RMA THE RISK MANAGEMENT ASSOCIATION

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What You Really Need to Know About Commercial Real Estate Underwriting: Back to Basics

Enterprise Risk • Credit Risk • Market Risk • Operational Risk • Regulatory Affairs • Securities Lending

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Developing the net operating income (NOI) or cash flow is an important first step in the prudent underwriting of a commercial real estate (CRE) property.

Quantitative analysis is one facet of prudent real estate underwriting, but the real estate math isn't a black-and-white exercise, nor is it simple formula lending. Many qualitative judgments feed into your estimates of property cash flow, coverage, and value that come from quantitative analysis. Your analysis should be completed in the context of the qualitative credit risk assessment. Doing so will avoid over-advancing on potentially weak property cash flow streams that will in turn jeopardize repayment prospects and bank portfolio quality.

An example of the interplay between qualitative and quantitative judgments is the vacancy factor applied to lease income for a project and how it will affect cash flow. This quantitative aspect cannot be interpreted without understanding the qualitative factors behind it. CRE operates in a dynamic marketplace that is affected by the surrounding properties, demographics, and local, regional, and national economics. Unlike other businesses, an income-producing property can't simply move its operation to another market or shift its product offering and price point.

It is important to remember that the numbers resulting from the quantitative analysis are only estimates. It's impossible to be absolutely certain what a property's future economics will be, despite the substantial amount of thought and diligence that is put into the analysis. There are simply too many

THE VACANCY FACTOR

How stable can this quantitative factor be over the life of the property?

First, if the property has longer lease terms in place with its tenants, this factor may be very stable and dependable. However, if the market or property type tends to have shorter-term leases in place (month-to-month or even annual basis), vacancy can rapidly fluctuate with market and competitive changes.

Second, a property's age, location, and desirability as compared to its competition can also be a factor when it comes to having a stable base of tenants and less risk of a vacancy increase, especially during times of market stress.

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variables in the analysis outside management's control, such as market rents, vacancy, and investor appetites. Lenders' assessments factor in their perception of the reliability of the calculated property cash flow. Consequently, the final underwriting must allow room for variable fluctuation. In workout or liquidation scenarios, an owner-occupied property may need to be sold as an income-producing property. If an owner-occupied building or project is converted into leased space, it's important to consider whether there could be additional, non-owner-occupied uses for the site that would help ensure the marketability of the collateral.

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QUANTITATIVE ANALYSIS GUIDELINES

The underwriting guidelines that a financial institution applies to its real estate loan decisions are an important part of quantitative analysis. There is, of course, a wide range of borrower financial measures that would be important to consider, including historical and projected financial performance, complete with liquidity, leverage, and profitability analysis. However, there are certain measures that relate directly to the non-owner-occupied real estate project itself:

- The maximum loan-to-value ratio (LTV) answers the question: How much is the bank willing to lend against the appraised value of the property?
- The maximum loan-to-cost ratio (LTC) answers the question: How much is the bank willing to lend against the total cost to build the property?
- The minimum cash equity answers the question: How much of the borrower's own funds (or those of investors) must be contributed toward the cost to build or purchase the property?
- The minimum debt service coverage ratio (DSC) answers the question: How adequately must the borrower cover principal and interest payments from internally generated funds?

CREATE A GENERAL OUTLINE

The lending policy should contain a general outline of the scope and distribution of the institution's credit facilities and the manner in which real estate loans are made, serviced, and collected. Specific areas to be addressed include:

- The lender's intended geographic scope.
- Limits for real estate loans by type and geographic market.
- Terms and conditions by type of real estate loan.
- Loan origination and approval procedures.
- Underwriting standards, including LTV limits consistent with FDICIA guidelines.
- Exception procedures.
- Capital capacity and parameters for making loans in excess of established LTV guidelines.
- Loan administration procedures.

