Income Property Lending

As the name implies, income property lending involves loans secured by real estate that generates income, and includes loans on both multifamily residential and nonresidential real estate. Loan repayment primarily comes from the cash flows generated by the operation or leasing of the real estate but may be supplemented by other sources of cash. For purposes of this section, income property lending includes the permanent (non-construction) financing of multifamily residential properties and nonresidential properties. One- to four-family residential real estate lending activities, including investor owned properties, are covered in Examination Handbook Section 212. Commercial loans to finance commercial or industrial business activities other than for the acquisition or holding of real estate and construction loans are discussed in Sections 213 and 214 of the Handbook, respectively.

LINKS
Program
Appendix A
Appendix B

Multifamily residential real estate lending includes permanent financing of apartment buildings, five or more dwelling units, retirement homes, and student housing. Section 1464(c)(1) of the Home Owner's Loan Act (HOLA) authorizes federal savings associations to invest in residential real estate loans, including multifamily residential real estate loans, without limit.

Nonresidential real estate lending includes permanent financing of shopping centers, hospitals, hotels, offices, stores, farms, nursing and convalescent homes, churches, and other commercial properties. HOLA limits a savings association's investment in nonresidential real property loans (including commercial and other nonresidential real estate loans) to no more than 400 percent of total capital, unless it obtains prior written approval from the OTS.

This handbook section covers the risks associated with income property real estate lending, and highlights supervisory expectations regarding the proper underwriting, management, monitoring, and control of this activity.

INCOME PROPERTY LENDING

There are many types of income-producing properties with unique characteristics and risks that are affected differently by economic and business cycles and trends. Local supply and demand conditions are key economic factors affecting these real estate markets. Multifamily housing is influenced by homeownership availability and affordability, vacancy rates, and local employment conditions. Office space is often dependent on white-collar employment, while retail, hospitality, and industrial real estate are affected by consumer spending, among other things.

Income property lending presents significantly different issues and risks compared with one- to four-family (1-4 family) residential real estate lending. For example:

- Commercial real estate and multifamily residential mortgage loans can be more susceptible to economic cycles and may experience higher default rates and loan losses during recessions.
- Underwriting analysis and credit evaluation is usually more complex for income property loans than for single-family residential mortgages.
- Appraisals are more complex and property valuations are more susceptible to price fluctuations.
- Lending risks are more concentrated among fewer, larger loans, which can have greater impact on the association's earnings and capital in the case of default.
- Environmental and special purpose property risks are generally more prevalent in income property lending.

In establishing an income property lending activity, an association should address the factors discussed in Section 201 of the Handbook, which include:

- How does income property lending fit into the association's strategic goals and business plan?
- Is this lending consistent with the association's risk profile and risk appetite?
- Is the lending activity part of a well-diversified lending strategy or is there a significant concentration in this one line of business? Has the association adequately addressed this concentration risk?
- Do management and the lending staff have sufficient expertise for this type of lending activity?
- Has the association established adequate loan policies and procedures?
- Does the association have an adequate and appropriately staffed credit administration and work-out functions?
- How are the risks of these types of loans managed – individually and across portfolios? Is the risk management function adequate?

Underwriting Income Property Loans

The discussion of underwriting standards in the Interagency Real Estate Lending Standards (RELS)(12 CFR § 560.101) applies to income property loans. Prudently underwritten real estate loans should reflect an analysis of all relevant credit factors, including:

- The capacity of the borrower, or income from the property, to adequately service the debt.
- The value of the mortgaged property.

- The level of equity investment in the property.

- Any secondary sources of repayment.

- Any additional collateral or credit enhancements.

Savings associations must establish clear written underwriting standards for income property loans. Specific underwriting criteria will depend on the property being financed, the creditworthiness of the borrower, and the source(s) of loan repayment. Savings associations must also establish clear requirements for documenting its analysis of the borrower's financial capacity, the borrower's creditworthiness and experience, and the value of the collateral. (Refer to the discussion on the five "Cs" of credit and loan documentation in Handbook Section 201.) The association must have underwriting criteria and documentation standards related to its specific type of income property lending activities. Moreover, the institution should establish prudent and appropriate loan terms for each loan type.

Market Analysis

> Performance of income producing property depends in large part on local and regional economic conditions.

Performance of income producing property depends in large part on local and regional economic conditions. As set forth in the RELS rule (12 CFR 560.100-101), a lender should monitor conditions in the real estate markets in its lending area so it can consider factors affecting the supply and demand for income producing properties in lending decisions and in monitoring loan performance after a loan is made. Such factors include:

- Demographic indicators, including population and employment trends, such as the job market, trends in job growth, sector growth, and the financial condition of local employers.

- Zoning requirements, including pending changes.

- 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 properties.

- Proposed and approved projects, including local development, approved development, and permits issued.

- Economic indicators, such as the local economy, community needs, interest rates, consumer spending patterns, and lending trends.

- Valuation trends.

Understanding the market is key in being able to better manage the risks associated with uncertainty and the cyclical nature of real estate markets.

Property Analysis

In evaluating the real estate, the lender should consider:

- Income capacity and stability.
- Condition and location of the real estate
- Quality and experience of management
- Fair market value
- Price stability
- Borrower equity
- Convertibility of the property.

