



OVERVIEW OF NEW CONSTRUCTION FINANCING

UNDERSTANDING CONSTRUCTION LENDING

SUMMARY: THIS ARTICLE DISCUSSES THE VARIOUS FORMS OF CONSTRUCTION FINANCING. IT DOES NOT COVER INFORMATION RELATED TO THE PURCHASE OF A NEWLY CONSTRUCTED “SPEC” OR “INVENTORY” HOME THAT IS OWNED BY A BUILDER AND TRANSFERRED TO A CONSUMER AFTER COMPLETION OF THE IMPROVEMENTS.

BUILDING A CUSTOM HOME HAS MANY ADVANTAGES. YOU CAN CHOOSE THE FLOOR PLAN AND THE ARCHITECTURAL STYLE OF THE HOME. YOU CAN ALSO CONTROL EVERY ASPECT OF THE DESIGN AND CONSTRUCTION TO ACHIEVE A RESULT THAT IS AS UNIQUE AS YOU ARE.

HOWEVER, THE PROCESS OF CONSTRUCTION FINANCING DIFFERS SIGNIFICANTLY FROM THE PROCESS OF FINANCING THE PURCHASE OF AN EXISTING RESIDENCE OR A NEWLY CONSTRUCTED “SPEC” OR “INVENTORY” HOME.

THE OLD METHODOLOGY – “BUILDER FINANCED”

WITH THIS METHOD, THE HOME BUILDER OBTAINS THE CONSTRUCTION FINANCING TO BUILD THE HOME ON A LOT THAT THE BUILDER OWNS THEN ESSENTIALLY SELLS THE HOME TO THE HOME BUYER UPON SUBSTANTIAL COMPLETION OF THE IMPROVEMENTS.

IN THIS SCENARIO, THE HOME BUILDER OBTAINS AN INTERIM CONSTRUCTION LOAN FOR WHICH HE MUST PAY NUMEROUS ASSOCIATED EXPENSES. THOSE EXPENSES BASED ON A \$350,000 LOAN AMOUNT WOULD BE APPROXIMATELY AS FOLLOWS;

- AN ORIGATION FEE OF 1% OF THE LOAN AMOUNT = APPX \$3,500.00
- A TITLE POLICY FEE OF .008% OF THE LOAN AMOUNT= APPX \$2,800.00
- AN APPRAISAL OF THE HOME TO BE CONSTRUCTED = APPX \$650.00
- A PROPERTY SURVEY = APPX \$500.00
- NUMEROUS MISCELLANEOUS FEES AND CLOSING COSTS = APPX \$2,000 - \$2,500.00
- INTERIM LOAN INTEREST @ 7% ON A GRADUATING SCALE BASED ON A PERCENTAGE OF COMPLETION = APPX \$7,000.00

WITH THIS METHOD, THE HOME BUILDER MUST THEN BUILD IN THE COST OF THE FINANCING INTO THE OVERALL PRICE OF THE HOME, I.E.; LOAN FEES, APPRAISAL, SURVEY, CLOSING COSTS, INTEREST, ETC. WHICH **ADD TO THE OVERALL COST OF THE HOME CHARGED BY THE BUILDER.**

THIS METHOD REQUIRES A 10% NON-REFUNDABLE DEPOSIT FROM THE BUYER PAID TO THE HOME BUILDER AS SECURITY IN THE EVENT OF A BUYER DEFAULT OR “WALK AWAY”, WHICH ALTHOUGH RARE, DOES HAPPEN. THE DEPOSIT IS APPLICABLE AS EARNEST MONEY TOWARD THE OVERALL PRICE OF THE HOME AND/OR THE DOWN PAYMENT REQUIREMENTS OF THE PERMANENT FINANCING THAT THE BUYER WILL ACQUIRE.

WITH THIS METHOD, THE HOME BUYER THEN OBTAINS THE PERMANENT MORTGAGE FINANCING TO FINALIZE THE SALE AFTER COMPLETION OF THE CONSTRUCTION PROCESS. FINAL CLOSING USUALLY TAKES PLACE WITHIN 1 WEEK AFTER SUBSTANTIAL COMPLETION AND CERTIFICATE OF OCCUPANCY.

THIS METHOD WILL NOT WORK IF BUYER ALREADY OWNS THE LOT. IT IS ILLEGAL IN THE STATE OF TEXAS FOR A PROPERTY OWNER TO DEED BACK A LOT TO A HOME BUILDER IN ORDER FOR THE HOME BUILDER TO OBTAIN CONSTRUCTION FINANCING. A BANK WILL NOT LOAN MONEY FOR CONSTRUCTION UNLESS THE LOT IS ROLLED INTO THE OVERALL FINANCING PACKAGE. IN THIS CASE, THE HOME BUYER HAS TO OBTAIN THE FINANCING ON THEIR OWN.

