Construction Loan Basics

Construction financing is used to buy vacant land and build a home; build a new home on property already owned; buy and renovate a home or renovate a property already owned. Depending upon the borrower and property, the loans can be available for owner-occupied properties, second homes or investment properties.

Construction financing is accomplished with two separate loans or as one loan with two phases/terms/rates:

1. **Construction loan that is subsequently "taken out" with a permanent mortgage:**

   A. In this type of construction financing, the actual construction loan is, basically, a balloon mortgage that must be paid off in 6 months, extendable to 12 months if more up-front points are paid. Occasionally, construction loans may not "balloon" for up to 24 months, but that is less common for loans that involve a single home, and involves more points (each point being one percent of the total construction loan).

   B. The points to be paid range from 1 to 4, or more, depending upon the credit-worthiness of the borrower, the loan-to-value, the type of documentation used and the balloon term.

   C. Interest is only paid on the actual construction money that has been released.

   D. Construction rates are usually based upon the Prime Rate (3% over the Federal Funds Discount Rate), which is presently 8.25%. The rate range from Prime, itself, to Prime plus 2.5 points, or more.

   E. The maximum loan to value on the construction loan only can vary tremendously from borrower to borrower, but ranges from less than 50% to about 70% (more rarely, 80%).

   F. The LTV on the permanent loan could be as high as 100%…it is really just a refinance loan. The important thing to consider on the permanent loan is whether the lender will base the loan on the estimated finished value, or if it will be based on the lower of cost vs value.

   G. The construction loan may, or may not be, from the same lender that issues the permanent loan commitment. If two different lenders are used, the construction lender bases their approval on the fact that the permanent financing ready to buy out the construction loan when the job is done. Thus, the first step is to obtain the permanent mortgage commitment, with all conditions met except for the final inspection verifying construction completion.

   H. It is becoming harder to find lenders who will issue those permanent commitments because they are concerned with changes to the borrower's credit, debt, employment and income, etc during the long construction period. Needless to say, another condition of the permanent loan commitment is that there not be more than marginal changes in this regard.

   I. Some lenders allow owner-builders, but many others require a licensed contractor. It may be possible to find a licensed contractor who will sign on as the general contractor, but allow you to do the work. But, that makes him responsible for your work, making most contractors leery of doing that. When a lender is willing to lend to an owner-builder, the owner-builder his only reimbursed for materials, not labor…though sub-contractors are paid as usual.

   J. With the two-loan process, there are two closings and two sets of costs. As lenders, that may not benefit us because some of construction lenders will not allow us to be paid for our efforts. That means we must be paid from the permanent financing and, other than collecting fees up-front from the borrower, there may be no way to prevent them from going elsewhere for the permanent loan when the construction is done.

2. "One-Time-Close" (OTC) Construction-to-Permanent Mortgages:

A. With an OTC loan, as implied by the name, there is only one formal settlement and one set of closing costs. This saves the borrower time and money and ensures that we, as lenders, get paid because we are generally paid at the time of the closing.

B. OTC loans are becoming the more normal way of financing construction because the lender is involved from step one, which brings them a higher comfort level. As implied by that statement, be aware that many lenders shy away from giving construction loans after the construction has begun. They make the assumption that the builder can't manage money very well if he didn't think he needed financing at first, and then ran out of money!

C. The rates will automatically change on these loans once the construction is finished. Very often, the construction rate is based on the Prime Rate, as above, during construction, and then is fixed at a lower rate once the permanent financing kicks in.

3. Points to consider on all construction lending:

A. The construction rate is usually a variable rate…as it will go up or down with the Prime Rate or other index that it is based upon.

B. The construction money is released in stages, called "draws" as the work is completed…that is AFTER each stage is completed. Thus, to be paid for a roof, the roof must be finished and, if required, inspected. In general, a portion of each draw is held back until all of the construction is finished and approved. This covers the lender in the event any construction is found to be deficient. The "hold-back" is usually about 10%. Since contractors want ALL of their money when they have done their work, the general contractor/borrower will have to put the amount of the holdback out of their pocket until received from the lender.

C. On new construction, there are usually 5 or 6 draws. Construction draws on some loans will pay for the vacant land acquisition, with the land being paid for out of the first draw. HOWEVER, bear in mind that the draw for land acquisition rarely pays for the land's total cost. It could pay for as high as 80% of the cost, or less than 50% depending upon the lender, borrower & loan program that was chosen.

