Appraisal and Real Estate Lending Requirements for Residential Tract Developments

Per Title XI of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989 (FIRREA), one of the five minimum appraisal standards for all federally related transactions is that all appraisals must "analyze and report appropriate deductions and discounts for proposed construction or renovation, partially leased buildings, non-market lease terms, and tract developments with unsold units." In September 2005, the five federal agencies jointly issued Frequently Asked Questions on Residential Tract Development Lending *(FAQs) to assist financial institutions in complying with the agencies' appraisal and real estate lending requirements for residential tract developments. The FAQs provide much needed clarification on this topic, but do not result in any new regulatory requirements. Specifically, the FAQs address how institutions should determine collateral value and calculate loan-to-value (LTV) for loans secured by tract development. This article looks at the FAQs from a bank reviewer's perspective.*

by Andrew M. Luzod and George R. Mann

For many years, the appraisal of residential tract developments has been a source of consternation for appraisers and lenders alike.

Prior to FIRREA, many development and construction loans were underwritten on the basis of aggregate retail prices, and this, in part, is what precipitated the minimum appraisal standards promulgated in FIRREA. Even today, however, many banks are still reportedly underwriting on this basis, or they are uncertain as to what "value" is required. *Frequently Asked Questions on Residential Tract Development Lending* was jointly released by the agencies in September 2005 to help provide guidance. The newly published document does much to address many questions posed by lenders and appraisers with regard to development properties, but it also raises other issues to be addressed.

Definitions

The FAQs apply to residential raw land, finished lots, and vertical construction where five or more units are constructed as a single development. Within this document, several key terms are defined.

- **Tract development**—A project of five or more units that is constructed or is to be constructed as a single development (per FAQ #1).
- **Unit**—A residential building lot; a detached single-family home; an attached single-family home; or a residence in a condominium building (per FAQ #1).
- **Loan amount**—The total amount of a loan, line of credit, or other legally binding commitment. For a line of credit, the legally binding commitment is based on the terms of the credit agreement (per FAQ #6).
- **Pre-sold**—A unit in which a buyer has entered into a binding contract and has made a substantial and nonrefundable earnest money deposit (per FAQ #2).

With regard to value, several definitions are discussed.

- For the calculation of LTV, value is the "market value" as defined in the agencies' appraisal regulations. The appraisal should reflect a market

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value upon completion of construction of the home(s) and the market value of any other collateral, such as lots or undeveloped land. Further, the appraisal must consider an analysis of appropriate deductions and discounts for unsold units, including holding costs, marketing costs, and entrepreneurial profit (per FAQ #8).

- For loans to purchase land or existing lots, value is the lesser of the actual acquisition cost or the appraised market value (per FAQ #8).
- For revolving lines of credit in which a borrowing base sets the availability of funds, value is the lower of the borrower's actual development or construction costs or the market value of completed units securing the loan multiplied by their percentage of completion (per FAQ #13).

Credit Structures

In the FAQs Overview, it is acknowledged that institutions employ a variety of credit structures for the financing of residential tract development. In the early 1990s, it was common practice for banks to provide funds to a developer for an entire tract development project or subdivision, and it was common practice to order an appraisal of the entire tract. However, today, most institutions tend to finance land acquisition and land development (A & D loans) separately from vertical construction of houses or condominium units. When this is the case, an appraisal of the entire tract is not appropriate.

- A & D loans are typically used to provide funding to a developer for acquiring the raw land intended for development and for meeting related costs for land improvements and infrastructure.
- Construction loans for vertical construction of houses or condominiums are typically structured either as revolving lines of credit, in which a borrowing base sets the availability of funds, or on an individual unit basis.

Understanding the loan structure and real estate collateral is a key element in identifying the appraisal assignment to be undertaken. For example, if an institution is funding only the site acquisition for a developer and no proceeds will be used for development, all that is needed for the appraisal is the current "as is" value of the land, as vacant and available for its highest and best use. However, if funding is also proposed for development of the raw land into fully developed residential lots, then the appraisal will also have to address the prospective market value when the land development is completed. If the land will be developed in several phases, the prospective value of the lots in the first phase must be estimated, plus the value of the remaining acreage for future phases. As stated in the answer for FAQ #3:

> The institution must obtain an appraisal, which includes appropriate deductions and discounts, of the entire tract of raw land or lots. The appraisal should reflect the value of the property in its current condition and existing zoning as well as the market value of land upon completion of land improvements, if applicable. The land improvements may include the construction of utilities, streets, and other infrastructure necessary for future development. An appraisal of raw land to be valued as developed lots should reflect a reasonable time frame during which development will occur. The feasibility study or the market analysis in the appraisal should support the absorption period for the developed lots; otherwise, a portion of the tract development should be valued as raw land.

