Credit Enhancement Options in Construction Lending: A Look at Traditional and Modern Tools

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When it comes to construction loans, there is no doubt that lenders carry significant risk. Although there are tools available at every step of the loan process to reduce lender construction risk via proactive risk management services, when it comes to protection against borrower or contractor failure, the tools available become reactive. In fact, in the event of borrower and/or contractor failure, these tools can cause significant headaches to the lender, often halting the project entirely.

Tools to prevent construction defaults often are also utilized as credit enhancement options for borrowers who need a boost in credit to qualify for construction loans, but each has its own list benefits and drawbacks.

Traditional Tools for General Contractor Failure. When it comes to options that can be exercised when a project fails as a result of contractor performance, bonds are the most commonly utilized. Although bonds can be good tools for public projects, they are often not the best choice for lenders since they can be slow to respond, tough to perfect claims, difficult to collect, and can result in expensive litigation. And in cases where the General Contractor is also the borrower, bonds are not really a viable option, often limiting the lender's ability to offer them a loan.

Traditional Tools for Borrower Failure. Aside from performing more stringent underwriting, typical credit enhancement options available to mitigate borrower failure include letters of credit, the inclusion of additional guarantors, and restricted cash. Although letters of credit can be a good option as they provide lenders access to cash with fewer obstacles, they can be expensive, require that the borrower be well-capitalized, and handcuff the borrower's operation by potentially restricting working capital.

Having additional guarantors on a project also improves a project's credit profile. However, it can be difficult to obtain additional guarantors and may also prove costly to the borrower as they may have to give up an equity stake in order to secure these guarantors. Although guarantors are required to sign a completion guaranty, historical precedence has shown that a lender's primary recourse against these instruments is an after-the-fact suit for damages.

The use of restricted cash as a credit enhancement tool is utilized when lenders want to be sure money is set aside specifically to repay a project's loan. Although funds placed in this account accrue interest and are reimbursed if the project is completed on time and on schedule, it ties up the borrower's working capital. In a developer's world where cash is king, any lender requiring restricted cash should not be surprised if such a requirement is a deal killer.

A Modern Credit Enhancement Tool. Another option for lenders looking to provide solutions to help their borrowers get approved for a construction loan is SureBuild℠ project completion insurance. This credit enhancement tool can be an attractive option for both lenders and borrowers alike.

Benefits to Borrowers. To begin, project completion insurance is significantly cheaper than most credit enhancement alternatives like bonds and letters of credit, which ultimately drive up the cost of the project. Less capital tied to the project also offers the borrower more financial leverage. Secondly, the ultimate goal of the borrower is to get loan approval. Do borrowers ever anticipate the need for project completion insurance or any other credit enhancement tool to be invoked? Of course not, as it means they would potentially lose everything. However, if having project completion insurance helps to close on their loan and give their lender peace of mind, it is an option most will happily explore.

Benefits to Lenders. Aside from being a less expensive credit enhancement option offered at a fraction of the cost of a bond, it is also a proactive construction risk management tool, often paired with professional services like a Completion Commitment and funds control. SureBuild℠ is quicker to call and, in the event of borrower failure, the insurance company would have plenty of notice to a claim and be able to fund expeditiously. Since the lender is the direct beneficiary of the project completion insurance policy, these funds would be available to the lender quickly and without the need for litigation.

Credit Enhancement Use Scenarios. Project completion insurance is a good option for any construction project where risk is elevated. However, typical projects where borrowers have needed a boost in their credit profile have been for one or more of the following reasons:

- ***Credit Concerns***
- ***Cashflow Concerns***
- ***Borrower is the General Contractor***
- ***Lack of Developer Experience***
- ***Developer Project Scope is Larger than Usual***
- ***New Project Type for Developer***
- ***Enticement for Lender Participation*** – Used in the event that the borrower's lender needs additional protections to lend on a new project type, such as solar.
- ***Change in Capital Stack***
- ***Complex Capital Stacks –*** In situations where the General Partner has sufficient cash to fund the project, but has a large number of limited partners, project completion insurance is a great option for two reasons. For one, it can be hard and time-consuming to underwrite each partner. Secondly, it can be tricky to get the limited partners to contribute in times of trouble.

How Project Completion Insurance Works. SureBuild℠ is enacted when there is borrower failure. Once the lender takes control of the property, SureBuild℠ is there to provide funding coverage for over budget construction costs. The insurance company would fund directly to the lender for each draw that is over budget as a result of non-optional change orders. [Note: There is a 10% copay.]

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While construction lending can be a high-yielding and profitable investment, it is high risk. It is important for lenders looking to make deals work for their borrowers thoroughly understand the benefits and drawbacks of the tools available to them. Choosing tools that are proactive and protect the lender at every stage of the process is crucial to assure a project gets completed, especially when it comes to lending to borrowers whose credit-worthiness is borderline. ▪

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