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Real Estate Lending Standards

*136 THE NEW REAL ESTATE LENDING STANDARDS FOR BANKS

Gary A. Goodman [\[FN1\]](#)

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The author analyzes the Uniform Rule on real estate lending for banks as well as the accompanying Guidelines. He analyzes the text of the Guidelines with respect to loan portfolio management considerations, underwriting standards, and loan administration procedures. He discusses what the Guidelines mean in terms of actual administrative enforcement and the potential hardship to banks presented by the Guidelines.

As part of the response to the financial debacle of the late 1980s, Congress enacted the Financial Institutions Reform, Recovery and Enforcement Act of 1989 (FIRREA). [\[FN1\]](#) Title 11 of FIRREA required that all of the four federal banking agencies [\[FN2\]](#) (collectively, the Agencies), the National Credit Union Administration, and the Resolution Trust Corporation prescribe appropriate standards for the performance of real estate appraisals in connection with federally related transactions under the jurisdiction of each such agency. Substantially similar regulations were adopted by such agencies the following year, mandating that all appraisals conform to the Uniform Standards of Professional Appraisal Practice promulgated by the Appraisal Standards Board of the Appraisal Foundation. [\[FN3\]](#)

***137** Subsequently, on December 31, 1992, the Agencies adopted a uniform rule on real estate lending for banks (the Uniform Rule). [\[FN4\]](#) The Uniform Rule requires that every bank adopt a written policy establishing appropriate limits and standards for granting real estate loans. The Uniform Rule specifically covers loans secured by liens on, or interests in, real estate, as well as loans made for financing permanent improvements to real estate, whether such loans are secured by liens on real estate. [\[FN5\]](#)

The Agencies crafted the Uniform Rule within contours mandated by the Federal Deposit Insurance Corporation Improvement Act of 1991. [\[FN6\]](#) Specifically, that act required the Agencies to consider the risks posed by real estate lending to the deposit insurance funds, the need for safe and sound operation of banks, and the availability of credit. [\[FN7\]](#)

Responding to this legislatively mandated list of concerns, the Agencies' Uniform Rule demands that each bank's written real estate lending policy be consistent with safe and sound banking practices and appropriate to the size of the bank and the nature and scope of its operations. [\[FN8\]](#) Once in place, such a policy must be reviewed and approved by the bank's board of directors at least annually. Further, each bank must monitor current market conditions to ensure the continuing appropriateness of its policy. The Uniform Rule also enumerates various sections that each real estate lending policy must contain-- namely, portfolio diversification standards, underwriting standards, loan administration procedures, and compliance-monitoring procedures. [\[FN9\]](#)

The Agencies' regulations, however, extend far beyond these vague commands of the Uniform Rule itself. In order to supplement and clarify it, the Agencies simultaneously promulgated guidelines (the Guidelines) that describe the criteria and specific factors that the Agencies expect banks to consider in establishing their real estate lending policies. The Agencies hoped that Guidelines (rather than a ***138** strict code of behavior) would leave banks flexibility while still promoting prudent real estate underwriting. [\[FN10\]](#)

Summary of the Text of the Guidelines

Loan Portfolio Management Considerations

The Guidelines require each bank's lending policy to outline the scope and distribution of the bank's credit facilities and the manner in which the bank makes, services, and collects real estate loans. The Guidelines also detail a number of items for a bank to identify or establish, including:

- [] The bank's proposed geographic lending area;
- [] A loan portfolio diversification policy with set limits for loans by type and geographic market;
- [] Real estate appraisal and evaluation programs;
- [] Management monitoring techniques, including timely and adequate reports to the bank's board of directors; and
- [] Loan origination and approval procedures, both generally and by size and type of loan. [\[FN11\]](#)

In formulating its loan policies and strategic plan, each bank must consider both internal and external factors. Internal factors include the bank's particular size, financial condition, expertise, and need to avoid undue concentrations of risk. External factors include general market supply and demand, population and employment trends, zoning requirements, current and projected vacancy and construction rates, lease terms, economic indicators (including trends and diversification within the lending area), and valuation trends (including discount and direct capitalization rates).

