Real Estate Development Program

Examination Objectives

To determine the level of risk that the related organization's real estate development activities present to the parent thrift and to implement corrective actions as necessary.

Examination Procedures

Level I

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1. Perform the appropriate examination procedures in Handbook Section 730.

2. Review the previous report of examination and all real estate development-related exceptions noted and determine if management has taken appropriate corrective action.

3. Review the Matters Requiring Board Attention and Corrective Actions from the three or four previous ROEs to ensure that the board and management have taken appropriate corrective action where necessary and persistent problems have not recurred.

4. Determine the type(s) of development projects and/or services in which the related organization engages.

5. Determine the risk associated with speculative practices (i.e., acreage warehoused for future development or disregard for negative factors pertaining to initial market or site analyses).

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6. Identify any concentration of development funds and determine the materiality of the risk involved.

7. Confirm that the qualifications and expertise of individuals assigned the primary responsibilities for overseeing real estate operations have been thoroughly evaluated and verified.

LEVEL II

8. Verify that the related organization has established and adheres to minimum documentation standards regarding real estate activities.

Determine the extent to which the related organization's procedures and internal controls serve to identify and control risk. Specifically, review a selected sample of asset files to:

Preacquisition Activity

- Ascertain the role(s) assumed by the related organization (i.e., property manager, developer, GC, lender and/or leasing manager) and other primary project participants.
- Verify the results of management's risk versus return analysis. (Are underlying assumptions reasonable and based on adequate analyses?)
- Determine whether management is making fundamental decisions concerning market characteristics, development costs, project constraints (i.e., physical, environmental, zoning), financing alternatives, and project feasibility.

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- Verify that the service corporation has thoroughly evaluated its development partners' reputation, experience, expertise, and financial capabilities. (Do partners have the capacity to meet financial and other obligations? Can personal guarantees be enforced?)
- Determine the adequacy of management's project feasibility analysis. (Does the site meet suitability and desirability requirements? Was the site evaluated for environmental hazards? Are future after-tax cash flow and development cost estimates realistic? Are construction plans and designs reasonable, cost-effective and based on sound assumptions?)
- Ascertain whether an appraisal was prepared by a qualified appraiser and whether the information was evaluated and verified by management. (See Handbook Section 208, Real Estate Appraisals.)
- Verify that management has taken action to ensure that real estate activities comply with local, state, and federal regulations (i.e., planning, zoning, housing codes, and environmental restrictions).

Postacquisition Oversight and Control

- Determine the related organization's form of real estate ownership (i.e., active, passive, joint venturer, general partner, limited partner) and related risk factors.
- Identify the organization's obligations and those of other parties as set forth in contracts, agreements, or other legally binding arrangements. (For example, how are profits, losses or additional funding requirements to be divided among general partners? What are the equity contributions of each development partner?)
- Ascertain whether management is effective in ensuring compliance with the terms and conditions of financing arrangements.
- Determine the risk related to financing arrangements for development activities and any guarantees made by the parent thrift or the service corporation developer. (What is the potential liability regarding loans from the parent to the service corporation, joint venture or partnership?)
- Determine whether competitive bidding is used for awarding contracts and the adequacy of the service corporation's evaluation of contractors and consultants.

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- Verify that construction contracts and measures for enforcing compliance with related provisions are effective in minimizing risk associated with development activity (i.e., provisions for inspection of completed phases, project scheduling, grounds for termination).
- Verify that projects are sufficiently insured and bonded.
- Evaluate the adequacy of systems for monitoring development progress and disbursing funds. (Do fund disbursements conform to predetermined cost estimates?)
- Compare development plans, budgets and marketing strategies to practices and progress. (Trends or material variances that may violate contractual obligations and/or effect project viability or marketability should be explained.)
- Confirm that the value of the land and any improvements are at least equivalent to the total amount of funds disbursed.
- If material, assess the effect of any economic changes since the onset of development on the project's feasibility.
- Determine the amount of any contingent or other potential liabilities.

Postdevelopment Activity

- Determine whether projections pertaining to leasing or sales activity are reasonable and whether established goals have or will, in all likelihood, be attained.
- Verify that marketing plans are based on a sufficiently current market analysis.
- Determine whether income and expense projections are reasonable (i.e., brokers' fees, leasing arrangements).
- Ensure that gains and losses on property sold are properly recognized in accordance with GAAP.

9. Evaluate financing arrangements, sales/purchases of real estate or other transactions with affiliates or insiders to determine their effect on the service corporation or its parent thrift.

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10. Verify that the organization's real estate activity and related transactions are properly accounted for under OTS capital reporting requirements. (See Handbook Section 730 for a discussion of OTS and GAAP reporting requirements pertaining to a thrift investment in a related organization(s).

EXAMINER'S SUMMARY, RECOMMENDATIONS, AND COMMENTS

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