Because the property serves as both the primary source of repayment of the loan and as collateral in the event of default, the lender must carefully analyze and document the property's value and its ability to generate sufficient revenue to service the debt over the life of the loan, given current and anticipated market conditions. In conducting its underwriting analysis, a lender will usually look at several factors, including income capacity (or debt service coverage), collateral value, and loan to value.

Income Capacity. Assessing the ability of the property's net operating income (NOI) to cover debt service requirements is key when relying on this income as the primary source of loan repayment. Typically the lender uses a debt service coverage ratio (DSCR) to make this assessment. The DSCR is the ratio of NOI divided by projected annual debt service. NOI is calculated as the gross revenue, minus a vacancy factor, minus operating expenses (including capital expenditures but excluding debt service). Some properties do not achieve stabilized occupancy until well after the initial lease-up or interest only periods. Also, many properties are leased with special incentives, such as rent free periods. For these reasons, DSCRs should be determined and evaluated using both current and stabilized rents and occupancy.

Savings associations must carefully evaluate NOI by evaluating the nature and stability of income, operating expenses, and rates of occupancy over time compared with market rates. Lenders should verify NOI information by obtaining borrower and property financial statements/tax returns, rent rolls, financial information on the major tenants, leases, and other relevant information, as well as comparative market data. Savings associations should assess the adequacy of a borrower's reserves relative to operating expenses and ensure that projected NOI reflects necessary contributions to reserves for maintenance and improvements to ensure their adequacy over time. An association should determine the level of stabilized occupancy and income based upon reasonably expected market conditions, taking into consideration historical experience and current market conditions.

The higher the DSCR, the better the ability of the property to generate sufficient income to service the loan. For example, a 1.32 DSCR provides a 32 percent buffer to cover higher than predicted rates of vacancy, unexpected maintenance and repairs, or increased costs. A lender may require a DSCR of 1.2x or higher, depending on the type of property and the stability/predictability of the NOI, although a ratio as low as 1.1 may be acceptable to a lender for projects with guaranteed rent features, such as a government office building. Note: Prudently underwritten multifamily mortgages may qualify for the 50 percent risk weight with a DSCR as low as 1.15 percent. See the discussion on property analysis in Appendix A.

Collateral Value. An assessment of the value of the property is also important. The method of valuation used will depend on the type of property being valued. This highlights the need for reliable appraisals or evaluations in accordance with OTS's appraisal regulations (12 CFR Part 564) and Handbook Section 208.

When estimating the value of income-producing property, the appraiser generally relies on the income approach to valuation rather than the comparable sales or cost approach. The income approach converts all expected future NOI into present value terms, using a variety of analytical methods. One method is the direct capitalization method, which estimates the present value of a property by discounting its NOI at an appropriate capitalization rate (commonly referred to as the cap rate). The direct capitalization method is appropriate for use in valuing properties with stabilized rents and occupancy. Another method is the discounted cash flow method, which discounts expected future cash flows at an appropriate discount rate to ascertain the net present value of a property. This method is appropriate for use in estimating the values of newer properties that have not yet reached stabilized occupancy, or for properties that are experiencing fluctuations in income.

The discount and cap rates used in estimating property values should reflect reasonable expectations about the rate of return that investors and lenders require under normal, orderly and sustainable market conditions. The appraiser's analysis and assumptions should support the discount and cap rates used.

Management must review the reasonableness of the assumptions and conclusions underlying each appraisal and should question any assumptions that appear to be too optimistic or pessimistic. When considering the reasonableness of facts and assumptions associated with the value of the collateral, lenders should consider:

- Current and projected vacancy and absorption rates.
- Lease renewal trends and anticipated rents.
- Volume and trends in past due leases.
- Effective rental rates and sales prices.
- Outstanding leases.
- Net operating income of the property compared with budget projections.

- Discount rates and capitalization rates.

Lenders should consider each of those factors under normal and stressed conditions. As real estate incomes and prices rise in periods of rapid economic growth, lenders should stress test cap rates and DSCRs to determine whether a property will be viable during a period of economic stress.

Nonresidential real estate may be designed for unique and specialized uses that could render it difficult to liquidate should the borrower default. This lack of liquidity presents an increased risk to the lending institution, particularly if it is forced to sell the property during periods of real estate market weakness. Marketing and holding costs, and the cost to convert the property to alternative uses with greater market demand, increases the difficulty of valuing such properties and presents additional risks to lenders who make loans on highly specialized properties.

Loan-to-Value Ratio. Residential and nonresidential loans are subject to 12 CFR § 560.100-101, the Real Estate Lending Standards Rule, including the attached interagency guidelines. The rule requires savings associations to maintain prudent written lending standards for its real estate loans, including standards for loan-to-value (LTV) limits. The LTV ratio is the ratio of the loan commitment amount divided by the lower of the purchase price or appraised value of the property at the time of origination. These requirements are discussed in more detail in Examination Handbook Section 212. Loans on improved property are subject to an 85 percent supervisory LTV limitation, although some lenders set LTV limits for nonresidential real estate loans at or below 75 percent. Aggregate loans in excess of the supervisory LTV limits, including 1-4 family mortgages, should not exceed 100 percent of the association's total (tier 1) capital. Within that 100 percent of capital limit, nonresidential and multifamily mortgages should not exceed 30 percent of the association's total capital.