Underwriting Standards

The Guidelines detail various underwriting standards. First, the Guidelines maintain that real estate loans should reflect all relevant credit factors. The Guidelines then list some of these factors: ***140**

- *139** () The capacity of the borrower, or income from the underlying property, adequately to service the debt;
- The value of the mortgaged property;
- The overall creditworthiness of the borrower;
- The level of equity invested in the property; and
- Any additional sources of repayment, collateral, guarantees, or mortgage insurance. [\[FN12\]](#)

Next, the banks' written policies must evaluate these credit factors via clear and measurable underwriting standards. These underwriting standards must in turn address the following:

- The maximum loan amount and maximum loan maturities;
- Amortization schedules;
- Pricing structure for different kinds of loans; and
- Loan-to-value (LTV) limits by type of property. [\[FN13\]](#)

LTV limits comprise a crucial component of the Guidelines. Roughly, an LTV ratio is the percentage derived (at the time the obligation to extend credit begins) by dividing the extension of credit by the total value of the property securing or being improved by the extension of credit plus the amount of any acceptable collateral securing the extension of credit. [\[FN14\]](#)

Ostensibly, each bank may establish its own internal LTV limits. The Guidelines, however, set supervisory LTV limits for various categories of loans:

- For raw land, the LTV ratio is to be 65 percent.
- For land development loans, 75 percent.
- For commercial construction loans, including multi-family residential property, condominiums, and cooperatives, 80 percent.
- For construction loans for residential property for one to four families, 85 percent.
- For improved property, 85 percent.

***140** The Guidelines do not invoke a specific LTV limit for permanent mortgage or home equity loans on owner-occupied family residential property for one to four families. But the Guidelines suggest that, if the LTV ratio equals or exceeds 90 percent, the bank should require appropriate credit enhancement in the form of either mortgage insurance or readily marketable collateral.

The Guidelines make clear that the LTV ratio constitutes only one of several credit factors that an institution should evaluate in underwriting a real estate loan. Loans made within the supervisory LTV limits will not automatically be deemed sound.

The Guidelines also recognize that, based on other relevant credit factors, exception loans (i.e., loans exceeding the supervisory LTV limits) may be appropriate. Banks must identify these exception loans in their permanent records and report at least quarterly to their boards of directors all such loans of significant size. For any given bank, the aggregate amount of all such exception loans may not exceed 100 percent of the bank's total capital. [\[FN15\]](#) Total exception loans for all commercial, agricultural, multifamily or other residential property that is not for one to four families may not exceed 30 percent of a bank's total capital.

The board of directors remains ultimately responsible for establishing appropriate standards for the internal review, approval, and justification of exception loans. The bank's senior management must then take action with regard to each proposed loan in accordance with such internal standards and the Guidelines. [\[FN16\]](#)

The Guidelines expect each lender carefully to consider not only the specific factors itemized previously but also any other factors that the lender considers significant. For example, if any subcategory of loans exhibits greater credit risk than an overall category, [\[FN17\]](#) a lender should consider implementing a lower LTV limit for that particular subcategory. [\[FN18\]](#)

***141** Although apparently subject to other Guideline requirements, several types of loans are excluded from any maximum LTV limits. These exclusions include:

- [] Loans renewed, refinanced, or restructured (1) without the advancement of new funds or an increase in the line of credit (except for reasonable closing costs) or (2) in connection with a workout, either with or without the advancement of new funds, if the restructuring is consistent with safe and sound banking practices and part of a clearly defined and well-documented program to achieve orderly liquidation of the debt, reduce risk of loss, or maximize recovery of the loan;
- [] Loans that facilitate the sale of real estate acquired by the lender in the course of collecting a debt previously contracted in good faith; and
- [] Loans to be sold promptly after origination, without recourse, to a financially responsible third party.

