

## **Construction-Friendly Bank: A Pre-Feasibility Study**

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### **Abstract**

Interviews with construction stakeholders re-confirmed the assertion that commercial banks have failed to understand construction. In contrast, banks respond otherwise. Construction personnel empathise with the concept of a 'construction-friendly' bank (CFB) but not banks! This impasse needs further study. Investigations reveal that a CFB could offer services hitherto not offered by commercial banks and currently available services could be packaged differently adding value to construction. Countries that have developed such responses include Mexico, South Korea and Sri Lanka and to a little extent New Zealand.

If banks were to respond to the needs of construction, they need to understand the nature of payment profiles, cost structures and supply chains, cash flow characteristics, contractual provisions, project performance characteristics in a local context whilst noting that construction is a heterogeneous industry in relation to financing needs. To what extent banks understand these is unknown.

A CFB could be set up as a unit within an existing bank or as a separate entity (with or without retention moneys), or as a public-private venture. A construction-friendly mix of strategic and operational decisions need to be made through a good understanding of the construction industry.

### **Keywords**

Banks, Construction, Finance, Lending, Monetary retentions

## **1. Introduction**

There has never been a better time to moot the idea of a construction-friendly bank (CFB)! Through various publications, the author has re-iterated that commercial banks have failed to understand construction (Abeysekera, 2002; 2003; 2005). Most banks do not seem to have staff academically qualified and experienced in construction. Their lack of keenness to understand and respond to the needs of construction may be due to the perception that construction is "risky" or there is less profit to be made in serving construction. Whatever the reason, obtaining facilities is not easy without good collateral. Cash deposits are factored downwards and not upwards perhaps due to the lack of recognition of multiple streams of income through multiple projects and also due to lack of interest in monitoring project performance. To make matters worse, banks that provide greater facilities to construction have also been seen as risky (Matthews, 2000). Given this background, construction industry cannot expect favourable facilities from commercial banks when compared with those provided to suppliers and the like. Consequently, mainstream contractors have to rely on suppliers and other service providers for credit facilities and/or leverage retention moneys to create surplus cash to manage construction (Abeysekera, 2006), and property developers have to rely on mezzanine funders to ensure adequate funds. Thus, it is not difficult to perceive why such practices add multiple layers of costs and not value.

The current global financial crisis has in no uncertain terms exposed the dark side of financial institutions so much so that national leaders have labelled some of their practices as “shameful”. There is an air of anger and mistrust with calls for reforms and restoration of confidence through transparent and more accountable systems of governance, greater state involvement and intervention, and in general for more professionalism. This augurs well for construction as institutions that provide finance for construction must demonstrate their understanding of the industry they serve. It is time that construction industry explores new ways of working and thinking about construction to bring in a new order: Construction is the fuel that ignites national development; finance is the spark that makes it possible.

Interestingly, there are several international banks operating in NZ but there is only one local (private, small) bank and one state funded bank known as Kiwibank. The latter was set up in 2002 perhaps in response to the domination of foreign banks and to provide a value-adding banking alternative with ‘Kiwi values at heart’. During its short existence, it has been able to lower transaction costs, provide a home loan guarantee to be the cheapest as no other bank has done. This is an example of what is possible if governments are willing and able as they could provide value-adding alternatives. Similar initiatives are explored in this study, particularly with a view to understand how others have responded to construction needs. Moreover, findings of a preliminary study on the pre-feasibility of a CFB (/unit) are also reported.

## **2. Reflectins on International Experience**

### **2.1 The Work National Bank and Services Public–BANOBAS** (Banco Nacional de Obras y Servicios Publicos)

Set up in 1933 to assist in the reconstruction of Mexico’s deteriorated urban infrastructure, BANOBAS has played a vital role in the growth of Mexico’s economy. The bank is government-owned but is believed to exercise a high degree of independence. One of its principal roles had been to provide lines of credit not only to government organisations undertaking public works but also to private construction contractors to accelerate national development. A wide range of financial services are provided to contractors. One essential feature of its support to industry is to provide short-term loans to public works contractors using contractors’ receivables as security. The risks involved would clearly be less when the client is a government agency as the uncertainty and the effort of collection would be less. Additionally, BANOBAS has a scheme that provides advances to construction contractors as a means of dealing with liquidity problems. A construction-friendly bank, it is believed that BANOBAS has played a major role in assisting construction contractors to overcome financial constraints (Abeysekera, 2002a; 2003).

