

Builder's Guide to Working With Lenders to Resolve AD&C Problems

The “Credit Crunch” virus has returned: The housing credit markets are in turmoil as weakening housing demand, declining home prices and rising defaults on subprime mortgages continue to buffet the system. The tightening of credit standards and sharp reduction in credit availability that emerged and spread in the consumer mortgage arena has already leapt to the housing production loan market. Builders are reporting an adverse shift in terms and availability on loans for land acquisition, land development and home construction (AD&C) and builders with outstanding loans are facing mounting challenges. Lenders are receiving current appraisals reflecting lower values on lots and homes, as well as market studies significantly scaling back absorption estimates. As a result, lenders are seeking additional equity for outstanding credits and balking at loan extensions. Defaults on AD&C loans are rising. The bank regulators have issued more restrictive guidance on real estate lending and are reviewing the methodology utilized by banks in determining loan loss reserves and levels of delinquent and nonaccrual loans for AD&C commitments. In this environment, banks are actively reducing exposure levels to home building credit.

How should builders respond? Timely communication and good faith negotiations can minimize the pain from the credit crunch. Do not ignore calls or other forms of communication from the lender. If a lender is aware the builder is on top of the situation and seeking solutions, the institution will be more likely to engage in positive dialogue. More often than not it is in the lender’s best interest to work with a builder on a loan to achieve the best outcome rather than to foreclose. The lender should be inclined to assist the builder in resolving factors impeding the timely construction, delivery and settlement of homes. The lender and the builder have a mutual interest in ensuring housing production is converted to revenues for the repayment of project debt.

NAHB has sought advice from banking experts and experienced builders on actions and options builders can pursue to achieve the best outcome on outstanding AD&C loans. The consistent message is to **take immediate steps to talk to your lender**. The following summarizes the details of this guidance.

Understand Loan Agreement and Lender’s Decision Making Process

The first order of business is a careful review of all documents relating to the loan. Identify all requirements, deadlines and penalties. Knowledge of such details offers a major advantage in evaluating and responding to communications from the lender. Also look for possible loopholes that may offer opportunities for modifications to the loan terms, particularly provisions that may allow more time and/or flexibility in repayment.

Knowledge of the lender’s decision making process is crucial. It is important to determine whether decisions are made locally or at regional or national headquarters of

the lender. Find out, as soon as possible, the names of the individuals who must sign off on all decisions affecting the loan. It is critical to involve the lender's decision makers as early as possible in the negotiation process. Also, determine the location of the loan file. Knowing whether the file is still with the originating/servicing office or has been transferred to a workout specialist or to the lender's legal counsel will affect the negotiation strategy.

Assemble a Comprehensive Package of Meeting Materials

A range of documents and data are essential to adequately present the project summary/status and the company's true financial capacity. It is helpful to provide information on both the company's market reputation and financial structure. Meeting materials must also detail a realistic business plan that can be thoroughly reviewed and understood. The preparation and collection of the meeting materials helps to prepare for the negotiating process. It is extremely important that all information is up-to-date. At a minimum, the meeting package should include the following:

- Current financial statements and project sales/settlement reports with monthly absorption numbers;
- Detailed global cash flows and valuation analyses with assumptions detailing the timing of settlement revenues, updated project cost (hard & soft) budget, expected net cash flow and resulting liquidity;
- Analysis of borrower and guarantor contingent liabilities;
- Current market study that determines value;
- Current sub-market analysis that identifies existing competition, provides support for expected sales prices, and estimates pace to turn inventory in the market;
- Information on sources of any additional liquidity or long term capital (family, trades, suppliers, or outside investors).

Utilize Outside Experts and Builder Association Contacts

Obtain professional advice, as needed, in gathering information and determining how best to proceed. There are many types of consultants available, including accountants, lawyers, and loan workout experts. Utilize local home builder associations to enlist assistance of associate members. This can be done in individual meetings or through formal or informal open forums and roundtables arranged by the HBA. It can also be helpful to ask the lender for recommendations. Working with individuals who already have established credibility with the lending institution can foster positive deliberations and outcomes.

Understand the Impact of Regulatory Constraints

The regulation and oversight of federally insured depository institutions, which account for the lion's share of AD&C lending, is the responsibility of multiple government agencies. Federal banking regulators have established an intricate framework of rules and guidance that sets forth requirements and protocol for banking institutions' real estate

lending practices. The Office of the Comptroller of the Currency (OCC) and the Office of Thrift Supervision (OTS) oversee the operations of, respectively, national and community banking institutions. These agencies are currently focused on understanding the depth of problems related to residential development and construction loans and developing responses through the supervision and examination process. The federal banking rules/guidance and related supervisory actions will govern a lender's actions and flexibility in dealing with outstanding AD&C loans.

Current market disruptions have led to a significant increase in the number of problem loans throughout the housing production marketplace. Slower sales and settlement volumes have caused increased concentration levels in real estate loans. The outcome is an adverse trend in criticized loans, non-performing assets, and additional loan loss reserves, providing impetus for bank examiners to reassess the levels of bank capital.

Loan Classification Ratings: Regulatory provisions require banking institutions to review their risk management and credit underwriting procedures and determine risk levels in existing loan portfolios. In this process, a "rating" system is employed to segment assets in categories of:

- Pass
- Special mention
- Substandard
- Doubtful
- Loss

The loan classification system reflects an estimate of probability of loss. The more severe risk ratings require additional loan loss reserves and/or a specific chargeoff when a loss is confirmed. Credits that are not able to repay principle and interest obligations would not be extended under the current structure in the normal course of business. There are additional requirements and accounting standards for banks to follow for problem loans, impaired credits and troubled debt restructurings (TDRs).

