

# Risk Connection

**A 12<sup>th</sup> District Training and Risk Information  
Program hosted by the Risk Coordination Unit**

*Division of Financial Institution Supervision and Credit*

Industry Experts Discuss:  
Risks with Construction  
& Development Lending

October 21, 2015

Stew Heller, Allen Greer, David Rosenthal,  
Jenny Redlin, Kent Robertson



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# Administrative Items

- All lines are currently on “mute.”
- Please hold questions until the designated question and answer period.
- To ask a question, press \*6 on your telephone keypad to unmute your conference line. Press \*6 again to put your line back on mute.
- If asking a question, remember to also ensure that your phone is not on mute.
- This presentation and accompanying materials are for internal staff only.

# About the Program

Risk Connection is a call-in program for delivering highly-targeted training and information on topics such as new job aids, new workprograms, new rules and regulations, and other risk-specific topics. The program is hosted and administered by the Risk Coordination Unit. These calls are recorded for future reference (see Exam Resources page on FISC Portal). Questions about the program can be directed to Wally Young, Director of the Risk Coordination Unit.

# Agenda - Speakers

- Introduce - Society of Chief Appraisers and Real Estate Collateral Risk Officers
  - Stew Heller, MDIV, MRICS
- Appraisal Related Issues
  - Everett Allen Greer, MAI, FRICS, AI-GRS
  - David Rosenthal, MAI, FRICS
- Environmental Issues
  - Jenny Redlin, REPA
- Cost / Construction Issues
  - Kent Robertson, P.E.

# Speakers

- **Stew Heller**, MDIV, MRICS, former Chief Appraiser for First Nationwide Bank, with 30+ years in the business and founder of Society of Chief Appraiser and Real Estate Collateral Risk Officers.
- **Everett Allen Greer**, MAI, FRICS, former Director of Research (8 years) and Western Appraisal Manager (10 years) for Bank of America, with 30+ years in the business. Also prior General Contractor.
- **David Rosenthal**, MAI, FRICS, Founder and President / CEO of Curtis – Rosenthal, Inc. since 1983. Company has a staff of 13 and offices in 3 locations within California. Prior loan officer with SPNB.
- **Jenny Redlin**, REPA, Principal with Partner Engineering and Science, Inc., with over 15 years in the business. Jenny has personally worked on more than 6,000 transactions.
- **Kent Robertson**, P.E., Founder and President of Professional Associates Construction Services, Inc since 1999, and previously worked for 10 years at Bank of America.