### **2.2 The Korea Construction Financial Cooperative (KCFC): A Retention-based Scheme**

KCFC is a unique organisation where its shareholders and customers are licensed contractors. With headquarters in Seoul, it has many regional branches. Their charges are very competitive to the extent that rates for bonds and guarantees appear to be a global minimum. Retention moneys held by public institutions forms the primary base for capital. Two main types of services are on offer: A guarantee service (i.e. for bid/ performance bonds, advance payment bonds, etc.) and a loan service for purchase of materials, equipment and plant by **mortgaging contract receivables**. Only licensed contractors can seek membership. They need to invest in the cooperative and facilities up to **20 times their investment** seem to be available to them. This is significantly different the practices adopted by commercial banks as what is offered by them is only **a fraction** of the security provided! Facilities provided by KCFC can only be expected from an organisation that understands construction (Abeysekera, 2002a; 2003).

### **2.3 Construction Guarantee Fund (CGF) Sri Lanka**

Sri Lankan contractors have faced considerable difficulties obtaining bank facilities notwithstanding favourable contractual terms providing mobilisation advances up to 20% of the contract price. This ‘client-financed’ approach has continued for a long time and it is now culturally unacceptable to do

otherwise. A landmark study in the late eighties led to the government increasing the advance by another 10% (for public projects). However, securing these advances was not easy as commercial banks insisted on collateral to the full value of the bond! The reluctance of public sector organisations to accept insurance bonds made matters worse. Given this impasse, contractors' associations investigated many options, including the use of a retention-based fund which was abandoned after the Government refused to release retention moneys. Eventually, the Treasury provided seed capital for a guarantee fund to be set up mainly for issuing bonds and guarantees. Unlike with KCFC, contractors were not required to seek membership or contribute any capital. Only licensed contractors were eligible to obtain secure services. They were required to provide two guarantors (contractors of equal or higher standing) who would take over in the event of a default; in essence, a system of counter indemnities were in place as a means of minimising risk (similar to the Master Builder guarantees in New Zealand). Other strategies introduced to minimise risks were (a) a project-based lien account, and (b) a semi-optional project monitoring service to ensure efficient management of projects. These strategies were useful for managing risk, enforcing financial discipline, and also for ensuring progress (Abeysekera, 2002a).

### 3. Understanding Construction

In order to find ways and means of supporting construction with value-adding options, it is paramount to understand the drivers, needs, and constraints of each other vis-à-vis banking and construction. According to Scott (2007), a banking specialist, "to measure a prospective borrower, **lenders must understand the demand/supply dynamics of the prospect's industry** as they affect cost structure, volume, pricing, distribution channels and capacity". Thus it is not enough to understand the borrower but the industry as well. Bankers are well versed in assessing the borrower. For example, the 5Cs lending norm of 'collateral, capacity/cash flow, character, capital and conditions' is well known and is useful to borrowers as well. The "2 ways out" approach also makes sense to ensure they get their funds back. These drivers cannot be underestimated. However, what seems to be lacking is a focus on the **industry** they serve.

Take the case of **payment profiles** in construction: A unique feature is that a portion of money is held back from all payments to contractors (or subcontractors) for release upon completion, a part soon after completion and the balance after the defect liability period. Moreover, such retention regimes and release mechanisms vary too! According to Scott (2007), a "firm's success is measured by its capacity to generate sufficient cash flow from operations to pay obligations, enhance its credit rating and maximise shareholder value". If this banking perspective is taken as a measure of success, NZ contractors, particularly medium to large scale contractors, has a golden opportunity as they could leverage retention moneys to create a large pool of surplus cash (Abeysekera, 2006) with no need for work in capital from banks. In fact, Abeysekera (2008) has cited retentions as a 'cash-cow' providing short-term investment opportunities. Trade contractors, however, do not have this luxury. Consequently, they tend to rely on suppliers for credit. This too is only possible for material intensive trades such as structural steel work, suspended ceiling work and electrical work but not for labour intensive trades like painting or formwork. Thus, not only is it necessary to understand **payment profiles** but **cost structures** and **supply chains**.

