4 Pillars of Underwriting

Thorough knowledge of what lenders scrutinize is the foundation of successful loan submissions

By Lloyd Kagin

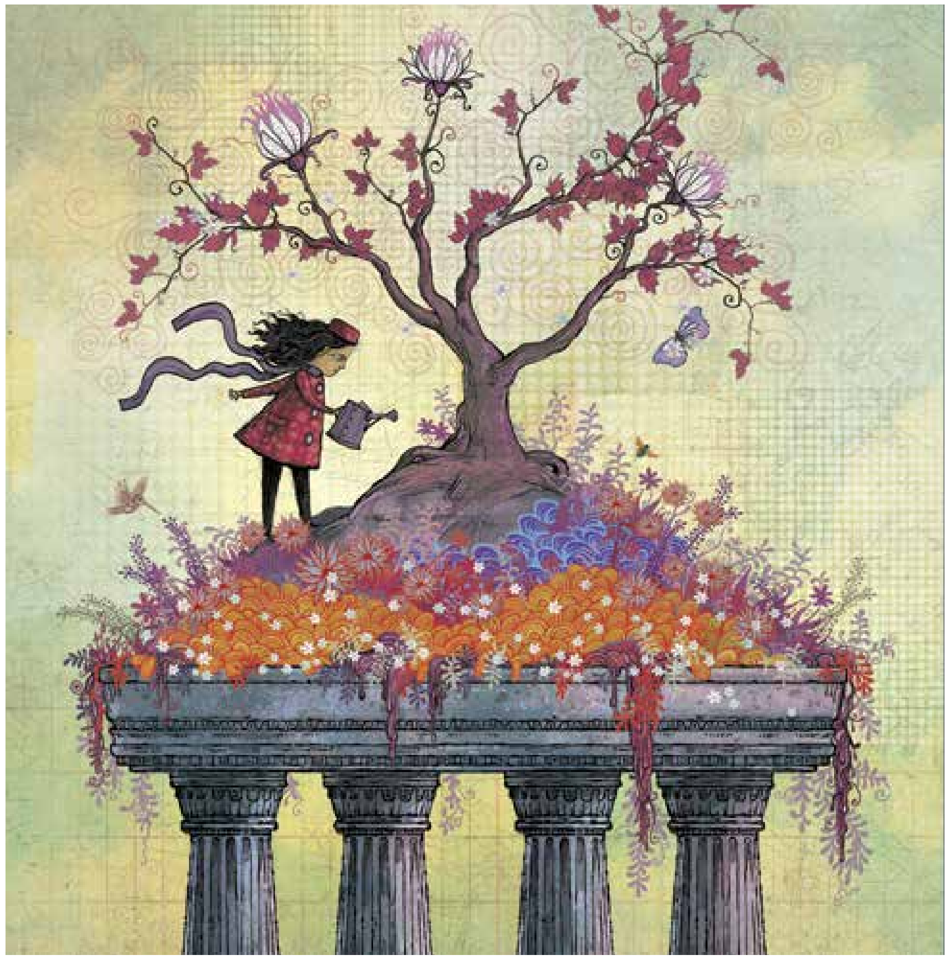

Illustration by Dennis Wunsch

In the past three years, lenders began to slightly ease their underwriting standards, which has created opportunities for institutional commercial real estate investors as well as the broader spectrum of commercial borrowers to fund their properties.

With the increase in funding activity and transaction volumes, it is vital for commercial mortgage brokers to understand the four fundamental metrics that lenders scrutinize in making credit decisions: loan to value; cash flow analysis; credit worthiness; and property analysis.

These four metrics make for the foundation upon which underwriting knowledge is built. Understanding them allows commercial mortgage brokers to make more effective loan submissions, paving the way for swifter decisions by lenders.

Commercial mortgage brokers' understanding of how lenders make funding decisions — and their ability to prepare and submit due diligence materials based upon this understanding — can help lenders make prompt funding decisions and loan commitments, which also makes for faster closings and creates a benefit to all parties involved in the transaction.

In particular, mortgage brokers should be aware of how the types of loans they seek are evaluated by these metrics. Although no two commercial mortgage loans are alike, understanding how an acquisition loan, refinancing loan or construction loan is evaluated gives mortgage brokers insight into what type of due diligence materials lenders seek during the underwriting process. After all, nothing makes a lender happier than a qualified borrower with a well-compiled due diligence file.

Acquisition and refinancing loans are evaluated in similar fashions by lenders with almost equal emphasis on loan to value, cash flow analysis, credit worthiness and property analysis. Construction loans are viewed differently — although all four pillars come into play, lenders tend to emphasize property analysis, loan to value and credit worthiness more than cash flow analysis.

No matter what the loan type, however, it is always helpful to know as much as possible about these four pillars of commercial underwriting.

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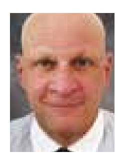

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1. Loan to value

The first underwriting metric considered by lenders is the relationship between the property loan amount and the market value of the property, referred to as the loan-to-value (LTV) ratio. Lenders determine this value by employing third-party experts. The property's market value is determined by a commercial appraisal, usually performed by a member of the Appraisal Institute (MAI) and written to the standards of the Federal Institutions Reform, Recovery and Enforcement Act (FIRREA).

MAI and FIRREA appraisals are the commercial real estate industry standard used for property valuation. Many lenders have internal guidelines for LTV in their underwriting practices. The higher the ratio, the more risk to the lender. Many LTV guidelines are proprietary to each underwriter and vary based on the type of property. Lower-risk properties, such as office or apartment buildings, have LTVs at the higher end of the spectrum. Higher-risk properties, such as construction loans and raw land, are at the lower end of the spectrum. Many lenders cap their loans at LTVs of 70 percent to 85 percent.

2. Cash flow analysis

Another important metric that lenders use in making underwriting decisions is the debt service coverage ratio (DSCR). The DSCR equals the annual net operating income of the property (gross income, usually rental income, minus the expenses necessary to operate the property) divided by annual debt service on the loan. A higher ratio means less risk to the lender.

Like LTVs, DSCR guidelines are typically proprietary to each underwriter and also vary based on the type of property. Many lenders seek DSCR ratios of 1.2 or higher, depending upon the property type.

3. Credit worthiness

Lenders go through several phases in reviewing a borrower's credit worthiness. In many commercial mortgage loans, the borrower is a single-purpose entity, a limited liability company (LLC) or a subchapter S corporation whose sole asset is the property to be mortgaged.

Whether the borrower is an LLC or an S corporation, the credit of the individual controlling the entity, usually referred to as the sponsor, is carefully vetted by the lender in the underwriting process. This vetting process usually includes detailed background checks and credit references. It also includes the submission of specific financial due diligence information such as income statements, balance sheets, cash flow statements and tax returns, all to ascertain the credit quality of the sponsor. As part of this credit-vetting process, lenders also require information for compliance with the requirements of the USA Patriot Act.

4. Property analysis

It's a common saying in real estate: location, location, location. If all other things are equal, lenders usually default to the location of the property to be mortgaged.

If you compare two properties sharing the same characteristics — similar LTVs, equivalent DSCRs and the same sponsor credit worthiness — lenders will usually favor those properties that are located in major metropolitan areas with known market access as opposed to other areas such as rural areas with less market access. Other aspects of the physical property also come into play in the underwriting process such as age, appearance and accessibility.

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Commercial mortgage brokers' understanding of these four pillars of underwriting and how they relate to the types of loans they're trying to fund is critical. In addition, to the ability to prepare and submit the due diligence information required by lenders efficiently can significantly speed up the underwriting process, resulting in better outcomes for everyone involved. ■