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BUILDING A PLATFORM FOR CONSTRUCTION RISK

A room full of industry veterans usually means some pretty good war stories, and this was true at the CLRM Roundtable. Participants focused on the risks involved in construction and the issues surrounding underwriting and loan administration.

BY BRIAN WARD

Construction is risky. There are a million things that can go wrong during any construction project. So it's no surprise that lending on construction projects carries risk as well.

Underwriters and administrators of construction loans have the challenging job of attempting to anticipate the innumerable potential problems. They must also balance risks with the rewards of a successful loan and monitor for red flags throughout the life of the loan.

The physical and engineering risks from a construction project can be overwhelming. They can include inadequate engineering plans, change orders to correct errors not identified early on, use of construction materials different from those originally specified, inexperienced contractors making costly errors, and so on.

CLRM Roundtable

Over 60 risk management professionals recently met for the Construction Lender Risk Management (CLRM) Roundtable, focusing on the physical and engineering risks, as well as underwriting and loan administration issues. The event included panel discussions, open forums, and networking in a private setting. The goal was to create an environment for lenders to share their perspectives and challenges and to learn from one another.

"These kinds of events can spur valuable discussions about guidelines and best practices. We're all experiencing similar issues, so when someone in the room shares a good idea on how to resolve them, we all benefit," said George Katsekes, senior architect at Northwestern Mutual Real Estate.

With construction making a comeback and a regulatory and credit climate much changed since the recession, the conversation was a timely one. "It's important, as we emerge from the collapse and begin building again, for people to learn from best practices of their peers and competitors," said Patrick Crandall, senior credit executive of Sabal Financial Group. "It will ultimately make for a stronger and healthier recovery."

The event included representatives from banks and other lending institutions of all sizes, as well as law firms, architects, engi-

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>
> **–PATRICK CRANDALL, SABAL FINANCIAL GROUP**

neers, and key industry stakeholders. The lenders were almost evenly split between those with backgrounds in finance and banking and those who came from engineering, architecture, construction, and contracting backgrounds.

Sharing the Dirt

With a room full of industry veterans, you can usually count on some pretty good war stories, and this was exactly the intent of the CLRM Roundtable. Lenders were candid about construction debacles, such as buildings being constructed outside of property lines or on unstable foundations, both expensive situations to remediate. Several attendees noted the importance of understanding “ground and down” factors, citing situations where a project was derailed by an inadequate geotechnical study or unidentified soil contamination.

Others discussed common problems found when reviewing engineering plans and documents, such as building system plans that don’t match up. For example, it is not uncommon to have slab openings in structural plans that don’t line up with vertical HVAC ducts, or doors that don’t match the sizes of the openings in the architectural/structural plans. This is why it is so important to have an experienced set of eyes go over these plans before any work starts.

“In my experience, the most common mistakes are an inadequate analysis of the proposed budget and insufficient time allotted for construction and lease-up or sell-out,” Crandall reflected. “There is constant pressure from developers to skinny down costs and contingencies, and underwriters must maintain discipline in adhering to their underwriting guidelines or have verifiable and compelling reasons to deviate. Similarly, there are inevitably going to be delays, so it is important to build some cushion into the schedule so there isn’t a shortage of interest reserve.”

Katsekes advised that “local familiarity is important, both for the lender and the team. You can get into trouble when you or your team isn’t familiar with the area, market demand, climate, etc. Contractors not knowing the local crews can also be a stressor.”

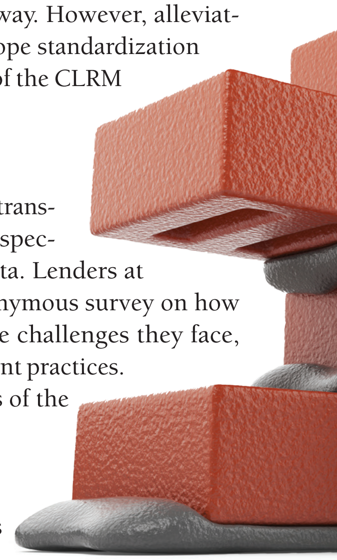
Creating Consistency Out of Chaos

There are many well-established practices to manage construction lending risk. (For an article on proactive alternatives to P&P bonds for managing construction risks, see “Construction Lending Risk That Knows No Bonds” in the June *RMA Journal.)*

However, risk management practices are very inconsistent across the industry, as are the expectations for the scopes of work and reporting. “One of the challenges with third-party relationships is ensuring consistent levels of service across multiple vendors,” noted Crandall. This was particularly evident in the wide variation in how document and cost reviews are done. The scope of work and information reported are different from engineer to engineer and lender to lender. Differing expectations for what should get done present challenges when syndicating a loan.