For revolving credit agreements with a borrowing base, loan amount is a function of the collateral's type, value, eligibility criteria, and advance rate. Loan amount also is equal to the outstanding balance of the facility plus any availability under the base. In this structure, value is the lower of actual development or construction costs or market value of the completed units multiplied by the percentage of completion. The following paragraphs contained in the answer to FAQ #10 pertain to revolving lines of credit with a borrowing base:

> A borrowing base is a lending condition incorporated into many revolving credit agreements that limits the institution's legally binding commitment to advance funds to the borrower. The borrowing base specifies the maximum amount the institution will lend to the borrower as a function of the collateral's type, value, eligibility criteria, and advance rates. The credit agreement also specifies a maximum commitment amount regardless of the amount of the borrowing

Figure 1

Sample Discounted Cash Flow Analysis
Proposed Subdivision—Land Value (fully developed)

Semi annual Period		**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**Totals**
Inventory-Beginning Period		110	104	92	77	62	47	32	17	5	
Unit Sales per Month		6	12	15	15	15	15	15	12	5	110
Inventory-End of Period		104	92	77	62	47	32	17	5	0	
Average Sale Price-House	+3%/year	$190,000	$190,000	$195,700	$195,700	$201,571	$201,571	$207,618	$207,618	$213,847	
Average Cost per Unit	+3%/year	$110,000	$110,000	$113,300	$113,300	$116,699	$116,699	$120,200	$120,200	$123,806	
Gross Sales Revenue		$1,140,000	$2,280,000	$2,935,000	$2,935,500	$3,023,565	$3,023,565	$3,114,272	$2,491,418	$1,069,233	$22,013,053
Less Expenses:											
Marketing/Commissions/Misc.	12%	136,800	273,600	352,260	352,260	362,828	362,828	373,713	298,970	128,308	2,641,566
Real Estate Taxes per Unit	$850	93,500	88,400	78,200	65,450	52,700	39,950	27,200	14,450	4,250	464,950
Construction Costs-Units Sold		660,000	1,320,000	1,699,500	1,699,500	1,750,485	1,750,485	1,803,000	1,442,400	619,030	12,744,399
Total Expense		**890,300**	**1,682,000**	**2,129,960**	**2,117,210**	**2,166,013**	**2,153,263**	**2,203,912**	**1,755,820**	**751,588**	**15,850,065**
Net Cash Flow		$249,700	$598,000	$805,540	$818,290	$857,552	$870,302	$910,360	$735,598	$317,646	$6,162,987
Present Value Factor at 23%		0.89686	0.80436	0.72140	0.64699	0.58026	0.52042	0.46674	0.41860	0.37543	
Present Value		$223,946	$481,007	$581,117	$529,425	$497,603	$452,923	$424,901	$307,921	$119,254	$3,618,097
										Indicated Average Lot Value	$32,892

base availability.

Typically, the borrowing base formula specifies different advance rates for each collateral type, such as land, developed lots, homes under construction, and completed and unsold homes. The amount of collateral in each category and the corresponding advance rates limit the borrower's ability to draw additional funds. The advance rates are generally higher for collateral with lower development, construction, and marketing risk. For example, the advance rate for developed lots is likely to be lower than that for a completed home. In addition, advance rates may vary among borrower credit agreements. Generally, institutions grant more liberal advance rates to borrowers that have greater financial strength. Collateral must meet specified eligibility criteria to be included in the borrowing base. These commonly include limitations on the number of speculative units and the duration of time a completed unit may remain in the borrowing base.

If the bank finances vertical construction costs on an individual unit basis and can demonstrate that the unit will be constructed and sold within 12 months, an appraisal of the individual unit or base model may satisfy the appraisal requirement. Per FAQ #11:

> In this case, the institution should be able to demonstrate, through a feasibility study or market analysis conducted independently of the borrower and loan production staff, that all units collateralizing the loan are likely to be constructed and sold within 12 months. For LTV purposes, the value is the lower of the market value of the collateral or the borrower's actual development and construction costs. The borrower should maintain appropriate levels of hard equity (for example, cash or unencumbered investment in the underlying property) throughout the construction and marketing periods.

