NAHB ISSUES UPDATE
December 2010

Acquisition, Development and Construction (AD&C) Credit

Lack of credit for land acquisition, development and residential construction (AD&C) is the number one issue facing the home building industry. Builders and developers are reporting excessive credit restriction, where lenders are cutting off loans for viable new housing projects and producing unnecessary foreclosures and losses on outstanding AD&C loans, which generally have been performing loans prior to lenders' actions. With the spigot for housing production loans cut off, there can be no housing recovery, which has major implications for the economy as a whole. NAHB is sounding this alarm in every appropriate venue and working hard to free up AD&C funding.

Background

Home builders continue to experience a significant adverse shift in terms and availability on land acquisition, land development and home construction (AD&C) loans and builders with outstanding loans are facing mounting challenges. Lenders are refusing to extend new AD&C credit or to modify outstanding AD&C loans to provide builders more time to complete their projects and pay off these loans. Lenders often cite regulatory requirements or examiner pressure that banks shrink their AD&C loan portfolios as the reasons for their actions.

While the federal bank regulators maintain that they are not encouraging institutions to stop making loans or to indiscriminately liquidate outstanding loans, reports from NAHB members in a number of different geographies suggest that bank examiners in the field are adopting a significantly more aggressive posture. Moreover, some institutions appear to be overhauling and downsizing portfolios independent of regulator/examiner pressure.

Reappraisals of performing loans are reducing the value of the collateral and forcing borrowers to suddenly come up with large amounts of cash. Many borrowers are solvent and making payments on their AD&C loans, but the cash call is impairing what was previously a good loan. Since most home building companies are small businesses and do not have the capacity to meet significant equity calls, the result is often foreclosure on a loan that had been performing and, in some cases, the additional equity requirements are forcing builders into insolvency. In almost every case, the institution would be better off working with the borrower to extend the loan, rather than shutting off credit.

Portfolio lenders – commercial banks and thrifts – remain the predominant source of residential AD&C financing, accounting for over 90 percent of originations. There are no alternative sources of housing production credit for most firms in the home building industry. These smaller home building companies have borne the brunt of the credit retraction.

Another setback for home builder borrowers is the rising number of bank and thrift failures. Builders with outstanding loans that are placed under FDIC control are frequently unable to contact a decision maker to deal with routine, but time-sensitive, matters related to loan draws or extensions.

Current AD&C Financing Conditions

Home builders are having extreme difficulty in obtaining credit for viable projects. Builders with outstanding construction and development loans are experiencing intense pressure as the result of requirements for significant additional equity, denials on loan extensions, and demands for immediate repayment. The credit window seems to have been slammed shut for builders all over the country.

These trends are supported by NAHB's member surveys of the availability and cost of AD&C credit. The latest survey shows that conditions continued to deteriorate through the third quarter of 2010:

- Well over half of respondents to this survey continue to report that the availability of credit for AD&C loans has worsened every quarter for 12 quarters in a row, from the fourth quarter of 2007 through the third quarter of 2010.

- The consecutive quarterly decline in loan availability has been true for all types of AD&C loans: land acquisition, land development, single-family construction, and multifamily construction.

- More than three quarters of the respondents who reported that conditions had become even worse in the third quarter of 2010 stated that lenders are simply not making new AD&C loans.

Economic Impact of the AD&C Credit Crunch

The problems in the housing sector have had a significant impact on the nation's economy. The sharp decline in home building from the 2005 peak – a drop of one million units – has translated into 1.4 million lost jobs for construction workers and the loss of $70 billion in wages. Factoring in impact of the housing plunge on industries that provide materials and services to home builders, the total impact of the housing slump has been the loss of over 3 million jobs and $145 billion in wages in all housing-related industries.

The ongoing credit problems for home builders will further inflate these totals and will cause longer-term economic damage. The development process is lengthy, taking years from the acquisition of land to the completion of homes. With lenders refusing to finance lot development, the pipeline of ready-to-build-on land will drain dry. This will result in a major delay in meeting demand for new homes when consumers return to the marketplace in more significant numbers. In cases where local, state and federal permits are also required, expirations of these permits will force builders to start the approval process anew, adding at least several years to the pipeline, along with additional costs. The effect will be most severe in markets that have not suffered the boom-bust extremes and would otherwise be poised for more rapid recovery.

