



Building Success. Together.

Fundamentals of Commercial Construction Lending

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Course Objectives

- Evaluate a commercial construction loan request and understand the basic risks versus stabilized CRE projects.
- Understand the key questions and documents needed to evaluate a construction project.
- Understand the construction draw process and other credit risks during construction of a project.

Handouts in Materials

- Owner's sworn statement
- General Contractor's (G/C) sworn statement
- Partial lien waiver
- Final lien waiver
- Reimbursement Affidavit
- Owner's Certificate as to completion
- Bank's certificate as to completion
- Sample Commercial loan checklist with construction loan specifics
- OCC Sample construction loan questionnaire
- AIA – Sample Document (Short form of agreement between owner & contractor)

Initial Poll

Types of CST lending by your bank

None

Residential? -- SFR, Townhomes, condos,
multifamily

Commercial? – Office, retail, Hotel, medical,
industrial

Owner occupied? – Small biz owner

All of the above



Loan Structure and Pricing Considerations

- Loan-to-value (LTV) vs. Loan-to-cost (LTC)
- “As Complete” vs. “As Stabilized” appraisals
- Interest rates and loan fees and 3rd party vendor fees

Loan-to-value (LTV) vs. Loan-to-cost (LTC)

- Construction lending starts with loan-to-cost calculation
 - Includes land/building purchase price + hard costs of construction + soft costs
 - Soft costs include:

Survey	Architect
Permits	Builder’s Risk Insurance

 - Real Estate Taxes
 - Estimated Interest during construction period.
 - Other items may be included depending on the bank.
 - Check with your bank’s loan policy.

Loan-to-value (LTV) vs. Loan-to-cost (LTC)

- Loan-to-value is based upon “as complete” appraisal
 - Appraiser considers G/C statement and owner’s statement costs and copy of the permitted plans to conclude a value
 - If it is owner occupant use, they will look at comparable type buildings
 - If some leases and renters expected, should move to “as complete, as stabilized” to determine a value once all the rental space is occupied
 - It is a forward looking appraisal with estimate of value at the time of completion, but uses current comparables

Supervisory LTV Limitations Construction related loans

LTV Limits

Each bank should establish its own internal LTV limits which should not exceed the SLTV guidelines shown in the following table.

SLTV Limits by Loan Category

Loan category	SLTV limit (less than or equal to)
Raw land	65%
Land development or improved lots	75%
Construction	
Commercial, multifamily, ^a and other nonresidential	80%
One- to four-family residential	85%
Improved property—commercial, multifamily, and other nonresidential	85%
Owner-occupied one- to four-family and home equity	90% ^b

^a Multifamily construction includes condominiums and cooperatives.

^b An LTV limit has not been established for permanent mortgage or home equity loans on owner-occupied, one- to four-family residential property; however, for any such loan with an LTV ratio that equals or exceeds 90 percent at origination, the bank should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

In establishing internal LTV limits, the bank should carefully consider the bank-specific and market factors listed in the “Loan Portfolio Management Considerations” section of this booklet, as well as any other relevant risk factors, such as the particular subcategory or type

Example calculation

Construction Loan Request Outline			
Client:	ABC Development		
Loan Address:	123 Main Street, Anytown, IL		
Type of project:	Owner occupant -- Small business		
Cost Basis		As-Complete Estimate	
Land Purchase:	\$ 240,000.00		
CST Costs:	\$ 500,000.00		
Other costs (Loan fees):	\$ 10,000.00		
Total Project Costs:	\$ 750,000.00	\$ 800,000.00	Est. Appraised Value
Loan Advance Rate:	80%	75%	
Max. Loan Amount:	\$ 600,000.00	\$ 600,000.00	
Amount Requested:	\$ 600,000.00	\$ 600,000.00	
Lendable Equity (Shortfall)	\$ -	\$ -	
	\$ 150,000.00	Equity into project (excluding RE taxes, interest & other soft costs)	
Estimated interest expense	\$ 19,250.00		
Estimated RE taxes	\$ 5,000.00		
Estimate insurance, utilities, etc.	\$ 2,500.00		
Total equity needed by owner	\$ 176,750.00		

