Understanding Construction Loans

1. **Know your options:** Today's construction loan choices include the 30 year fixed, 15 year fixed, 1 year ARM, 3/1 ARM, 5/1 ARM, 7/1 ARM, 10/1 ARM and the popular interest-only loans. You can get a short term 1 year loan that you have to refinance into a new conventional mortgage loan once the construction is completed. This two time process costs you two sets of closing costs and you have to re-qualify for the new loan once the home is completed, but you also have more flexibility when shopping for conventional mortgages than when you're dealing solely with construction lenders. [1] A popular construction loan today is the "one time close", also known as the "all-in-one," "rollover" or "construction-to-permanent" loan. You have one set of fees and one closing.

2. **Get pre-qualified for a loan:** This will help to determine if the requested loan amount is within your budget. It will also allow you to find out what the monthly land or mortgage payment is going to be, and to make sure you qualify before you run out and buy land.
   Realize that most loan products typically go hand in hand with banking guidelines. These guidelines are provided to loan officers to coincide with the customer's qualifications. For example, if you have a very high (FICO) credit score with land free and clear, you have more loan options than the person with a very low (FICO) score and no land equity.
   Construction loans are most often "story loans". In other words, the lender needs to know what exactly you want to accomplish, why you want to do it, and how you intend to accomplish it (e.g. what is your 'story'), before they can recommend a program and approve your loan. For instance, if you intend to live in the home after the project is complete (owner-occupied), your options, rates, and even potential lenders may be very different than the same loan to an 'investor' who intends to immediately resell the property.

3. **Factor interest reserve and contingency funds into the cost of building your new home:** Interest reserves are added to your loan amount to make the monthly payment on your loan. Yes, you read that correctly, you will not have to make a monthly construction loan payment while your home is being built. The payments are made from this interest reserve account and no, it’s not free. This reserve is added to your construction loan amount. Interest reserves were designed for the benefit of the customer. Most people building a new home are either paying rent or have an existing mortgage payment while their home is being built. The last thing a customer needs is another monthly payment while building. So, banks created the interest reserve account by adding up the estimated interest payments over a 12 month period and add this to the loan amount. If you do not want interest reserves added to your construction loan amount, you can ask to make your own monthly construction loan payment. Contingency funds are added to the loan amount just in case you need more money to build your new home. With all good intentions, construction loans tend to have cost overruns. The bank adds 5% to 10% of the

cost breakdown and adds this amount to the loan amount just in case you have cost over runs or need better appliances. If you don’t need or use this extra contingency fund then it will not be added to your mortgage upon completion of your new home.

4. **Shop around:** Most banks offer loans, but not choices. One way to get different choices is to go shopping to every bank in town. Call your local banks and ask for the construction loan department or a construction loan officer. Most of the time, you won't get anywhere. If you do find a bank that will do a construction loan, they usually can only offer one product that may or may not be competitive in today's marketplace. An alternative is to call an experienced construction loan broker who has done all of the homework for you and has direct access to hundreds of banks nationwide. A broker is a representative for hundreds of banks. Although the broker serves as middle-man, his or her services will not cost you anything extra. That's because brokers get loans at wholesale rates, and pass them along to their clients at retail prices, just like any other business. In fact, because or their volume, many brokers are able to offer their clients better deals than you can get by talking to the banks on your own.

5. **Make sure the construction lender is experienced:** Local banks, if they do construction loans, might be able to offer you a great rate. National Lenders are more likely to have construction programs, but the drawback is that they do not necessarily have their fingers on the pulse of the local Real estate market. But your first consideration should be construction lending experience. Even more than a mortgage loan, a construction loan is complicated. Avoid using any entity that provides you with a loan officer who doesn't have significant experience providing construction loans to consumers. Although some loan officers are salaried employees, most loan officers are salespeople who usually have one main goal in mind when helping you with your loan request, and that is the commission (also known as loan fee, points, or yield spread premium). The following questions allow you to quickly find out if your loan officer is experienced at construction loans and is not simply after your money. If the loan officer (sales person) can answer these questions with no problem then they have passed a pretty good litmus test:

   - How long have you been doing construction loans?
   - What is the loan to cost (LTC) required for construction loans? This is cash equity such as down payment on land. This can range from 5 to 20%.
   - What is better? The voucher or draw disbursement system and why? Draw is now the most popular because the customer has the control of the money. Many banks do not even offer a voucher system.
   - Does the bank require a contingency and an interest reserve account? This is a choice, assuming you qualify for additional funds. Some banks automatically add both to the loan amount.

6. **Submit your loan application:** The first thing your loan officer wants to see is your completed loan application. The loan application called the (1003) will tell a

story of your financial picture. The loan officer will analyze this and other documents (including your credit report) to determine whether you qualify. This analysis yields a ratio called the debt to income ratio, and depending on the bank's underwriting guidelines, this ratio will usually range from 36% to 45%. The debt to income ratio is the percentage of your gross monthly income that is or will be consumed by monthly debt payments (including your new mortgage payment, taxes and insurance). The amount of total debt payment should not exceed 36% to 45% of your monthly income. Some banks will allow you to exceed this ratio if you have an excellent credit history and excellent credit score. The completed loan application will tell the loan officer many things including:

- What type of loan you want
- How much money you need
- Where you currently live
- If you rent or own
- Your social security number
- Your current employers
- A list of all your assets (money) and liabilities (bills)
- How much money you make
- Stated income allows you to qualify without verifying your income on your tax returns, W-2s or pay stubs. The only thing the bank verifies when applying for a stated income loan is your credit score, bank statements and that you're employed.
- How much real estate you own
- Some declarations along with some government questions

7. **Decide if you are going to lock in your interest rate until completion of your house, or let them float in the hopes that rates will go down:** If the rates are heading upward, lock. If the rates are stable, relax. If the rates are headed downward, float. Always ask. Is the construction loan rate locked upfront or floating during the construction loan period? Then ask, is the rate during the construction loan the same rate when the loan converts into the mortgage period. A typical construction loan nowadays is a construction to permanent loan that may or may not allow you to lock-in today's low interest rates until the home is completed. If you choose a loan that does not allow you to lock in upfront, the interest rate may end up higher along with your monthly payment. This is usually not what you want, so be careful. Some things to watch out for:

- Some lenders have a higher interest rate if you lock in upfront.
- Some lenders try and sell you on a higher rate or adjustable rate during construction with the hope of a float down rate after the home is built.
- Some lenders have a non competitive long term lock along with a fee.
- Some lenders have such bad service no matter what rate or program they have, it's not worth doing business with them.

8. **Enter into a written contract with a builder/contractor:** Construction loans are a little more paperwork intensive than purchase money loans. Every construction loans has a part known as the builder’s package. A builder’s package includes items such as a builder’s statement or resume which includes things like previous experience references and credit and banking references, a line item cost breakdown, a materials list and, last but not least, a construction contract. A line item cost breakdown is an integral part of a construction contract and such it should be referred to at all times. It is common for a homeowner to change some specification or other and it is highly recommended that a firm change order be written in these cases. A construction contract is a written agreement between the borrower and the builder for services to be provided by the builder for a stated consideration. A properly written and customary contract contains:

   - A clear statement outlining the responsibilities each party will perform.
   - The date of the contract, the scheduled dates for commencement and completion of construction of the project. An event date, rather than the actual date, is sometimes acceptable.
   - The amount of payment the builder is to receive for each stage of construction, as well as under what conditions it will be received, such as passing inspection etc. If the property is located in a state that charges sales tax, the contract must specify whether the amount includes state sales tax.
   - Proper reference to a completed and signed Line item cost breakdown and list of materials.
   - A payment method that is compatible with the line item cost breakdown and the disbursement procedures of the investor.
   - Provisions for possible changes to plans or specifications by appropriate change orders. Since most construction loans have a contingency provision a cost over run may be paid for using that provision.
   - Full identification of all parties and definition of all names used in the contract (contractor, owner, subcontractors and architect).
   - Architect's responsibility, if any.
   - Signatures of the borrower and contractor.

9. **Get construction insurance:** There are three types of insurance needed to build. All banks require the first two insurances, course of construction and general liability. Workman's compensation is only required if your builder has employees. If your builder tells you he is not required to provide any insurance whatsoever, he is most likely correct because it is not a law to have insurance to build a house. This requirement is set forth by the bank. So make sure you hire a reputable builder with insurance, it will help your construction loan close much faster.

   - Course of Construction Insurance. This policy is an all risk policy to include, fire, extended coverage, builder's risk, replacement cost, vandalism and malicious mischief insurance coverage.
   - General Liability Insurance. You or your builder can provide this policy. This policy is a comprehensive general policy or a broad form liability endorsement.

The minimum amount of $300,000 for each occurrence is required. If the builder provides the insurance a general policy of $1,000,000 or a broad form liability endorsement is required. Ask your builder upfront if they have general liability insurance. If they do not ask if they have a problem providing the insurance. Some builders cannot afford or simply do not want to pay for the insurance and then guess who has to provide it, yes, you do. You can save yourself a lot of headaches and money if you work with a builder that has insurance.

- Workman's Compensation Insurance. If your builder owns his own company and has employees that are helping to build your home, workman's compensation is required. If the builder simply subcontracts out the work and does not have employees per se, they will need to write a letter acknowledging that they do not have employees and are not required to have WCI.

10. **Ask your loan officer to provide you a copy of the estimated construction loan budget:** This budget is not usually meant for the customer but an experienced construction loan officer should not have a problem providing this to you. The budget is created from your costs and includes every cost within the loan including land balances, closing costs, interest reserves, contingency and bank fees.

11. **Make sure your loan officer has structured your construction loan properly:** Structuring construction loans for approval is vitally important and is the last thing on most customers' minds. Common mis-structured loan scenarios include:

- Missed deductions
- Low cash equity
- Improperly completed appraisal
- Unexplained credit derogatory
- Income incorrectly calculated
- Mismatch of customer loan request to the correct lender
- Plain and simple incompetence

Tips:

Understand that mortgage rates, including construction loans, follow bond markets which change constantly. Thus, a quoted rate may not be available even after a relatively short period of time. All a lender can do is to say that "if these facts are true and we were locking the loan today, this is what I can offer."

All borrowers need to be aware that construction lending is becoming very hard to come by; your credit and equity will be scrutinized very carefully in today's business climate.

Also so called "stated income loans" are no longer available by any lender under the new tighter lending guidelines.

Check with your lender about the requirements of lien waivers. Many require one for each draw on the construction account. IF you are using a builder, they may require them as well of their subs, make sure you know how payments to subs are being handled and that waivers are returned in a timely manner.