The Guidelines contain additional exclusions for loans guaranteed or insured by federal, state, or local governments and for a wide range of traditional corporate and business loans not considered true real estate lending, even though such loans might involve real estate collateral or

improvements. [\[FN19\]](#)

Additionally, the Guidelines provide technical rules interpreting LTV limits in a variety of situations, such as loans for multiphase real estate projects, loans involving collateral pools, cross-collateralized loans, and loans with senior or subordinate liens. [\[FN20\]](#)

The Underwriting Standards section of the Guidelines also lists several special items that loan policies should establish for development and construction projects and for completed commercial properties:

- Requirements for feasibility studies and sensitivity and risk analyses; ***143**
- *142** () Minimum requirements for initial investment and maintenance of hard equity by the borrower (e.g., cash or unencumbered investment in the underlying property);
- Minimum standards for net worth, cash flow, and debt service coverage of the borrower or underlying property;
- Standards for the acceptability of and limits on nonamortizing loans;
- Standards for the use of interest reserves;
- Preleasing and presale requirements for income producing property;
- Presale and minimum unit release requirements for nonincome-producing property loans;
- Limits on partial recourse or nonrecourse loans and requirements for guarantor support;
- Requirements for takeout commitments; and
- Minimum covenants for loan agreements. [\[FN21\]](#)

Loan Administration Procedures

The banks' written loan policies must set forth several kinds of loan administration procedures:

- Documentation procedures must specify the type and frequency of financial statements and appraisals, including verification of information provided by the borrower;
- Loan closing and disbursement;
- Payment processing;
- Escrow and collateral administration;
- Loan payoffs
- Collections and foreclosure procedures, including: Delinquency follow-up methods; foreclosures timing; extensions and other forms of forbearance;
- Claims processing (e.g., seeking recovery on a defaulted loan covered by a government guaranty or insurance program); and
- Servicing and participation agreements. [\[FN22\]](#)

***143** Enforcement and Interpretation

If a bank ignores a guideline, no definite or financial penalty accrues, but the bank thereby invites extra scrutiny from regulators. [\[FN23\]](#)

The Agencies' examiners routinely evaluate the real estate lending policies to determine if the policies align with safe and sound lending practices and with the Uniform Rule and associated Guidelines. In such evaluations, examiners take into account the following factors:

- [] The nature and scope of the bank's lending activities;
- [] The size and financial condition of the bank;
- [] The quality of the bank's management and internal control;
- [] The expertise and size of the loan administration staff; and
- [] Market conditions. [\[FN24\]](#)

Not surprisingly, the Guidelines instruct examiners to vigorously investigate exception loans. A bank comes under increasing scrutiny as the total amount of its loans in excess of the supervisory LTV limits approaches the fixed aggregate limits (usually, 100 percent of total capital, as discussed previously). [\[FN25\]](#) Additionally, the Guidelines note that an excessive volume of exception loans may signal a weakening of the bank's underwriting practices, or may suggest a need to revise the loan policy. [\[FN26\]](#)

The Guidelines attempt to steer a middle course between rigid edicts and friendly advice. This tension inheres in both the text of the Guidelines and in its application. Consider, for example, the following commentary by the Agencies:

The LTV framework has been adopted in guideline form, rather than in a regulation, in order to add flexibility. Under the Guidelines, institutions may lend in excess of the supervisory LTV limits where credit is justifiable under the specific circumstances. Nevertheless, the agencies believe that LTV limits are an important element of prudent underwriting criteria and that lenders should carefully set and follow such limits. [\[FN27\]](#)

***144** Here, the Guidelines' authors praise flexibility, but they also imply that banks should routinely heed the relatively detailed LTV formulas and restrictions found elsewhere. Furthermore, interpretation of the broad language in the Guidelines certainly requires subjective judgments. The extent to which regulators will actually change lenders' behavior, then, depends upon how strictly regulators choose to interpret and apply the Guidelines.

Very recently, a top federal regulator, Robert Mialovich, clarified his vision of what some analogous guidelines entail. Mialovich, the FDIC's associate director of supervision, is the first contact person listed in the

commentary to the Uniform Rule. [\[FN28\]](#) In a May 18, 1993 conference following the FDIC's release of new bank audit rules and guidelines, Miailovich stated that:

Guidelines ... are just that ... You do not "violate" the guidelines; you are not in "compliance" with guidelines. They are in fact the strong opinion of somebody whose voice we think you pay attention to.

But within the realm of judgment and documentation, and management running their own institutions ..., one has a lot of room to do what one thinks is correct. And so if the concept of guidelines is going to make any sense, we've got to all guard against them becoming like a regulation.