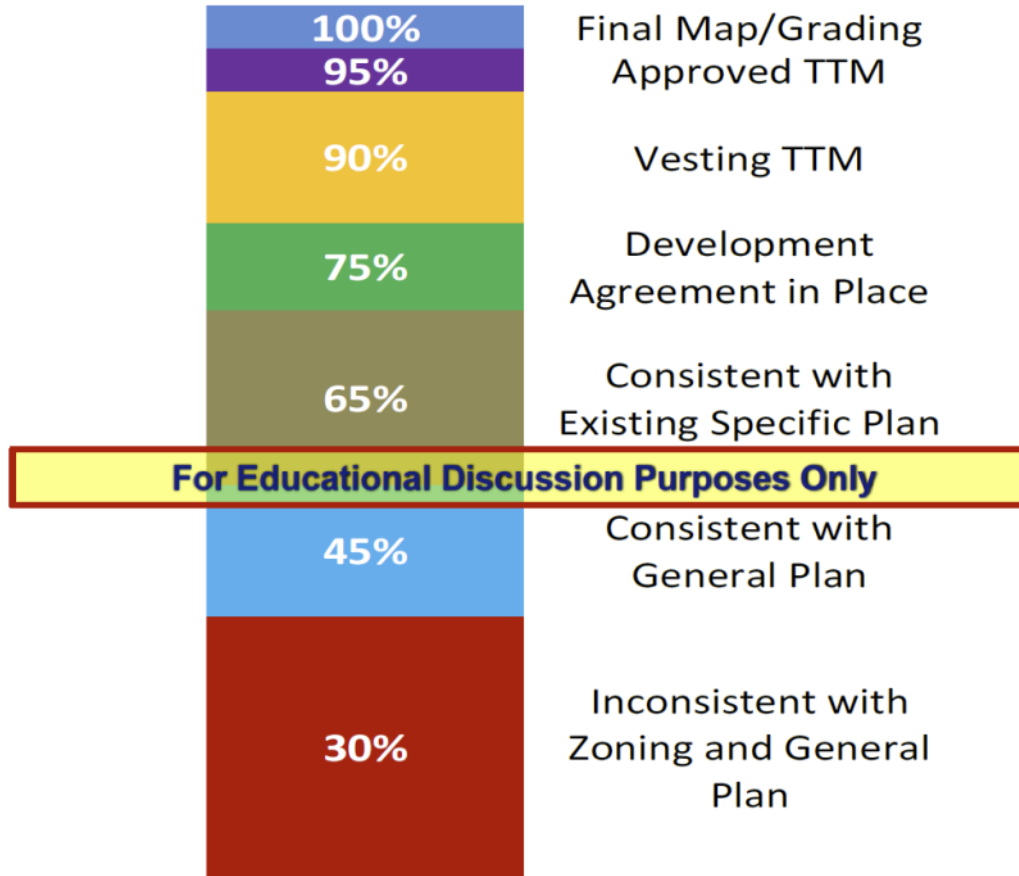
# APPRAISAL ISSUES

- Entitlements
- Environmental Impact Reports
- Development Delays - Impacts
- Extraordinary Assumptions
- Hypothetical Conditions
- Participation Risk
- Reliability of Data

# Entitlements

- “By Right” Zoning
- Deed Restrictions (Chicago Bar example)
- Architectural / Design Review Boards
  - (Santa Monica example)
- Citizen Groups (Water Garden Example)
- Preliminary Approval with Conditions
- Preliminary Approval without Conditions
- Final Approval with Conditions
- Final Approval without Conditions
- Post-Completion Requirements (Culvert e.g.)

# Entitlements & Value





# Subdivision Entitlements

- 5+ Units
- Subdivision Public Reports (DRE)
- Pink – Preliminary Subdivision Report
  - (Allows Deposits to be taken)
- White Report – Final Subdivision Report
- Tentative Tract Maps
- Vesting Tentative Maps
- Final Tract Maps
- Development Agreements
- Tricks Used to Avoid Subdivision Reports

# Environmental Impact Reports

- Addresses Elements of a General Plan
  - Land Use, Circulation, Housing, Conservation, Open Space, Noise, Safety
- Negative Declarations
- Mitigating Factors (conditions of approval)
- Money, Money, Money
- Utility Infrastructure
- Roads, Freeway, On / Off Ramps
- Public Service Improvements
  - Schools, Libraries, Police/Fire Stations
  - Examples – Playa Vista, San Diego NTC

# Development Delays

- Entitlement Delays
- Construction Delays
- Unforeseen Issues
- Maintaining Entitlements During Delays
  - San Diego Example – Pour Concrete
- Market / Highest and Best Use Changes
  - Lancaster Example – Lethal Weapon

# Extraordinary Assumptions

- Used when uncertain about something
  - Often buried in appraisal report
- Plans
- Costs – Direct & Indirect (Dirt Example)
- Development Timeline
- Approvals
- Absorption / Lease-Up / Sellout
- Appraisers Never Really Know These!
- Generally Rely on 3<sup>rd</sup> Party Source
- Assumption Only as Good as the Source

# Hypothetical Conditions

- Used when a condition is known to be not true at the time – often “buried” in report
- Value As If Clean
- Value As If Completed
- Value As If Stabilized
- Value Assuming Lease is Signed
- Current vs. Future Value examples
- Conditions of Approval (often not considered)

# Participation Risk

- Agent versus Participating Bank
- Access to Information
- Due Diligence
- Third-Party Professional Reviews
  - Shared or Not?
  - Internal vs External?
  - Who Hired Them?
  - Independence?

# Reliability of Data

- Land Sales – Entitled vs. Not?
- Developers Generally Put Property in Escrow, then COMPLETE entitlements prior to closing. What was price based on?
- Plans / Engineering / Other Items Included in Sales
- Extraordinary Assumptions

# Environmental Due Diligence



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# Risk Management in Today's CRE Environment



# Risk Tolerance



# Scope

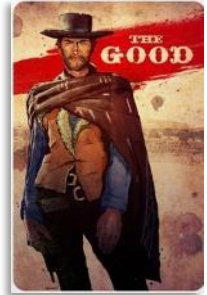
- Scope should be based on client's risk tolerance and risk management policy
- Limited Environmental Reports\*
  - Transaction Screen
  - Limited ESA
  - Environmental Desktop Screen / RSRA
  - Regulatory Database Reviews
  - Environmental Loan Screen