Regulatory Developments

In general, the federal banking regulators have been reminding financial institutions to adhere to the December 2006 bank regulatory Guidance on Understanding and Managing Commercial Real Estate (or CRE) Risks. Federal banking regulators have taken note of tighter lending conditions. In November 2008 they issued a joint statement urging banks to lend to creditworthy borrowers. Further, they warned that excessively tight lending standards could exacerbate current market conditions leading to slower economic growth.

Building on the 2008 statement, in October 2009, the regulators issued new guidance on *Prudent Commercial Real Estate Loan Workouts*. The objective of the new guidance is to encourage financial institutions to pursue workouts on troubled CRE loans, a category that includes residential AD&C loans. Their stated intent is to ensure that supervisory policies and actions do not impair the flow of credit to viable borrowers and projects. The statement says that financial institutions that implement prudent CRE workouts will not be subject to criticism for engaging in such efforts and loans should not be subject to adverse classification solely because the value of the underlying collateral has declined.

In February 2010, the federal banking regulators released a joint statement encouraging institutions to engage in prudent lending to creditworthy small business. The statement urged banking institutions to focus on the viability of the borrower's business, rather than the borrower's geographic location or industry sector. The regulators said they are working with the banking industry and supervisory staff to ensure that supervisory policies and actions do not inadvertently curtail the availability of credit to sound small businesses.

These statements are positive steps in encouraging workouts as a preferred course of action and in directing examiners to make balanced assessments of institutions' workout efforts. The direction provided on allowing institutions to avoid using liquidation values when assessing collateral and on bifurcation of loans should be helpful to builders and developers. In general, however, the criteria specified for prudent loan workouts will allow institutions fairly limited ability to structure workouts for AD&C borrowers. Since AD&C loans are collateral-dependent with no internal cash flows to service principal and interest, borrowers on these loans will have to demonstrate other sources of loan repayment, provide additional collateral and/or make principal repayments to satisfy the criteria for prudent workouts. Many AD&C borrowers are not in a position to meet such requirements. In addition, the higher likelihood of a reclassification of a restructured AD&C loan as a troubled debt restructuring likely will discourage institutions from pursuing workouts on AD&C loans.

While the statements of the banking regulators seem to support a pragmatic and balanced approach, NAHB has seen no evidence that the problem of extreme pressure on lenders by bank examiners is abating. Builders and bankers continue to complain of excessive actions from bank examiners. Such comments leave the impression that bank examiners are still more comfortable with the restrictive approach and are not exhibiting the flexibility necessary to facilitate reasonable and prudent lending practices.

Legislative Developments

NAHB is continues to raise awareness in Congress about the lack of AD&C financing and the possible adverse economic impacts. When this issue first became apparent, NAHB's Government Affairs Department began quickly placing direct pressure on federal elected officials to address the root problem of AD&C lending – the lack of regulatory flexibility in bank commercial real estate threshold regulatory guidelines. NAHB's congressional efforts initially involved urging elected officials to put pressure on federal banking regulators, but have since expanded to pursuing specific legislative proposals to address AD&C lending issues.

Since the beginning of this problem, NAHB has continually submitted statements to the House Financial Services and Small Business Committees, in addition to the Senate Banking

Committee, stressing the need for banks to open the lines of credit for viable home building projects and urging regulators to enact concrete reforms to ensure that appraisals accurately reflect true market values. NAHB's statements on AD&C lending have also helped direct specific questions during congressional hearings towards key federal banking regulators on the actions they have taken, or lack of action, to address our lending concerns. NAHB's communications to Congress on AD&C lending have also been the main priority for the past several Legislative Conferences. While NAHB's congressional outreach has produced numerous letters to federal banking regulators from key elected officials seeking specific regulatory changes, regulatory problems continue to persist.

