



REQUIRED READING: Prevent Construction Lending Mishaps Through Careful Review

Penny Roach, Friday 11 April 2008 - 08:12:41

Recently, the dramatic market changes have prompted many lenders to start evaluating their construction lending programs. Before this change, for the past several years, some construction lenders were not focused on risk management - but, rather, market share.

By their very nature, construction loans are highly profitable, but also quite risky, as a lender is essentially lending funds on collateral that does not yet exist. Thus, when the market began to cycle, lenders started to take a closer look at not only their profitability but also the inherent risks involved with operating such a program.

Ultimately, upon evaluation, some lenders determined that construction lending was not for them. But a lender does not necessarily have to get out of the business just because of potential pitfalls. Any lender can operate a successful and profitable construction lending program if it develops and follows some simple and prudent risk management procedures.

This goal may be accomplished internally, as some lenders can attest, or a lender may outsource the process to a qualified risk mitigation firm. Either way, the overall objective of any lender is to identify all of the risks associated with a project up front and to outline a process to mitigate those risks throughout the life of the project.

Most successful construction lenders, therefore, have both a pre-loan and post-loan mitigation process in place. Whether in-house or through a vendor, lenders can typically mitigate an average of 50% to 60% of their risk just by reviewing the contractor's credibility and creditworthiness - in addition to a budget's feasibility and comprehensiveness - prior to closing the loan.

One of the most important elements is to comprehensively evaluate the qualifications of the contractor to determine if he or she is qualified to build a project.

It is critical to ascertain the contractor's experience, character and creditworthiness: Does the contractor have the previous experience to oversee the scope of the project? What projects have they worked on before? Were they successful? What about licenses and insurance? Or audited financial statements?

As a general rule, all of the money will be funneled through the contractor's bank account and ultimately controlled by that contractor. Is he or she legitimate and in good standing with subcontractors and suppliers? Is the contractor qualified to deliver the project on schedule, within budget and free of mechanics' liens?

An effective construction lending program or risk mitigation firm will review all of these elements to make a recommendation on whether or not they feel that the contractor is qualified to spearhead the project.

Close examination

Another crucial pre-loan process is an initial project review or budget feasibility study. This component is in place to assist the lender in determining if the project is achievable from an overall cost perspective. In order to properly evaluate the project and effectively approve it for production, the lender must have a detailed understanding of the project scope and associated costs.

It is up to the lender and/or the risk mitigation firm to complete a comprehensive review of the construction contract, construction budget, plans and specs, and environmental and soils reports. This examination process, in turn, identifies any risks to the lenders and determines if there are any missing key elements in the construction process.

The examination process is most essential, as the lender must evaluate the project from both a cost and key element of construction perspective.

Some questions a lender must pose can be very basic: Does the budget total correctly, and does the budget match the contract amount? Or does the disbursement schedule follow the project's construction progress?

Other areas to review demand a more meticulous approach: Does the contract clearly define the scope of the work? Have both parties signed the contract? Or are there unusual components that could significantly impact cost?

Regardless of how these areas of examination are handled, the initial project review phase is a complicated process that needs particular attention and evaluation by a qualified individual or company that has extensive experience in cost estimating and is familiar with the potential perils of construction. By not properly reviewing the project from a cost perspective, the lender runs the risk of being left with an incomplete project and no available funds.

After a comprehensive contractor evaluation and project review have been performed, a lender can close the loan with the knowledge that it has a qualified builder in place and a complete and feasible budget from which to disburse funds.

The next phase of a successful construction lender's process is handled during the funding and disbursement portion of the construction project. While it may seem that once the contractor has been reviewed and the project determined feasible, all that is left is to disburse the funds, other steps remain to be done.

The funding module

As any profitable construction lending program can demonstrate, funds should only be released when work-in-place can be confirmed. This safeguard ensures that each phase of construction is completed

before any monies are released and that the project is never, for example, 75% disbursed and only 50% complete.

In addition, an effective funding module will guarantee a project is also progressing in a timely manner, that all the bills are being paid and that the project is being managed to the approved budget. Maintaining such critical components as management reporting and draw-status reports will also assist a successful lender in navigating the vast number of change orders, scope adjustments and schedule hiccups - all of which are inevitable occurrences in construction projects.

Another project component that is frequently overlooked is proper draw documentation, such as on-site construction inspections and the collection of invoices and statutorily compliant lien releases.

Many lenders will outsource their inspection businesses and combine with their internal funds disbursement teams. A qualified inspection vendor will provide a comprehensive site review in addition to making use of digital photographs and a Web-based reporting system.

This part of the process, while seemingly small, is an effective way to reduce the chances of disputes that may occur during the funding process. It additionally provides validation that the work is complete, in place and on the correct property.

The statutory compliance component of draw documentation is also often not considered a priority, especially when a lender is working within its home state or with a familiar contractor.

But what if a project is outside of a lender's local footprint? Statutory mandates may occur prior to loan closing, during or after completion of the construction. Crucial to any construction lender, these mandates mean it is imperative to collect the proper documentation required in each and every state of operation to avoid potential lender liability issues. After all, the borrower will always look to the deepest pocket - typically the lender - when a problem arises.

At each step of a project, lenders looking to tighten up their risk management procedures and stay in the construction business can take stock in knowing that there are numerous ways to make their construction lending program sound without sacrificing profitability.

Whether internalized or outsourced, a prudent risk management process will provide a safety net during this unpredictable market and turn those potential pitfalls into profits.

Penny Roach is executive vice president of business development at Granite Loan Management (GLM), Granite Construction Inspections and Granite Commercial Management. GLM provides construction loan management and construction risk mitigation services on a national basis for financial institutions. Roach can be contacted at (888) 456-4888 or penny.roach@graniteloan.com.

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