11

“As Complete” vs. “As Stabilized” appraisals

- “As Complete”
 - Appraiser considers G/C statement and owner’s statement costs and copy of the permitted plans to conclude a value
 - If it is owner occupant use, they will look at comparable type buildings
- “As Stabilized”
 - If some leases and renters expected, should move to “as complete, as stabilized” to determine a value once all the rental space is occupied
 - It is a forward looking appraisal with estimate of value at the time of completion, but uses current comparables

Interest rates and loan fees

- Construction loans are considered one of the riskiest types of loans banks will make
 - Pricing is typically floating rate (Prime + 1.0%, floating with a floor interest rate) or some other index a bank chooses.
 - Commitment fee of 1.0% to the bank or more
- Other loan fees

Appraisal	Construction title escrow	Draw inspection fee
Phase I Environmental	Lender's title insurance	RE tax monitoring

Income producing vs. Business Owner occupied

- Income producing
 - Considerations include debt service coverage (DSC) ratios
 - Type of project (apartments, retail, office, hotel, industrial, medical, etc.)
- Business Owner occupied
 - Considerations include saving on current rent expense
 - Business cash flow to service the debt

Small retail strip center

- New CST single story retail with 5 tenants and parking for their customers and employees
- Typical make-up (national fast food, hair/nail salon, phone store, cleaners and workout facility)
- Speculative or pre-lease 2 of 5 tenants with national fast food as one

Sample deal (\$3 million)

- ACQ cost
- CST costs – See Handout G/C statement & Owner's statement
 - Hard costs (work that constitutes lien waiver events)
 - This includes building materials (lumber, brick, electric, plumbing, HVAC, etc.)
 - Soft costs (permit, zoning, interest reserve, RE taxes, builder's risk insurance)

Sample Retail Center CST loan

(See Handout #1 & #2 for supporting details)

Construction Loan Request Outline			
Client:	GHI Development		
Loan Address:	123 First Street, Anytown, IL 98765		
Type of project:	Retail Strip Center		
	Cost Basis	As-Complete, As-Stabilized Estimate	
Land Purchase:	\$ 1,000,000.00		
CST Costs:	\$ 2,250,000.00		
Other soft costs			
Architect:	\$ 75,000.00		
Permits:	\$ 50,000.00		
Builders Risk Insurance:	\$ 10,000.00		
Survey:	\$ 2,500.00		
Real Estate Taxes:	\$ 50,000.00		
Interest Reserve:	\$ 93,000.00		
Loan fees:	\$ 35,000.00		
Total Project Costs:	\$ 3,565,500.00	\$ 4,000,000.00	Est. Appraised Value
Loan Advance Rate:	75%	70%	
Max. Loan Amount:	\$ 2,674,125.00	\$ 2,800,000.00	
Amount Requested:	\$ 2,665,000.00	\$ 2,665,000.00	
Lendable Equity (Shortfall)	\$ 9,125.00	\$ 135,000.00	
	\$ 891,375.00	Required Equity into project	
Estimated interest expense	\$ 92,947.50		
(Assumes 6.0% loan rate; interest only; 50% of CST cost outstanding + 100% of loan outstanding at closing)			

