Construction Lending in 2020
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About the American Bankers Association/Built Technologies Research Study Construction Lending in 2020, a joint survey initiative by the ABA’s Endorsed Solutions Group and Built Technologies, examines the banking industry’s construction lending businesses, including staffing levels, products and portfolio composition. It also provides insights into how banks are adapting to competitive, regulatory and economic imperatives to become more efficient, manage expenses and improve profitability. The ABA Benchmarking & Survey Research group collected survey data from 123 banks—financial institutions of all sizes—those with less than $500 million in assets (45%), $500 million to $1 billion (20%), $1 billion to $2.5 billion (19%), $2.5 billion to $5 billion (5%), and more than $10 billion (11%).

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CONSTRUCTION LENDING IN 2020
Results of an American Bankers Association research study

INTRODUCTION: About the Construction Lending Survey

The American Bankers Association conducted the Construction Lending Survey in conjunction with Built Technologies, an ABA-endorsed provider of construction loan management software. The purpose of the survey was to gain insight into the state of play in what has been one of the most robust areas of banking in recent years: the provision of credit for developing and building both residential and non-residential properties.

The survey itself is a snapshot of construction lending as it stood before the COVID-19 outbreak of 2020. The report goes a step further, examining the survey findings as well as the mindset and experience of bankers in the immediate aftermath of the pandemic.

The survey questions are intended to take inventory of banks’ construction lending businesses, including staffing levels, products and portfolio composition. The survey also delves into how banks are adapting to competitive, regulatory and economic imperatives to become more efficient, manage expenses and improve profitability.

The survey reflects responses from 123 banks, nearly two-thirds of which (65 percent) had assets of less than $1 billion. The overwhelming majority (97 percent) were already active in construction lending. Participants came from all corners of the United States, with all 10 geographic regions represented. The largest cohorts came from the Plains states (20 percent), New England (19 percent) and the Great Lakes region (16 percent).

Bankers reported being involved in a wide range of construction lending activities, with 91 percent engaged in single family new construction and an equal portion providing commercial real estate loans. Additionally, 81 percent said they funded builders’ speculation (spec), one-off and pre-sold residences; 78 percent provided consumer renovation loans; 67 percent offered lines of credit to home builders; and 64 percent financed fix-and-flip residential loans.
Three-quarters of participants held roles in lending, describing themselves as working in lending (45 percent) or being responsible for mortgages (24 percent) or credit (5 percent.) The remaining one-quarter of respondents said they worked in commercial banking (9 percent), risk (6 percent), operations (3 percent) or another area (7 percent).

Over the next two years, banks indicated, they are likely to improve their construction lending business by expanding training, streamlining loan administration, upgrading technology and outsourcing.

Participants were split as to whether they expected construction lending to grow in 2020 (47 percent) or remain stable (48 percent). The remainder predicted a decline in volume. Participants said some factors that would make them inclined to expand their construction loan portfolios more aggressively included less risky loans (54 percent), less complex compliance (40 percent), or less time needed to manage loans (28 percent).

In interviews conducted during April and May 2020, participants said their fundamental view of the market remains unchanged, although they acknowledged a period of transition is inevitable. Bankers identified strong credit cultures and a focus on risk management as keys to thriving in a challenging post-COVID-19 environment.

And Then COVID-19 Hit

It’s impossible to talk about any facet of economic growth and bank lending without acknowledging the extraordinary disruption caused by the COVID-19 outbreak, which was officially declared a pandemic on March 11, 2020. The Great Lockdown, as it has come to be called, has triggered the largest global recession since the Great Depression, and the construction business has felt the impact.

The COVID-19 crisis differs dramatically from the 2008 financial crisis in many key respects. One of most important distinctions is that the bank industry worldwide entered this crisis with strong capital and liquidity buffers designed to see them through adversity. These and other reforms undertaken since 2008 crisis are what enabled banks to quickly become part of the solution during COVID-19, fulfilling their role as financial intermediaries and providers of credit in response to the upheaval.

Banks have embraced one of the lessons of the last crisis—the need for thorough underwriting and a strong credit culture.
“Being prudent in your underwriting is warranted at all times,” says Brenda Hughes, senior vice president and director of mortgage and retail lending at First Federal Savings Bank of Twin Falls, Idaho, a $705 million-asset institution. “When something like this happens, you take a step back and evaluate programs. If you find you don’t have to make drastic changes, then your programs are probably being appropriately run.”

Bankers acknowledge that construction lending may slow for a while, and it will be necessary to rigorously analyze the portfolio and work with borrowers. And, because of the uncertainties created by such an unprecedented disruption, they are making adjustments and recognize that further changes may be necessary depending on how the economy recovers.

“We tightened up a little bit on loan-to-value ratios,” says David Brennan, senior vice president of Cape Cod Five, a $3 billion-asset mutual based in Barnstable, Mass. But, he adds, “community banks are more local and our decision makers are engaged in the community. We’re in a good position to understand the risks of the specific markets we operate in.”