Recognizing the continued pushback from federal banking regulators, and utilizing the momentum of NAHB's grassroots and lobbying messaging, legislative efforts have broadened to focus on developing programs aimed at overcoming regulatory impediments. NAHB had legislation introduced that would establish a new residential construction loan guarantee program within the Department of Treasury to guarantee loans made to home building companies for viable construction projects. The legislation would direct $15 billion in loan guarantees, for a period of three years, for lenders participating in the new program. The legislation, the *Residential Construction Lending Act* (H.R. 5409), was introduced by Representatives Brad Miller (D-NC), Joe Baca (D-CA), and Carolyn Maloney (D-NY), on May 26, 2010, and has continued to generate congressional cosponsors.

NAHB also weighed-in forcefully to allow construction loans to small builders to be eligible for the new $30 billion small business lending fund signed into law on September 27, 2010 by President Barak Obama. Through intensive lobbying and grassroots efforts, NAHB was successful in passing stand-alone legislation in the House of Representatives (H.R. 6191) that would allow small home building firms equal access to the new lending fund. H.R. 6191 is currently pending action in the Senate.

<u>NAHB Position/Recommendations</u>

Financial institutions should be encouraged to fund viable new projects and to take steps to avoid foreclosure on AD&C loans by accommodating loan modifications and workouts. Regulators should issue more flexible guidelines that will encourage banks to maintain funding for residential AD&C loans in good standing that fall below their underlying value. While NAHB welcomes the new CRE guidance, the workout criteria is focused on income-producing properties which will help multifamily builders, but will only provide fairly limited ability to structure workouts for AD&C borrowers. For this policy to be truly effective, more flexibility in workouts for AD&C loans is needed.

In the vast majority of cases, lenders would be better off working with their builder/developer borrowers to modify or extend loans, rather than requiring additional equity or shutting off credit. This is a lesson that has been demonstrated by holders and servicers of home mortgages who now increasingly attempt to work out a mutually beneficial solution with struggling borrowers. The alternative is to incur foreclosure and real estate owned expenses, only to sell the property for cents on the dollar.

NAHB is urging regulators to encourage lenders to work with residential construction borrowers who have loans in good standing by providing flexibility on re-appraisals, loan modifications and perhaps forbearance, to give builders sufficient time to complete projects and sell their inventory. Further, institutions that have received federal bailout funds should be required to account for how these funds have been used in lending on new projects and/or working out more flexible terms to facilitate continued funding and eventual repayment of performing AD&C loans.

NAHB Actions

At the 2010 Fall Board meeting, NAHB's Board of Directors approved a recommendation making AD&C financing NAHB's number one advocacy priority. The Board directed that NAHB continue to provide adequate and appropriate resources on resolving this issue. Further, that NAHB redouble its efforts to find an effective solution to this credit crisis, which is likely to be accomplished only by forceful Congressional action, and to focus its considerable advocacy resources on this mission.

Since the credit crisis began, NAHB has been engaged in intensive efforts to improve the availability of credit for home builders. These efforts have included:

- Ongoing series of meetings with each of the federal banking regulators where examples were presented where credit has been denied to a viable project or where a lender has taken adverse actions on a performing outstanding loan due to regulatory pressure;
- Working with the Federal Deposit Insurance Corporation (FDIC) on behalf of builders with loans caught in FDIC receiverships;
- Joint outreach to banking organizations and joining with banking groups in some of the meetings with the regulators to present a unified voice against regulatory excess;
- Working with members of Congress to raise awareness of the negative regulatory environment for housing production credit;
- Introduction of legislation to establish programs to increase the flow of AD&C credit;
- Identification of potential alternative sources of housing production credit and facilitation of home builder access to such nontraditional sources as private equity funds;
- Pursuing changes in the appraisal system to remove the inappropriate influence of distressed sales on home values and improve the accuracy of the valuations of new homes, particularly homes with green building features (See Appraisal Issues Update);
- Several webinars to help NAHB members deal with AD&C financing problems; and,
- Engaging in an aggressive media campaign to publicize the problem and pressure policymakers to take action.