17

Borrower:		GHI Development		Property Address:		123 First Street Anytown, IL 98765			
Assumptions:		Loan Amount	\$2,665,000	PP/ Value	\$4,000,000	Vacancy	10.00%		
	Interest Rate		5.00%	LTV	66.63%	Management Fee	5.00%		
	Amortization (Years)		20			Repairs & Maintenance	2.00%		
	Repayment Term (Years)		5			Inflation Rate	3.00%		
	Repayment Type	Principal & Interest							
	Fixed or Variable	Fixed							
	Targeted Debt Service Coverage	1.20							
YEAR		Bank Pro Forma 2020		Bank Pro Forma 2021		Bank Pro Forma 2022	Appraisal "As complete As Stabilized" 2020		
Base Annual Rental Income -- Tenant A		\$120,000	100.0%	\$123,600	100.0%	\$127,308	100.0%	\$108,000	100.0%
Base Annual Rental Income -- Tenant B		\$72,000	60.0%	\$74,160	60.0%	\$76,385	60.0%	\$60,000	55.6%
Base Annual Rental Income -- Tenant C		\$50,000	41.7%	\$51,500	41.7%	\$53,045	41.7%	\$48,000	44.4%
Base Annual Rental Income -- Tenant D		\$72,000	60.0%	\$74,160	60.0%	\$76,385	60.0%	\$66,000	61.1%
Base Annual Rental Income -- Tenant E		\$84,000	70.0%	\$86,520	70.0%	\$89,116	70.0%	\$78,000	72.2%
Gross Annual Income		\$398,000	331.7%	\$409,940	331.7%	\$422,238	331.7%	\$360,000	333.3%
Less Vacancy/Collections		(\$39,800)	-33.2%	(\$12,360)	-10.0%	(\$12,731)	-10.0%	(\$10,800)	-10.0%
Effective Gross Income		\$358,200	298.5%	\$397,580	321.7%	\$409,507	321.7%	\$349,200	323.3%
Electricity -- Utility		\$1,918	1.6%	\$1,976	1.6%	\$2,035	1.6%	\$3,000	2.8%
Gas -- Utility		\$1,366	1.1%	\$1,407	1.1%	\$1,449	1.1%	\$1,500	1.4%
Insurance		\$12,000	10.0%	\$12,360	10.0%	\$12,731	10.0%	\$10,000	9.3%
Management Fees		\$19,900	16.6%	\$20,497	16.6%	\$21,112	16.6%	\$18,000	16.7%
Real Estate Taxes		\$50,000	41.7%	\$51,500	41.7%	\$53,045	41.7%	\$50,000	46.3%
Repairs & Maintenance		\$0	0.0%	\$2,400	1.9%	\$2,472	1.9%	\$2,000	1.9%
Sewer -- Utility		\$0	0.0%	\$0	0.0%	\$0	0.0%	\$0	0.0%
Water -- Utility		\$3,700	3.1%	\$4,000	3.2%	\$4,120	3.2%	\$4,000	3.7%
Miscellaneous		\$0	0.0%	\$0	0.0%	\$0	0.0%	\$0	0.0%
Total Operating Expenses		\$88,884		\$94,140		\$96,964		\$88,500	
Net Operating Income		\$269,316		\$303,440		\$312,544		\$260,700	
Proposed P & I Debt Service		\$211,054		\$211,054		\$211,054		\$211,054	
Debt Service Coverage		1.28		1.44		1.48		1.24	
Maximum Loan Supported (1.20x DSC)		\$2,833,902		\$3,192,980		\$3,288,770		\$2,743,240	

18

3rd party vendor fees

- Appraiser
- Title company construction payouts
- Draw inspections
- Plan & cost review by architect

Construction Loan Checklist

- Architectural Plans and specifications
- Construction Budget (G/C statement)
 - Plan & cost review by independent 3rd party
- Building Permit
- Other due diligence and documents
 - Evidence of builder's risk insurance
 - G/C liability insurance
 - Letters of credit or performance bond to municipalities

Architectural Plans and specifications

- Full set of plans shows layouts of proposed building on the property
- Interior layout of proposed building with rooms and dimensions
 - Square footage of building; both usable and total
- Type of materials used for building (Wood, masonry, stone, metal, etc.)
- Survey to see dimensions of land

Construction Budget

- General Contractor's (G/C) statement
 - Itemized listing of subcontractors by type of work
 - For example (Electric, plumbing, carpentry, masonry, HVAC, demo/excavating, etc.)
- Owner's sworn statement
 - Includes permit, architect, survey, legal, zoning, real estate taxes, builder's risk insurance and interest expense (depending on the situation)

New Construction vs. Rehab projects

- Does the project fit the neighborhood?
- What's behind these walls in a rehab project?

Building Permit

- Most municipalities require a building permit for new construction projects.
- The municipality must approve the scope and plan of the project. They want to ensure the project meets the current building codes required by the municipality.
- Sometimes they require it for rehab projects depending on the scope of the project.
- Municipality also ensures the type of project is located in the appropriate zoning district (commercial, retail, industrial, retail, etc.).

