Construction Lending News

CLN

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Character and Fraud Protection and Prevention

By Dev Strischek[1]

Well before this latest economic crisis, bankers have employed The Five Cs of Credit as an analytical tool to evaluate their borrowers' willingness and ability to repay their obligations. The Five Cs are *character, capacity, capital, conditions,* and *collateral,* and four of them—capacity, capital, conditions, and collateral—measure ability to repay.

It is the fifth C, character, that assesses willingness to repay, and borrowers are not equal in this area because some are weak at the outset and others weaken under adversity.[2] Playwright Oscar Wilde admitted, "The only way to get rid of temptation is to yield to it.... I can resist everything but temptation." The German philosopher Goethe advised, "You can easily judge the character of a man by how he treats those who can do nothing for him." And Abe Lincoln observed, "Nearly all men can stand adversity, but if

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Dev Strischek

[1]© 2001 by RMA. Strischek is managing director, corporate and commercial credit policy, asset quality/credit policy division, SunTrust Banks, Inc., Atlanta, Georgia. A former RMA president, he serves on the Editorial Advisory Board of The RMA Journal and has contributed numerous articles on the construction industry as well as "spilled milk" and other articles.

[2] Dev Strischek, "The Five Cs of Credit," *The RMA Journal*, May 2009, pp. 34–37.

Real Estate Outlook: Bernanke on Housing

By Carla Hill[3]

The recovery of the housing market and economy has been slow and arduous. Legislators and leading economists alike know that housing is the key to helping jobs and Americans get back on their feet.

Federal Reserve Chairman Ben Bernanke recently spoke at the 2012 National Association of Homebuilders International Builders' Show and made some strong statements about the housing market and what has and has not happened in recent years.

"The economic recovery began more than two years ago, but it doesn't feel like much of a recovery for many Americans--certainly for those of you who depend on the housing sector for your living, as well as for the millions of others who have seen their home values plummet or lost their homes through foreclosure," he said.

Historically during recoveries we've seen that "resurgent" housing is what fuels employment and rising incomes.

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[3]Carla Hill, M.A., works on the Realty Times staff as Managing Editor for our online publication. She also is Producer for the real estate news channel, seen daily on RealtyTimes.com and on video newsletters nationwide.

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Real Estate Outlook: Bernanke on Housing *(continued)*

Today's recovery efforts however are coming up again a number of actors that constrain demand. Bernanke added, "Household formation has been down, particularly among young adults.

High unemployment and uncertain job prospects may have reduced the willingness of some households to commit to homeownership. Availability of mortgage credit is an important constraint."

> "The uptrend in home sales is in line with all of the underlying fundamentals – pent-up household formation, record-low mortgage interest rates, bargain home prices, sustained job creation and rising rents."

The housing market is on the move, however, albeit slowly. In the latest existing-home sales survey by the National Association of Realtors (NAR), sales showed promising movement for the month of January. This is the third gain in the past four months. Existing-home sales rose 4.3 percent for the month.

Lawrence Yun, NAR chief economist, said strong gains in contract activity in recent months show buyers are responding to very favorable market conditions. "The uptrend in home sales is in line with all of the underlying fundamentals – pent-up household formation, record-low mortgage interest rates, bargain home prices, sustained job creation and rising rents."

The Western region of the U.S. experienced the largest jump in sales, rising 8.8 percent for the month. This brought it's annual pace within 3.1 percent of the spike seen in January of last year.

The second largest rise was seen in the South, which rose 3.5 percent. The Northeast and Midwest experienced gains as well, rising 3.4 and 1.0 percent respectively.

"The broad inventory condition can be described as moving into a rough balance, not favoring buyers or sellers," Yun said. "Foreclosure sales are moving swiftly with ready home buyers and investors competing in nearly all markets. A government proposal to turn bank-owned properties into rentals on a large scale does not appear to be needed at this time."

Additionally, nationwide production of new single-family homes and apartments also rose 1.5 percent in January. According to the U.S. Commerce Department this was the second-best pace seen since October 2008.

"Today's solid housing starts report indicates that builders are putting more of their crews back to work, and adds to the growing field of evidence that the overall housing market is gradually but consistently moving in the right direction," said Barry Rutenberg, chairman of the National Association of Home Builders (NAHB).