A savings association's internal policies should establish appropriate standards for the type and amount of borrower equity by setting maximum LTV ratios pursuant to 12 CFR § 560.100-101. The lower the LTV ratio, the greater the borrower's equity or investment in the property. Borrower equity provides a cushion to the lender against loss in the event of borrower default. Also, the more cash equity a borrower has in a project, the more likely the borrower will remain committed should cash flows decline.

Other security. Lenders often secure all business-related assets of a company so they can sell the building and all related furniture and equipment in the event of foreclosure. Also, a lender may obtain an assignment of rents for the security property, a cross-collateralization agreement covering the principal's other business real estate, and chattel agreements for related business property. A lender may also take other measures to enhance its positions in the event of borrower default. Not only is the lender in a better collateral position in the event of default, but default on the one loan would trigger default on the borrower's other projects. This may provide extra incentive for the borrower's continued commitment to the project.

Borrower analysis

Underwriting criteria and analysis will depend on the borrower's legal status and the primary source of loan repayment. The borrower may be an individual, individuals, corporation, or partnership. Owners of closely held companies may rely on personal income and assets to service the debt, in addition to income from the real estate.

Underwriting criteria and analysis will depend on the borrower's legal status and the primary source of loan repayment.

For businesses less than three years old, lenders should obtain personal guarantees from the principals and evaluate their credit history. For corporations with a proven track record, lenders should evaluate business performance and credit ratings and determine if the business is strong enough to support the loan without guarantees. Lenders should view guarantors as secondary repayment sources and fully evaluate their ability and willingness to repay the loan in the event of a default. When the borrower is a shell company or entity whose only or primary asset is the real estate securing the loan, the association should consider obtaining personal endorsements or guarantees from the principals and requiring additional collateral to reduce net credit exposures. The reliability of the operating and cash flow information on the real estate take on increased importance in these instances.

History and Experience. Associations should thoroughly investigate a borrower's experience with similar real estate projects to determine if the borrower has the expertise and resources necessary to manage the project profitably and successfully during unexpected economic or other setbacks. Borrower history and track record are an indication of character, competence, and ability. It is also important that the borrower demonstrate a history of timely and accurate financial reporting and performance on other loans with the association as well as with other lenders. It is important for the institution to review the borrower's nonbank creditors and trade accounts as well as credit bureau and Dun and Bradstreet credit reports to assess the borrower's credit standing. A review of several months of checking account activity is also useful to determine the cash needs of the borrower/business and give indications of borrower liquidity.

Financial Capacity. Depending on the borrower, the lender may analyze personal financial statements and tax returns, or corporate financial reports. Current and accurate financial statements are integral to making informed and sound lending decisions, so a lender should insist on complete and signed statements. The lender should obtain current and accurate borrower financial statements, two to three years of current business or personal tax returns, and profit/loss and cash flow statements on the business or security property. It is important to compare financial statements and tax returns detailing the borrower and the property's financials over time to look for consistency, financial strength, and reliability of information. For partnerships and similar entities, it is important that tax returns include k-1s when there are partnership entities on the balance sheet. Without those, cash flows will be inaccurate.

When the borrower is a corporation or business entity, financial capacity is generally determined by conducting an analysis of its current financial statements. Net working capital (current assets minus current liabilities) show borrower liquidity. The debt to equity ratio (borrowed funds divided by net worth) shows reliance on outside financing indicating leverage. Return on assets and return on equity show profitability and management efficiency. Borrower ratios can be compared with average ratios for similar businesses. Ratio analysis is important to help determine the borrower's financial strength and management capabilities. Similarly, a thorough understanding of the borrower's current and projected cash flows is essential. See Appendix A for a more detailed discussion on financial analysis.

A review of corporate documents such as corporate borrowing resolutions, articles of incorporation, and certificates of good standing, are also appropriate. With larger income property loans, lenders should have a loan approval memorandum (or memoranda) in the loan file that documents the underwriting analysis, the strengths and weaknesses of the proposed transaction, and the approving officer's reasons for approving the loan request.

Loan Terms

Granting nontraditional mortgage terms in the financing of commercial and multifamily real estate properties can substantially increase the risk of the commercial real estate portfolio if not underwritten prudently. Nontraditional payment terms and features include interest only loans, discounted initial payments, option ARMS, and extended terms. Interest only periods are often granted for construction and lease-up periods. Such terms should only be granted in cases where the underwriting analysis demonstrates that they are appropriate for both the borrower and the association. Moreover, debt to-income ratios should be calculated based on fully indexed, amortizing payments. When a borrower does not qualify for a loan without the discounted or liberal payment terms, the borrower could be exposed to payment shock when the loan is recast or refinancing is required, thereby exposing the institution to default and potential loss.

Loans to borrowers who do not have repayment capacity from sources other than the sale or refinancing of the collateral pledged are generally considered unsafe and unsound. Loans where property cash flow provide the primary repayment source is acceptable, provided that such income, together with other borrower income, is sufficient to repay the loan. However, when repayment is solely dependent on the sale or the refinancing of the property, the loan is collateral dependent. Institutions originating collateral-dependent mortgage loans may be subject to higher capital requirements, criticism, and corrective action.

Loan Policy Exceptions

The board of directors should establish specific safe and sound policies and procedures for the approval of loans that fall outside the limitations of the savings association's approved loan policy. Approval authority should be detailed by officer and loan amount. The nature of the exception and the amount of the loan should dictate the level of approval required with higher level approval required for more significant exceptions and larger loans. It is also important for associations to establish reporting and enhanced monitoring procedures for exception loans.

