CONSTRUCTION LOAN MONITORING WHITE PAPER

INTRODUCTION

Construction lending can be a high-risk investment. From contracts that fail to protect the owner's interests, to poor quality work that diminishes the value of the collateral, the risks are varied and substantial.

Competent Construction Loan Monitoring can help protect banks, lenders, and financial institutions from these risks. This paper contains everything you need to know to determine what Construction Loan Monitoring services your institution should invest in, as well as how to get the most out of them.

WHAT IS CONSTRUCTION LOAN MONITORING?

Construction Loan Monitoring is a group of services that help protect banks, lenders, and financial institutions from the risks inherent in construction lending, including:

1. Incomplete or poorly detailed contract language that leads to bad time and cost estimates, excessive rework, and/or subpar quality outcomes
2. Problems that arise during the construction process that lead to cost and time overages and/or quality issues
3. Overfunding for incomplete work, or funding that is issued too early or too slowly
4. Funding for trades that are not paid by the General Contractor, resulting in liens against the collateral
5. Inadequate bonding and insurance by the contractor

All five categories of risk can be mitigated with Construction Loan Monitoring, which usually includes three core services:

- Plan and Cost Reviews (PCRs)
- Construction Loan Inspections (CLIs)
- Construction Funds Control

WHAT IS A PLAN AND COST REVIEW?

Plan and Cost Reviews (PCRs) are a critical component of Construction Loan Monitoring, and should occur before the loan is underwritten. PCRs help lenders evaluate and mitigate risks related to contract documents, before construction begins.

During a PCR, the Construction Loan Monitoring company will review every line of the construction contract and all of the construction documents to ensure that everything is coordinated, in line with the requested construction amount, and will meet the lender's expectations. The review should include line-by-line evaluation of:

- Construction plans to ensure they are complete, detailed, and constructible
- Cost breakdowns of the construction budget, to ensure costs are in line with current market pricing for both labor and materials
- Contract protections to ensure they adequately protect not only the owner but also the lending institution

The PCR should pay attention especially to the 3 C's of Construction: Cost, Constructability, and Contingencies.

THE 3 C'S OF CONSTRUCTION

COST REVIEW

Evaluate requested fund amounts to ensure that they are appropriate for the job and proportioned correctly, to avoid front-loading and cost padding.

CONSTRUCTABILITY

Review construction plans to ensure that they are adequately detailed, account for real-world conditions, and are unlikely to generate unnecessary change orders and rework.

CONTINGENCIES

Review allowances for contingencies to ensure they're in line with industry standards and appropriate for the specific conditions of the individual project.

Cost Review

An average commercial construction contract will contain between 50 and 250 line items. Funding for each line item is tied to current market costs and the construction process timeline. The PCR team must maintain deep and current knowledge of the construction industry in order to evaluate these costs effectively. The review should include:

- **Line Items.** These include windows, drywall, concrete, grading, utilities, and much more. They should each be evaluated to ensure the costs are appropriate and properly timed, to avoid front-loading and padding from the contractor or developer.
- **Draw Schedule.** Some contractors may attempt to front-load costs to improve their cash flow, which increases risk for the lender. The PCR will evaluate the order in which each construction process must occur, and when each trade should be scheduled on the critical path, to ensure the real-time draw schedule provides adequate funds at the right time, without exposing the lender to unnecessary risks.

Constructability

Poorly designed or inadequately detailed construction plans will cause excessive change orders and rework, both of which increase cost and erode the value of the loan. A constructability review by experienced construction professionals helps ensure that construction plans are adequately detailed, account for real-world conditions, and are unlikely to create conditions that lead to excessive change orders and rework. When gaps or problems are discovered, plans can be amended to protect the project before construction begins.

Contingencies

Even the best-laid plans for construction and renovation will experience contingencies. For this reason, all construction contracts should include appropriate allowances based on industry standards and the specific conditions of the individual project.

BONDING, INSURANCE, AND TIME TO PAY?

In addition to the 3 C's of construction, every PCR should evaluate whether the contract requires appropriate levels of bonding and insurance from the General Contractor, whether there are liquidated damages clauses, what the payment terms are, and whether there are clauses (such as off-site storage) that don't agree with bank policies.

Contractor's Insurance

Proper insurance and bonding can represent between ½ and 3% of a total construction loan. In order to make their proposal more attractive, some contractors try to shave their costs with insufficient insurance and bonding. The PCR will review the contract to ensure it requires insurance and bonding in line with the needs of the project.