WHILE IT IS A BIT LESS HASSLE FOR THE HOME BUYER ON THE FRONT END TO HAVE THE HOME BUILDER OBTAIN THE CONSTRUCTION FINANCING THE **BIG DOWNSIDE** TO A “BUILDER FINANCED” PROJECT IS THAT THE HOME BUYER IS ESSENTIALLY PAYING FOR **2 SETS OF CLOSING AND FINANCING COSTS** RELATED TO THE CONSTRUCTION OF THE NEW HOME;

1. HOME BUILDER’S CLOSING AND FINANCING COSTS ARE “ADDED” TO THE OVERALL COST OF THE HOME AS A COST OF CONSTRUCTION.
2. HOME BUYER THEN MUST PAY ALL THOSE COSTS AGAIN UPON OBTAINING THE PERMANENT FINANCING.

ESSENTIALLY THE BUYER HAS PAID DOUBLE FOR CLOSING AND FINANCING COSTS IF THE HOME BUILDER OBTAINS THE CONSTRUCTION FINANCING. THIS CAN BE AVOIDED HOWEVER BY THE FOLLOWING FINANCING OPTIONS.

NEW METHODOLOGY – “OWNER FINANCED/ONE TIME CLOSE”

THERE ARE **TWO BASIC STRATEGIES** OF FINANCING THE CONSTRUCTION OF A NEW HOME ON A LOT OR LAND THAT YOU ALREADY OWN OR THAT YOU WILL PURCHASE FOR THE PURPOSE OF BUILDING A NEWLY CONSTRUCTED DWELLING.

1. THE TRADITIONAL STRATEGY IS REFERRED TO A **“CONSTRUCTION-TO-PERM”** FINANCING AND INVOLVES A TWO-STEP PROCESS. THE FIRST STEP INVOLVES THE TEMPORARY FINANCING OF THE ACQUISITION OF THE LOT (IF NOT ALREADY OWNED) AND THE CONSTRUCTION OF THE DWELLING ON THE LOT. THE SECOND PHASE INVOLVES CONVERTING THIS “INTERIM” LOAN INTO A “PERMANENT” MORTGAGE LOAN.

2. THE OTHER STRATEGY IS TO UTILIZE A SINGLE LENDER (AND USUALLY A SINGLE LOAN WITH A CONVERSION FEATURE) TO PROVIDE THE FINANCING FOR THE INTERIM CONSTRUCTION PHASE AND THE PERMANENT MORTGAGE LOAN. THIS COMBINED FINANCING ARRANGEMENT IS TYPICALLY REFERRED TO AS A **“ONE-TIME-CLOSE”**.

CONSTRUCTION-TO-PERM FINANCING

A CONSTRUCTION-TO-PERMANENT (OR “CONSTRUCTION-TO-PERM”) FINANCING ARRANGEMENT IS THE TRADITIONAL FORM FOR COMPLETING A NEWLY CONSTRUCTED RESIDENTIAL DWELLING. WITH THIS FORM OF FINANCING THERE ARE THREE STAGES: [1] THE “PRE-APPROVAL” OR “COMMITMENT” STAGE, [2] THE “INTERIM LENDING” OR “CONSTRUCTION” PHASE, AND [3] THE “PERMANENT LOAN” PHASE.

PHASE 1. THE FIRST PHASE IN THIS ARRANGEMENT IS TO OBTAIN **PRE-APPROVAL FOR A PERMANENT MORTGAGE LOAN**. THIS PROCESS IS SIMILAR TO THE PRE-QUALIFICATION OR PRE-APPROVAL STAGE OF THE FINANCING OF AN EXISTING HOME (NOT NEW CONSTRUCTION).

- THE BORROWER WILL MAKE APPLICATION FOR AND SUBMIT ALL OF THE REQUIRED DOCUMENTATION TO A PERMANENT LENDER TO OBTAIN PRE-APPROVAL. AN APPRAISAL REPORT FOR THE PROPOSED RESIDENCE IS PREPARED “SUBJECT TO COMPLETION OF IMPROVEMENTS”.

- THE APPRAISER WILL OBTAIN THE ARCHITECTURAL PLANS, CONSTRUCTION DOCUMENTS AND SPECIFICATIONS OF MATERIALS AND BASED ON THIS INFORMATION THE APPRAISER WILL STATE AN OPINION AS TO THE VALUE OF THE HOME ONCE THE IMPROVEMENTS ARE COMPLETED.

- BASED ON ALL THIS DOCUMENTATION THE PERMANENT MORTGAGE LENDER WILL THEN APPROVE THE APPLICATION AND PROVIDE A “COMMITMENT LETTER” ADDRESSED TO THE BORROWER (AND SOMETIMES, THE INTERIM LENDER) STATING THAT THE BORROWER SATISFIES THE CONDITIONS FOR THE

PERMANENT MORTGAGE LOAN THAT WILL “TAKE OUT” THE EXISTING INTERIM LOAN.