D. The mortgage payments during construction are based upon the actual draws issued up to the point that the payment is due the payments are usually interest-only. Very often, the last draw doesn't get taken as part of the construction loan but, rather, is paid to the builder at the time the loan rolls over into the permanent financing.

> Compare the payment on a $100,000 construction loan, which has had half of that money released in draws, with the payments on the $100,000 permanent loan. Let's assume that the construction financing is at 10% (Prime plus 1 ¾) and the permanent financing (30-year term) is a 7% interest rate:
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> Interest-only payment on the $50,000 present balance equals:
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> 10% annual rate / 12 = .833% per month x $50,000 = **$416.67**
>
> P & I payment on $100,000 @ 7%, 30-year fixed rate: **$665.30**

E. In most cases, money that is a leftover from the construction loan (after actually releasing all monies that are due for actual costs AND the hold-backs) is not paid to the borrower. Rather, it is used to pay down the balance on the permanent financing right at the start. Of course, that doesn't lower the payments but, as with all pre-payments of principal, it shortens the term and reduces the amount of money that goes to interest on each future payment.

F. Construction lenders vary significantly in terms of:

- Documentation types available,
- Whether or not the borrower may be the builder (owner-builder, See Above)
- Whether "spec" building, investment property construction is okay.

For example, one lender will allow the loan with stated documentation for an owner-occupied rehab loan, but new construction must be "full-doc". Because of the NJ predatory lending laws, a number of construction lenders are inclined to only make loans to investors, rather than owner-occupants, which would be unusual for normal loans. Other lenders will not make construction loans unless the amount borrowed is large enough (over the conventional loan limit) to be above the predatory loan limits.

G. New construction will generally requirement full sets of architect sealed blueprints; zoning and building permits issued; full specifications of the improvements; and the cost estimate of a professional construction consultant, in addition to the usual appraisal, survey, etc.

H. Construction lending requires insurance specifically intended to cover construction situations, but it can be converted to a more usual type upon construction completion.

I. Costs are usually higher on construction loans, even if the "One-Time-Close" is chosen, because of the inspection fees for each draw, the cost of the construction consultant, as well as other fees that may be charged at the time of settlement. However, the total cost should still be less than buying a brand-new home from a contractor.

4. **Conventional-Government (FHA/VA/RSA) Construction-to-Perm Loans:** Notes on other standard programs - FHA construction (rehab/refinance or new construction) program 203(k); FannieMae (Homestyle build/renovate construction-to-perm program) or FreddieMac rehab loan:

1. FHA will allow the rehab or construction of up to 4 units if the borrower will live in one of them. However, the 203(k) program does not permit owner-builders.

2. Fannie conventional loan equivalents allow such a loan but the property cannot be more than two units if one will be owner-occupied. On a second home, or strictly investment property, it can only be a one-unit property. FreddieMac offers rehab, but not ground-up construction loans.

3. Unlike other construction-to-perm, rehab, or purchase-rehab-loans, these programs will allow final LTV's of 95% or even a bit more (FHA) for owner-occupied homes. Investor properties under the conventional loan products are limited to an 80% LTV, but can be as high as 90% LTV if Desktop Underwriting (FannieMae HomeStyle program) gives an "Approved-Eligible" recommendation.

4. Bear in mind that, when the mortgage is more than 80% of the final value, the lenders will insist upon non-tax-deductible mortgage insurance. AND, on FHA loans, there is always mortgage insurance regardless of the term or LTV It can drop off after a varying number of years depending upon the initial borrower contribution percentage. (It would never "go away" if only the legal minimum borrower contribution is made, unless it is later refinanced.)

5. RSA, the former Farmers Home Loan program, can go to 100%. These loans are in a state of flux and the funds must be appropriated every year. And, the money always runs out before the fiscal year ends. Talk to your mortgage broker about the availability of these loans. Bear in mind, too, that RSA loans have income limits and also mortgage limits that are less than the other programs. The goal of the program is to finance basic housing, though the income and mortgage limits have gone up from what they used to be, when you had to be fairly disadvantaged in order to qualify. These days, houses approaching $200,000 (or more) can sometimes be approved. Do bear in mind the "basic housing" concept, however: RSA won't pay for finished basements, garages, pools, etc.