A common practice in projects funded by international organisations (such as World Bank) is to provide a **mobilisation advance** secured through an advanced guarantee bond. This is a contractor-friendly practice for a number of good reasons (Edgerton *et al.*, 1997) though uncommon in NZ. The real beneficiaries of this practice are contractors who are not cash-rich and who do not have the opportunity to leverage retention moneys (as noted earlier), especially when banks require collateral to the full value of the advance, the benefits would be lost! Part of the advance is recovered from payments for work done. Although, risks are reduced, the bond remains in place without a commensurate reduction in collateral! So is the case with performance bonds. Clearly, this is not being contractor-friendly. A CFB would not be so; it would seek friendly-opportunities and structure services differently (say by providing reducing bonds) and introducing new services (such as rolling advances and financial advice) constantly seeking innovative solutions to lending risks whilst managing **performance risks**.

Given this background, it is pertinent to ask what contractor-friendly solutions could be introduced to overcome the stifling impact of collateral. The answer to this question must surely come through an understanding of what construction is. Here are few questions that need answers:

- To what extent does the risk of non-performance reduce as the projects progress? If the risk of non-performance reduces, can collateral for bonds be reduced?
- To what extent can future payments be mortgaged given that a project is a guaranteed stream of income? Should all projects be channelled through one bank to minimise risks?
- Could retentions be used as collateral? Are retention-based trust accounts a solution?

In order to respond to these and other questions, it is imperative that banks must understand demand/supply characteristics as noted by Scott (2007) but focussing on construction: Construction is a project-based industry often with long duration projects with guaranteed income streams. Payment profiles, cost structures and supply chains, cash flow characteristics, contractual provisions, performance risks are different to other industries as explained earlier (see also Scott, 2007 for further insights). The asset-base of most contractors is weak making construction an industry with high returns on capital. These must be understood within the **local construction culture**. Construction is a **heterogeneous industry** in relation to **financing needs** with a need to differentiate property developers with main-stream contractors, civil engineering contractors with building contractors, and contractors with subcontractors in order to provide a construction friendly service.

## **4. Industry Comments on Construction-Friendly Bank**

### **4.1 Introduction**

Empirical data for this pre-feasibility study was sourced through a coursework assignment undertaken by students enrolled in the 2008 Construction Economics paper at the AUT University in Auckland, NZ with 25% of the marks allocated to it. They were required to work in groups and prepare a report on the very topic of this paper. Each group had to collect data through interviews with senior industry personnel. In all, 20 interviews were conducted with personnel from banks (6), contractors (6), project management firms (5), property developers (2) and consulting engineering practices (2).

### **4.2 Interviews with Commercial Banks**

Initial findings reveal that banks do not have much empathy with the concept of a ‘construction-friendly’ bank (or branch). A respondent from one of the leading banks believe that there is nothing more that needs to be done and that if such a bank were to be set up that it might “compromise the safety of the NZ banking system”. However, when compared with examples given in sections 2 and 3, it is the author’s view that not enough value-adding solutions have been provided to meet the needs of the construction industry. As to whether this is due to the lack of understanding of the construction community or for instance due to the lack of willingness to provide innovative solutions is hard to say at this stage.

The general consensus that emerged from interviews was that local banks were “risk averse” preferring to serve “well established” customers. Moreover, it was revealed that they have set limits for construction lending. As to how these limits are set is unknown. No doubt, credit quality is important to banks to avoid financial disasters but such inclinations are of concern to construction given the general perception that construction is a high-risk industry. Yet, there is a need to find banking solutions that are friendlier than at present. The reasons for this ‘non-friendliness’ needs further investigation. Is construction too risky? On the issue of ‘pre-construction loans’, it was noted earlier that it provides a “spark” for performance. However, this does not seem to be appreciated by banks as requests for loans do not fit in with standard lending criteria: Their response was that as these needs could be accommodated through a temporary overdraft facility, there was no need for it. However, a CFB would see it differently, for instance, by

granting a pre-agreed loan whenever a new project was awarded to be recovered fully either from the first bill or in two or more stages by mortgaging future payments through a lien account for all projects handled by the contractor or on a low-security basis. Changes to the current credit rating system from a 'negative-only' environment to a 'positive-environment' would certainly be an impetus (Slade, 2009)

The position with regards to bonds and guarantees is not friendly either, as banks usually require cash equity to the full value of the bond. This might be acceptable to contractors who leverage retentions as noted before but not for others. This differentiation is important to empathise with the needs of contractors and subcontractors. Therefore, a CFB solution would be to reduce requirement for collateral as projects progress without insisting on cash equity. As a risk minimising strategy, it could use existing guarantees (say by the Master Builders Federation) or adopt strategies similar to those practiced by CGF. Of course, the full value of the bond would still be in force from a client's perspective: A shift in service philosophy would be required from risk avoidance to risk minimisation. Whether a conventional bank would entertain such a shift in thinking is perhaps one of the biggest challenges confronting the CFB concept.

