Tariffs, Construction Loans And Materialism

lending performance business customers

Summary: How does the sudden rising cost of materials affect construction loans? We offer ways to mitigate this risk, as higher tariffs are absorbed into building projects.

We found some odd facts that show people really like to collect stuff. For instance, the LA Times reports the average American home has about 300,000 items and the NY Times reports 10% of Americans rent offsite storage to hold all of their junk. As if that weren't enough, the Department of Energy reports a whopping 25% of people with two car garages don't have room to park cars inside them. Materialism it seems is alive and well in America still.

When it comes to materials of another sort in banking, consider that higher tariffs on steel and aluminum are pushing up the cost of construction projects. This can strain loans already on thin margins. To protect the bank, lenders will want to pay attention to materials costs and counsel borrowers. It is vital to get borrowers to build clear, contractual roadmaps to address price increases on raw materials with both suppliers and subcontractors.

Canada, Mexico, and the European Union (EU), which produce about 33% of the steel and aluminum the US imports, enjoyed temporary tariff exemptions on those metals. The exemptions ended in June, though, delivering a sharp rise in costs.

Given that building projects have pre-identified funding, what happens if costs rise unexpectedly? Already the price of construction materials has risen by 9.6% in the past 12 months, so projects will be running thinner.

A large rise in the cost of materials can also put a contractor's vendor contracts at risk. Subcontractors commonly guarantee the cost of materials for 18 or 24 months in contracts that are often made a year in advance of breaking ground. If prices go up, vendors are contractually obliged to pay the extra cost. In normal years, contracts allow for a modest increase -- but no one expected the sharp rise we're seeing now.

If a subcontractor is earning just 5% on the project overall, it could be difficult to adapt to an unexpected swell in the cost of materials. Dragging a vendor to court adds more expenses to the project and might push the subcontractor into bankruptcy. That does not help the contractor's chances of finishing the project.

Instead, construction lenders are already working with borrowers to cover more expensive materials. That might mean asking the borrower to put more equity into the project, reducing the scope of the project or moving to a more phased building approach over a longer time perhaps. Seeking out cheaper alternative materials and cutting other costs may help too.

Bankers should also work with construction borrowers to explore ways to mitigate the risks of upcoming projects. Pre-development materials sourcing, where contractors and subcontractors purchase all the materials they'll need at the beginning of a project, is one way to protect against price shifts.

Where that's not practical, flexibility in contract provisions around likely price escalations, clearly defining who will pay any extra costs, can help protect the contractor and in turn, the bank.

Make sure your construction customers have strong, practical contingency plans and be sure to consider the environment as well. No one wants rising prices to dictate design choices, but knowing how a contractor will adjust a project to accommodate budget changes can make the difference between success or failure for both a building project and the loan supporting it.

DEPOSIT OPPORTUNITY YIELDING 2.30%

In an effort to expand our relationships, PCBB is pleased to offer community banks a money market deposit account rate of 2.30%, subject to availability. Contact operations@pcbb.com.