To continue to see strides in the housing market, though, Bernanke stands by his advice that we need to continue to develop and implement policies to aid the housing sector. "No single solution will be sufficient. But sustained efforts to address the many interlocking factors holding back the housing market will pay dividends in the long run."

Character and Fraud Protection and Prevention *(continued)*

you want to test a man's character, give him power."

So how do we ensure that our borrower's character is not undercut by the temptation of power, money, or personal aggrandizement? Is an ounce of prevention against temptation worth the pound of cure for the consequences?

Character: Able and Willing?

Character can be defined as the combination of mental and ethical traits marking and often individualizing a person, group, or nation. Its synonyms include decency, dignity, nobility, quality, reputation, worth, honesty, and integrity.[4]

Typically ranked first among The Five Cs in evaluating creditworthiness, character is a banker's judgment of a borrower's willingness to pay. Unfortunately, a borrower's resolve and determination to repay is often tested by hard times, poor business conditions, declining revenues, falling income, and cash shortages. The other Cs have their places, but if the borrower is tentative or hesitant in his promise to repay the debt, the lender is taking a risk at the outset of the credit extension so great that the other Cs are unlikely to mitigate it.

History is replete with examples of broken promises: Nazi Germany invaded the Soviet Union in 1942, despite Hitler and Stalin's 1939 Nonaggression Pact. Henry II imprisoned his wife Eleanor of Aquitaine for 16 years, from 1173 to 1189, for failing to love, honor, and obey him, especially after she supported their son Henry's revolt against him. Imperial disregard for promises seems to be an occupational hazard, and Napoleon summed it up royally: "If you wish to be a success in the world, promise everything, deliver nothing."

These examples of how power tends to undermine character suggest that bankers ought to expand character analysis to include a review of which controls a borrower has in place to remove temptation and shield the firm and its employees from other corruptive influences. The borrower may be willing to honor the firm's obligations, but in order to preserve the value the borrower puts on reputation, honesty, and integrity, it may be necessary to help others in the firm stay resolute.

Questions of Character: Don't Count Them Out

One way to communicate the importance of character to the bank's evaluation of creditworthiness is to tactfully integrate the following 12 questions into the loan interview or search for the answers through secondary sources and references.

1. *Financial information:* Is the firm or its principals unwilling to provide financial information?

2. *Support from the principals:* Are the principals unwilling to offer personal guarantees, provide collateral, or accept any conditions or covenants?

3. *References:* Are the principals unwilling or unable to provide references from colleagues, competitors, suppliers, lenders, customers, lawyers, accountants, etc.?

4. *Communication:* Are verbal, phone, or electronic communications difficult to establish and maintain? Does the borrower pass on only good news and pass over bad news?

5. *Creditors:* Has the firm or any of its principals ever walked away from a loan or refused to pay a creditor?

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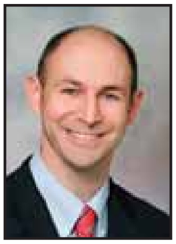
[4] Dev Strischek, "The Quotable Five Cs," The RMA Journal, April 2000, pp. 47–49.

Update on Mechanics' Lien Law in Iowa

By Neal Westin[5]



Neal Westin

Under Iowa's current mechanics' lien statute, nearly every party furnishing any material or labor to any building or land for improvement, alteration, or repair by virtue of a contract with the owner, contractor, or subcontractor is granted a lien upon the building or improvement to secure payment for the material or labor provided. The definition of "owner" includes "the record titleholder and every person for whose use or benefit any…improvement is made....".

Recent efforts have been made to substantially revise the mechanics' lien statute, but those efforts have been unsuccessful thus far. It appears likely the mechanics' lien statute will eventually be revised to simplify some of the lien perfection requirements and perhaps adopt a state-wide lien recording system, but it is unclear when the state legislature will enact such changes.

The impetus for the current proposed changes was the residential construction meltdown in or about 2008, when a number of major homebuilders shut down. Dozens of homes being built, or completely finished but not yet sold, were difficult to close and sell due to potential liens against such homes, which could not be readily ascertained. Under existing Iowa law, a subcontractor would have a lien against the home for up to ninety days after the date of last work or material furnished, which lien would relate back to and be prior to subsequent and intervening interests.