Some delays were inevitable amid the pandemic as states and some municipalities imposed worksite restrictions that affected construction, says Michael Taylor, director of community banking at Synovus, a $50.6 billion-asset banking company based in Columbus, Ga. “If there’s a two-month delay on projects, you would want progress inspections to determine if you’ve lost ground or are at the same place as at the last inspection. You have to determine if anything needs to be redone or corrected.”

“Our goal remains to get the project built according to plan, in a timely fashion, and on budget,” Taylor says. So as soon as COVID-19 struck, the bank began triaging its construction portfolio.

He noted that the stage of construction is one determinant of risk. “For example, a house that is framed up, but not under roof, has some elevated risk—and once the roof is in place until the project can be secured with doors and windows in place, risk is at its highest level,” he says.

“We broke down our construction risk and focused on the high-risk projects first,” Taylor says. Also, projects that were within a month of their conversion date to permanent financing were given high priority so that they could get over the finish line.
Getting a Grip on Construction Loan Risk

When a crisis hits, it's necessary for lenders to regroup and get a handle on new sources of risk in the portfolio. In the aftermath of the COVID-19 outbreak, construction lending deserves a close look to process short- and long-term implications, said risk management experts from Promontory Financial Group.

Construction lenders need to pay attention to the strength of the project sponsor and gauge their ability and inclination to support a project, says Alison Melick, a Promontory Financial Group director. Understanding the capital structure and equity stack of the deal is critical, she added. It's equally important to assess the capacity of end-of-project commitments, including the condition of pre-sale and take-out financing and major lessees.

In the short term, some banks may find it preferable to continue with some construction projects that are already underway, Melick says. “It's important to think about end use, because the world is being divided into essential and nonessential requirements.” For example, construction for hospitality and dining are likely to be more vulnerable than single-family or multi-family construction in places where the housing stock is low, while assessment of the demand for office space under a new normal environment needs to influence decision-making for office construction projects.

Managing through this process depends on the lender being deeply knowledgeable of local markets, says Angela Chi, a principal at Promontory Financial Group.

“Community banks have a natural affinity and closeness with their communities. Some will be able to take a more individualized approach with borrowers.”

Angela Chi,
Promontory Financial Group
While it is hard to envision many large construction projects getting off the ground during a period of such uncertainty, it’s important to recognize that this crisis is distinct in many respects from the 2008 financial crisis.

“The difference is that 2008 was truly a real estate bubble,” says Margaret Cheever, a Promontory Financial Group director. “The market now is uncertain and it’s very hard to model, but the fundamentals aren’t what they were in 2008, when there were extensions of credit that were based on extreme expectations of growth.”

There is more likely to be a way forward if the end use of the completed project meets an essential need, such as additional housing units in a fast-growing market or more affordable units, and if there is time to ride out upheaval. A project that is set to be completed and sales to launch in two years might be a good risk if the capital structure of the financing is strong and the borrower is willing to continue to support the project.

“This is going to be a time for lenders to test the underwriting and controls they have in their construction portfolios. When a crisis hits, the portfolios of those with stricter underwriting standards and controls will have the advantage,” Melick says.

Being proactive with customers is also critical right now, Melick says. “Good bankers will be getting on the phone to their customer and keep open lines of communication and up-to-date status reports.”

However, ultimately it is the customer’s responsibility to ask for any relief they may determine they need. Lenders need to appropriately consult bankruptcy and loan workout counsel to frame the dialogue and negotiation with the customer before entering into any discussions about modifications to terms. “This is the time for lenders to ensure they have sufficient bankruptcy counsel representation lined up to represent their particular interests in syndicated and bilateral loans and to safely engage with their borrowers,” Melick says.

Banks with challenges in their construction portfolio will likely de-prioritize new money origination and shift resources to restructuring capacity, Melick says. “Their main job for the near to medium term may be to manage the intense process of restructuring the book.”
Some prudent steps for banks to consider right now include revisiting appraisals and determining the status of funding for the project beyond the loan itself.

And strategically, it’s prudent to start thinking what long-term effects the COVID-19 outbreak may produce. Questions lie ahead about whether the way we use buildings is changing permanently, Melick says. More shopping could move online; colleges and universities may offer more distance learning programs. “People who invest in construction are first in line to have to grapple with these issues,” she explains.

What’s Driving Construction Lending Today

Construction lending pumps life into American communities, and banks are pivotal players in funding both residential and commercial building and rebuilding. Banks are primary players because of their long-established ties to and knowledge of communities, as well as their ability to tailor products and services to customer needs.

Lending to support construction often requires the sort of hand-holding at which banks excel, as well as a sophisticated understanding of local markets. These are key reasons why “construction lending remains a sweet spot, particularly for community banks,” says Deborah Whiteside, senior vice president for ABA Endorsed Solutions. Construction lending is by and large a balance sheet business that requires lenders to work closely with borrowers every step of the way. By contrast, residential mortgage lending, another banking mainstay, has come under intense profit pressure as financial technology firms and other nonbanks have swarmed in and as products have become increasingly commoditized.

“Local banks do construction lending better than anyone else,” says David Brennan, senior vice president at Cape Cod Five. “Nonbanks have taken over 70 to 80 percent of the mortgage business, but this is a business they haven’t been able to get to.”

