

The worst bet in real estate today: Construction loans



By Brett T. Roseman for USA TODAY

Fencing walls the Riverside Square condo and retail development in downtown Algonquin, Ill. The developer filed bankruptcy in early 2009.

By [Paul Wiseman](#), USA TODAY

The biggest bank killer around isn't some exotic derivative investment concocted by Wall Street's financial alchemists. It's the plain old construction loan, Main Street banks' bread and butter for decades.

Deutsche Bank has called them "without doubt, the riskiest commercial real estate loan product." The Congressional Oversight Panel, a financial watchdog, has warned that construction loans have deteriorated faster and inflicted bigger losses on banks than any other real estate loans.

And the worst may be yet to come. Banks, adopting a desperation strategy known as "extend and pretend" or "delay and pray," have been reluctant to admit defeat, repossess half-completed housing developments and strip malls — and dump them on a depressed market at a big loss. "There probably are many loans out there that are in worse shape than reflected on lenders' books," says Chicago construction lawyer Joshua Glazov.

Even so, the numbers are already grim:

- Across the banking system, nearly 17% of construction loans were non-current — at least 90 days past due or otherwise in trouble — at the end of March, a record level and a stark contrast to less than 5.5% for all loans, according to the latest numbers available from the Federal Deposit Insurance Corp. For construction loans on one- to four-family residences, the percentage of bad loans is even worse: nearly 23%.

"Construction loans are experiencing the biggest problems with vacancy or cash-flow issues, have the highest likelihood of default, and have higher loss severity rates than other commercial real estate loans," the Congressional Oversight Panel, tasked with overseeing the federal bailout fund, reported earlier this year.

- The 10% of banks that had the highest concentration of construction loans at the end of

LOANS TURNING SOUR

More construction loans are going bad than any other kind. Percentage of loans by category that were 90 days or more past due among FDIC insured lenders on March 31:

All real estate loans	7.6%
Construction/development	16.8%
Non-farm non-residential	4.2%
Multifamily residential real estate	4.6%
Home equity loans	1.7%
Other 1- to 4-family residential	10.2%
Commercial/industrial loans	3.1%
Loans to individuals	2.3%
Credit card loans	3.1%
Other loans to individuals	1.4%
All other loans/leases	1.7%
Total loans/leases	5.5%

* = includes farms
Source: FDIC

2007 account for more than half of the 274 banks that have failed between then and Aug. 6, according to an analysis for USA TODAY by SNL Financial in Charlottesville, Va.

- Even the banks that have survived despite holding high concentrations of construction loans remain vulnerable. Their average "Texas ratio" — which measures their bad loans as a percentage of their capital and reserves against loan losses — stood at 101% on June 30, up from 90% three months earlier, SNL found. Anything over 100% signals that a bank is in danger of failing. For construction-loan-heavy banks, the median Texas ratio — which weeds out the worst cases — was still high, at 62%.

"It's been a bloodbath out here," says bank consultant Tod Little of BNK Advisors in Las Vegas.

Developers typically take out short-term, adjustable-rate loans to buy and develop property. The bank releases money in increments — as the developer needs it — and puts some of the proceeds in a reserve from which the builder makes interest payments before the project starts generating revenue. After the project is completed — and tenants have moved in and started paying rent — the developer takes out a longer-term mortgage to pay off the construction loan.

'Cocaine' for banks

Many small and midsize banks, eager for growth, grew addicted to construction loans during the housing boom. "Construction lending is really the cocaine of the banking industry," says veteran banker Rollo Ingram. "They're easy to do. They're big-dollar loans that can bulk up a balance sheet. And there are always developers who want loans."

Construction loans — officially labeled "acquisition, development and construction" loans — surged more than 150% between the first quarters of 2003 and 2008, when they peaked at \$631.8 billion. (Overall loans rose just 55% during the same period.) If a bank said no to a construction loan, "The developer could just go down the street," says Brandon, Fla., bank consultant Jon Campbell.

And some of the people getting loans during the real estate frenzy of the mid-2000s were amateurs, says Boston bank consultant David Brown: "They were contractors who got the bug and felt they could make a living at being a developer."

