## A New Model for Commercial Construction Loan Administration

hrough the recent real estate downturn, construction lending has seen a significant decline in volume. As the commercial real estate industry begins to recover, a new model for construction lending is developing. Non-traditional construction lenders such as life insurance companies, specialty finance companies and real estate investment trusts (REITs) are funding new construction projects through the use of third-party construction loan administrators. This new construction lending activity

provides opportunities for mortgage bankers and other intermediaries.

Construction lending has historically been the province of commercial banks. Construction loans are the cornerstone of bank real estate lending activities. Community and regional banks extend construction loans to local developers; national banks lend on larger projects and use syndication as a vehicle to finance the largest developments. Banks provide the short-term, floating-rate financing and associated construction loan administration through completion of the project, lease-up and stabilization.

Upon project completion and stabilization, portfolio lenders or issuers of commercial mortgage-backed securities (CMBS) provide the permanent fixed-rate financing.

Construction activity is beginning to re-emerge from its recent decline. Total construction start activity peaked in 2007 at \$730 billion in volume. By May 2011, construction start volume had declined 53 percent from its peak to \$385 billion. Volume recently increased to \$469 billion in October 2011, according to McGraw-Hill Construction Research and Analytics, New York. As commercial construction activity declined, banks have reduced their construction loan administration staffs proportionately.

During the recent downturn, portfolio lenders have been opportunistic in providing permanent loans on high quality assets. Life insurance companies have been aggressive in bidding for well-located, institutional-grade properties with strong tenants and sponsors. Portfolio lenders have been very competitive on permanent loans secured by properties net leased to high-quality tenants including the federal government, health-care and academic institutions. Loans on institutional-quality multifamily properties and investment-grade-rated tenants are also in high demand.

To secure these permanent loans, life insurance companies and specialty finance companies are offering combined construction/permanent loans, and using third-party construction loan administrators to support this

activity. Developers find these construction/permanent loans an attractive alternative to finance their properties. Borrowers can take advantage of today's low-interest-rate environment by locking in attractive financing and realizing the efficiencies of a single negotiation and loan closing. They also limit their risks associated with having to secure permanent financing in an uncertain future market environment. Mortgage bankers are finding opportunities to represent borrowers and place these types of construc-

tion/permanent loans with their portfolio lending relationships.

Third-party construction loan administrators provide an efficient and effective means for lenders that do not have the in-house resources and capabilities to offer construction loans. This provides the lender with the expertise and resources to manage construction lending risks related to contractual, budget, design and scheduling matters. On behalf of the lender, the construction loan administrator is responsible for monitoring the project budget, including all designated sources and uses, and

will coordinate with the inspecting engineer, manage any reserves that are provided to cover insufficiencies, perform funds administration services (including inspections and title updates), review disbursement documentation and provide detailed client reporting on the status of the project and fundings.

Third-party construction loan administrators are typically engaged prior to closing, at which time they complete a document and budget review, participate in closing activities and attend the initial planning meeting. Postclosing services include construction and budget monitoring, disbursement administration, title management, loan servicing and reporting.

As part of the pre-closing services, the construction loan administrator will review the initial loan documents and supporting materials and perform a line-item budget review of costs, and participate in the closing process. The construction loan administrator typically will participate in a preliminary meeting among the development team, which may include the general contractor, project architect, borrower representative, inspecting engineer and business representatives of the lender. The primary goals of this initial planning meeting are to establish and review disbursement procedures, draw backup and communication contacts for the project.

After the loan closes and construction commences, the loan administrator's activities intensify. In monitoring the

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project budget, the loan administrator provides a summary of budget revisions and reallocations, or summary notation of any budget discrepancies or out-ofbalance situations, as well as a change order summary addressing related questions or concerns, such as budget adequacy, timing or other issues.

Financial controls are an important component of the loan administrator's responsibilities. The loan administrator reports on funding status, including allocation of approved, eligible costs for equity and loan proceeds, and other sources of funds (grants, reserves, tenant reimbursables), highlighting the current disbursement request amount, previous amounts disbursed and amount remaining to be funded. The loan administrator makes a recommendation of the amount of funds eligible for disbursement, and related items requiring follow-up are also included. A disbursement summary is provided to the lender, which may include a list of exceptions to pre-established guidelines such as funding restrictions or document requirements. Typically, this review of disbursement requests and funding is performed once a month.

Loan administrators with banking affiliates can provide treasury and cash-management services specific to the project needs. During construction, the loan administrator can issue direct or dual-payment checks to approved vendors from escrowed loan or equity funds. Residential sales deposits can be tracked unit-by-unit with detailed accounting of earnest money, upgrades, customizations and interest. Commercial lockbox accounts can be established with effective cash-distribution waterfall accounting.

The loan administrator manages the title administration process and coordinates the request for title searches and bringdowns prior to each funding, and obtains the written endorsement to evidence the updated title coverage. As part of this process, the loan administrator manages interim exception documents and identifies options for resolving open issues.

One of the most important functions of the construction loan administrator is to review project performance by monitoring project leasing or sales activity. Residential project information includes review of purchase agreements, adherence to prequalified sales criteria, requests for variances or concessions, and unit closing and release detail. Commercial leasing is monitored for adherence to predetermined criteria, tenant improvement thresholds and lender acceptance.

Some construction loan administrators have experience in providing special credits management and resolution services in the event of default. These services include assisting the lender in the asset management, workout, restructuring and disposition of underperforming and defaulted construction loans, with the specific focus on resolving the unique issues inherent in distressed construction projects.

Qualified third-party construction loan administrators can provide an invaluable resource to lenders that do not have the internal expertise and capabilities to manage construction loans. Construction loans are inherently risky, and a professional construction loan administrator can provide a wealth of experience to manage and mitigate these risks. The use of a third-party service provider also is economically efficient, allowing the lender to have the resources available only when needed and paying variable expenses as its construction lending volume increases and decreases over time. This business model is expected to gain further market acceptance as the commercial construction lending business revives.

Stacey Berger is executive vice president of Midland Loan Services, a PNC Real Estate business. Midland is a leading provider of loan servicing, asset management and technology for the commercial real estate finance industry, including construction loan administration services. He can be reached at stacey.berger@pnc.com. The views expressed by the author are his own, and this column was prepared for general informational purposes only and does not purport to be comprehensive. The information and views in this publication do not constitute legal, tax, financial or accounting advice or recommendations to engage in any transaction. The views expressed in this update are subject to change due to market conditions and other factors.

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