One of the key challenges with the current mechanics' lien statute is the lien filing and notice process. Although contractors and subcontractors can obtain a lien over the land and building on which they are working, it is currently very cumbersome for contractors and subcontractors to do so. It can also be difficult for property owners to determine whether there are liens on their property at any given time.

There are also a number of intricate, time-consuming steps that must be taken to enforce an Iowa mechanics' lien. Currently, to be able to enforce a mechanics' lien, a contractor must first give notice to the owner of the claim for payment associated with the potential mechanics' lien against the property. In some circumstances, the contractor must provide the owner with a list of all of the subcontractors working on the property and update the list as more subcontractors are added. Failure to comply with these notice requirements can be fatal to a mechanics' lien, as the statute currently provides that a contractor who does not comply with the notice requirements may not be entitled to a lien against the property. This can be extremely challenging given the difficulties identifying the "owner" of a property, especially in cases where the homeowner is not readily apparent during the home construction process.

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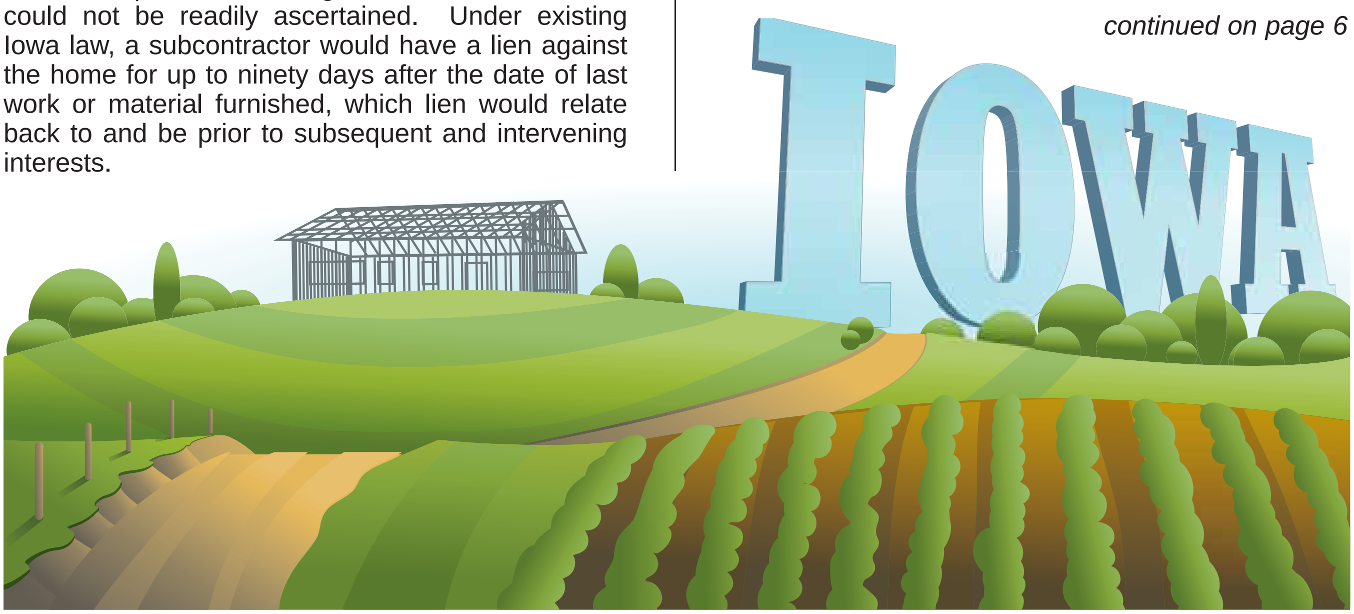

[5] NEAL WESTIN, is a shareholder at Nyemaster Goode, P.C. in Des Moines, Iowa, representing clients in business, real estate and immigration matters. Neal graduated with honors from the University of Texas School of Law in Austin, Texas, and received a bachelor's degree from the University of Iowa. Mr. Westin may be reached at 515.283.3120 or nwestin@nyemaster.com.