\*do not offer Innocent Landowner protection

# Bank Environmental Policy

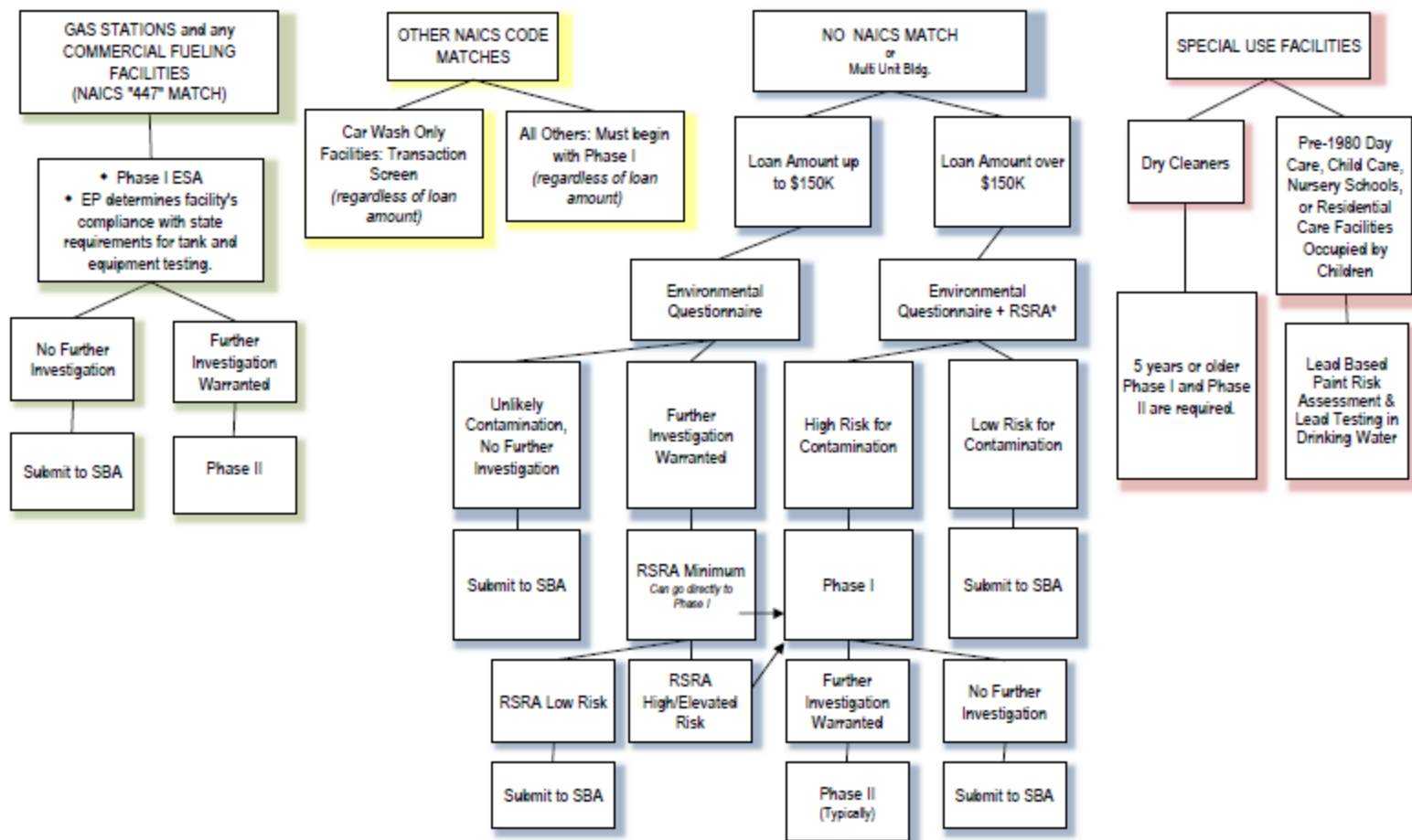
- **The Good:** Robust Policy, Internal environmental Risk review Team, Robust Vendor Management/Approval process.
- **The Bad:** Policy in place but never abide by it or it is poorly written.
- **The Ugly:** No Policy in place, have never heard of environmental risk



# STEPS OF ENVIRONMENTAL INVESTIGATION

According to SOP 50 10 5(H) Effective Date: May 1, 2015

Lender Determines NAICS Code For Properties' Current And Known Prior Uses



# Phase I ESA

Performed to determine any liabilities associated with the property, and to fulfill AAI obligations for protection from liability under CERCLA



