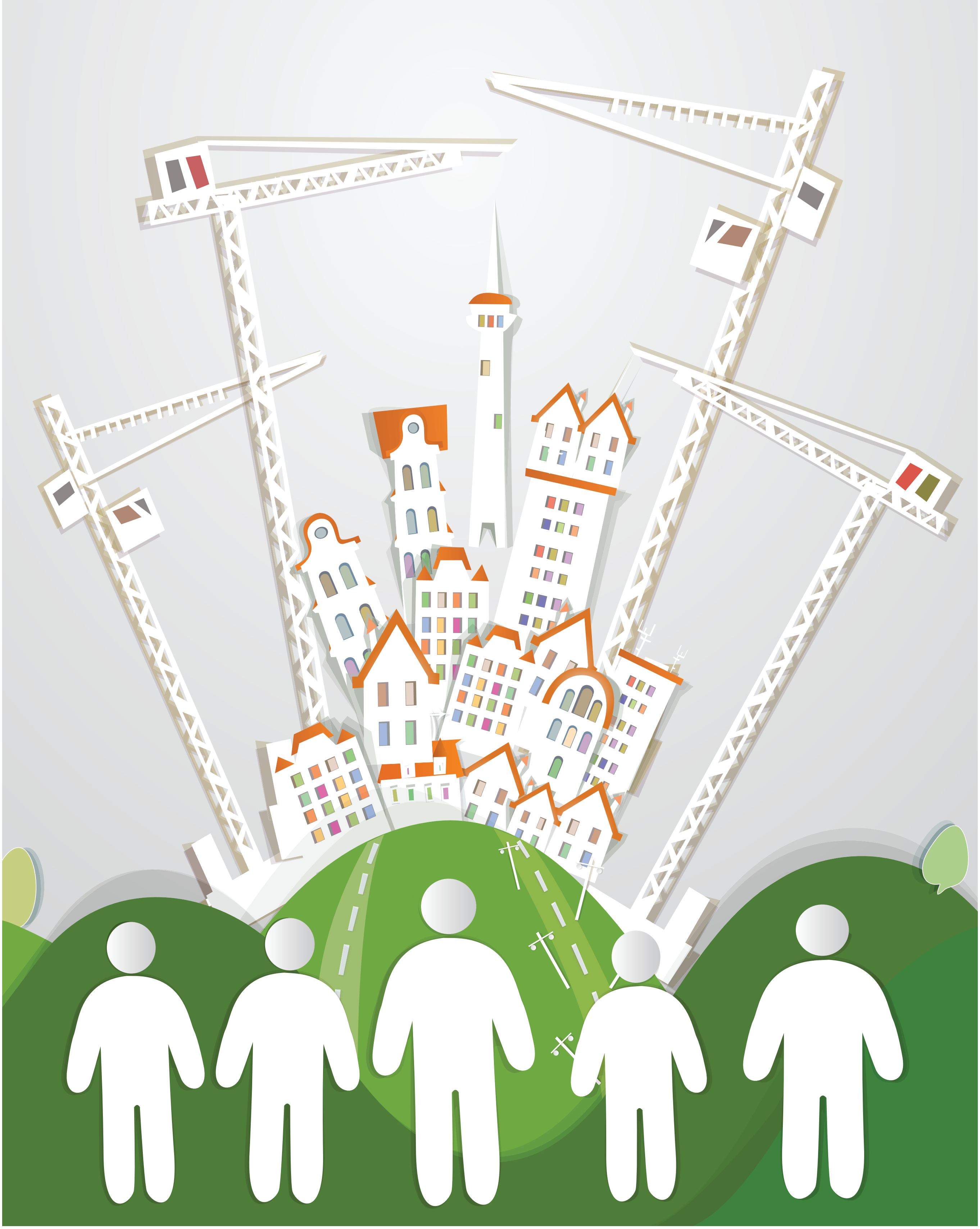

CONSTRUCTION LENDING RISK MANAGEMENT

BUILD IT RIGHT SO THEY WILL COME

This article draws on a presentation made at RMA's Risk Management Conference in Washington, D.C., last November and an RMA webinar presented in February 2015.

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The legendary golfer Arnold Palmer once said that the road to success is always under construction—so, in order to stay on course, the successful road builder must manage the construction risk.

Construction is a risky business, and any bank extending credit to finance construction encounters both credit and operational risk. First, the borrower's ability to repay directly or indirectly depends on the successful completion of the project. Second, successful completion depends on competent execution of the construction.

