



CONSTRUCTION LENDING: TREASURE TROVE OR “BOON DOOGLE”?

Real estate construction lending can be a valuable service for bank customers, a good source of revenue to the bank and contribute to the community's development efforts. The basic idea of construction lending is to fund the construction of buildings with a mortgage lender to assume the permanent financing when the buildings are completed. While the concept is simple, implementation can be challenging.

Over the years, the writer of this article has seen various problems in construction lending including houses built on the wrong lot. Recently BancInsure has paid two claims on the same bank involving the more common problems of poor construction quality and the construction loans being fully funded before the construction is complete.

Our investigation of the claims revealed that there was a lack of lending policies and procedures for construction loans and that the personnel handling these loans were inexperienced and lacked training. The claims were settled with BancInsure contributing in excess of \$80,000 for each claim under the Lender Liability Endorsement to BancInsure's Directors' and Officers' Liability Insurance Policy.

It is beyond the scope of this article to discuss all of the intricacies of construction lending. The following general comments are offered for your consideration. The primary areas of concern should be policies, procedures and personnel. There should be comprehensive lending policies for all types of loans including construction loans. A bank should have a procedure manual with detailed requirements as to documentation and procedures. Personnel handling construction lending should be experienced and well trained, or very closely supervised by bank officers knowledgeable in construction lending.

While it is beyond the scope of this article to offer a complete course in construction lending, the following items are basic. In addition to the documentation requirements common to all real estate loans, deeds, mortgages, title opinions, etc., construction loans should include a construction loan agreement, builder's risk insurance, flood zone statement, survey, copy of construction contract, copy of the plans and specifications, building permit, construction progress (inspection) reports and take-out agreement for permanent financing. The construction loan agreement should clearly spell out the responsibilities of the borrower and the bank. Advances on construction loans should not be made without documented inspections of the construction site. Loan advances should not be made without the borrower's specific approval.

There are many training resources available for construction lending from the various banking organizations.

We trust that these comments have been helpful.

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