Loan Purchases and Participations

When lenders purchase income property loans from or participate in loans with other lenders they should perform and document an underwriting/due diligence analysis that is as thorough and complete as when they originate the loan. A participant must perform its own independent credit analysis in order to determine that the borrower is creditworthy and the participation is prudent. Participants should not rely on information provided solely by the originator. Participation documents should show that the participant is exercising independent judgment concerning the borrower's financial strength and the valuation of collateral. Moreover, participants should obtain copies of all relevant loan documents, including security agreements, appraisals, financial statements, credit reports, loan approval memoranda, disbursement sheets, title and recording documents, and periodic financial statements and payment reports generated after loan closing.

Savings associations that purchase participations must enter into participation agreements that are structured to allow them to protect their own interest if a participated loan defaults. Participation agreements should be structured to clearly outline the obligation of the originator to furnish timely credit information and to provide notification of material changes in the borrower's status. Agreements should also outline the terms under which the originator can modify the loan, guaranty, or security agreements, and what role the participant will play in such decisions. Participation agreements should also include the ability of the participant to require action related to all risk areas, including property maintenance, loan modifications, and work out arrangements. Finally, the participant is responsible for ongoing monitoring of the loan's performance and the financial condition of the borrower commensurate with the size and complexity of the loan.

Documentation

An association should base its documentation requirements for income property loans on prudent industry practices and OTS regulation 12 CFR § 560.170. That regulation states that:

Each savings association and service corporation should establish and maintain loan documentation practices that:

- Ensure that the association can make an informed lending decision and assess risk on an ongoing basis.
- Identify the purpose and all sources of repayment for each loan, and assess the ability of the borrower(s) and any guarantor(s) to repay the loan in a timely manner.
- Ensure that the claims against the borrower, guarantor, security holders, and any collateral are legally enforceable.
- Demonstrate appropriate administration and monitoring of its loans.
- Take into account the size and complexity of its loans.

Income property loans (whether originations or participations) are generally more complex than other real estate loans and therefore require more documentation, which will vary on the size of the loan, the property type and use, and the borrower/guarantor's legal structure. Typical documentation may include:

- Credit memorandum or form supporting the loan decision and documenting approval.

- Application signed by borrower(s)/guarantor(s).
- Sales or construction contract, if applicable.
- Appraisal and appraisal review.
- Feasibility study.
- Comprehensive current financial statements for all borrowers and guarantors, signed by the borrowers/guarantors, including loan covenants that require this.
- Federal, state and local tax returns for all signatories.
- Appropriate business licenses.
- Credit and Dun and Bradstreet reports for borrower and guarantors.
- Rent rolls, as appropriate.
- Assignment of rents.
- Corporate/Partnership organizational documents and corporate resolution, as appropriate.
- Insurance policies (hazard, liability, business interruption, key employee).
- Title insurance.
- Title recording documents.
- Mortgage or deed of trust, promissory note, security agreement.
- Environmental risk assessment.

Credit Administration

As discussed in Handbook Section 201, associations must have a loan or credit administration function with experienced staff and strong internal controls. Associations should conduct the following activities as part of the credit administration function:

- Loan closing and disbursement, including preparing appropriate legal documents, recording appropriate documents, and disbursing funds per the terms of the loan agreement.
- Payment processing, including collecting and applying loan payments.

- Escrow administration, including the timely collection and payment of insurance premiums and property taxes.
- Collateral administration, including maintaining documents to reflect the status of the lien, the value of the collateral and the protection of the collateral (e.g., insurance).
- Loan payoffs.
- Collection and foreclosures.
- Claims processing.
- Property inspections.

One key aspect of credit administration is the ongoing monitoring of the borrower's financial condition, and the financial status and physical condition of the income property. Such monitoring is essential to evaluating the loan portfolio, revising lending standards as needed, and effective risk management. Such activities should be appropriate to the size and risk of the portfolio. Lenders should require at least an annual submission of financial and property information and conduct property inspections as needed to verify its condition and ensure proper maintenance. Lenders should document the results of on-going monitoring activities in the loan file.

In addition, a savings association should have an experienced and knowledgeable collections and workout staff to address problem loans.

Concentrations

Concentrations of income-property loans and participations can present additional risks for lenders. It is essential that management identify concentrations within its portfolio (by geography, loan type and industry). Management should ensure that the level of risk associated with these loan concentrations is consistent with its risk appetite, its risk limits, the sophistication of its risk management function, and its level of capital and reserves. Ongoing monitoring of the loans, controlling concentrations through effective MIS reporting, ongoing assessment of market trends, and stress testing of the portfolio to assess the impact of adverse economic scenarios, are all essential risk management techniques, especially when concentrations of risk exist.

Concentrations of income-property loans can present additional risks for lenders. It is essential that management identify concentrations within its portfolio.

On December 14, 2006, OTS issued *Concentrations in Commercial Real Estate Lending, Sound Risk Management Practices*, as CEO Memo 252. The primary focus of the guidance is that savings associations actively engaged in CRE lending, especially those that are entering or rapidly expanding CRE lending, should do both of the following:

- Perform an internal self-assessment of exposure to concentration risk; continually monitor potential exposure to such risk; and report any such identified concentration risk to senior management and the board of directors.