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UNDERWRITING GUIDELINES: FDICIA SUMMARY

In the early 1990s, the Federal Deposit Insurance Corporation Improvement Act (FDICIA) required the industry to set standards and guidelines for extension of credit secured by liens on real estate or made for the purpose of financing permanent improvements to real estate. Banks did not necessarily have to overhaul their own guidelines because of FDICIA. In fact, many institutions were, and remain, more conservative in their own underwriting standards. The FDICIA guidelines include general requirements for inclusion in financial institutions' real estate lending policies as well as specific LTV limits to which lenders must adhere.

Each insured depository institution must adopt and maintain a written policy that establishes appropriate limits and standards for all extensions of credit that are secured by liens on, or interests in, real estate or made for the purpose of financing the construction of a building or other improvements. Every officer needs to know where to find the policy for his or her financial institution before becoming involved with real estate lending of any kind.

In addition, banks are required to establish real estate appraisal and evaluation programs and to provide for timely and adequate management reports to boards of directors.

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Banks must adopt written policy guidelines that address maximum loan amounts and maturities by type of property, acceptable amortization schedules, pricing structures by type of real estate loan, and LTV limits by type of property.

In addition, for development and construction projects and completed commercial properties, the policy must also establish requirements for:

- Feasibility studies.
- Minimum equity requirements.
- Minimum standards for net worth,
- Cash flow and DSC.
- Standards and limits for non-amortizing loans and the use of interest reserves.
- Preleasing and presale requirements for loans for income-producing properties.
- Presale and minimum unit release requirements for loans for non-income-producing properties.
- Limits on partial recourse or nonrecourse loans.
- Requirements for guarantor support.
- Requirements for takeout commitments.
- Minimum covenants for loan agreements.

Internal LTV limits should not exceed the following supervisory limits:	
Raw land	65%
Land development	75%.
Commercial, multifamily, and other nonresidential construction	80%.
One-to-four family residential construction	85%.
Improved property	85%.

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REGULATORY GUIDANCE

High portfolio concentrations in real estate categories, especially construction and speculative projects, accelerated the collapse of the savings and loan (S&L) industry in the 1990s. This created the need for FDICIA and related regulations. A decade later, in the 2000s, financial institutions were again faced with some of the same problems. To help better monitor these portfolio concentrations, inter-agency guidelines were issued in 2006. Further, as real estate markets weakened in 2007 and 2008, a joint policy statement was made concerning the prudent handling of problem CRE loans.

The CRE concentrations guidance established new thresholds for levels of CRE loans as compared to a bank's capital. These thresholds to be monitored were divided into two categories: construction and land development loans and total CRE loans. The total CRE category excludes owner-occupied loans. Also, the thresholds in the guidance do not apply to Federal Saving Banks (FSBs) because these institutions must already comply with portfolio composition rules via the Qualified Thrift Lender (QTL) test within the Home Owner Loan Act (HOLA).

Banks that exceed the thresholds or have exhibited high levels of growth in CRE loans are expected to have stronger risk management practices and procedures for CRE lending, as further outlined in the guidance document.

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The guidance outlined and re-emphasized seven key areas of CRE risk management: board and management oversight, portfolio management, management information systems, market analysis, credit underwriting standards, portfolio stress-testing and sensitivity analysis, and credit risk review function.

The policy statement on prudent CRE loan workouts addressed the challenges banks faced in dealing with CRE borrowers with diminished cash flows, deteriorating property values, or prolonged sales and rental absorption periods. The document outlines risk management elements for loan workout programs, defines loan workout arrangements, discusses classification of loans, and reviews regulatory reporting and accounting considerations.

ADDITIONAL RESOURCES

The RMA Journal published two excellent articles about the interagency concentrations guidance:

1. "Regulatory Guidance on Commercial Real Estate Risk" (April 2007) explains the guidance and the seven key areas.
2. "Adapting to CRE Concentration and Risk Management Guidelines" (April 2007) describes one bank's firsthand experience in incorporating the principles.