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# Phase I Scope



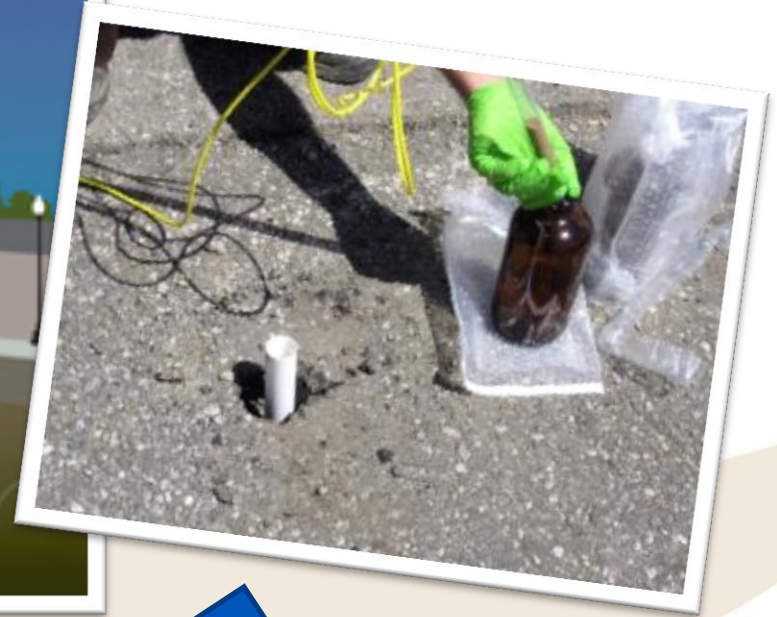
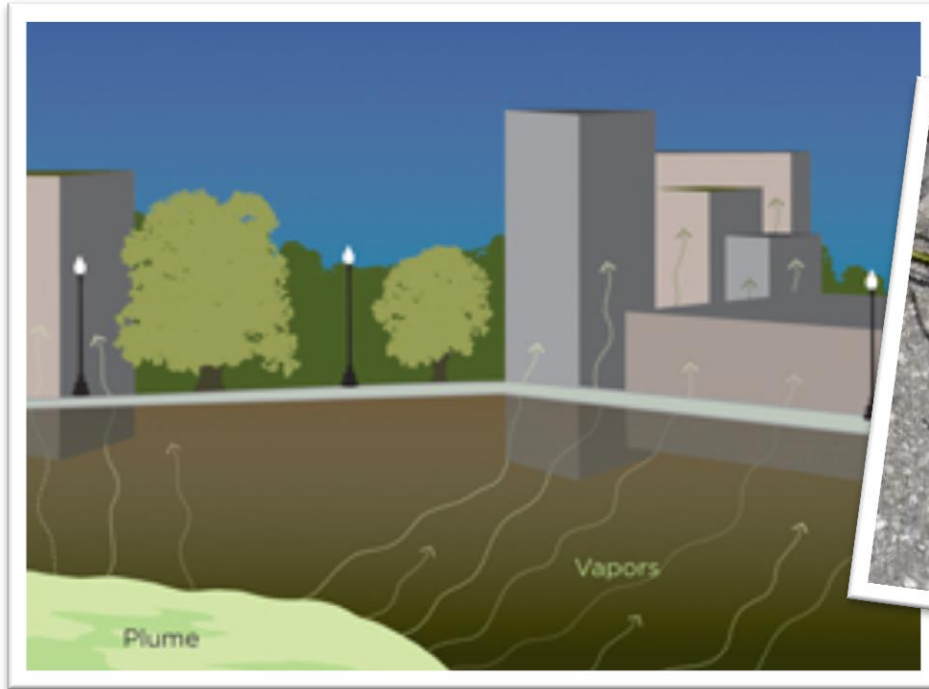
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# Red Flags