The lower of cost or market value is used, as retail values do not account for time value of money, holding costs, marketing costs, and entrepreneurial profit.

Deductions and Discounts / Market Analysis

Per FIRREA, appraisals are required for residential land and units (as defined above) when the loan amount is over $250,000. For residential tract development, FIRREA also states that the appraisal must reflect appropriate deductions and discounts for holding costs, marketing costs, and entrepreneurial profit.

Expenses related to holding costs and marketing costs vary by market, but generally include sales commissions, advertising costs, real estate taxes, insurance, maintenance, and homeowner's association dues. Our experience has shown these expenses typically range from 8% to 12% of gross revenues.

Discount rates are derived from a variety of sources. The best indicators are from local market participants. National sources include RealtyRates.com and Korpacz, but care must be given to the use of national publications, as their data often reflects the lowest rates for the best product types. Most local developments are not investment-grade properties and would warrant higher discount rates. Discount rates also can include or exclude entrepreneurial profit. Appraisals should reflect what market participants do, not necessarily a particular client's desire. The national surveys mentioned above almost always show the discount rate inclusive of entrepreneurial profit.

Like expenses, discount rates can vary by market. However, our experience shows a rather stable range of 20-25% (inclusive of entrepreneurial profit) for finished lots. Vertical construction sometimes has discount rates below 20%, with better projects approaching 15%.

A development approach to value using a discounted cash flow (DCF) analysis is typically used to arrive at an estimate of market value that considers these deductions and discounts. A sample DCF is shown as Figure 1.

Lastly, per FAQ #3, appraisals should include a feasibility study or market analysis that supports the absorption period of the devel-

Figure 2

Housing Demand Worksheet

1	Population change during study period - city/county
2	Population change during study period - market area
3	Average household size during study period - city/county
4	Average household size during study period - market area
5	Total new housing units demanded - city/county (1 / 3)
6	Total new housing units demanded - market area (2 / 4)
7	Percentage of single-family housing units demanded
8	Number of single-family housing units demanded in market area during study period (6x7)
9	Number of single-family units demanded each year of study period
10	Minimum lot price range in subject subdivision
11	Maximum lot price range in subject subdivision
12	Ratio of lot price to total housing price in subject type developments
13	Minimum housing price range in subject subdivision
14	Loan amount
15	Monthly payments
16	Annual payments
17	Percent of principal and interest payments of household income
18	Estimated household income (16/17)
19	Maximum housing price range in subject subdivision
20	Loan amount
21	Monthly payments
22	Annual payments
23	Percent of principal and interest payments of household income
24	Estimated household income (22/23)
25	Percentage of new household demand for subject type lots
26	Total market area demand for subject type lots (8 x 25)
27	Annual market area demand for subject type lots
28	Market area supply of subject type lots
29	Total market area residual demand during projection period (26-28)
30	Duration of existing supply without subject (years)
31	Duration of existing supply with subject (years)
32	Subject capture rate
33	Annual number of lots captured by subject (27 x 32)

oped lots. This market analysis should analyze the future supply-and-demand relationship and not rely only on historical absorption rates of competitive projects.

Market Analysis for Valuation Appraisals[1] discusses various levels of market analysis. Specifically, the authors identify four levels of analysis that can be performed:

- Level A—general and descriptive, not subject specific; relies on historical data rather than future projections.
- Level B—employs area-wide market data on a general property class; the projected property use conclusions are more subject specific, and the timing projections depend on interpretation of market-wide data on the property type.
- Level C—incorporates future-oriented forecasting techniques; future demand and absorption are forecast by first projecting the growth of population, income, and employment; provides detailed submarket data on which to base absorption; a Level-C inventory includes all properties that currently exist in the defined market as well as all planned properties.
- Level D—provides the most detailed level of market study available.

Although the regulators do not provide specifics regarding the required level of market analysis, a Level-C market analysis should suffice. Many banks require a Housing Demand Worksheet (see Figure 2) to demonstrate support for projected absorption in appraisals. Another excellent source for this level of market analysis is CCIM's Site-To-Do-Business, which has a housing demand module that incorporates much of the information required for a Level-C analysis.

