

## LOAN WORKSHEET #4 – REAL ESTATE LENDING

Real estate loans are borrowings for the purpose of buying, improving, or holding real property or leasehold estates. Repayment is expected from the sale of the property, its net operating income, or the cash flow of the owner occupying or enjoying the use of the property. Loans having real estate as additional collateral are not considered real estate loans for purposes of this procedure. Risks associated with real estate lending stem from volatile real estate values, lack of secondary sources of repayment, environmental hazards, and changing government regulations.

Evaluate	Comments
<p>_____ <b>1.</b> Are written real estate lending policies established as required by 12 CFR 365.2 (Regulation H, section 208.52 for fed member banks), and are these policies adequate with respect to the following:</p> <p style="margin-left: 40px;"><b>A.</b> Is the policy reviewed and approved by the board at least annually?</p> <p style="margin-left: 40px;"><b>B.</b> Does the bank monitor conditions in the real estate market to ensure that policies continue to be appropriate?</p> <p style="margin-left: 40px;"><b>C.</b> Is the policy:</p> <ul style="list-style-type: none"> <li>• Consistent with safe and sound banking practices?</li> <li>• Appropriate for the size of the bank and nature and scope of operations?</li> <li>• Are diversification standards included, such as a certain target level of single-family homes, development loans, etc.?</li> </ul>	

## LOAN WORKSHEET #4 – REAL ESTATE LENDING (continued)

Evaluate	Comments
<ul style="list-style-type: none"> <li>• Are prudent underwriting standards that are clear and measurable stipulated, including loan-to-value limits?</li>   <li>• Are loan administration procedures for the real estate portfolio established, including but not limited to:               <ul style="list-style-type: none"> <li>➤ Closing procedures.</li>   <li>➤ Type and frequency of collateral evaluation.</li>   <li>➤ Type and frequency of financial statements.</li>   <li>➤ Collection and foreclosure procedures.</li>   <li>➤ Delinquency follow-up procedures.</li> </ul> </li>   <li><b>D.</b> Does the policy reflect consideration of the Interagency Guidelines for Real Estate Lending, Appendix A to 12 CFR 365? Note: Part 365 requires only “consideration” of the Guidelines. Therefore, bank policy may be in contravention with aspects of the Guidelines and not result in an apparent violation of law. Instead, the issue should be addressed as a contravention of FDIC policy.</li> </ul>	

## LOAN WORKSHEET #4 – REAL ESTATE LENDING (continued)

Evaluate	Comments										
<ul style="list-style-type: none"> <li>• The Guidelines stipulate that internal loan-to-value limits should not exceed the following:</li> </ul> <table style="width: 100%; border-collapse: collapse;"> <tr> <td style="padding-left: 20px;">*Raw land</td> <td style="text-align: right; padding-right: 20px;">65%</td> </tr> <tr> <td style="padding-left: 20px;">*Land development</td> <td style="text-align: right; padding-right: 20px;">75%</td> </tr> <tr> <td style="padding-left: 20px;">*Comm., multi-family, &amp; other nonresidential. construction.</td> <td style="text-align: right; padding-right: 20px;">80%</td> </tr> <tr> <td style="padding-left: 20px;">*1-4 Family residential prop.</td> <td style="text-align: right; padding-right: 20px;">85%</td> </tr> <tr> <td style="padding-left: 20px;">*Improved property</td> <td style="text-align: right; padding-right: 20px;">85%</td> </tr> </table> <ul style="list-style-type: none"> <li>• Are documentation, approval, and reporting requirements addressed?</li> <li>• Are geographical areas in which the bank will consider lending stipulated?</li> <li>• Are terms and conditions for lending by loan type indicated?</li> <li>• Are collateral inspection procedures addressed?</li> </ul> <p style="margin-top: 20px;">_____ 2. Does the bank have a real estate appraisal and evaluation program as required by 12 CFR 323 - Real Estate Appraisals (or 12 CFR 225.63 Regulation Y, Subpart G for Fed members), and outlined in the accompanying Interagency Appraisal and Evaluation Guidelines. In general, this would include:</p>	*Raw land	65%	*Land development	75%	*Comm., multi-family, & other nonresidential. construction.	80%	*1-4 Family residential prop.	85%	*Improved property	85%	
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## LOAN WORKSHEET #4 – REAL ESTATE LENDING (continued)

