

The Risk Illuminator

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Construction Contingencies may require additional Analysis



Many lenders utilize methods for determining the adequacy of contingencies which have been “passed down from generation-to-generation”. Some of the most common include utilizing either 3% - 5% of construction hard costs, or a straight 10% of hard costs. When rehab, conversion, or special site work considerations are present, the standard generally rises to 10% - 15% of hard costs. Some of these are driven by company policy and/

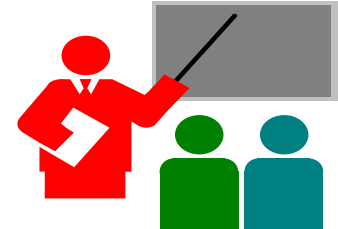
or some are driven by experience. It may be especially beneficial to the lender's loan performance to review the adequacy of the construction contingency with certain transaction specific elements in mind.

The contingency is a specific allowance that provides for unforeseen construction difficulties and/or for oversights during the course of construction. Usage of the contingency line item should **always** be via the change order process. Change orders are inevitable in nearly every construction project. This written document is typically prepared by the architect or the contractor and should minimally be signed by both the owner and the contractor. Change orders that are properly executed (dated & signed by necessary parties), prepared timely (as soon as the change is determined to be necessary), and are prepared precisely (specifically listing the necessary change including labor and/or materials) help ensure continued job progress, as well as being valuable at a future date if the legal system is utilized to resolve disputes.

Change orders or “extras“, and subsequent use of the contingency line item, arise for reasons including:

- ⇒ Unforeseen field conditions, including subsurface conditions;
- ⇒ Correction of design discrepancies, errors, or emissions;
- ⇒ Owner requested changes;
- ⇒ Changes required by building officials that may arise due to interpretations in building code;
- ⇒ Changes in the availability of building materials & products;

See Contingency page 2



**Hard-Hat
University**

“POP QUIZ #8

Match the terms with the definitions:

1. Impost
2. In-situ
3. In-toto
4. Impeller
5. Incuse
6. Intrados

A. A rotary wheel w/vanes used inside a casing to move fluid.

B. Undisturbed, in place, as in natural soils or landscape.

C. A load-bearing portion of a wall/pier supporting the end of an arch.

D. The inside curve of an arch or vault.

See Quiz page 2

TOPICS IN THIS ISSUE

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Contingency (from page 1)

- ⇒ Changes in project staging;
- ⇒ Inflationary trends during the life of the project;
- ⇒ Unanticipated weather problems and/or other schedule delays; and
- ⇒ Unforeseen changes in the viability of subcontractors or suppliers.

All of the above should be considered when reviewing the adequacy of the construction contingency. Many of these factors are directly related to the stage of completion of the construction documents, particularly the plans & specifications. Plans that are more fully developed obviously have less uncertainty, and are less likely to require field changes, than conceptual or preliminary drawings. To account for the design stage of the plans, the relationship manager may want to consider the following rules of thumb, in addition to the standard 3% - 5% of hard costs:

- ◆ “For Construction” plans [0% - 3%];
- ◆ “Working Drawings” [2% - 7%];
- ◆ “Preliminary Drawings” [7% - 10%];
- ◆ “Conceptual Drawings” [10% - 20%].

In the final analysis, contingencies are a matter of informed judgment, the lender's tolerance for risk, the competitiveness of the project, and the credit of the borrower. A thorough analysis of the above will help prevent problematic surprises.

Quiz (from page 1)

E. A stamped figure as in patterned metal ceiling tiles.

F. On the whole, as in bidding a job that includes all facets of work.

Answers: 1-C, 2-B, 3-F, 4-A, 5-E, 6-D