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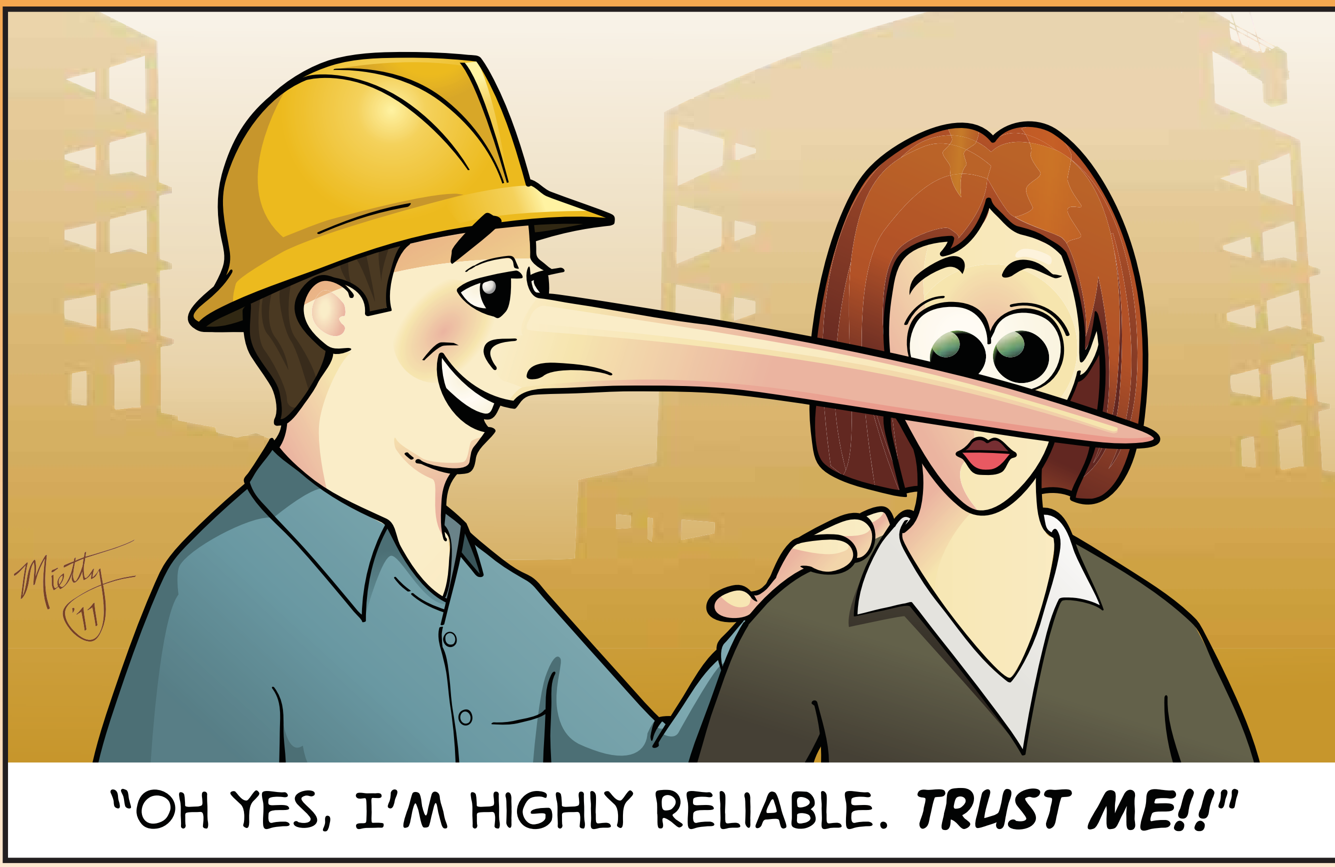

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Update on Mechanics' Lien Law in Iowa *(continued)*

The Iowa legislature has considered a number of bills in recent years to correct some of the mechanics' liens statutory deficiencies, but no bill has made it through the Iowa General Assembly.

One recent effort is HF 411, introduced during the 2011 legislation session but not enacted, which adds a definition for "general contractor" to § 572.1, which covers "every person who does work or furnishes materials by contract, express or implied, with an owner," but it does not include "a person who does work or furnishes materials on contract with an owner-builder." The bill also re-defines "owner-builder" as "the legal or equitable titleholder of record who furnishes material for or performs labor upon a building, erection, or other improvement, or who contracts with a subcontractor to furnish material for or perform labor upon a building, erection, or other improvement and who offers or intends to offer to sell the owner-builder's property without occupying or using the structures, properties, developments, or improvements for a period of more than one year from the date the structure, property, development, or improvement is substantially completed or abandoned."