- Implement risk management policies and procedures appropriate to the size of the portfolio, as well as the level and nature of concentrations and the associated risks, to monitor and manage those risks effectively.

The guidance also reminds savings associations that they are subject to a 400 percent of capital statutory investment limit on nonresidential real estate lending, which does not include loans secured by multifamily residential properties. In addition, through existing guidance and practice, OTS expects savings associations to continuously assess and manage all concentration risk.

As part of its ongoing supervisory monitoring processes, OTS uses certain criteria to identify savings associations that may have CRE concentration risk. These include savings associations that:

- Are approaching their HOLA investment limits.

- Have experienced rapid growth in CRE lending.

- Have notable exposure to a specific type of or high-risk CRE.

- Were subject to supervisory concern over CRE lending during preceding examinations.

- Have experienced significant levels of delinquencies or charge-offs in their CRE portfolio.

These supervisory monitoring criteria serve as high-level indicators to identify savings associations potentially exposed to CRE concentration risk. For a savings association that exhibits any of these risk elements, determine whether its internal concentration risk assessment and resulting risk management practices are commensurate with of the level and nature of its CRE exposure.

The effectiveness of an institution's risk management practices will be a key component of the supervisory evaluation of its CRE concentration risk. Evaluate the association's internal CRE analysis to assess CRE exposure levels and risk management practices. In evaluating the level of risk, consider the association's own analysis of its CRE portfolio including the presence of mitigating factors, such as:

- A successful track record of managing the risks in CRE concentrations.

- Portfolio diversification across property types.

- Geographic dispersion of CRE loans.

- Portfolio performance.

- Underwriting standards.

- Level of pre-sold units or other types of take-out commitments on construction loans.
- Portfolio liquidity (ability to sell or securitize exposures on the secondary market).

Multifamily Residential Real Estate Considerations

The availability of affordable rental properties is a critical need in many communities across the country. Savings associations play an important role in providing financing for these properties in their communities. Because of the large size of many multifamily loans, default risk can pose a greater danger to an association's profitability and solvency. Lenders must manage the multifamily credit risk exposure by adopting lending standards that include concentration limits, and prudent LTV and debt service coverage ratios.

The risk inherent in multifamily loans depends on:

- The ability of the property to generate sufficient cash flow to service the debt.
- The ability of the borrower to effectively market, manage, and maintain the property.
- The borrowers' character and financial strength (i.e., ability and willingness to repay the loan), and financial strength to weather economic downturns.
- The collateral support provided by the real property over the anticipated life of the loan.
- Loan terms.
- Local demographic and economic conditions, including demand for rental property.
- Location and condition of property.

Renters are much more mobile than homeowners. Because of the high turnover associated with multifamily properties, investors must constantly work to keep their units rented. Vacancy rates can increase dramatically. Lenders should closely monitor vacancy rates and trends, and the owner's efforts to keep properties rented.

Undercapitalized borrowers may neglect needed maintenance when cash flows are inadequate. This is called "milking" the property, which can cause accelerated deterioration. Borrowers with troubled properties may "milk" much of the value out of the property before defaulting and turning the property over to the lender. This will significantly decrease the value of the property at foreclosure. Therefore, it is important that lenders monitor property maintenance and improvements to ensure they are timely and appropriate and that the condition of the property does not deteriorate. Lenders should also ensure that maintenance reserves are adequate to provide for necessary improvements and upgrades over time.

Older properties may require substantial rehabilitation and investment to keep them economically viable. However, the borrower may be able to take advantage of community investment tax incentives and government subsidies to finance improvements. Before an institution relies on these incentives and subsidies to determine if the borrower qualifies for financing, it should insure that the incentives would survive foreclosure.

Lenders should regularly monitor market factors that can influence the demand for multifamily housing over time, including work force composition, employment trends, competition, availability and affordability of local housing, and regulatory trends, to anticipate and address potential problems.

Commercial and Other Income-Producing Property Lending Considerations

Commercial and other nonresidential real estate lending is essential for the economic development of our communities. When commercial real estate loans are prudently underwritten and the risks properly managed, such loans can be a profitable business activity. However, financing commercial real estate can present a high degree of credit risk. As with multifamily loans, the larger loans can have a more serious impact on capital and earnings in the event of default. The loans are susceptible to changes in economic and demographic conditions, sensitive to fluctuations in interest rates, and can be affected by:

- Competitive market factors that cause a property to not achieve or sustain its income according to plan.
- Changes in the regulatory environment, such as zoning regulations, tax laws, and environmental regulations.
- Lease terms and the inability to rollover leases as they expire.
- Changes in interest rates, particularly when the debt carries a floating rate and the leases carry fixed rates.

Associations must understand the risks associated with the types of properties financed and use the underwriting process to mitigate those risks upfront. As with multifamily residential lending, a lender must assess:

- The ability of the property to generate sufficient net operating income to service the debt. This includes assessing the stability/volatility of income and vacancy rates given:
  - Current and expected market conditions and trends.
  - The ability of the borrower to market, manage and maintain the property.
  - The adequacy of reserves.
  - The stability of operating expenses.

  - Consideration of borrower and/or property cash flow declines or diversions away from loan payments.

- The financial strength and character of the borrower, and the borrower's ability to weather setbacks.

- The financial strength and stability of the major tenants for office and retail space.

- The fair market value of the collateral.

- The quality and location of the property.

- The need for additional reserves, additional collateral or guarantors on the loan.