# Vapor Risk



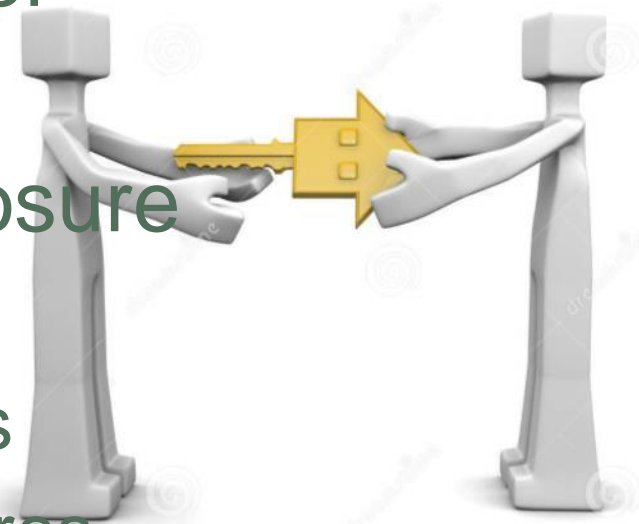
Human Health  
Screening Levels



Vapor Intrusion vs. Encroachment

# War Story

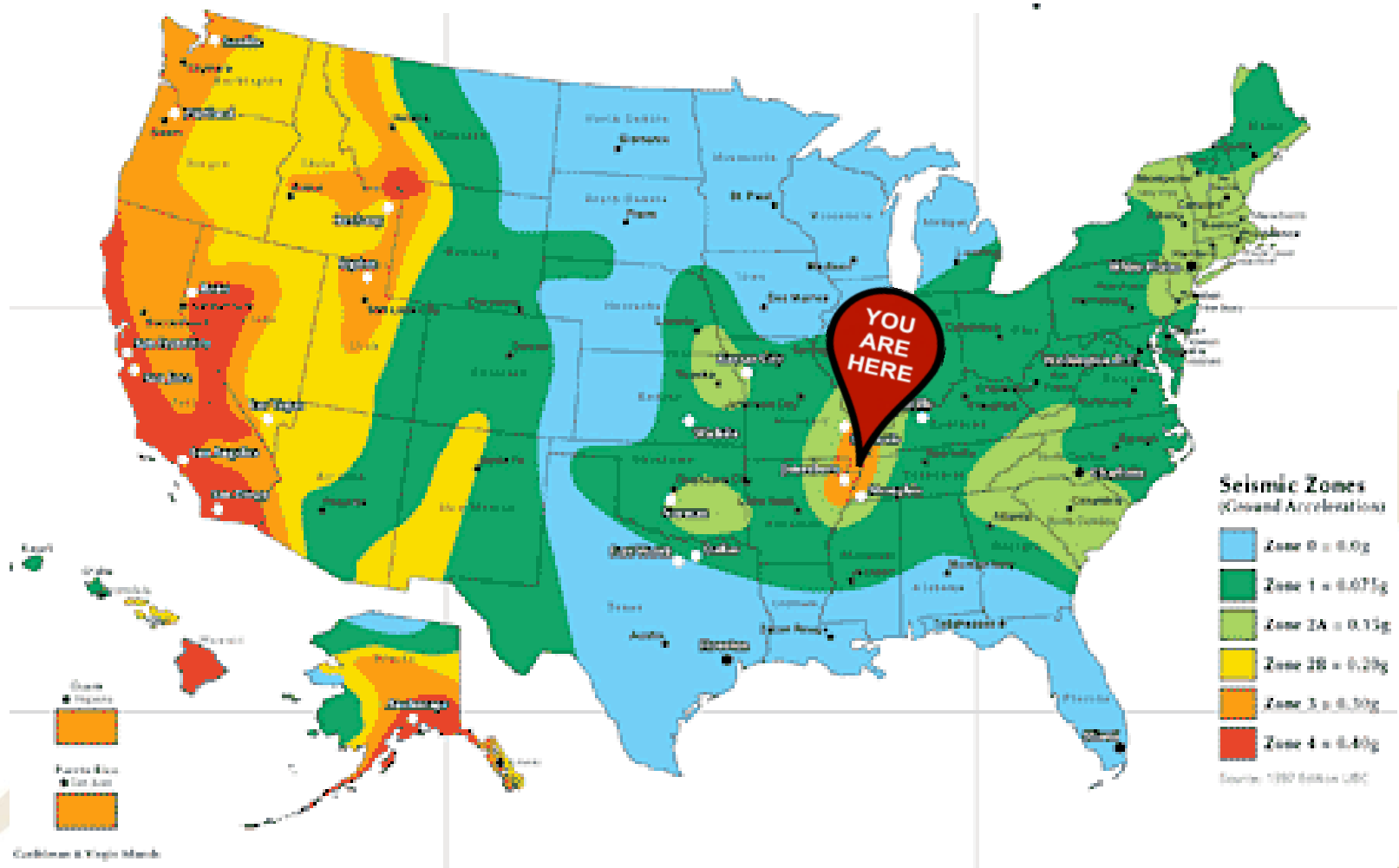
- Made loan on raw land tract for home development. No Env DD preformed
- Downturn happened, developer “handed back keys”
- Phase I ordered before foreclosure
  - Previous landfill/vapor concerns
  - Storm water run off issues/ fines
  - Mold issues on half built structures



