

# Addressing the AD&C Lending Crisis



## Background

Severe and widespread problems in the mortgage and housing markets have cast a pall over the housing production market, prompting an aggressive response from lenders and regulators. Home builders and developers report dramatic deterioration in credit availability and intensifying pressure on borrowers with outstanding loans. 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 acquisition, development and construction (AD&C) loans.

Credit for AD&C loans has tightened significantly over the past year and does not show signs of abating, at least in the short-term, according to NAHB's builder survey of AD&C financing conditions. In the latest survey, 72 percent of respondents stated that the availability of credit for single family construction loans worsened in the latest quarter compared to the previous period. By comparison, only 54 percent of respondents made such an assessment a year earlier.

In addition, there were increasing reports of tightening terms or conditions on outstanding loans as 38 percent reported tighter loan terms for outstanding land development loans; while 39 percent stated stricter terms on outstanding single family construction loans. Of those reporting tighter terms, 62 percent stated that lenders were requiring partial pay-downs based on re-appraisals, 58 percent cited demands for increased collateral and 42 percent said lenders had terminated lender-funded interest reserves and were refusing to allow additional draws. Twenty-five percent reported that their loans had been called.

The federal banking regulators continue to maintain that they are not instructing institutions to stop making loans or to indiscriminately liquidate outstanding loans. Nevertheless, the bank regulators have raised concerns about real estate lending and are encouraging institutions to increase capital and loan loss allowances and to take other strong measures to manage

problem loans. Regulators also have expressed grave concerns over the high concentration of commercial real estate loans (the category that includes residential AD&C loans) in institutions' portfolios.

Reports from NAHB members in a number of different geographic areas, however, suggest that bank examiners in the field are adopting a significantly more aggressive posture and some institutions appear to be overhauling and downsizing portfolios independent of regulator/examiner pressure. We understand that examiners are conducting more frequent bank examinations, and requiring institutions to get updated appraisals on AD&C projects and to increase loan loss reserves. Overly conservative appraisals are presenting further challenges by limiting sales and refinance opportunities and exacerbating pressure on outstanding mortgage and housing production loans. The heightened regulatory scrutiny is having an impact on borrowers and many builders are rapidly drawing down interest reserves and have had to put up additional equity as appraised values have declined.

The latest 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.

## Solutions

In the vast majority of cases, the institution would be better off working with the borrower to modify or extend the loan, 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 property disposition expenses, only to sell the property for cents on the dollar.

The same economic principles apply to banks that hold AD&C loans. Rather than calling loans or taking other damaging actions, banks would be acting in their own best interest by modifying or extending loans for borrowers who are not in default and have projects worthy of completion. This would allow borrowers to develop alternative repayment plans, adjust their finances or find other funding sources until they are able to complete and sell the homes. In more difficult housing markets, resources from the Treasury Department's Troubled Asset Relief Program (TARP) could be employed to provide banks with additional capacity to accommodate loan modifications and workouts.

## Recommendations

- › **Regulators and lenders should provide leeway to residential construction borrowers who have loans in good standing by providing flexibility on re-appraisals, loan modifications and perhaps forbearance on loans to give builders time to complete and sell their inventory.**
- › **Banks should account for how they are using TARP funds in lending on viable new projects and in working out more flexible terms to facilitate continued funding and eventual repayment of performing AD&C loans.**
- › **Earmark up to \$20 billion of future TARP requests to allow banks to avoid excessive equity calls and other adverse actions on performing loans.**

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