Construction loan demand grew as both residential and nonresidential construction recovered from the Great Recession that ended in June 2009. The construction industry was severely
hard-hit by the recession, shedding 2.3 million jobs, from the peak of 7.7 million workers in April 2006 to the trough of 5.4 million in January 2011, according to data from the Federal Reserve Bank of St. Louis. As of November 2019, 97 percent of these jobs had been recovered, bringing construction employment to 7.5 million workers. But the COVID-19 outbreak dealt a blow, reducing employment to 6.6 million construction workers as of April 2020.

Construction lending also suffered during the Great Recession, tumbling dramatically over five years to $202 billion Q1 2013, one-third of the $632 billion level achieved as of Q1 2008, according to data from the Federal Deposit Insurance Corp. As of the end of December 2019, construction loans outstanding by banks and thrifts reached $361.4 billion, an impressive 79 percent climb from 2013’s low point, but still 43 percent below the peak volumes of 2008.

Total construction spending in the U.S.—a broad measure that includes both new structures and improvements to existing structures—exceeded $1.3 trillion in 2019, roughly on par with 2018 levels, and the trend had been moving upward since spending hit a trough of $788 million in 2011, according to U.S. Census Bureau data. During 2019, residential lending volume fell 4 percent from December 2018 levels, marking the first decline in a decade, but residential construction volume had more than doubled in 10 years.

“More than 85 percent of construction projects have debt in the capital stack, and banks are the primary source of capital fueling the industry,” says Chase Gilbert, CEO and co-founder of Built Technologies.

Nearly half of survey respondents appeared to be benefiting from the construction revival. In all, 49 percent reported their construction lending business grew over the past two years, including 10 percent who described the growth as “significant” and 39 percent who called it “moderate.” A further 43 percent said business was stable, and 8 percent noted a decline.

Residential construction has been driven higher by the fact that homes are urgently needed to replace older housing stock and accommodate growth in the number of households, according to the National Association of Home Builders. “Net new households are being formed faster than new single-family and multifamily

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1 Federal Reserve Bank of St. Louis, current employment statistics, [construction](#).
2 Annual value of construction put in place, 2008 to 2019, U.S. Census Bureau. (Annual historical data chart, line 6.)
homes are coming online to accommodate them,” NAHB said in a 2018 research report. Additionally, the number of older homes still in the housing stock “have been declining at quite a slow rate.”3

Builder confidence in the market for newly built single-family homes took a sharp drop in April 2020, falling 42 points to 30 on a 100-point scale as the impact of COVID-19 was felt, according to NAHB data. But confidence bounced up by 7 points to 37 in May 2020, “a signal that the housing market is showing signs of stabilizing and gradually moving forward in the wake of the Covid-19 pandemic,” says NAHB. Any number over 50 indicates that more builders view conditions as good than poor.4

Fannie Mae’s April 2020 housing forecast predicted a 9.3 percent decline in housing starts in 2020, to 1.169 million total units in 2020, from 1.290 million in 2019. The forecast foresees a rebound in 2021, with housing starts jumping 7.5 percent, to 1.258 million units. Single-family construction is expected to decline 7.6 percent, to 821,000 units in 2020, versus 888,000 in 2019, but is seen rebounding to 909,000 units, a 10.7 percent increase, in 2021. Fannie Mae expects multifamily construction to dip by a sharp 13.2 percent to 349,000 units in 2020, versus 402,000 in 2019, and to remain at that level in 2021.

Predictions that a major recession was on its way in 2020 had already prompted some market participants to voice caution about construction during the second half of 2019. In September 2019, the Federal Advisory Council—a group of 12 banking industry representatives who serve as advisers to the Federal Reserve—said construction lending “continues to be positive but is slowing due to weakness in single-family construction.” While construction and development loans at banks grew by 2.7 percent in the 12 months through December 2019, this was down from 5.2 percent in the year-earlier period.

The Federal Advisory Council noted that construction costs are elevated due to high prices for raw materials and labor shortages, but saw signs that labor costs were stabilizing in some West Coast markets. It also noted that delinquency levels remain at or near historically low levels.5

“Residential construction lending is an important driver of profits because of the volumes we do.”
Brenda Hughes, First Federal of Twin Falls

5 Record of meeting, Federal Advisory Council and Board of Governors, September 6, 2019.
At a November 2019 meeting, the Federal Reserve’s Community Depository Institutions Advisory Council—consisting of a dozen banks, thrifts and credit unions with assets of less than $10 billion—said construction lending was “healthy in most commercial and residential categories,” and credit is readily available. Pressures are coming in the form of higher costs for materials and labor along with permitting costs, which are pushing up prices for new construction, with the greatest impact falling on construction of lower-priced homes. In some markets, this translates to greater focus on rehabilitation rather than new construction. There were pockets of interest in pre-fab construction for both housing and commercial properties. Construction demand was strong in states with high population growth and lower tax structures. They also noted that in many cases, non-bank lenders are providing permanent financing before construction is finished.

“One thing we are seeing is that building techniques are changing rapidly as builders adapt to higher construction and labor costs,” says James Chessen, ABA’s longtime chief economist who retired earlier this year. "Bankers will be giving careful thought to how to finance different types of projects."