Now a third risk has recently been added to the risk management portfolio. Banks now must maintain capital at 150% of their construction loan exposure. This gives banks a very strong incentive to ensure that the construction activity they finance starts and ends on time and that it comes in on budget.

The purpose of this article is to explain the factors critical to establishing and maintaining a successful real estate construction administration (RECAD) function. Simply put, RECAD is essential to mitigating construction risk and making that field of dreams a reality. Build it right so they will come.

Bank Appetite for Real Estate Lending

Every bank has to decide if and how much it wants to engage in real estate lending. Will the bank's appetite be satisfied with just owner-occupied (O-O) real estate, or does it also want to pursue real estate developer-investor (REDI) opportunities?

While both types of lending are secured by real estate, O-O loans are assumed to be paid back from the borrower's operations, and the real estate collateral is assumed to be necessary to the borrower's operations. In contrast, REDI loans are paid back from the planned sale or rental of the property.

In either case, the income to repay construction loans requires the property to be built on time, on budget, and in line with the plans and specifications. The O-O borrower probably wants to move in and initiate operations to generate cash flow from its business activities. The REDI borrower wants to sell or lease the property to generate cash. Once again, the key to both is making sure the construction funds are used quickly and correctly to complete the project.

The broader and deeper the bank's commitment to construction lending as part of its real estate strategy, the more necessary it is that construction lending management be in the hands of full-time, experienced professionals, either as a separate department or as a function centralized as much as possible within a smaller bank.

Common Reasons for Failed Construction Projects

One way to get a sense of a bank's goal with a RECAD unit is to look at some common causes of construction project failure:

- Inadequate budget.
- Contract based on incomplete design.
- Discretionary changes.
- Inadequate management of project revisions.
- Unforeseen conditions.
- Inexperienced project team members.
- Inadequate project oversight and coordination.
- Unrealistic schedules.
- Resource shortages.
- Completion delays.
- Misdirection of funds and resources.

What becomes clear after just a cursory review of this list is the need for the bank to simultaneously practice preventive maintenance while managing the funding of ongoing construction. Managing the construction lending process occurs before, during, and after the construction is completed.

GIVEN THE TASKS AND RESPONSIBILITIES EXPECTED OF RECAD, THE UNIT SHOULD BE AS INDEPENDENT OF THE REAL ESTATE LENDING FUNCTION AS POSSIBLE.

RECAD Responsibilities

RECAD is generally tasked to manage and monitor the progress and funding of construction projects financed by the bank. Its role typically includes pre-closing, post-closing, construction administration, and post-construction.

Pre-closing activities include the following:

- Obtaining copies of construction contracts, building permits, and plans and specifications.
- Obtaining a review of construction plans and budgets by a qualified professional.
- Engaging a third-party inspector to provide a limited scope plan and cost review/inspections.
- Verifying that the property is suitable for the proposed improvements.
- Evaluating the adequacy of the construction schedule.
- Verifying leasing and pre-sale information.
- Confirming receipt of an acceptable appraisal.
- Verifying the loan-to-value.
- Confirming receipt of acceptable environmental due diligence.
- Confirming property taxes are paid and current.
- Reviewing the borrower's budget—particularly sources and uses of proceeds to verify that sufficient funds are available to complete the construction.
- Determining project feasibility.
- Receiving and reviewing the boundary survey.
- Reviewing title policy binder/abstract to remove exceptions and documenting clear reasons for exceptions that cannot be cleared.
- Reviewing flood insurance due diligence.
- Participating in a pre-construction meeting with the borrower, contractor, and inspector to lay out funding draw requirements and logistics.
- Reviewing the builder's risk insurance.

Post-closing tasks include the following:

- Reviewing the title policy to determine if title updates/endorsements are required.
- Reviewing the construction loan agreement's funding draw requirements.
- Confirming that the loan package is complete.
- Confirming that the contractor is appropriately licensed and bonded if required.
- Arranging progress monitoring by a qualified professional.

Construction administration and monitoring of ongoing construction includes these activities:

- Receiving draws from the borrower.
- Reviewing any change orders.
- Coordinating periodic progress monitoring independent of the borrower to verify completion in accordance with approved loan documents, evaluate disbursement requests and schedule, and evaluate the adequacy of remaining funds.
- Escalating any issues, as appropriate.
- Coordinating title updates, if required.
- Checking the budget for sufficiency of proceeds.
- Verifying required equity injections.
- Performing necessary flood due diligence before funding vertical construction if improvements are being constructed in a special flood hazard area.
- Receiving and reviewing updated liability insurance certificates.
- Verifying conformance with requirements of the construction loan agreement.
- Reviewing periodic title date-downs and lien status.
- Ensuring sales proceeds are applied to principal in a manner consistent with the loan agreement.
- Assuring the appropriate use of contingency funds.