It did not end well. Construction loans started blowing up when the real estate market collapsed and the economy tumbled into recession. The 10 biggest banks, facing problems of their own with subprime mortgages, were largely immune to the deterioration in construction loans, which accounted for just 2% of their assets in 2007, according to the Federal Reserve. By contrast, construction loans accounted for more than 10% of assets at banks that didn't rank in the top 1,000. "What's causing the problem is Main Street America, the construction loan made by the bank down the street," says Bill Bartmann, who owns a debt advisory firm. "They built, and nobody came."

Making matters worse: Community banks never sold the construction loans to investors the way banks unload auto loans and residential mortgages. "Most construction loans are so unique, so different, so non-homogenous, that you can't securitize them," Bartmann says. "They were kept on the books of the banks that originated them." And there, many of them started to turn rotten.

A failure's postmortem

Rollo Ingram witnessed one spectacular flameout up close. He was chief financial officer at Atlanta's RockBridge Commercial Bank, which opened in 2006, backed by other members of the city's business elite.

RockBridge told banking regulators it planned to specialize in business lending. It didn't, plunging instead into real estate and construction loans. The bank told regulators in 2006 that construction loans would account for 5% of its portfolio. By the end of 2007, they accounted for 42%. Business loans, which were supposed to make up 50% of RockBridge's lending, came to just 28%, according to an after-the-fact autopsy by Federal Deposit Insurance Corp.'s inspector general.

Nor did RockBridge recruit veteran loan officers with enough experience to safely assemble its risky portfolio, the inspector general concluded. "They hired younger, less-experienced ones, and didn't hire

enough of them," Ingram says. He says he was forced out in 2008 when he complained about the risky direction the bank was taking.

By the time RockBridge failed last December, more than 60% of its construction loans had gone sour.

Other banks on SNL Financial's list of failed construction-focused banks fared even worse: At Chicago's Ravenswood Bank, more than 69% of construction loans went bad before regulators pulled the plug Aug. 6. By the time Wheatland Bank in Naperville, Ill., failed in April, more than 80% of its construction loans had gone belly-up. Security Bank of Gwinnett County, Ga., failed a year ago with three-quarters of its construction loans underwater. Georgia saw more construction-focused bank failures (34) than any other state between the end of 2007 and August, according to SNL.

Brown of RMPi Consulting in Boston blames the banks themselves. He says many banks, trying to cut costs and boost profits, dropped training programs that would have taught loan officers how to assess risks on construction projects and other loans: "I could see it coming for five years," he says. "Banks got sloppy; banks got greedy; banks got lazy."

But Little says many construction loans were prudent when banks made them. Some banks demanded that developers make 50% down payments only to see the value of the projects drop 80%: "That's really killing the community banks."

He says regulators are unreasonably forcing banks to take losses on real estate loans and pushing them out of business when they would rebound if given enough time to work with borrowers and await a recovery in real estate. "They're bayoneting the wounded," he says.

Then again, a council of federal bank regulators issued a statement last October encouraging banks to work with commercial real estate borrowers struggling with empty office space and storefronts, evaporating rental income and collapsing property prices. "Prudent loan workouts are often in the best interest of both financial institutions and borrowers, particularly during difficult economic conditions," the council said, adding that regulators wouldn't force banks to write down otherwise good loans "solely because the value of the underlying collateral declined."

"The regulators have probably held back in places," lawyer Glazov says.

Troubled construction projects are a nightmare for banks. "If a bank forecloses on a house, it's a house. Everybody knows what to do with it," Bartmann says. "But if you're dealing with a half-constructed hotel or a half-constructed strip mall, not only does no one want it, you now have to maintain it" — trim the hedges, pay the property taxes, write checks to the power company. So, many bankers have chosen to wait it out, extending the terms of loans to troubled developers to keep from having to foreclose and take possession of a half-built headache. Which leaves bad loans and troubled property in limbo.

"The loans aren't coming to market," says Sam Chandan, president of Real Estate Econometrics in New York. "The distress is sitting on bank balance sheets."

Concludes **Wayne Heicklen, co-chair of the real estate practice at the New York law firm Pryor Cashman**: "They're hoping the existing borrowers or someone else will come along and put more money in the project and make it right."