Miailovich further noted that this approach carries with it the notion that "a strong suggestion from regulators may actually leave bankers little choice." He continued, "We will have to see how that plays out over time. There is a little bit of a challenge there, when your regulator gives you a suggestion." [\[FN29\]](#)

While Miailovich's remarks do not legally bind the Agencies, his speech is of interest because many people apparently do still perceive the Guidelines as strictures to be violated or complied with. For instance, Charlotte Bahin, a regulatory specialist at the Savings and Community Bankers of America, claims that banks must adopt policies that substantially comply with the Guidelines. [\[FN30\]](#)

Indeed, when the Uniform Rule and Guidelines first appeared, some bankers complained that the Guidelines would function as de facto regulations. These people saw regulators as opponents, rather than partners, of the banking industry. [\[FN31\]](#)

***145** At that time, certain regulators (including Miailovich's superior, the FDIC's director of supervision) in fact admitted that they would have preferred more rigid and punitive regulations. [\[FN32\]](#) Nevertheless, after receiving over 1,300 comment letters and after fashioning the compromise embodied in the final version of the Guidelines, regulators became determined to preserve the advantages of the flexible approach. The commentary to the Uniform Rule, for example, expressly lists some of the undesirable consequences of implementing rigid LTV decrees--namely, possibly higher lending costs, constricted credit, and reduced economic growth. [\[FN33\]](#)

Also, the relevant federal agencies, under the Clinton administration, generally support reducing the burden of the bank examination process and of bank regulation overall. Beyond their increasing use of guidelines, [\[FN34\]](#) the Agencies have released a policy statement incorporating the following goals:

[] Minimizing disruptions caused by the examination process. In particular, the Agencies agreed to reduce duplication and increase

coordination of examinations by multiple agencies;
[] Emphasizing the most important objectives of examinations (e.g., safety and soundness of banks) while eliminating their less productive aspects;
[] Minimizing ambiguity and increasing uniformity of regulatory interpretation, wherever possible; and
[] Reviewing all regulations and interpretations to eliminate "unnecessary burden" on the industry. [\[FN35\]](#)

Of course, this recent joint statement is phrased abstractly. The federal government remains free to clarify its specific real estate lending standards. Yet in the first three months since the new regulations took effect, the Agencies have issued only typographical corrections and one technical explanation. [\[FN36\]](#) Therefore, it remains *146 difficult to predict exactly how the Agencies will judge a particular bank's lending program.

Potential Hardship to Banks

The regulations explicitly refuse to carve out exceptions either for well-capitalized banks or for small banks.

In the former case, some well-capitalized, well-managed institutions requested higher LTV limits or even exemption from the Uniform Rule. These institutions do pose relatively less risk to the federal deposit insurance funds. Still, the Agencies decided to apply the regulations even-handedly to all banks.

The Agencies reasoned that the financial condition of even a well-capitalized bank could deteriorate very quickly if prudent real estate lending policies are not followed. Furthermore, the Guidelines as written identify internal characteristics, such as financial condition, as factors to be considered in adopting an appropriate lending policy. [\[FN37\]](#) Therefore, strong banks with sophisticated lending staffs will generally be permitted to establish policies allowing loans up to the maximum LTV limits, whereas weaker banks may need to adopt more conservative loan policies. Those banks allowed to lend at the maximum LTV limits may actually benefit from the new regulations, since those banks will reap a competitive advantage (vis-a-vis weaker banks) in offering greater credit for any given property value.

One could still argue that, even for the strongest banks, the imposition of maximum LTV limits places a fundamental constraint on the ability of banks to provide real estate capital. But this claim probably exaggerates the restriction: After all, the new limits, even if stringently enforced, are identical to those which prevailed until they were repealed by the Garn-St. Germain Depository Institutions Act of 1982. [\[FN38\]](#)

Nevertheless, the administrative and monitoring costs demanded by the regulations may severely burden small banks: [FN39] The Uniform Rule's very flexibility translates into vast amounts of paperwork. According to the Agencies' own estimate, banks collectively *147 will spend 571,400 hours per year creating, reviewing, adopting, disseminating, and implementing the required written real estate loan procedures. [FN40] Also, banks must create internal systems to ensure that their standards are being followed, to spell out the terms and conditions of loans, to detail loan origination, administration, and approval procedures, and so forth. Finally, banks must forecast the future of their real estate markets and adjust their loan policies accordingly.

