Coping with Construction Realities

As construction lending tightens, brokers must realize what lenders need to see

By Penny Roach,
executive vice president of business development, The Granite Companies

Illustration: Keith Negley

As the dust starts to settle on the crash of the residential construction industry, the construction side of the market has felt the impact in a number of ways. The crash has affected construction lenders' images, their future and the opportunities for commercial brokers to find funding for construction loans.

But prudent construction lenders are surviving — and even thriving. How?

To best answer that and to determine how they can work for you, it's wise to examine construction lenders' responses to the fallout, their mitigation tactics and the components that have contributed to their survival.

According to a Sept. 30, 2007, survey by the National Association of Residential Construction Lenders (NARCL), residential construction lenders reported a decline in volume and an increase in delinquency and write-offs within their portfolios for the first time in more than a decade. This past September, *The Denver Post* also reported that 37 lenders no longer have construction-lending programs out of the approximately 70 in place between 1991 and 2006. This represents a loss of nearly $30 billion in financing, according to the article.

Many external factors have brought the construction industry to its knees in the past year. According to the aforementioned NARCL lender survey, the top external threats for construction lenders are:

- **Perceived and actual risks to construction lending;**
- **Decline in home values and appraisals;**
- **Higher risk and default among builders;** and
- **Secondary-market reductions and changes.**

What looms in the outside marketplace is nothing compared to what has happened internally with many lenders. Two of the most-prevalent internal impacts have been the downsizing of parent corporations and long-standing risk-management issues, according to the NARCL survey. In addition to product-tightening, the management of defaulted loans and long-term funding capabilities also has weighed heavily on lenders.

The combination of these external and internal factors has affected most divisions within these construction lenders. Many are scrambling to get on board with risk-mitigation firms or underwriting departments.

But lenders that are seeing growth in their programs and that have continued to be profitable can attribute much of their success to

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risk-mitigation components put in place through outsourcing or conservative, strategic management. These are the lenders that commercial brokers often would be wise to check out when posed with a construction-loan scenario.

MITIGATION TACTICS

Lenders have several options for mitigation policies that can secure them and their brokers against a market crash or simply against a project that has gone south.

Many successful construction lenders implement a pre- and post-loan-mitigation process to cover each aspect of the construction project. This process includes reviews of the contractor and the project itself. With these in place, most lenders mitigate their risk by reviewing a contractor's credibility and the borrower's creditworthiness, in addition to a project's feasibility, before the loan closes.

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When first evaluating a construction project, lenders consider a contractor's qualifications extremely important. If the contractor is not qualified to manage the project, it likely won't matter how effectively the lender manages the funding. The contractor also has the largest influence over the success of the project and the funds disbursed.

According to the NARCL survey, the top reasons for a builder-related loan default are a lack of working capital, inexperience, high number of starts without a customer, a cut-back credit line or a high cancellation rate.

Your construction lender will examine these elements in your loan scenario. As a broker, you should ensure they're as solid as they can be.

In addition, lenders often will order an initial-cost review or budget analysis to ward against project default. Reviewing the project's scope and associated costs will help lenders decide if they should take on a particular loan. Ensuring that all the elements of a construction project are in place is important, as is a cost-per-square-foot analysis to help lenders avoid underbid line items.

Other questions that construction lenders might ask include:

- **Does the budget add up correctly?** Is it front-loaded?
- **Does the budget match the contract?** and
- **Does the disbursement schedule follow the project's progress?**

Lenders also will review the contract to avoid any unforeseen issues. Their questions:

- **Is the contract between the contractor and the owner?**
- **Does the contract define the scope of work?**
- **Are provisions listed outside the lender's policy?**
- **Is the contract fully executed?**
- **Are there unusual payment terms?**

As a broker, not reviewing these terms can lead to turmoil once construction has started and changes begin.

Although few construction lenders implement an entire contractor-review and project-review process, choosing to bank on their funds-disbursement system instead, these steps will highlight the most important question to the lender — is it lending enough to complete the asset?

MANAGING THE PROJECT

Once lenders know they have a qualified contractor and an accurate budget in place for funds disbursement, they draft appropriate guidelines to manage disbursement through the life of the project. Some lenders adhere to a "work in place" philosophy, in which they ensure each phase of a project is complete before releasing funds. In this type of arrangement, funds are not fully disbursed until each phase of the project is complete. This is an important point for your clients to keep in mind.

Operational issues also can trip up lenders at this point, especially if they are short-staffed or process loans using outdated technology. The current market has seen challenges related to training, maintaining and acquiring construction-lending personnel. A number of lenders outsource tasks to risk-mitigation firms.

Technology also has been a stumbling block for many lenders that cannot sustain their workload with a reduced staff. Those who have updated their processing technology often have additional comfort with credit risks in their portfolio. They also often have streamlined their systems and shortened their turnaround times, which can allow them to take on additional business.

HOW LENDERS SURVIVE

With tightening credit policies and a decrease in marketing budgets, the industry also has seen a reduction in sales channels. Thus, the number of companies offering construction-loan programs also has dwindled. Successful lenders that are still operating a construction-loan program realize the need to target growth opportunities as well as the management to handle those opportunities.

Surviving construction lenders are evaluating the market to manage their programs and growth. At the same time, they are looking to reduce risk and mitigate those risks that do come up. They also recognize the need for construction-loan products, even as the market contracts.

Clearly, these components will continue to change with the mood of the industry. But lenders that have integrated a comprehensive risk-mitigation system often will be those that are around to witness the changes. For brokers seeking funding for construction scenarios that cross their desks, these could be the ones to keep in mind.

Penny Roach is executive vice president of business development for The Granite Companies — Granite Loan Management, Granite Construction Inspections and Granite Commercial Management. Roach has more than 15 years' mortgage-banking experience with firms such as Chase Manhattan Mortgage Corp. and First Republic Bank. She has held positions from operations and underwriting to sales and origination. GLM provides construction-loan-management and construction-risk-mitigation services for financial institutions nationwide. Reach Roach at (888) 456-4888 or penny.roach@graniteloan.com. Visit www.graniteloan.com.