Due Diligence for Construction

- Owner's plan and pro-forma income impact
- Income producing vs. Business Owner occupied
- G/C experience and capabilities for the scope of the planned project
- Zoning and permits and variance issues

General Contractor (G/C) experience and capabilities

- Does the G/C have the knowledge for the scope of the planned project?
- Specialized knowledge (hotel, gas station, medical, etc.)?
- Is the G/C familiar with local municipal building code?
- Years of experience of G/C?
- Other projects completed of similar type by the G/C?

Zoning and permits and variance issues

- Is the property zoned for the proposed project?
 - Switching from industrial to retail or office
- Any variances needed from neighboring properties?
 - Chicago has specific approvals if building is wider than other in neighborhood or deeper; neighboring properties need to approve
- Permit issues
 - Appropriate building permit obtained
 - Permits from other municipal agencies (i.e. underground permit for elevator buildings sometimes needed due to impact to existing sewer/water, subways, etc.)

Lien Waivers and the Construction Draw process

- Types of lien waivers (material, partial & final)
- Draw inspection requirements – Third party vendors involved
- Ensuring the construction budget stays in balance throughout the draw process
- Title company construction escrows

Types of lien waivers (See Handouts)

- Material
 - Needed from material supplier to subcontractor
 - Examples include concrete, lumber, plumbing materials, electrical materials, etc.
- Partial
 - Needed from subcontractor if only partially completing their part of the contract
 - Electricians and Plumbers complete the rough-in work; then return to install light fixtures and plumbing fixtures (tubs, toilets, sinks)
- Final
 - Needed from subcontractor once the full contracted work is completed
 - Sometimes contracts require retainage whereby all contractors are not paid a % of their total contract (10% to 20%) until the project is completed and approved by the municipality and/or the owner
- Lien waiver law is specific to each state;
 - Contact your bank's legal counsel if you are not familiar with contractor lien law

Draw inspection requirements

- Third party vendors involved
 - Inspecting architect (separate from the project architect; hired by the bank)
 - Experienced G/C or builder that is familiar with the type of project and whom the bank trusts
 - Appraiser

Balancing the construction budget

- Ensuring the construction budget stays in balance throughout the draw process
 - How does the bank handle out-of-balance situation?
 - Hold the draw payment
 - Require more funds from borrower
 - Increase the construction loan (if the value of the project increases; need updated appraisal)

Example balancing the construction budget

NAME AND ADDRESS	KIND OF WORK OR MATERIAL	ADJUSTED TOTAL CONTRACT (INC. EXTRAS & CREDITS)	AMOUNT PREVIOUSLY PAID	AMOUNT OF THIS PAYMENT	BALANCE TO BECOME DUE
JKL Finish	Trim Carpentry	\$50,000.00	\$50,000.00	\$10,000.00	(\$10,000.00)
MNO Trim	Millwork	\$40,000.00	\$40,000.00	\$5,000.00	(\$5,000.00)
IJK Electric	Electrical Fixtures	\$150,000.00	\$150,000.00	\$10,000.00	(\$10,000.00)
STU	Electric Labor	\$200,000.00	\$200,000.00	\$20,000.00	(\$20,000.00)
TBD	Low Voltage	\$40,000.00	\$40,000.00	\$10,000.00	(\$10,000.00)
TBD	Landscaping	\$80,000.00	\$0.00	\$0.00	\$80,000.00
ABC	Cleanup	\$25,000.00	\$10,000.00	\$0.00	\$15,000.00
LMN	G/C	\$250,000.00	\$200,000.00	\$20,000.00	\$30,000.00
TBD	Contingency	\$90,000.00	\$70,000.00	\$0.00	\$20,000.00
TOTAL		\$2,250,000.00	\$2,080,000.00	\$75,000.00	\$95,000.00

