

Real Estate *Update*

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## Construction Lending

*Rating Agency Guidelines Address Securitization*BY JEFFREY B. STEINER  
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Once dominated by a small, specialized group of lenders, the construction financing market has recently expanded to include Wall Street lenders that typically concentrate on loans destined for securitization in the commercial mortgage-backed securities (CMBS) market. As a general rule, securitized loans consist of fully funded loans of a five- to 10-year term secured by mortgages on fully stabilized, cash-flowing properties. The recent securitization of pools of loans secured by properties to be converted to condominiums (many of which included substantial renovation components) and the introduction by Fitch Ratings of criteria for rating commercial real estate construction loan pools are both signals of Wall Street's acceptance of loans secured by properties undergoing significant construction.<sup>1</sup> Furthermore, the CMBS market appears ready to tolerate pre-development transactions, exposing investors to unique market-related risks. Fitch Ratings has identified certain elements of construction loan administration that limit lender risk and thereby help identify the likelihood of loan default such that the agency may more accurately determine the rating of bonds issued in connection with such a loan. The following discussion highlights the manner in

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which such structured finance lenders have addressed the elements peculiar to construction lending and presents ways in which some of the market's concerns can be addressed.

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**Structure Issues**

As a general matter, to the extent properties securing a CMBS loan undergo any required repairs or rehabilitation, such work is generally funded out of a fully funded reserve held by the lender and disbursed to a borrower upon requisition. Assuming a short time frame and a somewhat limited scope of such construction work (e.g. ordinary course tenant improvements), borrowers generally accept the expense of the related negative arbitrage. This practice allows the securitization of the related mortgage loan since the loan is funded in its entirety and construction-related risks have been lessened as the required construction work would presumably be limited in scope and the budget and timeframe of the related work would be largely predictable and easy to monitor.

Fully funded construction reserves are typically not an option for transactions

involving a broader amount of construction since the negative arbitrage would be cost prohibitive to a property owner. In a typical construction loan, advances are made on an ongoing basis to limit carrying costs. Accordingly, to the extent a lender intends to securitize any portion of a mortgage loan secured by a property undergoing construction, the loan must be bifurcated into fully funded and unfunded or partially funded portions.

While such a bifurcation may be familiar to New York attorneys where Lien Law requirements provide greater lien protection for loans properly allocated between so-called acquisition and building loans, the principle here has broader application. The first portion of such a loan is fully funded at closing while the second portion is funded in tranches upon the completion of certain construction-related events. As between the two loans, the fully funded loan carries a lower risk in that the lender enjoys greater protection from mechanic's liens and the loan will be sized based on the raw value of the underlying property rather than reflecting the prospective value of a fully completed construction project. The fully funded loan portion is not free of construction risk, however, since the property owner's ability to service any loan secured by the property relies upon the completion of an income-producing improvement on such property. Accordingly, any securitization of the fully funded loan will require the lender to make certain risk disclosures related to the project completion timeline and budget and to establish funded reserves to ensure timely payment of real estate taxes, insurance and debt service.

## Risk Factors

Securitization of any loan hinges on the overall quality of the underwriting of the particular loan as reflected by the rating agencies' assessment of the various risks involved and the possibility of default. As the likelihood of default decreases, the relative rating of the bonds related to such a loan increases. Fitch's analysis focuses on evaluating the underlying loan and the precautions that should be put in place to lessen the risk of loss related to construction and pre-development problems.

The risks involved with construction lending center around "whether a project will be successfully completed lien-free, on-time and within budget so a project can support conventional takeout financing at the construction loan's maturity."<sup>2</sup> This analysis differs from that of a permanent loan, in which the risks are somewhat more market-related and objective. Construction loan risks such as the reliability of contractors, construction delay and cost overruns are more difficult to analyze with any real certainty. In order to analyze a mortgage asset secured by a property undergoing construction, as opposed to a mortgage secured by an income producing property, the related construction issues must be clearly identified and attendant risks mitigated accordingly.

In reviewing methods to reduce risk factors associated with construction lending, Fitch has put forth a number of points to be addressed that decrease the likelihood of default. The first point focuses on the reliability of the future fundings necessary to finance completion of the contemplated construction. According to Fitch, to ensure the availability of funds necessary for the completion of the project, any future funding obligation should be guaranteed by a company having a debt rating of at least "A."<sup>3</sup> Given this concern, loan documents should include limitations on any construction lender's ability to transfer the future funding obligations to an entity that would be deemed unacceptable by the rating agencies.

Another key element to any construction project is an experienced sponsor who is involved in all stages of the project

development.<sup>4</sup> Sponsors are expected to have experience constructing, managing and marketing the particular type of project proposed and a level of liquidity sufficient to meet the needs of the project. Rating agencies analyze the sponsor's global financial and property portfolios in an effort to ensure that the sponsor has the economic wherewithal to complete the project even if there are cost overruns or delays that require an additional investment of capital.<sup>5</sup> To address such capital concerns, loan documents should provide for financial covenants to maintain net worth and liquidity thresholds as well as reporting requirements to allow a lender to verify such state of facts.

In addition to reviewing the financial health of the sponsor, lenders must also focus on the economic viability of the project as a whole. In response to this concern, rating agencies take into consideration the loan-to-value ratio, loan-to-cost percentage and the existence of subordinate financing. Market stability and vulnerability to natural disasters are also included in this evaluation. According to Fitch, deals may be structured in a way to address these concerns by providing for "full recourse to the sponsor, [the requirement of] hard equity, [imposition of] pre-leasing requirements to deter speculative building, and [the requirement of] interest reserves. Lenders may also require personal guarantees of completion, performance and repayment from the sponsor."<sup>6</sup> The greater the likelihood that the proposed project will be completed, the less likely that there will be a default under any portion of the loan. For example, loan documents may address the rating agency concerns for a construction loan related to the development of a residential condominium by providing for, in addition to standard guaranties of completion and the requirement of builder's risk insurance, the establishment of certain condominium filing or pre-sale benchmarks that must be met before additional portions of the loan are advanced.

Lenders are also expected to play a critical part in monitoring the construction process. Beyond lending capital, construction lenders and their third-party

construction consultants play a supervisory role to ensure the project has a realistic building schedule and budget. As construction progresses, the lender is charged with conducting monthly inspections to determine whether certain milestones are met prior to disbursement of additional funds. Lenders must continually evaluate the adequacy of reserves and cost allowances as well as the accuracy of scheduled budgeting. REMIC rules prohibit the ongoing monitoring and discretion regarding construction fundings from being the responsibility of the securitization trustee and, as such, the loan documents must provide accordingly.

## Conclusion

Not only has there been a revitalization of the construction-lending business, there has also been a budding new growth opportunity in the form of securitization of construction loans. Given the recent introduction of securitization to the already complex construction loan process, there are a number of factors to be considered by a lender interested in participating in this arena. Lenders must be mindful of the default probability rating assigned to their respective loans and the factors they have control over to merit a favorable rating. With the advent of rating agency guidelines regarding construction loans, there is ample motivation to draw Wall Street lenders towards construction loan securitization as a viable investment opportunity.

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1. Fitch Ratings Know Your Risk: Commercial Mortgage Criteria Report—Rating Commercial Real Estate Construction Loan Pools. Jan. 4, 2006. [www.fitchratings.com](http://www.fitchratings.com).

2. *Id.* pg. 3.

3. *Id.* pg. 3.

4. *Id.* pg. 3.

5. *Id.* pg. 3.

6. *Id.* pg. 3.