Another significant change in HF 411 is the creation of a State Construction Registry ("SCR"), a central repository for the submission and management of preliminary notices and notices of commencement of work on all residential construction properties, to replace the current filing system operated by all (99) Iowa counties.

Under the proposed SCR, contractors and others seeking to obtain mechanics' liens must post their pre-lien notices as well as their notice of commencement with the SCR, and the owner and other interested parties can access the notice filings through the SCR. This way, rather than requiring potential lienholders to mail notice to specific persons who may be difficult to ascertain, the lienholders can submit their notice to the SCR database and all interested parties can then access that information electronically.

The proponents of the bill believe the proposed changes will improve the mechanics' lien system in Iowa for potential lienholders as well as homeowners. Utah recently adopted an SCR-like statute similar to

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Survey: Commercial Real Estate Lenders Ready to 'Shell Out' in 2012

By Mike Sorohan[6]

A survey of commercial real estate lenders at the recent Mortgage Bankers Association Commercial Real Estate Finance/Multifamily Housing Convention said sentiment leans toward "strong notes of aggressive capital coming back" in higher volumes.

The survey by Jones Lang LaSalle, Chicago, at the recent CREF convention in Atlanta said each of the 20 institutional lenders with whom it held private meetings indicated a stronger appetite or allocation for placing commercial real estate mortgages in 2012. JLL also partnered with Penton Media Research on a proprietary survey that compiled feedback from 186 borrowers and 136 lenders that together comprise a total median $73.3 million in commercial real estate asset value. The survey said lenders reported positive expectations for 2012 funding aims including a 12 percent uptick in expected capital placement this year.

"We expected to hear bold predictions from all of the lending sources along the capital stack and they didn't disappoint with strong inclinations to place commercial real estate debt," said Tom

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[6] Printed with permission by MBA Commercial/Multifamily NewsLink.

Update on Mechanics' Lien Law in Iowa *(continued)*

the proposed Iowa legislation. Those providing labor or materials for a real estate project in Utah must post notices of commencement, preliminary notices, and notices of completion with the SCR, and interested parties can then check the SCR listings to ensure that there are no surprise lien claims. This system appears to work well in Utah, as it ensures that notices are easy to post and view. If a similar system is adopted in Iowa, there could be a similar improvement in this state's mechanics' lien system for those seeking to enforce liens as well as those owning or purchasing real estate.

Survey: Commercial Real Estate Lenders Ready to 'Shell Out' in 2012 *(continued)*

Fish, co-head and executive managing director of Jones Lang LaSalle's real estate investment banking business. "We were pleasantly surprised with lenders' acceptance of risk as more indicated they had cash flow for the secondary markets and property types, indicative of lenders moving up the risk curve."

> "...lenders view commercial real estate mortgages as attractive investment opportunities versus alternative bonds or other fixed-rate alternatives."

"While absolute borrowing rates are at historic lows, lenders view commercial real estate mortgages as attractive investment opportunities versus alternative bonds or other fixed-rate alternatives," said Mike Melody, co-head and executive managing director of Jones Lang LaSalle's real estate investment banking business. "That should result in larger allocations to commercial real estate this year from life companies, commercial banks and commercial mortgage-backed securities originators.

Tom Melody, co-head and executive managing director of Jones Lang LaSalle's real estate investment banking business, said he expects debt financing to remain very strong in the core space from commercial banks, life companies and CMBS.

"Each of the main capital sectors were bullish on 2012 capacity and it seems life company volumes could be up 10 to 20 percent in 2012 and CMBS issuance could rise by 50 to 100 percent over 2011 this year," Melody said.

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6. *Taxes:* Is the firm or its principals delinquent in payment of taxes, fees, licenses, etc.?

7. *Fraudulent practices:* Has the firm or any of the principals ever been involved in deceptive, misleading, or fraudulent practices?

8. *Management competence:* Do any of the firm's principals lack the skills, training, and experience necessary to perform their functional responsibilities?