- Remaining construction loan available balance only \$150,000

Title company construction escrows

- Title company acts as a 3rd party fiduciary between the bank and the borrower
- Funds wired to title company from bank
- Subcontractors paid directly by title company via lien waiver process
- Title companies generally charge for set-up fee and a per draw charge as well

Red Flags in Construction (CST) Lending

- Lack of borrower experience in CST - Character
- CST budget out-of-balance – Not enough funds to finish project
- Variable rate loan – Rapid increase in interest rates
- Lack of liquidity or access to liquidity by borrower to pay to finish project if slowdown in delivery or timing
- Lack of G/C experience or competence to complete project
- Building code violations during project (delay in completion)

Types of Construction Contracts

FIXED PRICE

- Fixed price construction contracts, also commonly referred to as “lump sum” or “stipulated sum” contracts, are the most common types of construction contracts. As its name suggests, under a fixed price contract a contractor agrees to construct a project for a “fixed” or agreed upon price.
- **Benefits:** These provide price predictability for project owners because absent changes in the scope of work, unforeseen conditions, or other circumstances that cause the project to change, the contractor must complete the work for the agreed upon price.
- **Drawbacks:** These can be more expensive for project owners than other types of construction contracts because contractors, knowing that they are going to be subject to a “fixed” price, will often build in a buffer to protect itself from cost overruns, for which the contractor would not be compensated. They can add to the time and cost of the design phase of a project, which can affect the overall project timeframe. They also can result in lower quality work because contractors may adopt a “cheaper is better” approach knowing that any cost savings they can achieve will improve their profit margin.
- **Best Use:** Projects with well-defined scopes of work, where the project owner wants price certainty.

Source: <https://www.wendel.com/publication/three-common-construction-contracts/>

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35

Types of Construction Contracts

COST PLUS

- Under a cost plus construction contract, also known as a time and materials contract, a project owner agrees to pay a contractor for its costs plus a fee, which may either be a fixed fee or calculated as a percentage of costs.
- **Benefits:** These offer the most design flexibility for project owners and best price predictability for contractors since owners can make design decisions along the way, and contractors know they will be paid for their time and cost of materials, no matter how long the project takes or the quality of materials used.
- **Drawbacks:** Because time and materials are variable, these contracts provide owners with the least control over costs. Because of the cost uncertainty, it can be difficult for owners to obtain construction financing. Finally, it can be difficult for contractors to schedule their work on the project and juggle workforce and other resources.
- **Best Use:** Smaller projects or specific scopes of work within larger construction projects where more flexibility is needed.

Source: <https://www.wendel.com/publication/three-common-construction-contracts/>

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36

Types of Construction Contracts

GUARANTEED MAXIMUM PRICE

- Under a guaranteed maximum price contract, project owners agree to pay contractors for their time and cost of materials plus a fee—but only up to a “guaranteed maximum price.”
- **Benefits:** Under this approach, contractors get a degree of price predictability because they will be paid for their time and materials and project owners retain more design flexibility. Similar to a fixed price contract, project costs are capped at a “guaranteed maximum price.” These contracts can include a shared savings provision whereby the parties agree to split any savings if the actual costs of construction are less than the guaranteed maximum price.
- **Drawbacks:** Contractors under a guaranteed maximum price contract often build in a buffer to protect from cost overruns that cause the contractor to exceed the guaranteed maximum price. If there is a shared savings provision, a contractor may try to increase the guaranteed maximum price in order to benefit from “more” shared savings. These contracts can take more time to negotiate and administer.
- **Best Use:** Best for sophisticated project owners and contractors.

Source: <https://www.wendel.com/publication/three-common-construction-contracts/>



High Volatility Commercial Real Estate (HVCRE)

- This is a regulatory capital rule (OCC - 12 CFR Part 3; FDIC 12 CFR Part 324; Fed – 12 CFR Part 217)
- Applies to Acquisition, Development & Construction (ADC) loans
- Minimum amount of cash equity (15%) required by borrower to not be considered HVCRE for capital purposes
- If HVCRE, then bank must maintain 150% of normal capital requirement for this specific loan commitment throughout the duration of the construction loan (until permanent financing, selling the project or paying the loan off in full).
- Applies to all commercial construction projects and residential with 5 or more units (some exclusions exist under 3 criteria – See next slide)



High Volatility Commercial Real Estate (HVCRE cont.)