“There is considerable competition from pension plans and insurance companies to acquire assets, and they are doing that earlier in the process than we’ve seen previously,” Chessen says, and the imperative for banks is to “make sure they are getting an adequate return.” Overall, he adds, “the trends are positive, but bankers are cautious by nature, and they recognize the economy is shifting into a slightly lower gear.” Financial institutions with proper risk management and appropriate capital levels are proceeding as long as there are no signs of big imbalances that would significantly disrupt the construction lending market, he added.

Survey respondents were generally positive about prospects. Only six percent of participants expected a decline in construction lending activity in 2020. A thin majority—48 percent—anticipated that business would remain steady, while 47 percent expected to experience growth. And among those expecting growth, 7 percent predicted it would be significant; the other 40 percent said it would be moderate.

“One thing we are seeing is that building techniques are changing rapidly as builders adapt to higher construction and labor costs. Bankers will be giving careful thought to how to finance different types of projects.”

James Chessen, former ABA Chief Economist
Construction Lending Report

The construction lending profile of a financial institution is highly individualized, reflecting the bank’s own strengths and the markets it serves.

- First Federal, a $705 million-asset bank in Twin Falls, Idaho, thrives on agribusiness, a growing sector that encompasses food production, processing, science, research, and related support services.

- Construction lenders at Cape Cod Five, a $3 billion-asset mutual based in Barnstable, Mass., serves a mix of permanent and seasonal residents, second-home owners and investors, according to David Brennan, senior vice president.

- Synovus, with its Sunbelt footprint and $50.6 billion in assets, meets homeownership and construction needs of customers across its Georgia footprint, and also has a niche in high-growth markets, which include resort communities such as St. Simons Island.

The survey found that banks of all sizes are involved in a wide range of construction lending activities, with community banks only somewhat more focused on residential customers than larger bankers are. It also drilled down to ask about what types of loan products they offer.

Participants were asked which types of construction activity their institutions undertook. Single family new construction and commercial real estate were neck and neck, with 91 percent of participants involved in each activity. In addition, 81 percent said they funded builders’ spec, one-off and pre-sold residences; 78 percent provided consumer renovation loans; 67 percent offered lines of credit to home builders; and 64 percent financed fix-and-flip residential loans. Respondents were allowed to choose all answers that applied to their institution.
While more than one in 10 banks engaged in single-family construction lending for consumers, the smallest banks—those with less than $500 million in assets—were the most likely to be in this business, with 98 percent mentioning the activity. Among the largest banks—those with $10 billion or more in assets—78 percent said they made single-family construction loans to consumers.

The starkest difference between large and small was in the fix-and-flip category, with 80 percent of the under-$500 million-assets participating, versus 11 percent of the $10 billion-plus banks. Flippers are traditionally small investors—that is, consumers—with an eye for fixer-upper bargains and the capacity to quickly buy, rehabilitate and sell properties.
CASE IN POINT: CAPE COD FIVE

Cape Cod Five offers one-step financing in the form of a construction-to-permanent loan that converts to either an adjustable or fixed-rate loan upon completion of the project. The vast majority of its loans are for owner-occupied construction. To qualify for a residential construction loan, “we do require that the borrower work with a licensed, bonded general contractor—it’s not a product for people who are doing it themselves,” Brennan says.

Cape Cod Five’s construction loans typically run up to 12 months, but may go to 13 or 14 months in some circumstances. “We can extend if the project is more complicated,” Brennan says. Complexities do occur, given the bank’s market location. Environmental considerations, such as septic system inspections, are a common source of slowdowns in the construction process, he notes.

Rehabilitation lending is another active area for Cape Cod Five, given its aging housing stock and unusual demographics. The local Cape Cod workforce faces a significant housing-wage gap in a community where home prices are driven up by retirees and second home owners who arrive during the bustling summer months. “Prices of homes here are driven not just by people who work here, but by people who come from all over,” Brennan says.

COVID-19 has not fully hampered the bank’s construction lending business. “We continue to see good volume in residential construction,” Brennan says. “Things have slowed down in certain towns that have limited how many people can be on a construction site, but hopefully we’ll see some improvement as they balance the issue of health and getting the economy moving.”

Demand remains solid, and one area of particular interest has been the second home market, a change he attributes at least in part to the COVID-19 outbreak. “It seems that some people in more densely populated areas may want to stretch out,” he said.

The bank’s risk management process is working well, Brennan adds. Approximately 80 percent of projects are progressing as scheduled; about 20 percent are asking for additional time. The bank is following secondary mortgage market guidelines on its own portfolio loans, he adds. “We’re going back and re-verifying employment income within 10 days before closing to ensure that borrowers still have employment and income and are capable of handling new debt.” New loans are being offered, but with at higher loan-to-value ratios and with increased reserve requirements.
Any steps a bank can take to improve efficiency should enhance customer satisfaction and improve profitability.