9. *Résumé fraud:* Have any of the firm's principals misrepresented their background, experience, skills, training, or education?

10. *Projection-budget performance:* Does the firm fail to meet its projections and/or meet its budget?[7]

11. *Unity in management strategy:* Do the firm's management and major stockholders or its partners disagree about the firm's goals and objectives?

12. *Site visit:* Do the firm's facilities appear poorly maintained, look unsafe, or feel uncomfortable?[8]

These questions state the obvious, but most of them rest on the assumption that the banker is making contact with the borrower. In the aftermath of the Great Recession, lenders have learned the hard way that remote sensing techniques work fine in detecting the formation of hurricanes and tornadoes, but are less effective in ferreting out potential human devastators.

Personal contact with the borrowing firm and its principals is the cement for the building blocks of credit agency reports, creditor checks, lien searches, and deposit verifications and paves the road to a creditworthy relationship.

Temptation: Willing and Able to Give In?

American writer Rita Mae Brown says, "Lead me not into temptation; I can find the way myself." Unfortunately, the way is not hard to find, so how hard does your borrower make the way hard to find? Besides embezzlement and ordinary theft, we now see information theft, business model fraud, and business process fraud. Business model fraud covers the company that sells illegal or worthless products or services—for example, a drug company selling unapproved drugs or a mortgage company packaging subprime loans. Examples of business process fraud include ignoring safety regulations or window-dressing quarter-end financial statements.

The Association of Certified Fraud Examiners (ACFE) surveyed the effectiveness of various fraud controls by calculating the differences in losses when the control was in place (CIP) and when the control was not in place (CNIP). The table on this page ranks 15 common controls in terms of the largest reductions. At the top of the list, the hotline fraud control reduced losses from an average of $245,000 to just $100,000—a 59% reduction.[9]

Fifteen Common Fraud Controls

	CIP (SM)	CNIP (SM)	Reduction in Losses (%)
1. Hotline	100	245	59
2. Employee Support Program	100	244	59
3. Surprise Audit	97	200	52
4. Fraud Training for Employees	100	200	50
5. Fraud Training for Management	100	200	50
6. Job Rotation/Madatory Vacation	100	188	47
7. Code of Conduct	140	262	47
8. Anitfraud Policy	120	200	40
9. Management Review	120	200	40
10. External Audit	140	215	35
11. Internal Audit	145	209	31
12. Independent Audit Committee	140	200	30
13. Management Certification of Financial Statements	150	200	25
14. External Audit of Financial Statements	150	200	25
15. Rewards for Whistleblowers	119	156	23

Source: Association of Certified Fraud Examiners
CIP = control in place, CNIP = control not in place

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[7] Dev Strischek, "Airing Out Revenue Projections: Letting the Wind Out of Sales Forecasts, The RMA Journal, November 2010, pp. 40–45.

[8] Dev Strischek, "Set Your Sights on Your Next Site Visit," The RMA Journal, April 2011, pp. 20–23.

[9] Laton McCartney, "Where There's Smoke, There's Fraud," CFO Magazine, March 2011, pp. 46–51.

Character and Fraud Protection and Prevention

(continued)

The eye-opener for bankers is that audited financial statements and management certification of the financials rank near the bottom of the list. Far more effective are the hotline, employee support program, surprise audit, and fraud training for employees and management, probably because the mere existence and enforcement of these controls make it clear that the company is serious about fraud at all levels of the firm.

These fraud controls should be familiar to bankers because of the monetary temptations in the industry's workplaces. The ACFE suggests seven steps for organizations wishing to prevent fraud:[10]

1. *Start at the top.* The board of directors and executive management must set the tone.

2. *Educate the staff.* Employees must be trained to understand which types of behavior or acts constitute fraud, how costly it is to the firm, and how to report suspicious activity.

3. *Change the culture.* First- and second-generation companies may find it easier to make their cultures more fraud-intolerant than more established firms because employees in younger companies usually have more of a personal stake.

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[10] Ibid.40–45.

Survey: Commercial Real Estate Lenders Ready to 'Shell Out' in 2012 *(continued)*

Lenders indicated that 62 percent of loans closed are for long-term and 38 percent are for short-term loans. Those percentages aren't expected to move much with 2012 long-term expectations at 64 percent and short-term at 36 percent.