“Some institutions have a very high tolerance for risk and do very little or inexpensive due diligence. My company is the opposite. We have much lower tolerance and do a high level of due diligence,” said Katsekes.

Institutions will always have different approaches, so this disparity is unlikely to go away. However, alleviating the inconsistency through scope standardization may become one of the missions of the CLRM Roundtable initiative.



Risk Management Survey

The goal at the event was to create transparency, not only by sharing perspectives but also by sharing hard data. Lenders at the discussion completed an anonymous survey on how they handle policy and costs, the challenges they face, and the drivers for risk management practices. What follows are some highlights of the survey results.

Drivers for Risk Management
Greater regulatory scrutiny was

one factor noted as contributing to tightened risk management practices since the recession. "A large number of regional and community banks were pushed into construction during the bubble years when the entire system was awash in liquidity," said Crandall. "Many were not prepared to manage construction risk and suffered during the downturn as a result, so the increased regulatory attention is a logical response," he said.

The community was eager to avoid even further regulatory scrutiny by raising the bar for best practices across the board, regardless of which regulators oversee a particular institution. As Crandall explained, "Sabal is a nonbank lender, so we are not subject to direct regulation in our lending businesses. However, we do work with regulated banks so we are always mindful of the regulatory landscape. We are also an approved servicer by the FDIC and have serviced assets for an OCC-regulated bank, so we are constantly in compliance with their requirements."

However, regulatory concerns were not the biggest driving factor. Ranked higher was avoiding loss, cited by 67% of the survey-takers as the main driver of their risk management objectives. "Cutting corners will come back to haunt you," warned Katsekes.

Policy

Most lenders indicated they update construction risk management policy regularly (95% have updated in the last five years). The key drivers of policy changes were noted as "proactive policy management" (71%) followed by "response to credit losses during the crisis" and "response to expansion of the institution's business plan" (both 38%).

Crandall advised lenders to "develop thoughtful and rigorous guidelines with appropriate flexibility to adapt to the inevitable changes that occur through a construction cycle, and then adhere to those guidelines."

Risk Management Challenges

Three top risk-management challenges were noted:

- Meeting fast turnaround time pressures internally.
- Balancing risk management with pressure to stay competitive.
- Doing more with smaller risk management staff.

Contributors to Loan Failure

Lenders who had experienced a construction loan failure in the past few years cited these contributing factors above all others:

- The construction project went significantly over budget.
- The project suffered from delays.
- Demand for the product collapsed.

In-house versus Outsourced Functions

Lenders indicated that they use a mix of internal and external groups for functions such as document and cost reviews, the monthly draw inspections (also called construction progress monitoring), and funds control. Crandall noted that "institutions cannot feasibly employ all of the expertise necessary to properly manage all aspects of construction risk. Well-vetted third parties are a critical component of managing construction risk."

"Our philosophy is to keep a constant light pressure on the deal," Katsekes advised. "Make sure that all the team members are fully engaged and get the key people out to the site, not just from your own company, but other parties as well. If you don't visit the site, bad things can happen. Have a good pool of consultants you can rely on and tap into their expertise. It's money well spent."

Looking Forward

Working groups to tackle specific issues are already in the making, and attendees were eager to continue the dialogue throughout the year. It is hoped that the event will become a forum for educating other lenders and helping to improve risk management practices across the industry.

"We are still in an evolving regulatory environment and early in the development cycle, so it will be important to reconnect, stay abreast of changing regulations, and learn from each other's war stories as we work through construction projects," Crandall concluded. ❖

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