project.

2. Commercial (Office, Retail, and Industrial)

Included within this category could be anchored shopping centers or strip malls, hotel/motel facilities, regional tenant "stand alone" facilities or niche medical office facilities for doctors, dentists, surgical or ambulatory centers. Condominium development and conversion projects have been the source of substantial credit losses for many regional banks over the past several years and, as a result, little, if any, new projects are being introduced. The medical facilities, regional tenant "stand-alone" projects, shopping centers or strip malls and hotel/motel projects all require an in-depth understanding of the history of and current market direction of the affected local economies before any consideration can be made for funding in these areas.

The commercial environment throughout this country was severely impacted by the recent recession when many office buildings were erected on speculation or tenants were not financially strong enough to withstand the adverse effects of the economic downturn. There should be pre-existing leases from financially sound independent parties or a firm take-out commitment in place as requirements for any commercial construction loan. Additionally, and as with any other type of construction lending, the Bank should investigate the character, expertise and financial standing of all related parties. The developer, contractor and subcontractors should be able to demonstrate the capacity to successfully complete the project to be undertaken. All final zonings should be in place for the intended use of the property prior to the first advance and Bank's Credit Policy as to maximum LTV, minimum equity contribution, size of loan and tenor of loan should be within the scope of the approved transaction and within parameters set forth in the Credit Policy.

Participations

Participation (versus direct lending) in any of these projects can be an option when size of the project; expertise or risk appetite prevents fully funding such construction loans. Participations are a means for institutions to be involved in transactions, or pools of transactions that they otherwise would not be able to be due to regulatory and or geographical restraints.

Once again, when considering participations you must first evaluate your internal expertise in handling such arrangements. The initial assessment of the lead institution on a participation arrangement should consider what the current expertise of that institution in this type of lending by asking:

- Does our internal lending staff have the necessary expertise in handling these participation lending relationships?
- Does the Bank have appropriate internal systems to track and monitor construction progress?

Even if the expertise is present, there must also always be open lines of communication between parties on these arrangements and at no time should there be an overreliance on the lead institution for administrating the loan. Participations can oftentimes become problematic when communication with the lead lender is not maintained throughout the project. It cannot be stressed sufficiently that the participant must remain fully informed and aware of all recent developments at each stage of construction.

Once the institution has determined its commitment to providing construction lending, recognizes its experience and expertise, identifies the type or types of projects it will finance, evaluates the many risks, determines the appropriate pricing vs. the risks in the loans, and establishes the necessary monitoring infrastructure and procedures, it could then proceed with the financing of such transactions. Once this point is arrived at and the plan is to engage or reengage in construction lending, it is then imperative to engage an experienced real estate counsel who is made aware of all conditions per approval of the construction loan; assignment of all contracts, permits, leases, etc.; all funding and draw requirements, as well as the guarantees required and pre-closing conditions pertaining to the project, borrower, and guarantors.

In conclusion, there are many considerations facing the institution when determining if commercial real estate construction lending is, in fact, an appropriate type of lending activity for the organization in the near future. CEIS Review provides a wide array of professional services to banks, credit unions, and other commercial lending organizations throughout the nation as well as internationally. Many individuals filling our ranks have deep experience and expertise in the area of Commercial Real Estate Construction Financing which, during any normal **loan review** examination, could inure to the benefit of the subject lending organization.

Regulatory Releases

Recent Releases which pertain to our clients

OCC - Linda Cunnigham names the OCC's First Chief Risk Officer

OCC - Reminder to Institutions regarding Emergency Preparedness

OCC Increasing Sustainable Loan Modifications and Reducing Foreclosures

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Thank you for taking the time to read our newsletter, Should you like to learn more about CEIS Review or any of our services offered please contact us.

Thank you and Best Regards,

The CEIS Review Team

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