- The need for specific loan covenants addressing such things as default, remedies, monitoring and reporting requirements, insurance, reserves, and other items to protect the lender.

Lenders must also understand the unique risks and considerations of various special purpose properties, establish underwriting standards that address these unique risks, and employ staff that have experience with the specific type of loans.

Hotels and Motels. The hospitality industry is highly dependent on trends in leisure and vacation spending and business travel. There is less income stability compared with other types of real estate. When financing hotels or motels, lenders should consider:

- Trends in local tourism and convention bookings and cancellations.

- Revenue sources, including identification of the primary clientele and factors that affect revenue generated from this clientele.

- The local labor pool and elasticity of wages.

- Stability and expertise of management.

- Ratings by the Automobile Association or industry groups.

- Average room rates and occupancy compared to industry averages.

- Zoning and alternative uses for the property.

- Adequacy of insurance coverage.

In assessing the financial capacity of the hotel, lenders should review income statements for a five-year period, given the unpredictability of revenues, and compare financial performance of the borrower with industry averages. Lenders should also ensure the adequacy of expenditures for maintenance and repairs. In assessing the borrower's ability to repay the loan, lenders should evaluate the borrowers earnings before interest and taxes. Given the seasonality and greater instability in revenues, lenders often require a coverage ratio of up to 175 percent, and may require the establishment of a sinking fund to cover debt payments in the event of cash flow problems or unforeseen capital or maintenance expenditures. In addition, loans generally do not exceed 55 to 60 percent of the value of the hotel. Loan covenants should address events of default, insurance coverage, maintenance, and reporting requirements. Lenders should regularly monitor the financial and physical health of the real estate.

Assisted-Living Facilities. Assisted-living facilities are real estate with a business component of services ranging from meals, housekeeping and transportation, to activities of daily living and medical care. The demand for assisted living facilities is strongly correlated to the demographics: the older the population in the community, the greater the demand for assisted living facilities. Income from assisted living facilities tends to be more stable and less cyclical than for other types of real estate; however, the payor mix can be important. Success of the operation of the assisted living facility, however, depends on the quality, reputation, and experience of management and staff; the condition and location of the facility; and the quality of care. Lenders should also carefully evaluate these and other factors, including: local demographic patterns, the supply of qualified staff, labor trends and costs, competition, turnover, breakeven occupancy rates, and convertibility of the property.

Religious Organization Facilities. Religious organizations are non-profit, corporate entities that are either owned by the membership or part of a denominational hierarchy. Loans to religious organizations are generally for expansion of facilities to support growing membership, increased community programs or school activities, kitchen facilities, etc. Lending to churches, synagogues, and other religious organizations can provide a financial institution with a lending relationship as well as community goodwill and an opportunity for increased deposit and other business relationships with the organization and its members.

Underwriting a loan to a religious organization involves an assessment of the trend, level and stability of income and expenses, and a determination of the amount of net operating income available for debt service. Primary income generally consists of tithes, offerings, other ongoing contributions or giving, and other sources of revenue such as school or day care income. Nonrecurring income, such as special one-time gifts and income from fund drives or capital campaigns, is generally regarded as secondary sources of income. A lender should assess a religious organization's primary income over at least a three-year period and be particularly aware of any significant variances. Fixed expenses generally consist of general and administrative expenses, debt expenses and clergy and staff expenses. Discretionary expenses include ministry, outreach and mission program related expenses. In conducting its financial analysis, a lender should consider the ratio of the loan amount to the gross annual receipts and the ratio of proposed annual debt service to gross annual receipts.

In conducting its due diligence, a lender should consider:

- History of the organization and membership trends.
- History or prior experience with building programs.

- Stability and experience of clergy, staff, and lay member leaders.

- Hierarchical structure and governance in order to assess other obligors and assets available to support the loan.

- Level of commitment from the members.

The collateral, loan terms, and interest rates on the loans will probably vary depending on the nature of the religious organization and its business. Institutions should conduct ongoing monitoring of trends in revenues, expenses, and membership.

A recent trend is where religious organization facilities are not special purpose use properties, but can be used for other business or commercial purposes. A lender's overall assessment should give proper consideration to the risks and benefits of such use.

Office and Retail Space. For office space, a lender should consider job growth and employment trends, existing office supply and vacancy rates, lease rollovers, market rents, local competitions, office space absorption rates, and rental rates and concessions. For retail, lenders will want to assess consumer spending patterns, local competition, financial health of local retailers, and alternative uses for space.

Environmental Risk and Liability

The potential adverse effect of environmental contamination on the value of real property and the potential for liability under various environmental laws are important factors in evaluating real estate transactions and making loans secured by real estate. Environmental hazards can be a source of high risk and potential liability to an insured institution or service corporation in connection with its real estate loans and investments. Potential environmental problems may exist in a myriad of forms such as asbestos insulation, underground storage tanks, surface impoundments, septic tank systems, or oil and gas wells.

Environmental hazards can be a source of high risk and potential liability to an insured institution or service corporation in connection with its real estate loans and investments.

Lender problems with pollution and hazardous waste contamination have grown as federal, state, and local governments have passed comprehensive environmental regulations and laws imposing liabilities on landowners and others for environmental cleanup. Lenders must be aware of and concerned with regulations that impose clean-up liability on an absolute or strict liability basis, particularly when governments have the right to assign liability to persons or entities no longer holding title to the property.