While these efforts will continue, NAHB understands that more needs to be done and thus is accelerating efforts to increase recognition by policymakers and the public of the importance of removing impediments to the flow of credit for housing production in order to significantly improve economic performance and increase jobs.

NAHB AD&C Advisory Group

In June, NAHB formed an AD&C Advisory Group to advise NAHB's leadership and Executive Board on what additional steps NAHB could take to help resolve the AD&C credit crisis. After considering a wide range of ideas, the Advisory Group identified the action items listed below as top priorities in the effort to address the lending crisis. While the Advisory Group reviewed many other potential action items, it selected the five action items listed below as the most feasible in the current economic and political climate.

1. Seek adjustments/greater flexibility in bank commercial real estate threshold regulatory "guidelines," particularly the 100% of capital threshold for residential development and construction loans.

2. Adjust loan classification criteria. The reserves a bank has to put toward a troubled debt restructuring are still too high to encourage most lenders to work with the borrowers.

3. Find a way to incentivize lenders to offer special mortgage programs for buyers of a home in a project where the lender has a troubled AD&C loan. (Banks in North Carolina and other places used TARP funds to fund these mortgages and it boosted sales in those projects.)

4. Look further into opportunities for banks to invest cash in foreclosed projects and increase their return when sold (Wells Fargo provides a good example).

5. End use of liquidation values in reappraisals of AD&C loan collateral, and pursue a waiver of LTV guidelines in cases where an outstanding loan is performing and the borrower can demonstrate a willingness and ability to service the debt.

As part of NAHB's efforts to implement these action items, NAHB senior staff recently have met with representatives of the FDIC, American Bankers Association (ABA), the Financial Services Roundtable, and the White House National Economic Council to discuss AD&C issues. Additional meetings are planned with the Independent Community Bankers of America (ICBA) in January and we also are working on arranging meetings with Treasury and Fed officials.

NAHB also is seeking input from NAHB Associate members regarding the impact of AD&C financing problems on their businesses. A form for Associate members to share their experience has been posted on NAHB's website and is available at: AD&C Financing Case Study - Associates. This effort is in addition to NAHB continued efforts to obtain case studies from NAHB builder members which can be submitted at: www.nahb.org/adccasestudy.

2010 Executive Board Discussion

During NAHB's 2010 Winter Executive Board meeting, the AD&C issue was discussed at length in two separate sessions where Executive Board members brainstormed on more "out-of-the-box" approaches. NAHB staff used the Executive Board discussion to develop strategies to address the issues, as well as tactics that could be used to implement one or more strategies.

Strategies have been categorized into the following five broad areas:

A. Remove regulatory barriers/alter appraisal system
B. Work with or confront banks in search for solutions
C. New federal program, loan guarantee or funding source
D. Increase housing demand
E. Develop new sources or new enhancement of credit

Tactics that could be used to implement one or more of the strategies were categorized as follows:

a. Create political buzz
b. Utilize grassroots influence
c. Emphasize jobs
d. Outreach to the news media
e. Create buzz through “new media”
f. Outreach to policy community

Strategies and tactics under each of these categories were developed into a matrix with a description of each, pros/cons, costs (hard and political) and staff assessment of the likelihood of execution and degree of impact to resolving AD&C financing problems if successfully executed (the last two apply to strategies only). The Senior Officers reviewed these materials and developed strategies/tactics that will be presented to the NAHB members at IBS.

Alternative Financing Efforts

NAHB continues to meet with private equity funds and other potential alternative sources of AD&C financing. NAHB has established an on-line service, the NAHB Finance Forum, where members can submit financing proposals and connect with potential lenders and investors. This service may be accessed at: www.nahb.org/financeforum.

The financing sources participating in the Finance Forum will also participate in NAHB’s second Finance Pavilion, which will be conducted at the 2011 International Builders’ Show. The Finance Pavilion will provide an opportunity for builders and developers to meet with financial companies and advisors to discuss project funding. More information is available at: www.buildersshow.com/financepavilion.