Small banks theoretically are afforded some protection from astronomical administrative costs by three different federal laws. The Regulatory Flexibility Act [FN41] requires administrative agencies to certify that their regulations will not have a "significant economic impact on a substantial number of small entities." If an agency cannot so certify, it must publish a flexibility analysis, describing alternatives to its proposed rule designed to minimize such economic impact. [FN42]

The Agencies chose to certify that the Guidelines would not disproportionately affect smaller banks. [FN43] The Guidelines supposedly take account of the size of each bank and of its lending staff. [FN44] If the Agencies did not realistically estimate the actual burdens on small banks, then those banks may have the right to challenge the regulations under the Regulatory Flexibility Act.

For similar reasons, one might argue that the regulations constitute a major rule within the meaning of Executive Order No. 12,291. [FN45] However, the Agencies asserted that their new rules would not result in major increases in the cost of bank operations within the meaning of the Executive Order and, hence, that the rules would not require a regulatory impact analysis. [FN46]

Furthermore, the Paperwork Reduction Act [FN47] requires the Agencies to consider suggestions for reducing the recordkeeping burden. Finally, as mentioned previously, the Clinton administration has issued a policy statement specifically pledging to eliminate *148 unnecessary paperwork in banking regulation compliance. [FN48] Therefore, regulators may soon prove receptive to amending the current Guidelines, if indeed administrative costs unjustly plague small banks.

Even if the regulations remain on the books as written, banks desiring to push the limits of the Guidelines might inaugurate policies that pass some of the risk of noncompliance onto customers. For instance, to protect against overestimating the value of the real estate, banks' loan documents might require additional collateral if the LTV ratio rises above a pre-set limit. A bank, however, will remain responsible to regulators for its own real estate appraisals, loan approvals, and underwriting criteria.

[FN^a] Partner in the New York office of LeBoeuf, Lamb, Greene & MacRae, specializing in secured lending. Mr. Goodman gratefully acknowledges the invaluable assistance of Andrew N. Adler, a third-year law student at University of Michigan Law School, who was a summer associate at LeBoeuf, Lamb, Greene & MacRae in 1993.

[FN1] [12 U.S.C. §§ 3310, 3331-3351 \(1989\)](#).

[FN2] The Federal Deposit Insurance Corp. (FDIC), the Federal Reserve Board (FRB), the Office of the Comptroller of the Currency (OCC), and the Office of Thrift Supervision (OTS).

[FN3] See [55 Fed. Reg. 34,684 \(1990\)](#) (OCC); [55 Fed. Reg. 27,762 \(1990\)](#) (FRB); [55 Fed. Reg. 33,879 \(1990\)](#) (FDIC); [55 Fed. Reg. 34,532 \(1990\)](#) (OTS); [55 Fed. Reg. 30,199 \(1990\)](#) (NCUA); [55 Fed. Reg. 34,219 \(1990\)](#) (RTC), amended, [57 Fed. Reg. 12,190 \(1992\)](#) (OCC); [57 Fed. Reg. 9,043 \(1992\)](#) (FDIC); [57 Fed. Reg. 12,698 \(1992\)](#) (OTS), codified at 12 C.F.R. pts. 34 (OCC); 208, 225 (FRB); 323 (FDIC); 545, 563, 564 (OTS) (1993); 722 (NCUA); 1608 (RTC); [amendments proposed, 58 Fed. Reg. 31,878 \(1993\)](#).

[FN4] See [57 Fed. Reg. 62,890 \(1992\)](#), text corrected in [58 Fed. Reg. 4460 \(1993\)](#), codified at 12 C.F.R. pts. 34, 208, 365, 545, 563 (regulations effective Mar. 19, 1993).

[FN5] 57 Fed. Reg. at 62,896.

[FN6] [12 U.S.C. § 1828\(o\) \(Supp. 1993\)](#).

[FN7] Id. [§ 1828\(o\)\(2\)\(A\)](#). See also H.R. Rep. No. 102-330, reprinted in 1991 U.S.C.C.A.N. 1901, 1901-1912, 1949 (legislative history).

[FN8] 57 Fed. Reg. at 62,893.

[FN9] Id.

[FN10] Id.