Brenda Hughes, First Federal of Twin Falls
CASE IN POINT: SYNOVUS

Synovus’s construction business straddles both the home builder and consumer markets, according to Taylor. For conforming consumer residential loans that it can sell into the secondary markets, terms typically run between 6 and 12 months. Portfolio loans can run 12, 14 or even 16 months. The bank places a priority on providing construction loans across its customer demographic spectrum, so there is not really a formal bottom limit on loan amounts, though loans under $100,000 are uncommon, and it lends as much as $3 million.

The bank has had success in financing second homes. Working with medical professionals—building first and second homes—is another specialty for Synovus.

Taylor says there are unique challenges with the consumer products. The homebuilders are an important source to get consumer loan referrals, but as soon as the loan process begins, the bank’s fiduciary responsibility lies firmly with the borrower, not the builder. Part of the required up-front due diligence for consumer loans is an assessment of the builder chosen by the homeowner. To carry out their fiduciary responsibility to the consumer, lenders must assess the homebuilder’s capacity to support and complete the project.

Being sure that builders have sufficient working capital and access to traditional trade credit is key, Taylor says. Most banks fund draws as specific phases of work are completed. Timing gaps can crop up when a builder requests payment before a specified milestone, such as an inspection, has been reached. This increases the dependency of access to draws for low-volume builders at unacceptable intervals, he explained. Any requests for draws prior to completion of work is not allowed, he added.

Despite the COVID-19 pandemic, construction loan volume is not slowing significantly for Synovus, Taylor says. “We are doing extra due diligence to identify any additional construction risks and if they are truly tied to the pandemic,” he adds.

Going forward, some tightening seems likely, says Taylor. “We are looking at how we underwrite project feasibility and we are going to have to ramp up how we evaluate builders. We have to watch out for any builders that start to display any red flags.”
What Types of Construction Loans Does Your Bank Offer?

<table>
<thead>
<tr>
<th>Loan Type</th>
<th>Percentage</th>
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<tbody>
<tr>
<td>Commercial real estate</td>
<td>86%</td>
</tr>
<tr>
<td>Multi-family residential</td>
<td>74%</td>
</tr>
<tr>
<td>Acquisition and development</td>
<td>67%</td>
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<tr>
<td>Builder lines of credit borrowing base</td>
<td>67%</td>
</tr>
<tr>
<td>Single-family new construction</td>
<td>95%</td>
</tr>
<tr>
<td>Single-family renovation</td>
<td>91%</td>
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</tbody>
</table>

Loans by the Number and Volume

Asked which types of loans they currently offer, 95 percent of participants cited single family new construction. Commercial real estate was next (86 percent), followed by single family renovation (83 percent), multifamily residential (74 percent), and builder lines of credit and acquisition and development loans (tied at 64 percent apiece.)

The survey provided two views on the size of banks’ construction and development loan portfolios: Total commitment value, or dollar volume, and number of loans. Most banks (62.9 percent) had construction loan portfolios of $50 million or less. A total of 46.1 percent had fewer than 50 loans, and 71.9 percent had fewer than 100.

At 83.1 percent of institutions, the in-house teams responsible for administering construction loans consisted of one to five employees, and 95.5 percent had no more than 10 employees.

Many banks try to have a range of products and services at their disposal in order to have maximum flexibility to meet market demands. “We can do construction loans on a very straightforward conforming piece of property, but also large scale projects,” says Brennan.
Spotlight on the Customer

It’s an article of faith in banking that relationships drive business. Consider the fact that the average U.S. adult has had the same primary checking account for about 16 years, and 26 percent have had it for more than 20 years.6

When it comes to construction lending, community bankers believe the same rule applies. When asked to rank why they believe borrowers choose a particular construction lender, respondents cited the following, in order:

1) Existing lender relationships
2) Lender is easy to do business with
3) Lender has fast draw processing
4) Low interest rates
5) Low administration fees
6) Lenders relationships with other departments

These results were consistent across asset size, except at the higher end of the spectrum. Banks in the $2.5 billion to $5 billion-asset range thought borrowers put more emphasis on low interest rates than on draw processing speed. Those in the $10 billion-plus range ranked being easy to do business with and having fast draw processing above borrowers’ comfort with existing lender relationships.

Training wasn’t the only customer-focused initiative. Twenty-six percent of survey participants said they had increased the size of the loan administration team and 22 percent said they had updated marketing and education materials. Fourteen percent had implemented a major technology upgrade; and 13 percent said they reduced or simplified loan fees. (Multiple responses were allowed.)

Asked to identify steps they intend to take over the next two years, training again topped the list, at 43 percent for banks overall. Banks also intended to brush up marketing and educational materials (23 percent), and implement a major technology upgrade and increase the size of the loan administration team (both 21 percent).

While First Federal of Twin Falls is not planning a “major” technology upgrade, it is on track to implement a mobile construction administration platform early in 2020. Any steps a bank can take to improve efficiency should enhance customer satisfaction and improve profitability, says Hughes.

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6 BankRate/MONEY magazine survey, October 2017.
Profitability and Efficiency

Profitability and efficiency go hand in hand in banking. Profitability ratios measure the net income a company is generating, while efficiency ratios measure how effectively a company is using its resources in pursuit of profits.

Survey respondents were keenly focused on improving their loan administrative functions to bolster profits. They also expressed a degree of comfort with raising loan fees and interest rates.