It's also possible that the Construction Loan Monitoring company may offer a bonding alternative called Construction Funds Disbursement, which provides similar protections but usually at a lower cost.

Liquidated Damages

Construction projects that fall behind schedule represent a significant unnecessary cost to the owner and the bank, due to loss of use and interest return on the loan. Sometimes, contractors may try to spread limited sub-trade resources over too many projects simultaneously, which can make it impossible to meet reasonable timelines. The PCR should ensure that the owner-contractor agreement contains well-defined liquidated damages language, to protect against losses due to failed timelines. A liquidated damages clause should define a reasonable, guaranteed completion date, along with specific financial compensation for every day past that date that the project remains incomplete.

Time to Pay

For obvious reasons, contractors generally prefer to be paid as quickly as possible, to cover their expenses and compensate their subs. Owners are usually happy to comply, but when payment timelines are too aggressive, they expose the lender to unnecessary risks.

Part of the risk is associated with the necessary due diligence to fund draw requests. This includes a complex series of activities:

- Receiving and distributing the contractor's payment request
- Deploying an inspector to the construction site to verify the validity of the draw request
- Obtaining lien waivers from subcontractors to protect the property from unreasonable liens
- Receiving, reviewing, and processing the inspector's report
- Completion of underwriting and internal administration
- Distributing funds

When time to pay is too aggressive, the lender may not have time to complete all of these steps. Late payments can lead to delays in construction and other problems. Most contractors would prefer draw request time to payment of about 10-15 days, but a more reasonable time to pay is 30 days. Your PCR should evaluate whether the time to pay terms in the contract reflect this reality.

Off-site Storage (and Other Clauses)

Due to the high variability of construction material costs, contractors often prefer to lock down the price on big-ticket construction items as soon as the contract is signed. This is a reasonable expectation in most cases, and should be provided for in the owner-contractor agreement.

However, it's important to verify that these and other specific clauses in the agreement do not conflict with the bank's policies, and that they are reasonable and appropriate for the job. The clause should include information about how the items will be stored, bonding requirements for the storage facility, and the rights of the lender and their representatives (the Construction Loan Monitoring company) to inspect the site for the presence and characteristics of materials, and the storage conditions thereof.

PCR CONCLUSION

Upon completion of the PCR process, the Construction Loan Monitoring company will deliver a report and recommendations. When completed correctly, the PCR helps lenders determine whether the construction contract adequately protects their interests, before the loan documents are signed.

WHAT IS A CONSTRUCTION LOAN INSPECTION?

While the PCR helps protect a lender's interests before construction begins, Construction Loan Inspections help protect the lender's investment during the construction phase itself.

Construction Loan Inspections monitor four key areas during the construction phase:

- Quality and completeness of work
- Costs in line with draw requests
- Change order requests
- Timeliness of payment

Quality and Completeness of Work

During a Construction Loan Inspection, your representative walks the job site to ensure that all work that the contractor reports as complete has been completed in a timely and workmanlike manner. It's important that the Construction Loan Monitoring company utilize qualified personnel with the skills and background to understand critical issues of engineering, architecture, and construction, and to identify problems when they arise. Regular Construction Loan inspections help ensure that both the contractor and the trades have completed the work they have invoiced for, and that the quality of the work meets industry standards as well as the specifications of the contract.

Costs in Line with Draw Requests

During the construction phase, contractors naturally want to be paid as much and as quickly as they can. Inflated draw requests are not uncommon as some GCs struggle to manage their cash flows. But when draw requests are not in line with actual costs of construction to date, they represent a substantial risk for the lender and owner.

A Construction Loan Inspection helps to ensure that all work that has been invoiced has in fact been completed, and that the materials and labor paid for line up with the draw request. It may also verify that invoiced materials have been purchased and are stored correctly in an adequately insured environment.

Change Order Requests

Change orders are a normal part of the construction process. They may represent changes requested by the owners or changes demanded by site conditions. They can also be triggered when inadequate detail was provided in the construction plans. Your Construction Loan Monitoring company should review all change order requests to ensure they are appropriate to the job and that costs are reasonable for the scope of work.

Timeliness of Payment

Most contractors survive from draw to draw, meaning they don't have cash available to pay subcontractors until they get paid themselves. This makes timeliness of payment critically important, as unpaid subcontractors are at risk of leaving the job, especially in the current environment of labor shortages. When this happens, it can trigger a cascade of events that cause construction delays and cost overruns.