Evaluate	Comments
<p><b>A.</b> Requirement that a market value appraisal performed by a state certified appraiser be obtained for real estate-related transactions over \$250,000, except under the exceptions in the regulation.</p> <p><b>B.</b> Requirement that an evaluation (meeting the criteria in the Guidelines) be obtained on transactions exempt from the above requirement.</p> <p><b>C.</b> Selection criteria and procedures to evaluate and monitor the ongoing performance of individuals who perform appraisals and evaluations.</p> <p><b>D.</b> Independence of the person performing appraisals or evaluations.</p> <p><b>E.</b> A program to assess the validity of existing appraisals or evaluations to support subsequent transactions.</p> <p><b>F.</b> Establishment of internal controls that promote compliance with these program standards.</p> <p>_____ <b>3.</b> Evaluate underwriting and servicing.</p>	

## LOAN WORKSHEET #4 – REAL ESTATE LENDING (continued)

Evaluate	Comments
<p><b>A.</b> Obtain and review loan committee packages on selected loans. Consider the following points:</p> <ul style="list-style-type: none"> <li>• Is the package of sufficient detail for an informed credit decision?</li> <li>• Are complex borrowing entities and their level of liability clearly defined?</li> <li>• Is the use of proceeds clearly defined?</li> <li>• Are terms consistent with the use of proceeds?</li> <li>• Are secondary sources of repayment noted and supported?</li> <li>• Is the appraisal attached and salient points noted, or is the committee solely reliant upon the officer's observations?</li> <li>• Are environmental hazards discussed?</li> <li>• Are exceptions to policy noted and approved by appropriate authority?</li> </ul> <p>_____ <b>4.</b> Evaluate loan administration.</p>	

**LOAN WORKSHEET #4 – REAL ESTATE LENDING (continued)**

Evaluate	Comments
<p><b>A.</b> Are deteriorating trends in market conditions, property condition or value, and borrower financial condition addressed on a timely basis?</p> <p><b>B.</b> Are updated appraisals acquired when borrower’s capacity is in jeopardy?</p> <p><b>C.</b> Are there systems and controls for monitoring collateral documents, tax payments, and insurance coverage?</p>	

## LOAN WORKSHEET #4 – REAL ESTATE LENDING (continued)

Evaluate	Comments
<p>_____ 5. Evaluate real estate development lending. Real estate development loans are borrowings for the purchase and development of raw land. Value added improvements including platting, subdividing, streets, gutters, and utilities. Developed lots or tracts are then resold to builders for ultimate resale to end users. Development may include single family residence, multi-family residence, retail, commercial, light industrial, manufacturing, recreational, or a combination of the above. When not building on a contractual basis for the end user, developers speculate on the demand for the planned improvements and anticipate sales proceeds in excess of costs. Borrowers are generally single purpose corporations, partnerships, or joint ventures. Risks associated with this type of lending stem from faulty assumptions regarding the demand for the project and the misapplication of loan and collateral proceeds.</p> <p>Consequently, lenders should demonstrate a knowledge of market trends, the ability to review and analyze appraisals, and the ability to monitor and control loan and collateral proceeds. Development loans are asset-based project loans and therefore should have well defined secondary sources of repayment.</p>	

**LOAN WORKSHEET #4 – REAL ESTATE LENDING (continued)**

Evaluate	Comments
<p>A. Evaluate the effectiveness of underwriting guidelines. The following minimum safeguards should be included:</p> <ul style="list-style-type: none"> <li>• Are appraisal assumptions verified or tested against known market trends?</li> <li>• Are absorption rates reasonable or overly optimistic?</li> <li>• Are plat and deed restrictions evaluated for compliance with local codes?</li> <li>• Are development budgets required and monitored?</li> <li>• Are interest reserves and soft costs reasonable?</li> <li>• Are inspections performed prior to each draw?</li> <li>• Are advances granted on a percent complete basis?</li> <li>• Does the policy include guidelines for establishing release prices in relation to cost, appraised value, and sales price?</li> </ul>	

