



## Risk Mitigation Reminders for Construction Loans

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**Summary:** Is construction ebbing or flowing? It depends. Commercial construction spending was down in March. Yet, architecture backlogs are full. Community financial institutions having construction loans in their portfolios will need to firm up risk mitigation, as they closely watch economic indicators. Here are three reminders to lower the risk with these loans in your portfolio.

On this day in 1935, Babe Ruth hit his 714th home run during one of his final baseball games. This record would stand for almost four decades. When he retired that same year, he had the most home runs, total bases, walks, runs batted in, and strikeouts during his career. In 1936, he was inducted into the Baseball Hall of Fame, one of the first five players to be welcomed.

While construction projects have also been welcomed by many lenders into their portfolios, construction spending has been mixed, according to Wells Fargo analysts. [Total construction spending increased 0.1% in March](#), but this was below the 0.8% expectation. Construction spending overall rose 11.7% YoY, yet important sectors saw spending drop. Commercial spending was down 1.9%, manufacturing declined 1.6%, and office construction spending dropped 0.2%. Still, single-family home spending rose 1.3% and lodging spending increased 0.5%.

On another bright note, the Architecture Billings Index, which precedes nonresidential construction spending by 12 months, hit 58 in March. This level is the highest since May 2021 and the second-highest during the economic recovery. Wells Fargo reported that *“at the end of the first quarter of 2022, architecture firm backlogs stood at an average of 7.2 months, a new all-time high since records started in 2010.”*

With many variables affecting the market, from rising prices to labor shortages and supply chain bottlenecks, risk mitigation is paramount. As you watch the key economic indicators, here are **three reminders of simple ways to mitigate your risk with construction loans**.

1. **Disbursement controls.** Make sure that the construction loan holdback is appropriately planned and managed. Work should be completed before disbursements are made. From the beginning, keep a keen eye on the construction project balance sheets, using comprehensive disbursement controls firmly. If you need to adjust those controls, now may be a good time to do that.
2. **Progress reports.** These reports are often provided when a draw is requested from the lender. However, lenders can include periodic inspections in the loan documents to allow for more progress updates outside of draw periods. These extra progress reports let lenders stay up to speed throughout the project. If issues are showing up, they can be remediated easier than later down the road. It also helps certify that the property's loan-to-value standards and cost-to-loan obligations are being satisfied.
3. **Project rights and contractual obligations.** While lenders are focused on the loan for the construction project, provisions need to be in place for project management in case the borrower decides not to fulfill their obligations. If the documentation does not clearly state that the lender takes over control of all plans under the contract, it could find the project in limbo, with no clear direction for loan payments. Without the clear designation of rights, neither architects nor contractors are obligated to fulfill the original contract. While no lender expects this to happen, it is a risk that is easily mitigated from the beginning.

Right now, construction seems to be continuing in some sectors, despite the headwinds of rising inflation and supply chain shortages. Yet, regardless of the construction sector, CFIs should watch for any changing or troubling signs and manage risks robustly. It may not be an easy road, but it doesn't need to be treacherous.

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## ECONOMY & RATES

Rates As Of: 05/25/2022 07:25AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	1.06	0.21	1.00
6M	1.53	0.12	1.34
1Y	1.99	-0.11	1.60
2Y	2.50	-0.22	1.76
5Y	2.73	-0.22	1.47
10Y	2.76	-0.18	1.24
30Y	2.98	-0.02	1.08
FF Market	FF Disc		LOBB
0.83	1.00		0.90
SOFR	Prime		QBFR
0.78	4.00		0.82

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