- THIS COMMITMENT AGREEMENT ASSURES THE INTERIM LENDER THAT THE BORROWER HAS THE ABILITY TO PAY THE INTERIM LOAN IN FULL (FROM THE PROCEEDS OF A NEW PERMANENT MORTGAGE) AFTER CONSTRUCTION OF THE DWELLING IS COMPLETED.

PHASE 2 IN THE SECOND PHASE THE BORROWER WILL SECURE A TEMPORARY “INTERIM” OR “CONSTRUCTION” LOAN FOR THE PURPOSE OF PROVIDING FUNDS TO ACQUIRE THE LAND OR LOT ON WHICH THE HOUSE IS TO BE ERECTED AND TO PROVIDE THE FUNDS NECESSARY TO CONSTRUCT THE DWELLING.

- IF THE BORROWER ALREADY OWNS THE LAND OR LOT ON WHICH THE HOME WILL BE ERECTED, THE INTERIM LENDER (USUALLY A BANK) WILL PROVIDE FUNDS TO PAY-OFF THE BALANCE OF ANY LOAN SECURED BY A LIEN ON THE LOT OR LAND.

- THE INTERIM LENDER WILL ALSO PROVIDE THE FUNDS NECESSARY TO CONSTRUCT THE DWELLING.

- THE INTERIM LENDER WILL NOT DISBURSE ALL OF THE FUNDS TO THE BUILDER OR THE BORROWER AT THE CLOSING. INSTEAD, THE INTERIM LENDER WILL DISBURSE THOSE FUNDS PERIODICALLY THROUGHOUT THE PERIOD OF CONSTRUCTION AS VARIOUS PHASES OF CONSTRUCTION ARE COMPLETED.

- THE DISBURSEMENT OF A PORTION OF THE TOTAL INTERIM LOAN FUNDS AS CONSTRUCTION PROGRESSES IS REFERRED TO AS A “DRAW”. THERE MAY MULTIPLE DRAWS THROUGHOUT THE CONSTRUCTION OF IMPROVEMENTS.

- THE BORROWER WILL PAY INTEREST ONLY ON THE DISBURSED PORTION OF THE LOAN PROCEEDS. AN INTERIM LOAN MAY BE EITHER A FIXED-RATE OR VARIABLE-RATE LOAN (USUALLY TIED TO THE PRIME RATE).

- THE INTERIM LENDER WILL USUALLY REQUIRE THE BORROWER TO PAY THE INTERIM INTEREST MONTHLY OR QUARTERLY AS IT ACCRUES DURING THE PERIOD OF CONSTRUCTION, HOWEVER, IN SOME CASES THE INTERIM LENDER MAY PERMIT THE INTEREST TO ACCRUE, NOT REQUIRING ITS PAYMENT UNTIL THE INTERIM LOAN IS PAID IN FULL.

PHASE 3 AS THE COMPLETION OF THE INTERIM CONSTRUCTION PHASE DRAWS NEAR, THE PERMANENT LENDER WILL UPDATE ITS MORTGAGE LOAN FILE OBTAINING UPDATED CREDIT, INCOME AND ASSET DOCUMENTATION TO OBTAIN AN UPDATED LOAN APPROVAL FOR THE BORROWER.

- ONCE THE CONSTRUCTION OF THE DWELLING IS COMPLETE, THE APPRAISER THAT PREPARED THE ORIGINAL WRITTEN APPRAISAL REPORT WILL INSPECT THE PROPERTY TO DETERMINE THAT THE CONSTRUCTION OF THE

DWELLING CONFORMS TO THE PLANS AND SPECIFICATION ON WHICH THE ORIGINAL OPINION OF VALUE WAS BASED.

- AFTER COMPLETING THE “FINAL INSPECTION” THE APPRAISER WILL RECERTIFY THE PRIOR OPINION OF VALUE.
- THE TITLE DOCUMENTS ARE ALSO UPDATED DURING THIS PROCESS AND WHEN COMPLETED, THE BORROWER WILL CLOSE ON THE NEW PERMANENT MORTGAGE, THE PROCEEDS OF WHICH WILL BE USED TO PAY THE BALANCE ON THE INTERIM CONSTRUCTION LOAN.