Bank Re-evaluation of Credits: In the current environment, lenders can be expected to order new appraisals to determine the current fair value of loan collateral and to identify and quantify potential losses. A lender's allowance for losses is not a cushion against possible future losses. Rather, it estimates a probable loss amount as of a specific review date and it reduces operating income.

Loan-to-Value (LTV) Limits – Internal Bank vs. Supervisory Ratios: Banks are required to establish internal LTV limits as part of their credit lending/underwriting policies. The banking regulators have established LTV guidelines for different categories of real estate loans. Generally, a bank's internal LTV limits will not exceed the regulators' supervisory guidelines, which are:

- 65%, -- raw land
- 75% -- land development

- 80% -- multifamily (includes condominiums and cooperatives)
- 85% -- 1-4-family residential (there is no established limit for 1-4- family residential where the bank is funding both the construction and permanent mortgage)

High loan-to-value (HLTV) loans are loans that exceed supervisory LTV limits. The aggregate amount of such loans cannot exceed 110 percent of a bank’s capital position. And, within this pool, all non-1-4 family residential loans cannot exceed 30 percent of total capital. These limits can further restrict additional funding by banks.

Bottom Line: The expanding timeframes for repayment, combined with decreased values and intensified regulatory scrutiny, will lead lenders to seek additional concessions from builders, including:

- additional cash equity
- additional collateral,
- guarantor support
- loan fees
- higher interest rates

Potential losses will be quantified and actions to minimize losses will be undertaken on a global basis. Moreover, lenders can be expected to make efforts to reduce the percentage of commercial real estate loans in their portfolios.

Present a Business Plan and Negotiate Effectively

Meet with the bank as soon as possible to attempt to reach a positive consensus. If possible, schedule the meeting prior to an event of default, which will help minimize the “surprise” factor for the bank. This approach offers significant potential benefits, including tangible offsets for any underwriting or valuation adjustments. Negotiate in good faith for continued loan advances, based upon current market conditions, to provide the funds to ensure (lien free) completion of site development and/or home construction and ultimate repayment. Keep in mind that the lender’s priority is to obtain repayment of the loan in a manner that will minimize losses and avoid regulatory penalties.

During the initial meeting:

- Minimize the number of participants and include a decision maker;
- Maintain a positive environment;
- Utilize an agenda that incorporates all existing issues that must be discussed;
- Start slowly and stay positive – reinforce the benefits of loan repayment as detailed in the plan;
- Discuss the small items first and attempt to settle everything at the end of the meeting;
- Focus on the future and not past accomplishments;

- Be realistic regarding expected performance and provide as much detail as possible with related assumptions;
- Clearly state and reinforce the joint benefits addressed in the plan;
- Listen effectively and carefully weigh options prior to responding or committing to an offer;
- Be prepared to make fair concessions in return for time and continued funding.

The initial meeting carries extra importance because it will most likely determine the environment, tone and success of future meetings and negotiations.

Expect negotiations to begin immediately: The lender may seek a variety of changes to the original loan agreement:

- more up-front equity
- additional collateral
- security for repayment guaranty
- establishment of performance benchmarks
- additional loan fees
- increased interest rate

Make sure you have a clear understanding of the position of the lender: Determine if there is a commitment to work together and if the seriousness of the situation is understood by all parties. Determining what is important is critical. Obtain specifics on what modifications may be required by asking the following questions:

- What else do you need to assist with the review?
- What are your concerns and what do you find to be unreasonable with the business plan?
- What do you propose we do now?

Avoid Common Missteps:

- Stay focused on the issues, remembering everything is negotiable, and attempt to receive something in return for every concession.
- Do not agree to any concessions without having sufficient time for careful review.
- Do not argue.
- Keep the climate positive and understand the position of the bank.
- Avoid “Deadlock” in the negotiating process.

Identify Legitimate Lender Issues: There are legitimate lender issues and a variety of possible builder responses for every situation. The preferred solution providing for maximum repayment of the related debt from the sale of the real estate will only occur with all parties working together to reach an agreement.

Examples of lender issues and possible responses:

Issue: Current LTV is too high and the ratio exceeds our policies.

Response: There are appraisal issues in today's market, however, reduction of debt is more important than a current LTV ratio calculation.

Issue: Additional cash equity is required to rebalance the loan.

Response: Must be able to preserve liquidity to ensure building operations continue. It is not possible to provide additional equity for all my properties.

Issue: Need to increase repayment provision to repay loan as quickly as possible.

Response: A portion of the settlement proceeds may be available to establish a pool of resources for the project.

Issue: The additional risk requires an increase in interest rate and loan fees.

Response: A higher rate of interest is possible as market conditions improve and is a reasonable compensation for allowing interest to accrue and be paid at time of home completion and settlement.

Issue: The bank examiners are requiring me to halt funding of the project.

Response: Don't regulatory guidelines provide flexibility to accommodate situations in which it is appropriate to continue funding?

Take Steps to Follow Up

Schedule the next meeting date and utilize the intervening time to consider alternatives to the options presented by the bank.

Explore Other Options

Some builders may encounter situations that do not offer enough leeway for negotiation with the bank or face a lender that refuses to consider reasonable proposals. In such situations, investigate the possibility of having another lending institution take over the loan. A different lender may see opportunities where the current lender is unwilling to proceed. Try to line up commitments for mortgage take-out financing from a lender approved for business with Fannie Mae or Freddie Mac in order to establish credibility for home appraisals and sales prices. Other options to discuss include bankruptcy and foreclosure procedures and, when all fails, litigation. These latter alternatives will likely require the builder to obtain professional legal advice.