Risks that a lender can face as a result of environmentally contaminated property include:

- The value of the collateral securing a real estate loan may be drastically reduced after discovery of the existence of hazardous waste contaminates.

- The borrower cannot repay the loan if he or she must also pay for the cost of cleaning up the contaminated property. The cost for cleanup can be significant and may exceed the institution's encumbrance on the property.

- Foreclosed properties could become a dumping ground for waste unless proper oversight of such properties is maintained.

- The real estate loan may lose priority to a cleanup lien imposed under the laws of those states that require super priority liens for the cost of cleanup. In each of these super lien states, a lien granted to the state securing the cost of cleaning up hazardous waste contaminates may have priority over a lender's mortgage.

- The lender may be liable to the extent of any credit extended to any debtor who has operated property containing hazardous wastes, has generated such waste, or has transported it in an improper manner. This risk extends to all creditors, not just those who hold as collateral the property containing the hazardous waste.

- The lender may become directly liable for the cost of cleaning up a site if it forecloses on a contaminated property or becomes involved in the management of a company that owns or operates a contaminated facility, or is involved in decisions pertaining to the disposal of toxic or hazardous waste.

- The lender may not be able to pursue his or her foreclosure remedies and may have no practical alternative but to give up its loan security, and the right to recover on the loan itself. This could necessitate charging off the loan balance.

- The borrower does not maintain collateral or property with an environmental risk potential in an environmentally sound manner.

- Aside from the statutory liabilities that can be imposed for toxic waste contamination, the potential liability for personal injury or property damage.

Environmental Risk Policy

The most expeditious means by which a lender may commence protective action against environmental risks and liabilities is to develop and implement a written environmental risk policy. Such a policy will serve several critical purposes, including establishing:

- A level of due diligence in all real estate loan transactions.

- Risk thresholds or a method of identifying environmental risk in properties being considered as collateral for acquisition and for refinance, and determining, given the association's risk thresholds, whether the property or site is considered low or high risk.

- Loan amount thresholds for determining when and what type of due diligence is required.

- Due diligence methods to use depending on the type of loan, the amount of the loan and the risk category, including borrower questionnaire or screening, site visit, government records review, historical records review, testing or inspections using qualified professionals, Phase I environmental assessment (ASTM standards), and Phase II environmental assessment.

- Appraisal requirements for disclosing and taking into consideration any environmental risk factors.

- Criteria for evaluating environmental risk factors and costs in the loan approval process.

- Criteria for determining the circumstances in which the lender may decline loan requests due to environmental factors.

- Environmental provisions for incorporation into transaction documentation:

  — For commitment letters: extent of due diligence required, borrower costs, approval contingencies, reporting obligations, documentation requirements, etc.

  — For loan documentation: reps and warranties, inspection requirements, reporting requirements, lien covenants, indemnification provisions, provisions allowing for the acceleration of the loan, and refusal to extend funds under a line of credit or exercise other remedies in the event of foreclosure.

- Collateral monitoring and periodic property inspection requirements throughout the loan term.

- A means of evaluating potential environmental liability risk and environmental factors that could impact value in the event of a foreclosure.

- Guidelines for avoiding owner/operator liability and for qualifying for innocent landowner defense under CERCLA (the Comprehensive Environmental Response, Compensation and Liability Act).

- Guidelines and controls to ensure the institution's adherence to safety and soundness principles.

Please see Appendix B for guidance on measures that a savings association should consider in identifying and managing environmental risks and liability from its real estate lending activities.

Supervisory and Regulatory Considerations

Warning Signs for Troubled Real Estate Loans

While some real estate loans may become troubled because of a general downturn in the market, others become troubled because of unsound or uneconomic underwriting practices. The existence of certain lending practices may be cause for supervisory concern. You should investigate the extent and impact of such activities on the asset quality and consider the need to cite such activities and concerns in the report of examination and to seek corrective action. The following lending practices may be cause for supervisory concern:

- Projects with inadequate income or cash flow.
- Borrowers with inadequate equity and, thus, inadequate incentive to stay with the project.
- Borrowers with little or no experience in the area of business related to the loan.
- Loans or additional advances to borrowers with whom the institution has had an unsatisfactory lending relationship or where the borrower has a poor credit history with other creditors.
- Modification or refinancing of loans, payments, or terms to mask delinquency.
- Reliance on stated but unverified financial or credit information.
- Loans with inadequate or unsigned financial statements or inadequate financial analysis.
- Loans to borrowers with inadequate financial resources or cash flows to justify and service the debt.
- Loans where junior liens create imprudent additional debt service requirements on the borrower.
- Loans resulting in imprudent concentrations by borrower or loan type.
- Loans where institution staff does not have expertise in underwriting or servicing the loans.
- Inadequate due diligence for the type of loan or property.
- Limited ongoing monitoring of loan performance, market trends, property and borrower financials, and property condition.

When evaluating an association's real estate loan portfolio, you should also look for:

- Inadequate or incorrect loan monitoring reports to senior management and the board of directors.
- Weakness in the real estate markets, such as declining rents or sales, increasing vacancy rates, tenant lease incentives.
- Declining revenues or increasing expenses where the causes do not appear to be temporary or reversible.

- Increased unemployment rates, declining absorption rates, declining business activity, etc., in geographic areas or industries where the association has exposure.

- Concentrations of risk not adequately identified or managed by the association.