[FN11] Id. at 62,896.

[FN12] Id. at 62,897.

[FN13] Id.

[FN14] For a more exact definition, see 57 Fed. Reg. at 62,898.

[FN15] "Total capital" is defined in 57 Fed. Reg. at 62,897 n.2 and references contained therein. See id. at 62,898-62,8999 for other technical definitions.

In determining the aggregate amount of such loans, banks should: (1) include all loans secured by the same property if any one of those loans exceeds the supervisory LTV limits and (2) include the recourse obligation of any such loan sold with recourse. Conversely, a loan should no longer be reported to the directors as part of aggregate totals when reduction in principal or senior liens, or additional contribution of collateral or equity, bring the LTV ratio into compliance with supervisory limits. 57 Fed. Reg. at 62,897-62,898.

[FN16] 57 Fed. Reg. at 62,896-62,898.

[FN17] "Overall categories" are listed above and include "raw land," "improved property," and so forth.

[FN18] See 57 Fed. Reg. at 62,897.

[FN19] See id. at 62,898.

[FN20] See id. at 62,897. The technical rules for LTV limits on cross-collateralized loans are further elucidated in Letter by John C. Price, Acting Assistant Director for Policy, Office of Thrift Supervision, OTS 93/RC-01 (Mar. 16, 1993).

[FN21] 57 Fed. Reg. at 62,897.

[FN22] Id.

[FN23] See Barbara A. Rehm, "Regulators Agree to Ease Limits on Realty Loans by Banks," American Banker, Oct. 14, 1992, at 1; Barbara A. Rehm, "Realty 'Victory' May Be Hollow for Small Banks," American Banker, Jan. 27, 1993, at 1.

[FN24] 57 Fed. Reg. at 62,898.

[FN25] Id. at 62,897.

[FN26] Id. at 62,898.

[FN27] Id. at 62,893 (emphasis added).

[FN28] Id. at 62,890.

[FN29] "Expect More Use of Guidelines," 60 Banking Rep. News 748 (BNA) (May 24, 1993).

[FN30] "Real Estate Lending Final Rule Gives Banks, Thrifts Flexibility, SCBA Says," 60 Banking Rep. News 41 (BNA) (Jan. 11, 1993).

[FN31] See "Why Banks Are Still Stingy," Fortune 20, 22 (Jan. 25, 1993).

[FN32] Rehm, American Banker, Oct. 14, 1992, at 1.

[FN33] See 57 Fed. Reg. at 62,892.

[FN34] See 60 Banking Rep. News (BNA) at 41.

[FN35] See Interagency Policy Statement on Credit Availability, [1993] Fed. Banking L. Rep. (CCH) § 51,149J (Mar. 10, 1993) (emphasis in original); see generally "How Federal Regulators Plan to Change Rules and Policies," American Banker, Mar. 15, 1993, at 12.

[FN36] See Real Estate Lending Standards, Office of the Comptroller of the Currency Banking Bulletin, 1992 WL 410042 (O.C.C.), at *1-26 & n.2; LTV Limits Applicable to Cross-Collateralized Loans, Letter by John C. Price, Acting Asst. Director for Policy, Office of Thrift Supervision, OTS 93/RC-01 (Mar. 16, 1993); [58 Fed. Reg. 4460 \(1993\)](#).

[FN37] 57 Fed. Reg. at 62,895.

[FN38] See [12 U.S.C. § 1464](#), History (appendix), at 761-774 (Lawyers Coop. 1992).

[FN39] Rehm, *American Banker*, Jan. 27, 1993, at 1 (quoting Jonathan Jerison, senior counsel at the Institute for Strategy Development).

[FN40] See 57 Fed. Reg. at 62,896.

[FN41] [5 U.S.C. § 605\(b\) \(Supp. 1993\)](#).

[FN42] *Id.* § 604.

[FN43] See 57 Fed. Reg. at 62,895.

[FN44] *Id.*

[FN45] [46 Fed. Reg. 13,193 \(1981\)](#).

[FN46] 57 Fed. Reg. at 62,896.

[FN47] [44 U.S.C. § 3504\(h\) \(1991\)](#).

[FN48] [1993] *Fed. Banking L. Rep.* (CCH), at 30,167.