Lending Guidelines

FAQ #4 reiterates the supervisory lending limits outlined in Regulation H (FDICIA). In summary, an institution may lend up to 65% of the value for raw land, 75% for land development or finished lots, 80% for multifamily residential construction, and 85% for one- to four-family residential construction. If a loan funds both land development and home construction, the applicable supervisory LTV limit is 85%.

- A loan's LTV corresponds to the final phase of the project. However, the bank or thrift needs to comply with the supervisory LTV for a given phase.
- Disbursements should not exceed actual development and construction costs for a particular phase.
- For a pool of collateral, collateral margins need to remain within the supervisory LTV limits as collateral goes in and out of the pool.

As an example, let's assume a bank is making an A & D construction loan. The bank can lend 65% of the lower of acquisition cost or market value for the land purchase, then finance up to 100% of development costs during the land development phase as long as the total does not exceed 75% of market value of developed land, then up to 100% of construction costs of units as long as the total does not exceed 85% of the market value of the completed units. See Figure 3 for an example of loan structure and lending guidelines.

The FAQs also state that an institution may not use aggregate retail sales prices of the individual units, also known as gross retail sales, as the market value to calculate the LTV ratio. This total does not reflect deductions and discounts for expenses and time, and it does not represent market value. Depending on the absorption period, market value is typically 10-30% or more below the aggregate of retail sales prices.

Other Underwriting Standards

FAQ #11 states that institutions should ensure that residential construction loans meet prudent real estate underwriting standards reflected in the lending guidelines. The agencies specify that institutions should:

- Establish appropriate limits on construction starts for speculative homes.
- Address any concentration risk to a particular builder or a specific development.
- Monitor market conditions and analyze demand and supply for residential housing.
- Maintain prudent controls for the advancement of funds for constructions costs.
- Perform periodic collateral inspections to verify construction progress.
- Confirm compliance with supervisory LTV limits.

Other Key Points

The FAQs provide good clarification on many points and issues

related to residential tract development. However, some points made in the document raise additional questions that require further clarification.

Pre-sold units. As stated in FAQ #2, "an institution may exclude pre-sold units to determine whether an appraisal of a tract development is required. A unit may be considered pre-sold if a buyer has entered into a binding contract to purchase the unit and has made a substantial and nonrefundable earnest money deposit. Further, the institution should obtain sufficient documentation that the buyer has entered into a legally binding sales contract and has obtained a written pre-qualification or commitment for permanent financing."

This topic raises several questions. For example, in an eight-unit tract development where four units are properly determined to be pre-sold, indicating that four units are remaining, is an appraisal required and, if so, what type of appraisal? In this case, the four units remaining may be interpreted as not meeting the definition of a tract development, which requires five or more units to be constructed. Therefore, individual model appraisals may be used in lieu of a DCF appraisal.

Another example is where entire condominium projects are reportedly 100% pre-sold. Caution should be taken here, especially in applying the test for determining if units are truly pre-sold. Most projects are not 100% pre-sold prior to a bank considering and approving a construction

Figure 3

Lending Example

This example is intended to show how different loan structures can impact the maximum loan amount for a given property. We will consider an acquisition & development construction loan versus a vertical construction loan, with references to FAQs #4 and #11.

Assumptions

Raw Land Purchase (assume approvals in place)—$20,000/developable lot
Lot Development Costs—$20,000/developable lot
Finished Lot Value (per appraisal)—$50,000

Unit Construction Costs—$60,000
Total Unit Cost (land and building)—$100,000
Retail Value (per appraisal) of Unit—$120,000 (no discounts or deductions)

Acquisition & Development Construction Loan

For land development, the bank can lend 65% of the lower of acquisition cost or market value for the land purchase, then finance development costs during the land development phase as long as the total does not exceed 75% of market value of developed land. In this example, the maximum loan amount on the land portion is $37,500 ($50,000 x 75%). This amount does not fully cover the raw land purchase price and lot development costs that total $40,000.

For the housing portion, the bank can lend up to 100% of construction costs of homes as long as the total does not exceed 85% of the market value of the completed home. However, for this loan structure, an appraisal must be done that reflects appropriate discounts and deductions. Per FAQ #8:

> *The appraisal should reflect a market value upon completion of construction of the home(s). . . Further, the appraisal must consider an analysis of appropriate deductions and discounts for unsold units, including holding costs, marketing costs, and entrepreneurial profit.*

Assume these deductions total 15% of the retail value of the house, the market value would be $102,000 ($120,000 less 15%). Applying an 85% LTV to $102,000 results in a maximum loan amount of $86,700.