Perhaps, one solution to the above mentioned problems with bonds would be to use trust-accounts to hold retentions. In fact, one of the respondents commented that such an account could attract "high interest" with interest calculated daily. It is contended that the public sector should take a **public-good** approach by depositing retention moneys in interest bearing trust accounts (as adopted in the UK and certain states in US). If so, there wouldn't be a need for retention bonds (on public projects) with medium to small scale contractors being able to leverage retention moneys to obtain **better credit facilities**. This perhaps is a response to the *lack of friendliness* of banks and making it easier for them to be *friendlier!*

### 4.3 Interviews with Construction Companies

Almost all respondents were supportive of a CFB. However, there were mixed responses for a bank that relied on retention moneys as a main source of funds – an idea that has been mooted by Abeysekera (2003) as a value-adding solution for problems connected with retentions. Few respondents pointed out that such a venture would go against open-economic policies. Such resistance is not surprising and is expected (see theories on retentions espoused by Abeysekera, 2008) but these responses could be due to a lack of understanding of the benefits such a solution might offer. Interestingly, one of the investigators had this to state (see Bird *et al*):

*"Initially I started by having casual chats with the senior Project Managers .... The general consensus in the office was not of a huge interest towards the topic. This to the best of my knowledge was due to the fact that most in the office have been practicing in the New Zealand construction industry over a number of years even though it is a diverse group that comes from Europe, South Africa and Asia, and the overseas examples of construction banks had not been something that anyone [had come] across. This required a change in approach and I tried communicating the purpose of the Construction Banks as revealed by our literature review. This triggered some interest and I had a healthy discussion with a couple of the Project Managers. They [then] compared the reasons behind establishing a [CFB] to two organisations ... in both South Africa and England.*

- 1. The Building Society: Although establishing for residential construction, it served a similar purpose of providing funding for the benefit of one industry compared to commercial banks, hence could provide tailored services and professional advice.*
- 2. The Merchant Bank: The Merchant Bank of the other hand are banks specialised in servicing businesses and project and act as planners and advisers and are devoted to the success of these ventures instead of just lending and collecting money.*

*[They] supported the idea of a [CFB] and said that similar to the above organisation, a construction bank could give our industry the much needed lifeline to pull us through the difficult times ahead."*

Respondents also indicated that banks do not fully understand the “construction business and contractors’ problems”. They also felt that “changes need to occur in the construction finance area to assist the construction industry to be resourced appropriately”; only one NZ bank seems to have an in-house construction specialist; others rely heavily on consultants for advice. It was also revealed that on property development projects, “the pressure on pre-sales was enormous and timeframe for each stage to be completed was very short ... [and] there was perhaps not enough equity allowed or up front funding”. Moreover, it was revealed that banks do not seem to differentiate property developers with main-stream contractors when assessing bank facilities. Interest rates were considered to be too high as well. One solution would be to move to a ‘client-financed regime’ as noted by Abeysekera (2002b) which would require banks to provide bonds with less recourse to conventional collateral. For example, a CFB could consider mortgaging future payments as noted before. There will, of course, be a need for due diligence through credit checks etc. Such problems seem to be far greater with smaller contractors with difficulties in “[providing] collateral, not enough history with banks, and inadequate turnover records”.

## **5. Constructon Friendly Bank: Pre-feasibility**

CFB is a value adding preposition for industry; the findings of this study confirm this and fuels further investigation. What seems to be contentious is the concept of a retention-based CFB. Interestingly, in order to test the feasibility of the latter idea, one of the groups (Bird *et al.*, 2008) studied projects handled by a leading cost consultancy firm in Auckland to arrive at an average percentage of retentions held. Investigations revealed that it was around 3%. They then used the annual value of non-residential output \$5B (average over 2005-2008, Statistics NZ) to estimate the value of retentions excluding the less formal residential sector. However, in order to arrive at the total value of retentions held, civil engineering works such as roads, bridges and water supply projects need to be considered. Unfortunately, this information is not directly available from Statistics NZ but using GDP (construction) and other available proxy indicators, an estimate of \$2.5B seems reasonable for the period of 2006/2007 totalling to an all in construction output of around 7.5B. Accordingly, the total value of retentions held could have been around \$400M fluctuating by about 30% (as per initial results of a simplistic model). This is a significant sum of money which could be leveraged for the greater good of industry and society at large rather than being left in the hands of a few. This is an issue that needs further investigation and refinement to assess how best such moneys could be utilised.