# Seismic Risk



# Addressing Seismic Risk

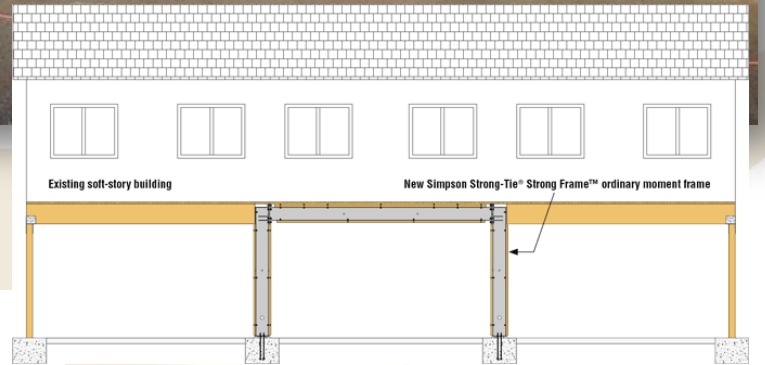
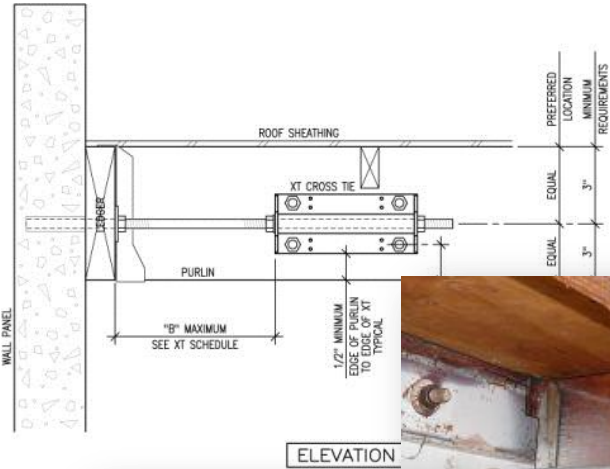


# Vulnerable Building Types

- Unreinforced masonry
- Soft-story buildings
- Concrete tilt-up
- Many others



# Retrofitting

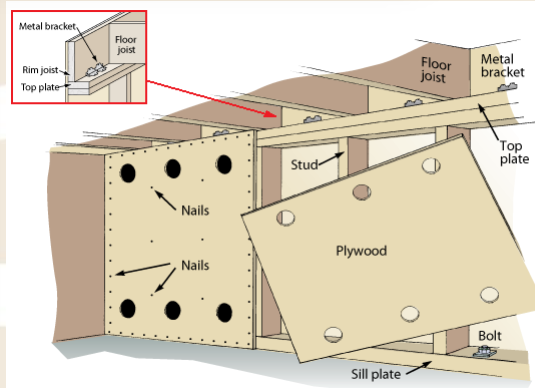


Cantilevered column retrofit

Wood frame metal-bracket retrofit



Wall-tie, cross-tie retrofit



# Retrofit Ordinances

- Increasing number of mandatory retrofit ordinances
- SF, LA, Santa Monica etc
- Aimed to improve seismic resilience of building stock, protect life safety and reduce costly collateral damage



**Retro-Fittest** of the **Survival**

**COMPLIANCE**



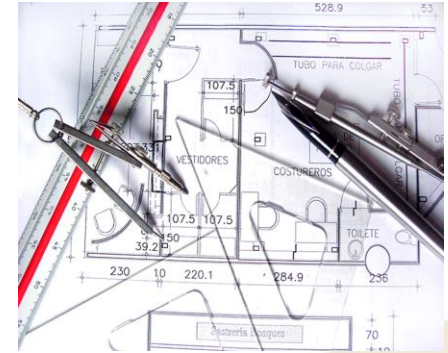
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# Construction Due Diligence

Kent Robertson, P.E.  
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- **Front End Construction Analysis**

(verify budget after review of plans, contracts, schedule, technical reports, experience of parties)



- **Progress Monitoring**

(verify work in place, monitor schedule, challenges and cost to complete)