Vertical Construction Loan

If the bank finances vertical construction costs on an individual unit basis and can demonstrate that the units will be constructed and sold within 12 months, an appraisal of the individual unit may satisfy the appraisal requirement. Per FAQ #11:

> *In this case, the institution should be able to demonstrate, through a feasibility study or market analysis conducted independently of the borrower and loan production staff, that all units collateralizing the loan are likely to be constructed and sold within 12 months. For LTV purposes, the value is the lower of the market value of the collateral or the borrower's actual development and construction costs. The borrower should maintain appropriate levels of hard equity (for example, cash or unencumbered investment in the underlying property) throughout the construction and marketing periods.*

Under the assumptions above, the value for lending purposes is $100,000, which is the lower of the market value ($120,000) or the actual development and construction costs ($100,000). As such, the maximum loan amount would be $85,000 (85% LTV x $100,000 value).

Conclusion

This example shows how different loan structures would require different levels of appraisal. However, under each scenario, the loan amounts are still fairly close.

loan, and an appraisal should be obtained prior to the bank making its credit decision. Therefore, the condo unit could be considered pre-sold in the appraisal assignment only if it was pre-sold prior to the borrower obtaining the construction loan. After loan approval, it is also quite typical to condition construction on a certain number of units being pre-sold. More specific guidance for condominium units is contained in FAQ #12.

In both scenarios, appraisals are required; however, more information is needed to determine how the collateral is to be appraised. In addition, when considering pre-sold units, it is important to consider collateral type (single-family home, condominium building, or improved lots).

We believe that the language stated in FAQ #2 does not imply that no appraisal is needed. Appraisals of the individual models may suffice in certain situations where a number of units are pre-sold. All banks are expected to have appropriate policies and procedures, as well as local knowledge about their respective markets, in order to obtain an appropriate appraisal on which to base their lending decision. Also, the guidance given for pre-sold units makes no distinction between speculative purchasers and owner purchasers. In markets where values are artificially inflated by speculative activity, the bank should appraise and fund properly.

Given the definition above, it is readily apparent that builder takedowns or mandated releases do not qualify as pre-sold units as they do not represent transactions to an unrelated buyer. Nor should this information and related release schedules be used as a sole basis for estimating absorption.

Hard equity. The concept of hard equity is discussed in the answers for FAQ #10 and #11, and an example of hard equity is stated as "cash or unencumbered investment in the underlying property."

If the borrower is contributing land or lots and the bank or thrift is financing vertical construction, hard equity could be the unencumbered interest in the land or lots. Any other interest would probably need to be evaluated in the context of asset quality and creditworthiness of the borrower.

FAQ #11 addresses the financing of vertical construction, and the regulator's intent was to set forth that the borrower needs to have an equity interest in each unit and throughout each phase of construction or marketing. In the case where the bank is financing units on the basis of undiscounted values, the bank should expect the borrower to have an equity interest on both a cost and market-value basis, and should not be funding borrower's equity on the front end of transactions.

Summary

The FAQs attempt to identify the typical types of financing structure in place for development properties, thus providing a basis for quantifying and valuing the corresponding real estate collateral. Specifically, this document does the following:

- Provides interpretation of when deductions and discounts are appropriate.
- Defines pre-sold units and a policy for excluding pre-sold units from analysis for a tract development.
- Establishes a basis for when model appraisals can be used in lieu of a tract development appraisal with appropriate deductions and discounts for holding costs, marketing costs, and entrepreneurial profit.

These clarifications have been long overdue and should help provide additional guidance to lenders, appraisers, and underwriters involved with residential tract development. Certainly, credit structures will continue to evolve in response to various market factors, but these FAQs make it clear that understanding of the loan structure is important in determining the type of appraisal needed and what is to be appraised. ❒

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Notes

1 Fanning, Stephen F., MAI; Grissom, Terry, MAI; and Pearson, Thomas D., MAI; *Market Analysis for Valuation Appraisals*, 1994, Appraisal Institute, www.appraisalinstitute.org/ecom/publications.