“In construction lending, there’s a lack of standardization in how fees are attributed to construction loans to begin with,” says Chase Gilbert of Built Technologies. “Right now, construction loans are very high touch, so it’s normal to have higher origination, administration or fund control fees. But if borrowers don’t perceive that they are getting anything for those fees, it won’t feel good to them.”

Profitability Measures

Operating a more efficient loan administration function was at the top of the list of steps banks have taken in the past two years—and plan to take over the next two years—to improve construction lending profits. Thirty-eight percent said they had taken steps in the past two years to increase loan administration efficiency; 40 percent said they planned to do so in the next two years.

“People are OK paying fees when they get value,” said Chase Gilbert of Built Technologies. “Right now, construction loans are very high touch, so it’s normal to have higher origination, administration or fund control fees. But if borrowers don’t perceive that they are getting anything for those fees, it won’t feel good to them.”

Chase Gilbert, Built Technologies
Over the past two years, banks said they increased loan fees (35 percent) and interest rates (23 percent). The interest rate hikes of 2017 and 2018 may, to some extent, be reflected in the upward trend in construction lending rates. The Federal Reserve’s target for federal funds rate stood at 1.5 percent to 1.75 percent as of October 31, 2019, 50 basis points higher than the levels of October 2017.7

In the next two years, participants said, they are considering increasing loan fees (28 percent) and raise interest rates charged for construction loans (15 percent.)

### Efficiency Measures

What have banks been doing over the past two years to improve the efficiency of their administration function, and what are their plans going forward?

Training once again topped the list, with banks viewing it as a way to improve efficiency as well as improve the customer experience. Just as banks invested in staff training to improve the customer experience, they also invested in it to improve efficiency. In all, 59 percent of survey respondents said they had undertaken staff training. A solid 46 percent said they had streamlined documentation and processes for both borrowers and builders, and 37 percent had reorganized staff. A significant 29 percent had outsourced inspections, scheduling, funds control and other services, while 20 percent had implemented a major technology upgrade.

Over the next two years, they expect to continue to emphasize training (61 percent) and continue streamlining initiatives (48 percent.) But the big mover was that plans to implement a major technology upgrade climbed into third place, at 26 percent, while outsourcing was steady at 20 percent.

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From Builder to Banker: Insights from a Career Switcher

The son of a mason, Frank Sorrentino remembers tagging along to work with his father and learning to lay bricks by the time he was 10. He entered the construction business right out of high school, got his civil engineering degree by attending college at night, and went on to build some of the largest, most elegant homes in the state of New Jersey.

Then, unhappy with the service his construction company was receiving from banks, he started his own bank. ConnectOne Bank, which he established in 2005 as a New Jersey Community Bank, had $6.2 billion in assets at the end of 2019, and a strong focus on construction lending.

“Contractors want as smooth a process as they can envision between when work is performed and when they can get the finance. There has always been a struggle in that process,” says Sorrentino. “Technology can make a lot of that process easier.”

ConnectOne has adopted digital technology (from Built Technologies) that integrates underwriting, review and field administration. “We can monitor a project almost virtually, with the builder and bank utilizing the same platform. Everyone in the chain, from construction inspectors to builders to underwriters, can all access the platform in real time,” says Sorrentino.
TECHNOLOGY: Streamlining and upgrading are rising priorities

Many banks in the construction lending business are intent on streamlining documentation and processes for both builders and borrowers. Time is money, and the ability to squeeze out unnecessary delays that occur in the loan funding process benefits banks while enhancing borrowers’ satisfaction. Forty-six percent say they have streamlined administration over the past two years to help profits, and 48 percent say they intend to do so in the next two years.

Construction lending has traditionally been characterized by frequent stops and starts, as materials are delivered, inspections take place, and documents are sent and recorded. But in the digital age, it is possible to hasten the process while gaining a more comprehensive view of it.

“Every construction borrower wants their money faster,” says Gilbert. The most innovative customer experience is moving toward mobile platforms where borrowers can see the status and progress of their loans in real time. In construction lending, where loans are advanced in phases, it is especially important for borrowers to be able to access details about what’s happening with their funds.

The draw system is at the heart of what makes construction lending uniquely suited to banks—and it is also a factor that makes construction lending more complex than the typical mortgage or commercial loan.

Bankers are fond of pointing out that closing a loan is usually the final lap in lending, but for construction loans, it’s when the starting gun goes off. Construction can’t begin until the loan is closed, and there typically nine to 12 months remaining before building is complete and the loan can convert to a permanent mortgage.

During the period when the loan is in process, the demands on construction lenders are at their most intense. The traditional way of monitoring construction loans is a spiral of budgets, inspections, photographs, project reports and spreadsheets.

“Unlike most loans, the real work starts the day you close a construction loan,” says Gilbert. “You hold back most of the funds and the loan is funded over time. Meanwhile, work is happening, people need to get paid, and you need proof money is spent on what it’s supposed to be spent on. It’s one of the most collaborative loans that exist, because it requires steady coordination between the bank, the borrower and frequently with the contractor.”
Many banks are focused on digitizing this intense phase of the construction lending process. The potential gains from simplifying the process are tremendous and have the ability to both speed up loan draws and provide borrowers, builders, lenders and supervisors with a sharper image of what is happening with the loan.