To reduce this risk, your Construction Loan Monitoring company should get on site within 24 hours of a draw request to inspect the work. A preliminary recommendation should be delivered within 24 hours after the inspection, with a full report to follow shortly thereafter. This helps to streamline the draw request process and ensure that payments are made in a timely manner.

WHAT IS CONSTRUCTION FUNDS CONTROL?

Construction Funds Control is another layer of Construction Loan Monitoring that helps lenders ensure that payments to all subcontractors and material suppliers are being made in a timely manner. Unpaid materials, subs, and trades can cause project delays or trigger liens to be issued against the collateral.

Construction Funds Control is often accepted as an alternative for Payment and Performance Bonds. Funds Control is usually both more cost effective and more proactive, protecting the investment before the construction process fails, rather than after.

When the Construction Loan Monitoring company provides Construction Funds Control, they will track and review Notices to Owner and subcontractor pay requests, ensuring that they are appropriate relative to the work in place. After confirmation, the Construction Funds Controller then makes payments directly to the subcontractors and materials suppliers, and obtains receipts for Affidavits of Payment.

This process ensures timely and correct payment, and creates a document trail that prevents unreasonable liens.

THE ROLE OF TECHNOLOGY IN CONSTRUCTION LOAN MONITORING

As with most industries, technology is changing the face of Construction Loan Monitoring at a rapid pace. While it's impossible to predict what new technologies may arise and change the game again, there are two key technologies that currently and substantially impact the Construction Loan Monitoring process:

- Mobile Inspection Software
- Drones

Mobile Inspection Software

Mobile inspection software can significantly decrease Construction Loan Inspection times and increase inspection quality. Apps like GLE's proprietary inspection app allow field inspectors to enter data directly into tables. The software then converts the raw data into tables and reports that are immediately and directly available to the relevant lending stakeholders. This makes it faster and more effective to inspect even large projects, and delivers higher quality data more quickly than was previously possible.

Drones (Unmanned Aerial Vehicles)

Inspection site visits are costly and time-consuming. Cameras mounted on drones allow faster, more frequent inspections, and also provide access to areas that might otherwise be difficult to inspect. For instance, sloped roofs, exterior walls of high rise buildings, and construction elements located in hazardous environments can all be safely inspected from the ground.

While an in-person inspection may always be a part of the Construction Loan Inspection process, drones make it faster and easier to get complete data from which to make funding decisions.

CHOOSING A CONSTRUCTION LOAN MONITORING PARTNER

Effective Construction Loan Monitoring is critical, and complex. Choosing the right Construction Loan Monitoring Partner can make the difference between many successful projects and potentially disastrous investments.

Here's what to look for in your Construction Loan Monitoring Partner.

Broad Expertise

Construction Loan Monitoring requires a multidisciplinary approach, involving a deep knowledge of engineering, architecture, construction, funding, contract language, current labor and materials markets, and trades. Look for a partner with broad and deep expertise in all of these areas.

Specific Expertise

Different types of projects require different types of monitoring. A hospital has different specifications and tolerances than a warehouse or an office building. Likewise, government projects must be handled differently than privately funded projects. Look for a Construction Loan Monitoring partner with extensive specific expertise in the type of project you are planning.

Proven Track Record

Expect your Construction Loan Monitoring partner to demonstrate a track record spanning at least a couple of decades. They should place a senior consultant on your project with at least ten years of experience. And they should be able to refer you to a deep list of satisfied clients.

National Footprint

A national firm can handle all of your Construction Loan Monitoring needs in one place, saving you time and money involved in vetting a new partner for every project. Such a relationship also means you know where the buck stops, and should mean that you always get seamless, simple support. A national footprint also allows your Construction Loan Monitoring team to get on site for your projects quickly and cost-effectively.

Speed

Time is of the essence when approving draw requests and change orders. Choose a Construction Loan Monitoring company with a proven track record and the systems and processes to ensure they can get on site within 24 hours of a draw request or change order, and deliver the information you need in a timely fashion.

CONCLUSION

Construction Loan Monitoring is a critical tool in your risk mitigation tool belt. Paired with Construction Funds Control, it can also reduce your costs and increase the value of your investments.

At GLE, we've been conducting Construction Loan Monitoring services for more than 30 years. We've served more than 70 lenders across the nation, of all sizes and types. We've worked on public and private projects, across all building types. Our multidisciplinary staff includes certified building inspectors, cost estimators, registered architects, professional engineers, licensed general contractors, and environmental professionals. We assign a senior staff member with more than 20 years experience to head up every single Construction Loan Monitoring project.

We would love to be your national or regional Construction Loan Monitoring partner. Contact us today to find out more.