Post-construction tasks include the following:

- Coordinating conversion of insurance from builder's risk to hazard insurance.
- Receiving and reviewing the certificate of occupancy.
- Receiving and reviewing estoppels from tenant.
- Receiving and reviewing contractor's final lien waiver.
- Coordinating the final title update, if required.
- Coordinating the accounting change from construction to permanent loan on the bank's books.

RECAD Independence

Given the tasks and responsibilities expected of RECAD, the unit should be as independent of the real estate lending function as possible. Within larger lending operations, the disbursement of funds calls for appropriate checks and balances, so a RECAD unit reporting to the commercial real estate lending manager is not usually enough separation to ensure the independent judgment required.

Reporting into the chief credit officer is one option; another option is to have the unit report to the bank's chief financial officer. Some banks combine the real estate appraisal function and RECAD into one independent unit reporting to the loan review manager. The key point is that, in order to do its job, the RECAD unit must be free from lender pressure to fund construction that is not in line with the budget or not up to the inspector's standards.

Staffing

RECAD staff should be experienced in and knowledgeable about real estate construction. If the bank specializes in certain types of real estate, such as medical office buildings or refrigerated warehousing, staffers with some background in the specialty certainly add value. What RECAD must have, however, is the respect of the bank's lenders, borrowers, and contractors.

A way of improving "real world" knowledge within RECAD is to have its staff take field trips to job sites for different types of properties and for projects in various stages of completion. RECAD staff can ask questions and see examples of items that might otherwise be confusing words on a draw request.

Costs and Pricing

RECAD is a necessary but expensive function to implement and maintain, so the bank must also decide at what level it will require RECAD's involvement in construction lending. A key question is whether the bank can afford not to employ RECAD. In other words, can the bank absorb the cost of a failed construction loan and the likely loss associated with liquidating an uncompleted project?

Most banks try to apply RECAD to larger loan exposures with "real" construction activity rather than to small loans deemed to be repair, maintenance, or cosmetic renovation.

Depending on the extent of construction lending, the borrower and real estate profile, and the bank's risk appetite, it may not be necessary to involve a RECAD unit in every construction loan. Though the basic elements of control should always be observed, construction loans for repair, maintenance, or cosmetic renovation may not warrant professional oversight. Moreover, the benefits may be limited for construction loan exposures under a predetermined threshold—say, $100,000.

In addition, an abbreviated RECAD process—call it "RECAD lite"—may be appropriate for exposures marginally above the threshold, ranging from $100,000 to $500,000. Likewise, more rigorous controls may be appropriate for high-dollar or high-risk loans.

Setting the boundaries and identifying appropriate levels of oversight should be a joint developmental activity that includes all lines of business engaged in construction as well as their credit partners. A policy requiring the RECAD manager and the final credit approver to agree on the application of RECAD to construction loan requests outside of the boundaries helps maintain a level playing field.

Finally, because most construction lending is now classified as "high-volatility commercial real estate"[1] and risk-weighted at 150% (versus only 100% for other commercial loans), construction loan pricing needs to cover credit, operational, and capital risks.

Conclusion

The Irish playwright Oscar Wilde once observed that "experience is simply the name we give our mistakes," but even an experienced construction lender can make errors. A RECAD function should help that same construction lender avoid mistakes and ensure on-time, on-budget, and on-plan completion of the project.

After all, if a bank has the risk appetite to engage in commercial real estate lending, it must also decide how much of a taste it has for construction lending. In turn, given the higher credit, operational, and capital risks associated with it, the construction lending process should be managed by a RECAD unit independent enough to oversee the funding and successful completion of construction projects. Ⓡ

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Note

1. See https://www.federalregister.gov/articles/2013/10/11/2013-21653/regulatory-capital-rules-regulatory-capital-implementation-of-basel-iii-capital-adequacy-transition.

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RMA offers two specialty courses for readers interested in enhancing their understanding of construction loan management: Construction Loan Management: Administering the Construction Loan Process *and* Analyzing Construction Contractors. *Look for details on RMA's website,* www.rmahq.org.