It is perhaps useful to note that one of the significant sources of profit of commercial banks is lending. If this is the case, one wonders whether they would be interested in supporting main stream contractors whose needs for lending is much less than those of property developers (and construction related manufacturers)! This is another matter that needs further investigation to establish what philosophies need to be adopted in setting up and managing a CFB either as a separate entity or as part of an existing institution. The role of government cannot be discounted in this regard.

### **5. 1 Strategic Considerations**

It was pointed out earlier that construction is the fuel that ignites national development and finance is the spark that makes it possible. Easy access to finance at affordable rates therefore impacts positively on the competitiveness and the wealth of nations. Examples from Mexico, South Korea and Sri Lanka are innovative examples of what can be achieved through government intervention. A similar but somewhat detached example is the Kiwibank in NZ as explained earlier.

The survey re-confirmed the assertion that commercial banks do not understand construction adequately. In contrast, banks interviewed feel otherwise stating that nothing more needs to be done. Perhaps, they are driven by commercial needs and wish to avoid risk-laden portfolios to improve credit quality given that they perceive construction to be risky. As to whether this is due to a lack of understanding of the true nature of the construction industry, or whether in fact construction is much riskier than many other

industries is unclear. Interestingly, none of the local banks promote construction lending compared with some banks in developed countries such as the Bank of Scotland or the Friendly Hills Bank in the US.

The operational philosophy of most local banks seems to be focussed on risk avoidance rather than risk minimisation. This impasse needs investigation. A potential solution is a CFB whose operational philosophy could be different. However, for this to be a reality, it is important for those who finance construction to understand that construction is by and large a **project-based industry** often with mortgageable long term income streams. Moreover, it is paramount to understand the **nature of payment profiles in construction, cash flow characteristics, cost structures and supply chains , contractual provisions, project performance risks**, and their **asset base** within a local context in order to provide innovative solutions. There are other issues too diverse to mention connected with supply/demand characteristics as noted by Scott (2007). Perhaps, banks need to have divisions specialising in construction with trained construction professionals. If so, construction might not be perceived as “risky”.

## 5.2 Economic Considerations

The solution of a CFB is a response to the difficulties faced by the construction industry to access finance easily and at affordable rates. There are of course, other solutions to this problem. For example, Abeysekera (2002) has mooted the idea of a ‘client-financed agenda’ focussing on main-stream contractors. CFB is yet another idea. So is the case of a retention-based CFB which is somewhat similar to residential tenancy boards (Abeysekera, 2003). The latter evoked mixed responses despite a favourable response in a previous study by Abeysekera (2003). Moreover, it was also commented that such a venture would be exposed to the vagaries of boom and bust cycles. However, what is interesting about a CFB is that it could actually act as a buffer against such cycles. It is therefore hypothesised that the **negative responses are due to the lack of understanding of the benefits such an entity might offer to small and medium scale enterprises** particularly if the government is an interested stakeholder. Further investigations would of course be necessary to assess its impact in a local setting including costs and benefits of these and other initiatives.

## 5.3 Operational Considerations

If such an entity is to be set up, then there are choices, say from a completely different institution to part of an existing bank or financial institution as noted above. The government might be able to provide seed capital as a public-private venture or funds raised through the industry. Services of a CFB could include “value added loans” (not loans per se) and/or “draw-down” accounts, ‘declining performance bonds’ (via-a-vis progress), bonds and guarantees (by mortgaging long-term project income streams, retention moneys, factoring deposits manyfold unlike commercial banks), advice on financial management and related training for contractors, fund buffers against boom/bust cycles, asset financing (at rates lower than mortgage rates), and funds for public-private finance initiatives. In fact, a CFB could provide a wide variety of services such as those provided by KCFC, CGF or for that matter services offered by Building Societies or Merchant Banks in a manner that is different to the operations of a commercial bank.

## 5.4 Financial Considerations

Commercial ventures are driven by a desire for profit. The CFB could operate on this basis, or else, it could operate on a not-for-profit basis. It could be a state venture or a private entity. These are matters that needs further investigation.

## 6. Conclusions

This pre-feasibility study asserts that there is enough evidence to move the CFB agenda forward. What is not clear is how such a venture could be spearheaded taking into consideration the local context. The ideal

form, structure and scope also needs to be established through further studies and industry consultations. Currently work is in progress to develop further understanding of a concept that has the potential to revolutionise construction.

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