While both of these more recent documents may not have the same impact on a bank's day-to-day lending activities as FDICIA, they are equally important in influencing how bank's management deals with its CRE portfolio. For example, these portfolio issues can filter down to playing a role in the types of properties the bank may be more or less active in because of concentration issues.

ANALYZING VALUE AND CASH FLOW

It is essential to assess both LTV and DSC as part of analyzing a loan's conformance to the FDICIA underwriting guidelines.

The value of an income-producing property is a function of the stream of cash flows, or rentals, generated by the property. Before determining the LTV

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measure, the lender must first identify the property's likely cash flow. These same cash flows are the basis for income available for debt service.

Although cash flow analysis pertains specifically to income-producing properties, some owner-occupied properties also include space leased to tenants. It's important to consider an owner-occupied property's potential ability to be leased for rental income, in the event the property has to be liquidated or managed during a loan workout. In many cases, this will allow the bank to gauge the value of the secondary source of repayment in an owner-occupied situation.

INCOME PROPERTY CASH FLOW ANALYSIS INFORMATION

The following questions yield the information needed to construct a cash flow profile for an income-producing property such as a downtown office building.

How much space does the building have available for lease?

Since it can be presumed that the space is not evenly divided into identical units, the space availability can be expressed in terms of total square footage available for rent. Some portions of the building are not available for rent, such as hallways and restrooms. For comparison with other buildings, it’s important to know if square footage is calculated on a gross basis, meaning all areas included, or on a net basis, excluding non-rented space.

How much does the space rent for?

Lease rates are sometimes negotiated and there is not necessarily one uniform rental rate in force. If possible, always underwrite to comparable market rental rates per square foot. Also, consider the nature of the rental space. Is it a basement or a penthouse?

Is every inch of space always rented out?

Logic says that there will always be some portion of the building that is not rented, perhaps because it's between tenants, under renovation, or vacant for some other temporary reason. Vacancy also includes an allowance for losses

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that might be incurred from tenants who may refuse to pay due to disputes, bankruptcies, or other reasons that rents cannot be collected. The general convention is to express the vacant space as a percentage of total rentable square feet.

What does it cost to operate the building?

Operating expenses are generally expressed on an annual basis, per square foot. These expenses include utilities, taxes, management fees, maintenance, marketing, insurance, and legal and accounting fees, for example. Some operating expenses are passed on to the tenant, depending on how the lease is written. In a gross lease, the building owner pays all expenses. A net lease passes some or all expenses on to the tenant. Because of expense uncertainties, a gross lease will usually have a cushion built into the lease rate. Generally, it is preferable to see net leases because the risk of cost increases can be passed on to the tenants. The most common type of net lease passes taxes, insurance, and maintenance expenses to the tenants. It's important to read the leases in question. Many times the terms net, triple net, net net net, and gross are used and could have subtle differences in different markets. Also, care should be taken to discover items such as expense stops, which limit the amount of expenses a landlord will pay. There is no substitute for reading and understanding the lease.

What is the annual cost per square foot of items that need to be expensed for eventual replacement?

It is important to include a provision for the replacement of, in the case of an apartment complex, dishwashers, refrigerators, ranges, air conditioners and furnaces, and roofs in the underwriting analysis, whether or not the borrower creates an actual sinking fund.

What does it cost to persuade tenants to renew their leases and to attract new tenants for space that becomes available?

Redecorating, renovation, and leasing agent commissions are often necessary to release space, even to the existing tenant. Rollover costs may vary from year to year because there may be either no leases renewing or three or four new tenants or lease renewals during any given year. For this reason, an allowance