“It’s incredibly hard to track current and future funding with traditional systems,” says Synovus’s Taylor. “We used to have a group spending days pulling together commitments, project funding coming up, and funding trends. Now that process is being digitized so we can have a living file with graphics and detailed data.”

Assembling the data in a centralized platform makes it easier to spot trends and aberrations. If any draws are over limit, they can be identified quickly. If draw requests are arriving faster or slower than anticipated, lenders can see it and address it.

“It takes a lot of handholding to make sure costs are in line with the draws that builders are requesting and that borrowers are agreeable to the draw requests,” Hughes (of First Federal) says. “You have to make sure draws match up with the building contract. If there are overruns, the lender has to make sure borrowers are prepared for them and have the funds allocated.”

**LOAN DRAW 101**

One of the defining features of a construction loan is the process referred to as the “draw.”

In contrast to most loans, construction loan funds are released in phases as specific project benchmarks are reached. The borrower requests a “draw,” and provided conditions are met, funds are advanced. The first draw often comes when the builder has laid down the foundation; setting up walls, roof, windows and doors and being able to lock up the interior is another typical milestone.

“You really have to be sure you’re setting clear expectations,” says Brennan of Cape Cod Five. “It starts with having a good framework and schedule. Typically, we allow six to seven disbursements throughout life of loan and make sure the contractor signs off on each one.”

And the bank keeps the focus squarely on the borrower. “We don’t disburse any money to the contractor—only to borrower,” Brennan said. “That’s where our fiduciary duty lies.”
CASE IN POINT: AT SYNOVUS, BETTER TECHNOLOGY SECURES RELATIONSHIPS

Physicians and private wealth clients occupy a unique niche in the construction client base at Synovus because of a specific second-home construction product the company offers. Giving those clients tools to monitor those projects remotely has been a game-changer, according to Synovus’s Michael Taylor.

“When physicians are building a new primary or secondary residence, they don’t have the capacity to go on site during the day because they’re booked solid, and they have so many screeners looking at their emails and texts,” Taylor says.

Adopting Built Technologies’ cloud-based hosting platform for construction administration changed the equation for Synovus, and physicians were far from the only beneficiaries. The platform provides an encapsulated forum in which the bank can communicate directly with clients about their construction projects, says Taylor. The platform brings together borrower, builder, inspector, appraiser and lender in one simple application, and makes it easy for even the busiest borrower to keep tabs on their construction project—and, most important to all involved, keep it moving forward.

The platform has also delivered value during the COVID-19 crisis, says Taylor. “Built came up with a construction stop map so we can immediately see if we have any projects that are affected by a municipal or state shutdown. Having a tech partner allowed us to focus on finding solutions instead of identifying the problem.”

The Construction Loan of the Future

Leveraging technology has the potential to help banks control what 46 percent of banks identified as their No. 1 cost driver: the expense of full-time equivalents. Regulatory and compliance costs were a close second, cited by 42 percent. Other expenses, including technology expenditures and sales and marketing costs, were each cited by 4 percent of survey participants.

It was a close call for Synovus, which nearly exited consumer residential construction at a time when bigger bank rivals were calling it quits. “One of the key factors for our decision was a labor resource issue,” says Taylor. By implementing a cloud-based hosting platform for construction loan administration, the bank was able to cut administrative staffing for the loans by 75 percent while also improving risk controls and delivering on its fiduciary obligations to borrowers.

“It’s incredibly hard to track current and future funding with traditional systems. We used to have a group who spent days pulling together commitments, project funding coming up and funding trends. Now that process is being digitized so we can have a living file with graphics and detailed data.”

Michael Taylor, Synovus
Regulatory scrutiny is unlikely to diminish, but technology has the potential to help banks present a crisp picture of their lending activities, progress on projects and risk exposure.

**Risk, Compliance and Regulatory Considerations**

Regulatory burdens and confusion are costly. Over the past several years, regulators have generated new requirements for disclosures relating to single-family construction loans throughout the underwriting and construction process. Questions about the treatment of these loans under the TILA-RESPA Integrated Disclosure rule have prompted many banks to exit the market. Prior to the implementation of TRID, these loans were exempt from RESPA because of their temporary nature. Under TRID, however, they are subject to the same disclosures as 30-year mortgages. Bankers have appealed to the Consumer Financial Protection Bureau for greater flexibility.

“There were times when we thought we might have to get out because TRID didn’t accommodate what we were doing,” says Brennan. “We had to get comfortable that we were making the best interpretation of the rules. The fact that everything in a construction loan is projected, including payments and escrows, made it hard to fit loans into the right bucket.”