## LOAN WORKSHEET #4 – REAL ESTATE LENDING (continued)

Evaluate	Comments
<ul style="list-style-type: none"> <li>• Do release prices place sufficient burden upon the borrower for slow moving or undesirable lots?</li>   <li>• Do terms require payout within three years after development is complete?</li>   <li><b>B.</b> Evaluate the borrower’s prior experience. Consider the following points:               <ul style="list-style-type: none"> <li>• The number of completed and sold projects.</li>   <li>• The complexity and size of other projects.</li> </ul> </li>   <li><b>C.</b> Evaluate financial statements. The developer’s financial statement is frequently highly leveraged and ill-liquid. Consequently, project analysis must be given a higher degree of importance in the evaluation of development loans. Secondary support should be provided through personal liability of the developers.               <ul style="list-style-type: none"> <li>• Have secondary sources of repayment been identified in the event that sales projections are not met? Typically, there should be sufficient outside income or liquidity to service at least one year of interest carry.</li> </ul> </li> </ul>	

## LOAN WORKSHEET #4 – REAL ESTATE LENDING (continued)

Evaluate	Comments
<ul style="list-style-type: none"> <li>• Analyze the statement to determine if it is an equity-based statement or includes gross values for assets and associated liabilities.</li>   <li>• Does management possess sufficient knowledge of the developer’s other assets and liabilities to assess their impact upon the borrower’s overall financial health?</li> </ul> <p>_____ <b>6.</b> Evaluate real estate commercial construction lending. Risks associated with construction lending stem from volatile market conditions and borrower’s whose financial condition is highly reliant upon the real estate market. Banks which do a poor job of monitoring construction progress and controlling funds are vulnerable to loss.</p> <p><b>A.</b> Evaluate policy and procedure for controlling construction advances. The following minimum safeguards should be included:</p> <ul style="list-style-type: none"> <li>• Are written construction loan agreements required?</li>   <li>• Is equity contributed before the first draw?</li>   <li>• Are advances granted on a percent complete basis?</li> </ul>	

**LOAN WORKSHEET #4 – REAL ESTATE LENDING (continued)**

Evaluate	Comments
<ul style="list-style-type: none"> <li>• Are inspections completed prior to funding draw requests?</li> <li>• Are inspections performed by disinterested third parties?</li> <li>• Are completion bonds or guarantees required on all large commercial or complex construction projects?</li> </ul> <p><b>B.</b> Evaluate management’s project analysis and underwriting. Consider the following points:</p> <ul style="list-style-type: none"> <li>• Are take-out commitments required?</li> <li>• Is there sufficient information in file regarding the proposed take-out/tenant?</li> <li>• Are cost breakdowns reasonable?</li> <li>• Are interest reserves and soft costs reasonable?</li> <li>• Is there sufficient information regarding demand for the proposed construction (market analysis/pre-leasing)?</li> </ul>	

**LOAN WORKSHEET #4 – REAL ESTATE LENDING (continued)**

Evaluate	Comments
<ul style="list-style-type: none"> <li>• Does the project conform with local codes or government standards?</li> </ul> <p>C. Evaluate the borrower’s prior experience. Consider the following points:</p> <ul style="list-style-type: none"> <li>• The number of completed and sold projects in the last 12 months.</li> <li>• The percentage of speculative or model projects on hand.</li> <li>• The complexity and size of other projects.</li> <li>• Any derogatory credit reports.</li> <li>• Any warranty claims resulting from poor quality work.</li> </ul>	