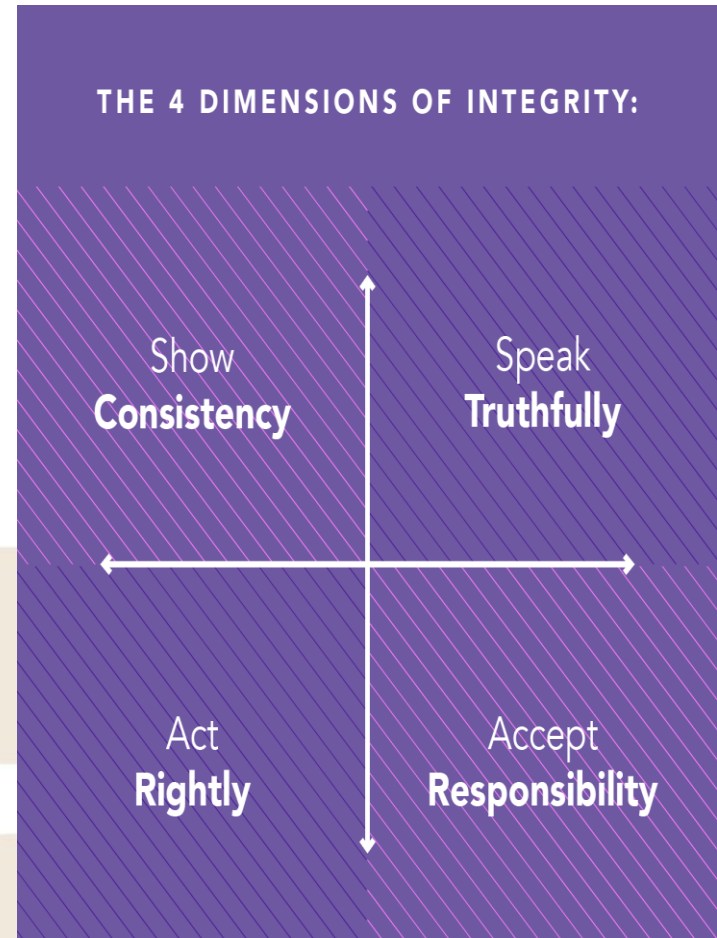


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# Integrity of Reporting

- **Providing reports to Borrower**
  - Taints the consultant's freedom to document opinions. If they know the reader includes borrower, opinions tend to be sanitized.
  - Reports are based on information obtained from field sources who may be compromised when they realize their cooperation if information shines a negative light on borrower.
  - Sometimes Banks obtain approval from borrower of the consultant used.



# Construction Analysis

## #1 Value Added

### Insure we have a good budget from the start

- Covers the full scope
- Anticipates the unique issues of the project
- Is balanced and error free



**THE GOSPEL ACCORDING TO  
ST LUKE  
CHAPTER 14:28-30**

**For which of you, intending to build a tower, sitteth not down first, and acounteth the cost, whether he have sufficient to finish it?**

**Lest haply, after he hath laid the foundation, and is not able to finish it, all that behold it begin to mock him,**

**Saying, This man began to build, and was not able to finish.**

# Construction Progress Monitoring #1 Value Added

## Know the cost to complete/loan budget in balance

- Percentage observed is in line with percentage drawn
- Tracking schedule. Costs of delays are budgeted
- Tracking changes. Change orders and pending change orders are budgeted