In general, bankers complain that TRID-related requirements pose important obstacles for construction financing. Current rules are unclear and subject to continuous regulatory tweaks and corrections. In addition, construction lending is not a commoditized transaction and precise terms and structure of these deals vary greatly. Local laws and requirements exacerbate such disparities and add confusion to the application of TRID requirements. The compendium of TRID and other difficulties means that lenders must invest in dedicated compliance systems to properly sustain construction lending operations. This upfront investment can be a significant barrier to entry into construction lending operations and often disqualifies lower-volume lenders that would otherwise be able to offer very valuable products in their communities.
Regulatory and compliance costs rank as the No. 2 driver of expenses in construction lending portfolios, cited by 42 percent of respondents, behind only staffing requirements. Forty percent of banks stated that they would be more aggressive in construction lending if compliance requirements were less onerous. Indeed, banks were acutely aware of the compliance and operational risks involved in construction lending.

Construction and completion risk are high on the list of considerations, and some methods bankers use to address these risks include diligently monitoring budgets, tracking draws to search for patterns and insisting that borrowers engage a general contractor. Lenders are more comfortable with borrowers who line up reliable construction resources with the skills and understanding of local codes and ordinances, and who also possess the market knowledge required to get the project completed.

If draws are over budget, or long periods elapse between draws, that can be a sign of a potential construction completion risk that needs attention, says Taylor. “Sometimes builders must give us a new timeline. Borrowers don’t want to find themselves out of compliance with loan agreements, and we don’t want to encounter conversion risk”—that is, not being able to convert construction financing into a permanent loan in a timely manner.

Technology is helping banks withstand scrutiny by making it possible to capture a complete record of every keystroke related to a loan, from application to closing to funding draws to conversion.

“There is no question that this business is more expensive than it was due to regulatory costs,” says Hughes. “It’s vital to make sure we have all our loan estimates correct so that when it’s time to float the permanent loan down to the market, it’s still in compliance with regulatory guidelines.”
Closing Thoughts

Construction lending has enjoyed a robust revival, reversing the setbacks experienced during the Great Recession, and the outlook remains favorable once banks and the economy navigate the fallout of the COVID-19 crisis.

Since reaching bottom in midyear 2013, construction lending has roared back, rising 79 percent to $361.4 billion at the end of 2019.

While volume remained short of pre-recession levels just as the Great Lockdown of 2020 began, prospects for a recovery are encouraging. Fannie Mae’s April 2020 housing forecast predicted a 7.6 percent dip in single-family construction in 2020, but a 10.7 percent rebound in 2021, putting next year’s new home building solidly ahead of last year’s.
Key Takeaways

Bankers, meanwhile, believe construction lending is a business that is uniquely aligned with their strengths, particularly in areas such as customer service, market knowledge and financial management. The key distinguishing feature of a construction loan—the draw system—requires steady communication among borrower, lender and builder, as well the integration of inspection reports and other data that impacts projects on their path to completion.

Underwriting and risk management will separate the weak from the strong. In interviews conducted after the COVID-19 crisis struck, bankers said they are carefully reviewing loans in the pipeline, tweaking some underwriting requirements such as loan-to-value ratios and reserve requirements, paying close heed to secondary mortgage market requirements, even if they tend to hold loans in portfolio, and scrutinizing builders’ track records and capacity. By and large, they voiced confidence that their approaches to underwriting and risk management, and their strong capital and liquidity, have put them in a strong position to help customers weather the storm.

A diverse product mix is typical of most banks. The vast majority of bankers surveyed offered multiple different categories of loans, including single-family construction, commercial real estate, builder project financing and lines of credit, rehabilitation loans and fix-and-flip loans. While smaller banks were somewhat more focused on residential construction lending, most respondents checked multiple boxes when asked about their offerings.

Relationships are paramount, but borrowers have options. Bankers believe that relationships drive the customer’s decision about where to borrow for construction lending. Experts agree that’s an important start, but observe that technology increasingly is a differentiator.

Banks are investing in training. Forty-three percent of banks ranked training as their No. 1 priority for improving the customer experience.

A smooth draw process is crucial. Construction lending is unique in that the loan closing is a starting line, not a finish line. Lenders advance funds only as key stages are attained in a construction project, such as laying down the foundation and roughing in major systems. Banks are deploying technology to help them manage a complex draw process that involves borrowers, builders and government inspectors.

Technology is accelerating the progress of loans and making construction lending ever more efficient. Armed with new, integrated technology, banks are increasingly able to provide borrowers with detailed status reports delivered in real time via digital devices. As banks seek ways to manage the administrative costs of providing construction loans, technology is emerging as a key to operating more efficiently.

Banks are highly focused on construction risk and completion risk, among others. They are leveraging tools to help them complete the construction phase in order to convert the loan to a permanent mortgage in a timely manner.
About Built Technologies

Endorsed by the American Bankers Association, Built’s construction finance technology connects commercial and consumer construction lenders, commercial real estate owners, commercial general contractors, residential homebuilders, specialty contractors, title companies and vendors to improve the flow of capital through the construction ecosystem—from lender to vendor.

By connecting all key stakeholders involved in the construction process in real time, the Built platform helps mitigate risk, power faster draws and payments, ensure compliance and inspire customer loyalty.

Headquartered in Nashville, Tennessee, Built is used by more than 100 of the nation’s leading construction lenders and thousands of contractors to manage over $20 billion of construction project value annually. For more information, visit www.getbuilt.com or follow Built on LinkedIn and Twitter.