- Loans with:

  — Rent, lease or other concessions or sales discounts that cause the borrower to have less cash flow than originally projected.

  — Delinquent lease payments from major tenants.

  — Tax arrearages.

  — Deferred property maintenance.

  — Lack of improvements or inadequate reserves for needed improvements.

  — Land values that assume future rezoning.

  — Environmental problems.

Risk Assessment -- Classification Guidelines

When evaluating income property loans for possible classification, you should apply the uniform classification definitions found in Handbook Section 260, Classification of Assets.

The following guidelines for classifying troubled collateral-dependent real estate loans apply when repayment of the debt will be provided solely by the disposition of the underlying real estate collateral, and there are not other reliable sources of repayment available.

For a troubled collateral-dependent real estate loan, as a general rule, any portion of the loan balance that exceeds the fair value of the collateral, less cost to sell, should be classified "loss." The amount of the loan balance in excess of the fair value of the collateral, or portions thereof, may be classified "doubtful" when the potential for full loss may be mitigated by the outcome of certain pending events, or when loss is expected but the amount of the loss cannot be reasonably determined. The portion of the loan balance that is adequately secured by the value of the collateral should generally be classified "substandard."

ALLL and Capital Considerations

Savings associations should maintain an adequate Allowance for Loan and Lease Losses (ALLL) for the losses inherent in their income property loan portfolios in accordance with generally accepted accounting principles and OTS policies and guidelines. See Handbook Section 261, Adequacy of Valuation Allowances, for additional guidance on the ALLL.

Capital levels should reflect the risk inherent in the portfolio. Most income property loans are risk weighted at 100 percent; however, when an institution has high concentrations of higher risk income property loans, capital levels above the minimum requirements may be warranted.

Multifamily real estate loans generally possess less risk than other income property loans and savings associations have historically invested in these loans successfully. While concentrations in income property loans may produce increased supervisory oversight and additional capital expectations, concentrations in performing multifamily loans do not generally present a supervisory concern, provided concentration risks are properly managed and underwriting, structure, and risk management are performed in a safe and sound manner.

Qualifying multifamily mortgage loans are risk weighted at 50 percent. The term qualifying multifamily mortgage loan means a loan secured by a first lien on multifamily residential properties consisting of five or more dwelling units provided that:

- Principal and interest amortization does not exceed 30 years.
- The original minimum maturity for repayment of principal is no less than seven years.
- All principal and interest payments for the preceding year were made on a timely basis.
- The loan is performing and is not 90 or more days past due.
- The loan is made in accordance with prudent underwriting standards.
- The loan balance does not exceed 80 percent of value for fixed rate mortgages and 75 percent for adjustable rate mortgages.
- DSCR for the most recent fiscal year is not less than 120 percent for fixed rate mortgages and 115 percent for adjustable rate mortgages.
- DSCR is calculated based on payments for a fully-indexed, amortizing loan.

In addition, multifamily loans that on March 18, 1994 were secured by a first lien on a 5-36 unit property with an initial LTV ratio of not more that 80 percent and an average annual occupancy of 80 percent that existed for at least one year (and continue to meet the criteria) are “grandfathered” in the 50 percent risk-weighting category.

All other multifamily residential and nonresidential real estate loans are risk-weighted at 100 percent.

REFERENCES

United States Code (12 USC)

Home Owners' Loan Act

§ 1464(5)(c)(1)	Loans or Investments Without Percentage of Assets Limitations
§ 1464(5)(c)(2)	Loans or Investments Limited to a Percentage of Assets or Capital
§ 1464(5)(c)(3)	Loans or Investments Limited to 5 Percent of Assets

Code of Federal Regulations (12 CFR)

Part 560	Lending and Investment
§ 560.170	Records for Lending Transactions
Part 561	Definitions
§ 563.41	Transactions with Affiliates
§ 563.43	Loans by Savings Associations to Their Executive Officers, Directors, and Principal Shareholders
§ 563.170	Examinations and Audits; Appraisals; Establishment and Maintenance of Records
Part 564	Appraisals
§ 567.1	Capital Definitions

Office of Thrift Supervision Guidance

CEO Memos

No. 252	Office of Thrift Supervision Guidance on Commercial Real Estate (CRE) Concentration Risks

Thrift Bulletins

TB 78a	Investment Limitations Under the Home Owners' Loan Act
TB 79a	Lending Limits Pilot Program

Handbook Sections

Section 201	Lending Overview
Section 208	Appraisals
Section 209	Sampling
Section 211	Loans to One Borrower
Section 212	One- to Four-Family Residential Lending
Section 260	Classification of Assets
Section 261	Adequacy of Valuation Allowances

Financial Accounting Standards Board, Statement of Financial Accounting Standards

No. 5	Accounting for Contingencies
No. 34	Capitalization of Interest Cost
No. 58	Capitalization of Interest Cost in Financial Statements that Included Investments Accounted for by the Equity Method
No. 67	Accounting for Costs and Initial Rental Operations of Real Estate Projects
No. 91	Accounting for Nonrefundable Fees and Costs Associated with Originating or Acquiring Loans and Initial Direct Costs of Leases
No. 114	Accounting by Creditors for Impairment of a Loan

American Institute of Certified Public Accountants Pronouncement

Statement of Position 78-9, Accounting for Investments in Real Estate Ventures (SOP 78-9)