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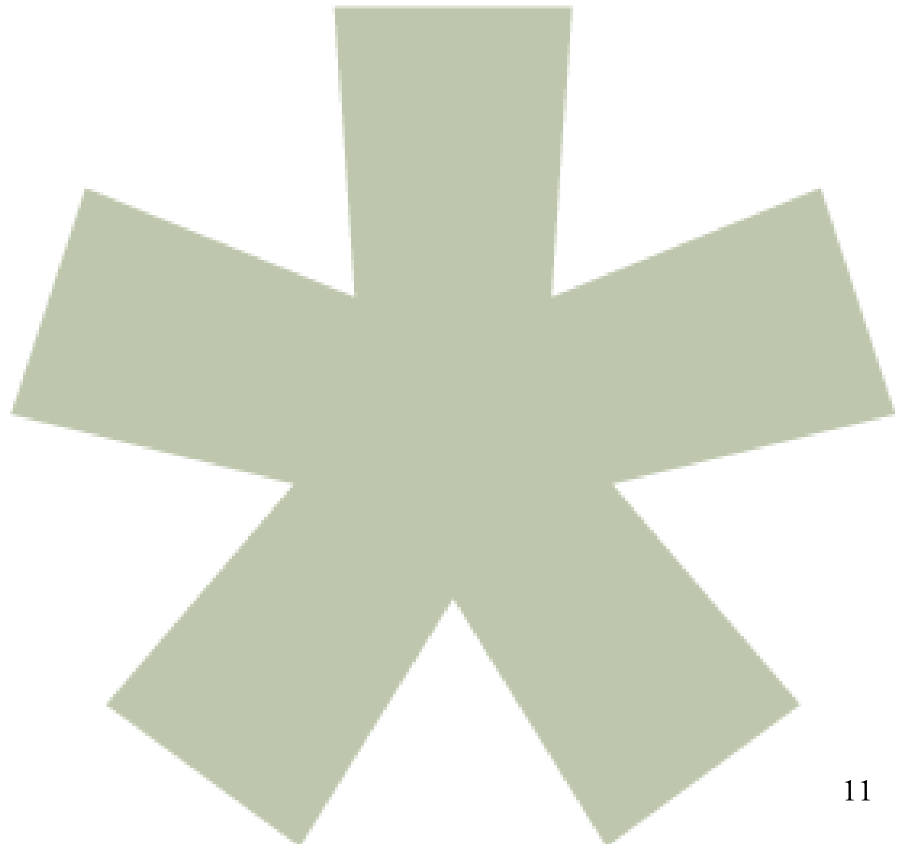
per square foot needs to be established and accounted for from the net cash flow.

The property owner or developer will supply the historical information or estimates for the income property cash flow analysis if the project is a new one. Regardless, due diligence procedures of independent confirmation certainly apply to real estate loans.

It is also prudent to survey the local market's revenues, vacancy percentages, replacement reserves, and operating and rollover expenses and to compare them to the owner or developer's information. It is also essential to evaluate information for competing projects, if available, including appraisal information from other developers and real estate brokers.

For more insight into this topic, please learn more about our Commercial Real Estate Lending Decision Process online course.



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ABOUT RMA

The Risk Management Association (RMA) is a not-for-profit, member-driven professional association serving the financial services industry. Its sole purpose is to advance the use of sound risk principles in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, operational risk, securities lending, and regulatory issues.

Founded in 1914, RMA was originally called the Robert Morris Associates, named after American patriot Robert Morris, a signer of the Declaration of Independence. Morris, the principal financier of the Revolutionary War, helped establish our country's banking system.

Today, RMA has approximately 2,500 institutional members. These include banks of all sizes as well as nonbank financial institutions. RMA is proud of the leadership role its member institutions take in the financial services industry. Relationship managers, credit officers, risk managers, and other financial services professionals in these organizations with responsibilities related to the risk management function represent these institutions within RMA. Known as RMA Associates, these 16,000 individuals are located throughout North America and financial centers in Europe, Australia, and Asia.

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RMA UNIVERSITY

In today's rapidly changing financial services industry, you need practical, day-to-day knowledge that will help you excel in your profession. RMA provides quality education to advance sound risk principles in the financial services industry. Traditional classroom training and online learning resources are available as open enrollments or in-bank training. Visit http://www.rmahq.org/events-training/rma-university/rma-university to learn more.

ESTATEMENT STUDIES

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