Seventy-six percent of lenders surveyed indicated they favor apartments as the best investment opportunity, followed by medical office at 33 percent and office-suburban space at 38 percent. Of the property types, hotels (48 percent), undeveloped land (33 percent) and unanchored retail properties (34 percent) pose the most concern to lenders reviewing loan applications.

JLL said the mood at CREF was optimistic, as lenders and borrowers alike held high expectations for the year ahead. Of those surveyed, positive sentiment prevailed, with 56 percent of lenders and 44 percent of borrowers expecting credit to be more available in the next 12 months.

JLL cautioned, however, that economic conditions continue to keep lenders up at night, with the majority of survey respondents rating the health of the U.S. economy, the state of the housing market and the creditworthiness of tenants as the strongest factors that produce a negative impact on the volume of the commercial lending business.

Construction-at-a-Glance

	Jan. 11	Jan. 12
Total Monthly Housing Starts*	636	699
One Unit	437	508
Multifamily	199	191
YTD Permits-Single Family*	26.3	29.9
YTD Permits-Multifamily*	9.7	16.4
Monthly New Home Sales*	310	321
Unemployment Rate	9.8%	8.8%

**Thousands of Units*

Source: U.S. Bureau of the Census, Construction Reports, Series C-20, Housing Starts. U.S. Bureau of Labor Statistics.

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The online RFP form may be used to request Construction Loan Management, Inspection, and Workout services. Users need to provide Lender and Project information, including the estimated duration and number of draws for the project.

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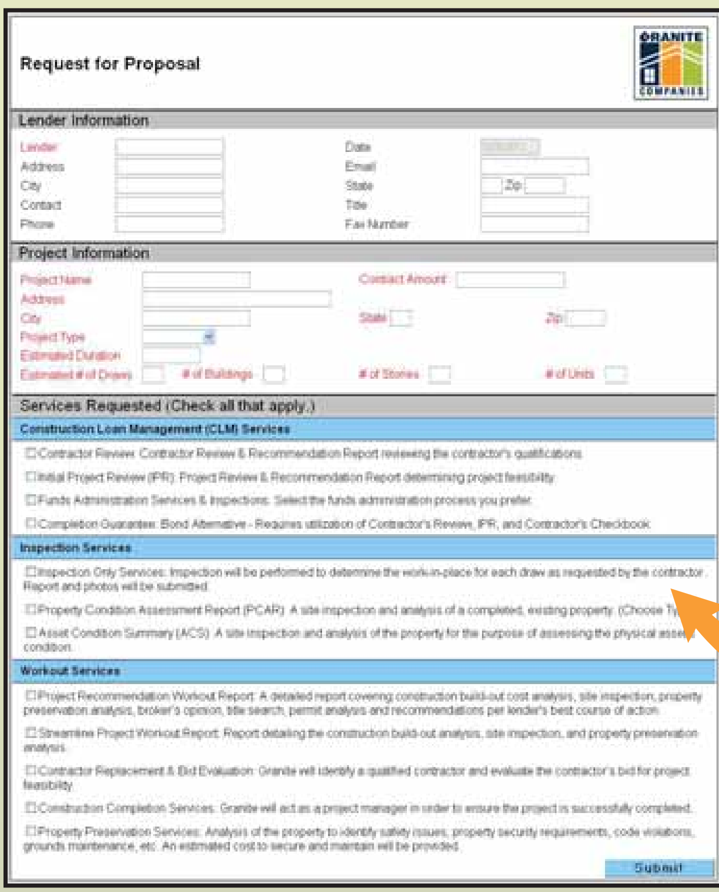
The RFP form may be accessed directly by going to: https://www.granitereports.com/forms/RequestProposal.aspx.


Request for Proposal

GRANITE COMPANIES

Lender Information

Lender | Date
Address | Email
City | State | Zip
Contact | Title
Phone | Fax Number

Project Information

Project Name | Contract Amount
Address
City | State | Zip
Project Type
Estimated Duration
Estimated # of Draws | # of Buildings | # of Stories | # of Units

Services Requested (Check all that apply.)