- 3 exclusion criteria

1. 1-4 family residential properties (except for land development loans for 1-4 family projects)
2. Real property that qualifies as “qualified investment” for community development (generally needs to meet CRA definition for this exception)
3. LTV is less than or equal to maximum permitted amount (generally 80%) and borrower contributes equity in the form of cash of at least 15% of the real estate project’s “as completed” appraised value.

High Volatility Commercial Real Estate (HVCRE cont.)

- FAQ dated 4/6/15 – OCC Regulatory Capital Rule commentary
- Examples:
 1. If 15% equity advanced after the bank loan funds, the loan cannot come out of HVCRE status.
 2. Free & clear real estate (unrelated to the project) cannot counts towards 15% equity; it must be cash.
 3. Deposits on pre-sales may not be counted towards the 15% cash equity.
 4. Only “as completed” appraised value is used to calculate the minimum 15% cash equity required to be excluded from HVCRE.
 5. Soft costs count as cash equity, as long as they are reasonable (comparable to similar services from 3rd parties).

High Volatility Commercial Real Estate (HVCRE cont.)

- Capital revisions affecting HVCRE effective 4/1/20
 1. Loans must primarily finance ADC activities. This excludes multi-purpose loans that also finance the purchase of equipment and other non-ADC activities.
 2. Revision permits full appraised value of borrower contributed land (less any liens) to count towards 15% of equity of “as completed” value.
 3. If land development loan (sewers, streets and/or other land improvements) for 1-4 family projects, this is HVCRE eligible (not excluded from the definition).

High Volatility Commercial Real Estate (HVCRE) Information sources

- Minimum amount of cash equity required by borrower to not be considered HVCRE
- <https://www.occ.gov/news-issuances/federal-register/2019/84fr68019.pdf>
- OCC 12 CFR Part 3; FDIC 12 CFR Part 324; Federal Reserve 12 CFR Part 217 – Under Regulatory capital treatment of HVCRE

Updated Regulatory Guidance – CRE Concentrations

- FDIC FIL-64-2023 – Issued 12/23/2023

1. Reiterates regulatory guidance from March 17, 2008.
2. Six items of to focus on for CRE Concentrations.
3. 2 items in particular for construction lending (C & D lending).
 - a) Manage concentration levels with relevant data and market conditions, including market segments
 - b) Timely updated financial info on borrowers, project and market conditions with attention to global financial analysis of obligors

Updated Regulatory Guidance – CRE Concentrations

- FDIC FIL-64-2023 – Issued 12/23/2023 (cont.)

Footnote 13 directly related to C & D loans:

Construction and development loans often are structured with an “interest reserve” as a portion of the initial loan commitment. During the construction phase, the lender typically recognizes interest income from the interest reserve and capitalizes the interest into the loan balance. If a development project stalls and management fails to evaluate the collectability of the loan, interest income could continue to be recognized from the interest reserve and capitalized into the loan balance, even though the project is not generating sufficient cash flows to repay the loan. In this case, the loan may be contractually current due to the payments being funded from the reserve, but future repayment of principal may be in jeopardy

AIA (American Institute of Architects)

Forms for larger projects

- Sample construction contract between owner and contractor (Handout #10)
 - See www.AIAcontracts.org for other forms used in projects

Construction loan checklists (Handouts)

- Sample from my bank
- Sample from OCC construction loan questionnaire
 - Addresses all areas of construction loan with focus on larger projects and provides some best practices to be successful with construction lending.

Other resources

- OCC Handbook within Real Estate Lending
 - <https://www.occ.gov/publications-and-resources/publications/comptrollers-handbook/files/commercial-real-estate-lending/index-commercial-real-estate-lending.html>
 - <https://www.occ.gov/topics/supervision-and-examination/credit/commercial-credit/commercial-real-estate.html>
- Banking trade groups (ABA or local state banking association)
- Other bank websites
- American Institute of Architects (AIA) www.aiacontracts.org/