



CONSTRUCTION INSPECTOR REVIEW

VOLUME 6, 3RD QUARTER 2007

WORD FROM THE HOME OFFICE

The construction finance market is changing. You see it daily on the news and it has been especially apparent in the Stock Market. Major lenders are in upheaval and borrowers and builders are looking for additional financing for their construction projects.

The good news is that companies like Granite who specialize in Risk Management systems and procedures are thriving in this changing market. Our unique suite of services assists lenders with their troubled and fluctuating portfolios, putting Granite in an ideal position to capture supplementary business.

As you know, Granite's client base is made up primarily of bank-designated institutions as opposed to mortgage companies who rely heavily on Wall Street lines of credit that have now been eliminated. As a result, Granite clients are recovering defaulted construction loan portfolios and utilizing Granite services.

Our business continues to flourish in light of current market conditions. Granite's success depends upon our relationship with our inspectors.

Thank you for your patience during these evolving times and for your continued excellent work.

The GCI Inspection Team

Mitigating Pre-Closing Construction Lending Risk

by John Morrissey¹

Construction lending, although highly profitable, includes a vast number of risks. Many of those risks exist prior to the loan ever closing, and it has been estimated that a substantial portion of a lender's risk can be mitigated through proper review of the project and contractor. Part I of this article will address proper techniques for reviewing a project and Part II of next quarter's article will address proper techniques for reviewing a contractor's qualifications.

A construction loan, by its very definition, requires a lender to approve a loan based upon collateral that does not yet exist. As a result, it is imperative that the lender possesses a detailed understanding of the project scope and associated costs. This process is typically referred to as project review, and the goal of a project review is to ensure that the lender is lending sufficient funds in combination with the borrower equity to complete the asset. Foregoing a project review can lead to budget deficiencies, missing key elements of construction and contract terms that are contrary to the lender's credit policy. All of these issues are avoidable and can be addressed when a lender properly analyzes all project information.

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New! GCI DEVELOPMENTS

Electronic Funds Transfer

As announced in our last publication and recent email blast, the EFT/ACH payment program has taken off. The response has been excellent and the system is working very well. If you have not already submitted your request to be activated in this payment system, please login to www.gcinspects.com and download the EFT forms. You may also email inquiries to Angie Kelley in our Recruiting Department at angie.kelley@gcinspects.com.

Watch for "Special Instructions"

The special instructions are a very important communication tool on the inspection orders. They communicate value and critical information regarding any special requirements associated with that order (i.e. contact builder for access, wait to inspect next Monday, etc.). These instructions are located in two areas on the website/

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Mitigating Pre-Closing Construction Lending Risk (cont'd)

Many lenders oftentimes view the inspector as their budget management tool. This can be detrimental because no matter how efficient and knowledgeable the inspector may be, he/she cannot regulate whether sufficient funds are available to complete the project. In addition, while an inspection may assist with maintaining a proper balance between loan funds disbursed and the overall percentage of completion, the real risk is that the project has been underbid by the contractor from the beginning and the lender will be left with an asset that is 80% complete and 100% disbursed. In order for a lender to mitigate their project risk, and avoid the above situation, the following steps should be taken:

REVIEW THE BUDGET

Each construction loan project should include a construction budget/cost breakdown. The following questions should be asked when reviewing the budget:

- 1. Does the budget total correctly?** A budget that does not total correctly could indicate that the budget submitted is just an estimate and not the "final" construction budget.
- 2. Does the budget match the contract amount?** If the contract is fixed price, or a cost plus with a guaranteed maximum price, the budget should match the stated amount on the contract. If these amounts don't match, then either the budget or the contract may not be the

"final" one agreed to by the contractor and borrower.

3. Does the budget contain all of the key elements of construction, i.e. (appliances, cabinets, counter tops, doors, drywall, electrical rough/fixtures, exterior finish, flooring, foundation, framing, grading, HVAC, painting, plumbing rough/fixtures, roofing, windows, profit/overhead)? An under-detailed budget that does not contain these elements could make it difficult for an inspector to accurately inspect the project. Asking the builder/borrower to indicate where certain key elements of construction are located within the budget can reveal items that will not be completed by the general contractor. Furthermore, excluded budget items can lead to borrower or contractor liquidity problems if left unaddressed. These key elements must be included in the budget to ensure sufficient loan funds are available to complete the home.

REVIEW THE CONTRACT

While the lender is not a party to the construction contract, it is important that the lender review the contract anyway. The following questions should be answered during the review:

- 1. Is the contract between the contractor and borrower submitted to the lender?** Although rare, sometimes a contract may not be between the parties that the lender expects.
- 2. Does the contract clearly define the scope of the work to be performed for the borrower? Could the contract be specifically enforced?**

3. Are all of the attachments described in the contract included? The lender should obtain a copy of the entire contract for review.

4. Are there any provisions in the contract outside of lender policy? Many contracts will contain language that is in conflict with bank procedures. The most common is payment terms outside the lender's policies. An example would be disproportionate deposits prior to any work being completed. While the lender is not a party to this contract the contractor expects its terms to be followed. Any conflicts with credit policy should be made clear to both the borrower and contractor up front to avoid problems later. These acknowledgements should be signed by the contractor and the borrower to ensure that the lender's terms and conditions will prevail.