Construction Loan Management (CLM) Services

- ☐ Contractor Review: Contractor Review & Recommendation Report reviewing the contractor's qualifications
- ☐ Initial Project Review (IPR): Project Review & Recommendation Report determining project feasibility
- ☐ Funds Administration Services & Inspections: Select the funds administration process you prefer
- ☐ Completion Guarantee Bond Alternative - Requires utilization of Contractor's Review, IPR, and Contractor's Checkbook

Inspection Services

- ☐ Inspection Only Services: Inspection will be performed to determine the work-in-place for each draw as requested by the contractor. Report and photos will be submitted.
- ☐ Property Condition Assessment Report (PCAR): A site inspection and analysis of a completed, existing property. (Choose Ty
- ☐ Asset Condition Summary (ACS): A site inspection and analysis of the property for the purpose of assessing the physical asse condition.

Workout Services

- ☐ Project Recommendation Workout Report: A detailed report covering construction build-out cost analysis, site inspection, property preservation analysis, broker's opinion, title search, permit analysis and recommendations per lender's best course of action.
- ☐ Streamline Project Workout Report: Report detailing the construction build-out analysis, site inspection, and property preservation analysis.
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- ☐ Construction Completion Services: Granite will act as a project manager in order to ensure the project is successfully completed.
- ☐ Property Preservation Services: Analysis of the property to identify safety issues, property security requirements, code violations, grounds maintenance, etc. An estimated cost to secure and maintain will be provided.

Submit

Screenshot of the new Online RFP form.

Character and Fraud Protection and Prevention

(continued)

4. *Conduct surprise audits.* The ACFE reports that companies that conduct surprise audits tend to have lower fraud losses and usually detect fraud more quickly. Fraudsters commit fraud if they think they will not get caught.

5. *Check employee backgrounds.* Human resources should confirm all work history and education claimed in an applicant's résumé and contact references. The ACFE recommends that new and current employees' compliance with company ethics and antifraud programs be incorporated into performance reviews.

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To Access the ONLINE RFP:

Go to **www.granitecm.com** and click on ***Submit A Request For Proposal*** from the left column.

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Go to **www.granite-companies.com** and click on ***Submit A Request For Proposal*** from the left column.

The same **Online Form** may be used to request both **Commercial** and **Residential** projects.

Character and Fraud Protection and Prevention *(continued)*

6. *Prepare a data-breach response plan.* Information loss and data breaches are now the most common form of fraud, so it is critical to implement a response plan for these events. In preparation, get answers to the following questions: Who will regularly review information policies and procedures, and who will monitor and test the physical security of the information assets? Government regulations have raised the penalties for firms that fail to protect their data.

7. *Make sure the board of directors focuses on fraud.* Corporate boards are held accountable for risk management and fraud. The board should be monitoring the firm's fraud-prevention controls, demanding explanations for fraud incidents, and requiring fixes for fraud losses.

Conclusion: Trust but Verify

Many people outside of banking have written about character and conclude that one either has it or lacks it. But simply identifying its absence or presence may be too shortsighted. Another way of viewing character is through its ebbs and flows over time, along with the tidal temptations of money and power. Jurist Oliver Wendell Holmes noted in an 1897 speech, "A man is usually more careful of his money than his principles."

To shore up a borrower's principles and reinforce his character, use the 12 questions offered above to measure and assess the stresses and strains on character. A borrower's straight answers to the questions, in combination with the most effective fraud controls, will help affirm a creditworthy character.

In the long run, character can be its own reward. Henry Wadsworth Longfellow explained its value this way: "It takes less time to do a thing right than it does to explain why you did it wrong." Examine character right, and you won't have to explain why it took you so long to learn what went wrong.

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April 30-May 2, 2012
Orlando, FL

National Association of Development Companies (NADCO) 2012 Annual Meeting
May 2-5, 2012
Orlando, FL

Texas Bankers Association 128th Annual Convention
May 9-11, 2012
Fort Worth, TX

Missouri Bankers Association 2012 Annual Convention
June 6-7, 2012
Lake Ozark, MO

2012 Tri-State Bankers Summit
June 10-12, 2012
Denver, CO

National Association of Government Guaranteed Lenders (NAGGL) Annual Conference
October 28-30, 2012
Dallas, TX