## LOAN WORKSHEET #4 – REAL ESTATE LENDING (continued)

Evaluate	Comments
<p><b>D.</b> Evaluate financial statements. Generally, a builder’s financial condition is highly leveraged and ill-liquid. If high levels of cash are noted, inquire about encumbrances relative to performance bonds. Historic financial information is not an absolute indicator of future performance due to factors such as competition and market conditions. Consequently, project analysis must be given a higher degree of importance in the evaluation of construction loans.</p> <ul style="list-style-type: none"> <li>• Is there sufficient liquidity to carry interest cost in the event that projected sales do not occur?</li> <li>• Are there viable secondary sources of repayment?</li> </ul> <p><b>E.</b> Does the construction in progress report indicate that the borrower has multiple projects and sources of financing?</p> <ul style="list-style-type: none"> <li>• If so, are the number and type of spec and model homes, vacant or low pre-leased projects, or lots excessive?</li> </ul> <p>_____ <b>7.</b> Evaluate income producing real estate lending.</p>	

## LOAN WORKSHEET #4 – REAL ESTATE LENDING (continued)

Evaluate	Comments
<p><b>A.</b> Evaluate policy, procedure and internal controls.</p> <ul style="list-style-type: none"> <li>• Does policy require periodic market surveys of occupancy and rental rates?</li> <li>• Does policy require periodic rent rolls?</li> <li>• Are rent rolls of sufficient detail to determine lease periods, square footage of unit, rent concessions, actual collections, and tenants?</li> <li>• Does policy require assignment of leases?</li> </ul> <p><b>B.</b> Evaluate underwriting and servicing.</p> <ul style="list-style-type: none"> <li>• Are leases obtained and reviewed?</li> <li>• Are tenant financial statements or credit information obtained and reviewed?</li> <li>• Are leases sufficient to amortize the loan?</li> <li>• Compare actual net operating income to appraisal assumptions.</li> </ul>	

## LOAN WORKSHEET #4 – REAL ESTATE LENDING (continued)

Evaluate	Comments
<ul style="list-style-type: none"> <li>• Evaluate lease-up assumptions and compare to actual results.</li>   <li>• Determine if borrower is offering lease incentives which may affect income.</li>   <li>• Evaluate market conditions to determine supply and demand for similar projects.</li>   <li>C. Evaluate financial statements. Generally, single purpose corporations, joint ventures or limited partnerships are used to finance non-owner occupied properties. Consequently, financial information will reflect high leverage, little liquidity and marginal profitability. As in development and construction financing, project analysis must be given a higher degree of importance in the evaluation of income producing real estate loans. Guarantor liquidity and surplus cash flow are secondary sources of repayment.</li>   <li>• Is net operating income (NOI) sufficient to meet debt service requirements?</li> </ul>	

## LOAN WORKSHEET #4 – REAL ESTATE LENDING (continued)

Evaluate	Comments
<ul style="list-style-type: none"> <li>• Are there reliable secondary sources of repayment? Individuals with direct or indirect liability should generally have sufficient equity in readily marketable assets to reasonably prevent the filing for bankruptcy to avoid their liability in the near term.</li> </ul> <p>_____ <b>8.</b> Evaluate systems to comply with Section 53 of the Property Code related to residential construction and home improvement lending.</p> <p style="padding-left: 40px;"><b>A.</b> Does the bank deliver to the owner all documentation relating to the closing of the loan not later than one business day before the date of the closing?</p> <p style="padding-left: 40px;"><b>B.</b> Does the bank provide the disclosure statement mandated by Section 53.255(b) prior to closing?</p>	

**LOAN WORKSHEET #4 – REAL ESTATE LENDING (continued)**

<b>Evaluate</b>	<b>Comments</b>
<p>C. When the bank disburses proceeds directly to the original contractor, does it obtain from the contractor a signed periodic statement (disclosing the expenses for which the contractor is seeking reimbursement or which it will pay from the disbursement), and forward it and a lender disbursement statement (which discloses the disbursements of loan proceeds that the lender has made since the last disbursement statement) to the owner before making a disbursement?</p>	