5. Is the contract signed by both parties? It should be. The laws in some states require that the contract not be signed until closing. If this is the case, the lend-

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JOIN OUR NETWORK!

GCI is constantly recruiting qualified individuals for our nationwide Inspector Network.

If you are qualified to perform either residential or commercial construction inspections and are interested in applying, please email us at:

inspectorinfo@gcinspects.com

to learn more about what GCI can offer you!



INSPECTOR CENTRAL

New! **GCI DEVELOPMENTS** (cont'd) report. First, they are viewable on the project web screen under the heading "Original Message to Inspector," and secondly, they are displayed on the inspection field report in the upper right section of the document. ■

UPCOMING EVENTS:



Visit our booth at the 2007 ITA Annual Expo in Las Vegas, NV!

**INSPECTION TRAINING ASSOCIATES (ITA) INSPECTION EXPO
LAS VEGAS, NEVADA
10/1 - 10/3**

Granite is conducting recruitment sessions during the ITA Expo. If you know of another inspector with construction inspection experience in either residential or commercial industries and who is looking for supplemental income, please send them our way.

For more information on the ITA Expo, visit: www.home-inspect.com.

"OUTSTANDING... IN THE FIELD"



John I. Humphrey is owner/operator of **Acadian Home Inspection LLC**.

Born and raised in New Orleans, John I. Humphrey has been in the inspection business for more than 14 years. The main focus of his business is general home inspection, pre-listing inspections and new construction inspections. He is a member of the Louisiana State Board of Home Inspectors (LSBHI #10082) and an American Society of Home Inspectors (ASHI #244447) Certified Inspector.

Married for 13 years with one daughter, John enjoys being a home inspector because he helps people make a sound decision when buying one of the largest purchases in their life. He started working with Granite in Fall 2005, a few months after hurricane Katrina devastated the Gulf Coast. He was fortunate that storm damage to his home was limited although it destroyed many others in the surrounding areas.

John welcomed the work from Granite since the housing market was not moving at a fast pace for a while after the storm. Most of his clients with Granite are long-time residents of New Orleans or new investors hoping to make it their home.

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GCI'S TOP 5

Top 5 Reasons for Incomplete Inspections

- 1. Not Reviewing Entire Project**
Review the entire project and all applicable line items on the budget with every inspection, not just the "Photo Focus" items.
- 2. Not Complying With "Special Instructions"**
Acknowledge and comply with all "Special Instructions" listed on the request.
- 3. Inadequate/Missing Photos**
Include photographs of key elements, i.e. onsite materials, specialty items (like water features) and required "Photo Focus" items.
- 4. Incorrect Property**
Verify property location to ensure an inspection of the correct property.
- 5. Incomplete Walk-Through**
Every room should be viewed and documented, with a photo when necessary.



Mitigating Pre-Closing Construction Lending Risk (cont'd)

er should condition their loan approval subject to receipt of a fully executed contract.

REVIEW THE PLANS

In order to ensure that the budget is adequate to build the project, a review of the plans is necessary. The plans should be a full "bid set", meaning that it is the set that the contractor is using to obtain bids from his subcontractors and suppliers. At a minimum, the plans should include elevations, floor plans for each floor, foundation plan, and a framing plan. Of course a larger more complicated home will require more detailed plans than a small home, and adjustments can be made for these differences. The following questions should be answered during the plans review:

1. *Is the square footage on the plans consistent with the square footage indicated on the appraisal?*
2. *Does the project detailed in the plans match the description in the contract?*

Is it the same asset that was used in the appraisal?

3. Does the asset have unusual components that would have a significant impact on cost? For example, is it being constructed on a steep or sloped lot. If this is the case, the foundation allowance in the budget should be closely scrutinized to ensure there are sufficient funds and a contingency may need to be included.

REVIEW THE OVERALL COST PER SQUARE FOOT

Finally, the project should be reviewed to ensure that the cost per square foot being charged for the construction is adequate to build the asset. The appraisal can be used to help with this review. On a Uniform Residential Appraisal Report, the appraiser will show a "Cost Estimated New." This is the appraiser's estimate of how much it would cost to build a similar project in the area. This amount should be compared to the contractor's budget and be within a reasonable variance of 10-15%. If not, the project may be underbid which leads to insufficient funds to complete the project. The lender should also consult an alternative resource other than the appraiser to confirm cost per square footage.

In conclusion, while the above review items may seem simple, a comprehensive analysis of these elements will mitigate a lender's construction risk. In return, the lender will realize a completed asset, and one, which is completed within the budget. It is by reviewing the project up front that both of these goals can be reached. ■

**Granite is a member of:
THE NATIONAL ASSOCIATION OF
CERTIFIED HOME INSPECTORS (NACHI)**



For more information about NACHI, visit them at www.nachi.org or explore their resources at www.inspectormall.com.

LOOKING FOR CONTRIBUTORS!

We are looking for contributors to the CIR newsletter. If you have an idea for an article or something you want us to review - let us know.

In addition, if you have authored industry-related articles and would like to submit something to the publication, contact our Marketing & Sales Department at 866.380.9504 or email us at sales@gcinspects.com.

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Comments & Compliments

We are always looking for feedback from the field. If you have a suggestion to make your job more efficient or have something nice to say, let us know.

We appreciate your input and look forward to hearing your thoughts and ideas.