THE “ONE-TIME-CLOSE”

- A “ONE-TIME CLOSE” LOAN IS A TYPE OF MORTGAGE THAT IS AVAILABLE FOR HOME BUYERS WHO HAVING A HOME BUILT FOR THEM BY A HOME BUILDER. THIS FINANCING ARRANGEMENT FOR CONSTRUCTION FINANCING COMBINES THE FOREGOING THREE PHASES INTO A SINGLE COMBINED PROCESS. WITH THE “ONE-TIME-CLOSE” TRANSACTION THE BORROWER OBTAINS PERMANENT LOAN APPROVAL AND CLOSES THE INTERIM AND PERMANENT LOAN TRANSACTION PRIOR TO THE COMMENCEMENT OF CONSTRUCTION. IN ESSENCE, THE LENDER ACTS AS BOTH THE INTERIM CONSTRUCTION LENDER AND THE PERMANENT MORTGAGE LENDER.
 - BECAUSE OF THE UNIQUE “TWO-HAT” PERSONALITY OF THE LENDER IN THIS TYPE OF FINANCING ARRANGEMENT THIS TYPE OF LOAN IS TYPICALLY PROVIDED BY BANKS OR MORTGAGE COMPANIES THAT HAVE CONSTRUCTION LENDING EXPERIENCE (AND ALSO ACT AS MORTGAGE BANKERS) OR MORTGAGE BROKERS WHO HAVE WHOLESALE OR CORRESPONDENT RELATIONSHIPS WITH THESE BANKS.
 - OTHER THAN THE FACT THAT THE INTERIM AND PERMANENT MORTGAGE ARE CLOSED IN A SINGLE TRANSACTION, THIS FORM FINANCING IS ACTUALLY VERY SIMILAR LOGISTICALLY TO THE TRADITIONAL CONSTRUCTION-TO-PERM FINANCING ARRANGEMENT.
 - YOU CAN LOCK IN THE PERMANENT RATE AT CLOSING, AND HAVE UP TO 12 MONTHS TO COMPLETE YOUR NEW HOME CONSTRUCTION. DURING THIS PERIOD, INTEREST IS CHARGED ONLY ON THE FUNDS THAT HAVE BEEN DISBURSED.
 - WHEN THE CONSTRUCTION IS COMPLETED, THE PERMANENT LOAN PERIOD BEGINS.

FINANCING & CLOSING COSTS

THE FINANCING & CLOSING COSTS ASSOCIATED WITH EITHER A **“ONE-TIME CLOSE”** OR **“CONSTRUCTION-TO-PERM”** LOAN WILL BE ALMOST IDENTICAL. UNDER EITHER FINANCING ARRANGEMENT THOSE EXPENSES BASED ON A \$350,000 LOAN AMOUNT WOULD BE APPROXIMATELY AS FOLLOWS;

- AN ORIGATION FEE OF 1% OF THE LOAN AMOUNT = APPX \$3,500.00
- A TITLE POLICY FEE OF .80% OF THE LOAN AMOUNT= APPX \$2,800.00
- AN APPRAISAL OF THE HOME TO BE CONSTRUCTED = APPX \$500.00
- A PROPERTY SURVEY = APPX \$500.00
- NUMEROUS MISCELLANEOUS FEES AND CLOSING COSTS = APPX \$1,000.00 - \$1,500.00
- INTERIM LOAN INTEREST @ 5% ON A GRADUATING SCALE BASED ON A PERCENTAGE OF COMPLETION = APPX \$6,000.00
- UNDER EITHER FINANCING ARRANGEMENT THE BORROWER WILL TYPICALLY PAY FOR CONSTRUCTION FINANCING WITH A VARIABLE-RATE OF INTEREST THAT WILL ONLY ACCRUE ON THE DRAW PORTION OF THE PRINCIPAL AMOUNT OF THE LOAN AS DRAWS OF PRINCIPAL ARE MADE ON THE LOAN.

MAJOR BENEFITS

BY UTILIZING A “ONE-TIME CLOSE” OR “CONSTRUCTION-TO-PERM” LOAN, YOU CAN;

- ESSENTIALLY ELIMINATE PAYING TWO SETS OF CLOSING COSTS THAT WOULD OTHERWISE BE INCURRED OF THE HOME BUILDER FINANCES THE HOME THE SELLS IT TO YOU AFTER COMPLETION OF THE IMPROVEMENTS.
- IN ADDITION, YOU WILL KNOW EVERYTHING ABOUT THE CONSTRUCTION AND/OR PERMANENT LOAN BEFORE YOU EVER START BUILDING.
- IN A BUILDER FINANCED SCENARIO, HOME BUYERS MAY END UP HAVING TO SETTLE FOR A PERMANENT LOAN THAT THEY ARE NOT COMFORTABLE WITH JUST SO THAT THEY CAN PAY OFF THE CONSTRUCTION LOAN AND BUY THE HOME FROM THE FROM THE BUILDER. NOT SO WITH AN “OWNER FINANCED/ONE TIME CLOSE” SCENARIO

FOR MORE INFORMATION OR QUESTIONS, PLEASE EMAIL US AT
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