# The 5 C's of Credit

- Character
- Capacity
- Capital
- Collateral
- Conditions



# Character

- \$50MM Land development



# Character

- \$20MM 84 Unit Condominium Development



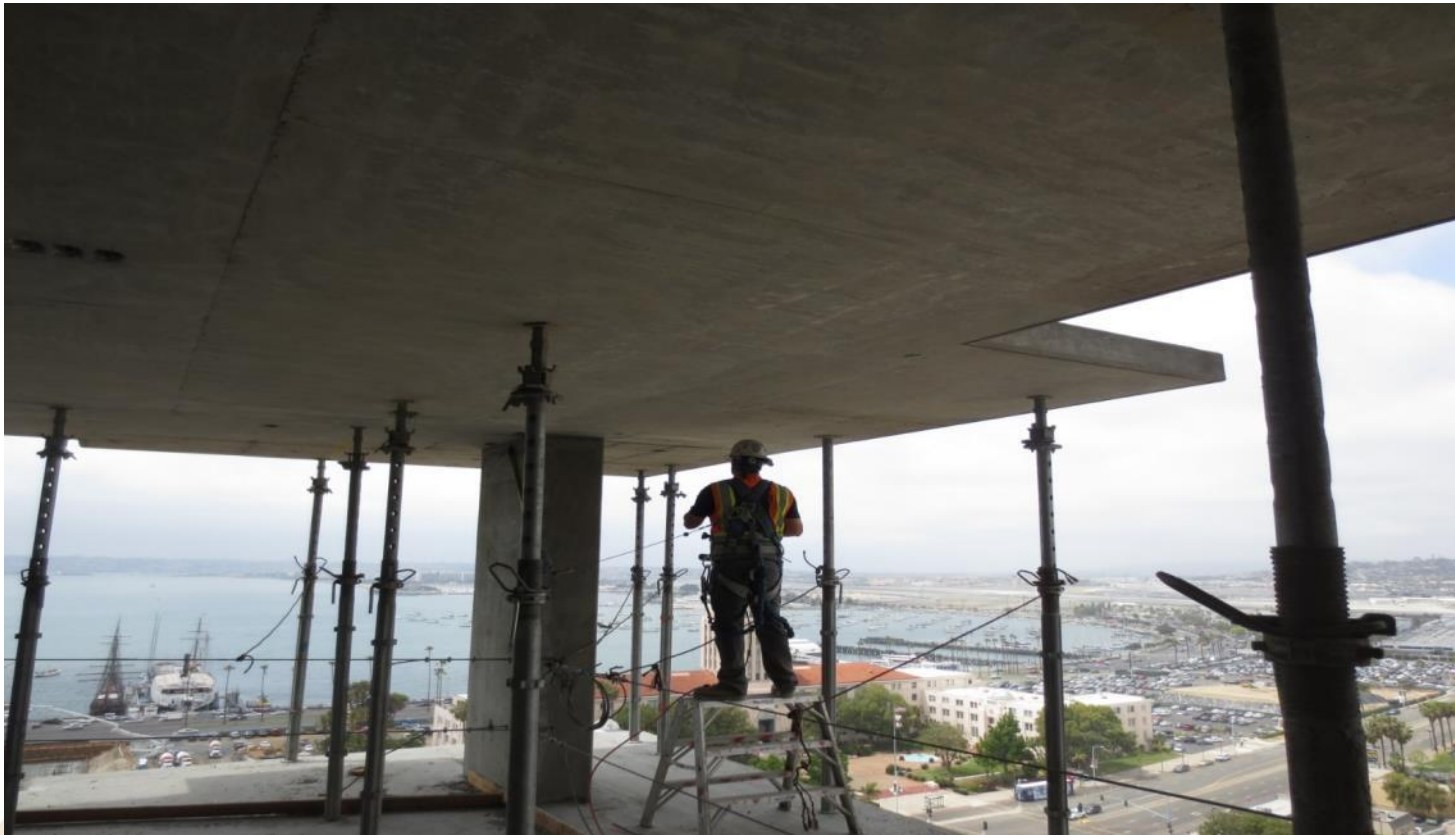
# Character (Cont'd)

- Hotel Development



# Capacity

- Office \$75MM



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# Capacity

- Apartments \$95MM



# Inadequate Capital

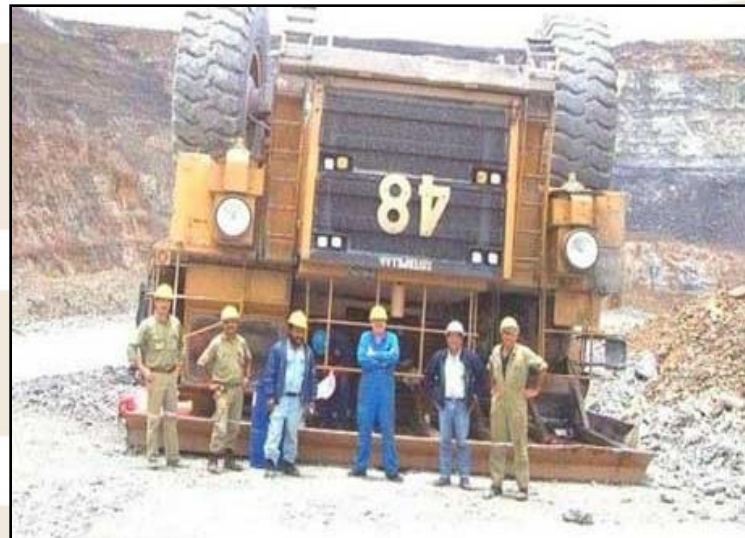
- Apartments \$25MM



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# Warning Signs

- Slow work - not much change from last month
- Billing is ahead of percent complete in the field
- Changes in superintendent/PM
- Too many City corrections - not getting along with City
- Dirty site/Super not on site/Work out of sequence
- Too many change orders
- Not providing pending COR log
- Evasive answers
- Changes in subs
- Not returning calls



# Who Financed This Project?



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# Call PACS

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