A Home Loan Trend to Watch

Construction-to-permanent loans are making a comeback

By Robert Verrino

Photo illustration by Dennis Wunsch

The residential real estate market continues to move ahead at a breakneck pace as the Great Recession moves further into distance in the rearview mirror. Wages are up, unemployment is down and interest rates are, remarkably, still at historic lows.

Generally speaking, these all are good signs for the mortgage industry. There is only one nagging detail: housing supply.

How tight has housing supply been this year? According to the National Association of Realtors (NAR), the total housing inventory at the end of this past August was 6.5 percent lower than the previous year.

"What's ailing the housing market and continues to weigh on overall sales is the inadequate levels of available inventory and the upward pressure it's putting on prices in several parts of the country," said NAR Chief Economist Lawrence Yun in a press release this past September. "Sales have been unable to break out because there are simply not enough homes for sale."

All across the nation, from rural communities to metropolitan cities, existing-home sales are declining as buyers scramble to find homes that will fit their needs and budgets. As a result, existing homes are selling quickly — and often for competitive prices. That's great news for cash buyers, but not so much for first-time buyers or existing homeowners who are hoping to upgrade to something larger.

This unique market situation — a surplus of eager buyers, paired with a shortage of available homes — has led to a revival of the construction-to-permanent loan. With no end in sight for the residential real estate inventory shortage, this option may prove to be an even more enticing option for frustrated buyers who are seeking a way to regain control of the homebuying process. Mortgage loan originators who are looking for ways to capture some of the market share they have lost because of declining refinance transactions should take note of this trend.

Two approaches

Typically, there are two approaches to lending to new-construction homebuyers: There is the two-loan process, in which the buyer takes out a construction loan and then a mortgage;

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and then there is the construction-to-permanent loan, which consolidates the financing for the construction and the mortgage into one single loan.

Construction-to-permanent loans initially gained popularity with community banks and credit unions. A local underwriter would consider the local real estate market, the buyer's creditworthiness and the risk of the project before making a lending decision.

This product eventually caught the eyes of national lenders. During the Great Recession, many buyers walked away from deals, however, and some construction companies went out of business. As a result, the construction-to-permanent loan fell out of popularity in lieu of more conservative options.

Today, construction-to-permanent loans are back in the spotlight. They provide relief from the competitive existing-home market for buyers who may not have thought they could afford a new-construction home. For small builders, these loans provide the peace of mind that a buyer has the financial backing to move forward with a project.

Advantages

Just as no home is one-size-fits-all, neither is any lending option. Originators should be prepared to educate buyers on the nuances of the construction-to-permanent loan. Let's start with some advantages that may help sway a buyer's decision. First, they are single-close loans.

This is arguably the most attractive benefit. Rather than applying for and closing one loan for construction, followed by another closing for a traditional mortgage, borrowers apply for one loan. Draws can be submitted directly to the builder. After the construction phase is completed, the loan is converted to a traditional mortgage, without any additional closing costs.

A second potential money saver comes from locking in the interest rate. Because of the variability of interest rates, borrowers who opt for a construction loan followed by a separate mortgage are at risk of interest rates increasing from the time construction starts to the day the separate permanent mortgage is finalized. With a construction-to-permanent loan, a borrower only needs to close one loan — which could result in substantial interest savings over the course of the loan.

Most borrowers will only pay the interest on the funds advanced to the builder during the construction phase. The construction phase can range from three to 12 months, giving the builder ample time to complete the home. Often, the savings in closing costs (only closing one loan instead of two) helps offset the costs of interest payments during this time frame.

Downpayment requirements on construction-to-permanent loans will vary by lender. Some lenders may offer programs with a downpayment as low as 5 percent of the loan value, but others may require one that is more substantial. This is an area where originators can distinguish themselves in this market by doing their research and finding lenders to work with that provide terms that will best fit their borrowers' financial situations.

Other considerations

There are a few other items that borrowers must consider with a construction-to-permanent loan. It is important for originators to be upfront with this information.

Buyers may need to provide more information as part of a construction-to-permanent loan application than would be required for a traditional mortgage application. Specific requirements may vary from lender to lender, but originators should be prepared to request details on the borrower's builder, location and home plans early in the application process. This type of loan requires three phases of approval: credit for the borrower, builder acceptance and project acceptance.

The interest rates available for construction-to-permanent loans are typically slightly higher compared to those available for a standard mortgage. This increased interest rate helps cover the added risk assumed by the underwriter while the home is under construction.

Individual homebuyers can typically obtain more competitive interest rates than builders, however, which can result in lower overall cost than if the builder had to obtain construction financing for the project. The builder would then bundle those financing fees — including the interest paid on that loan during the construction phase — into the final price.

For buyers who don't already own the land on which they intend to build, the cost of land can be another concern they may wish to discuss. The purchase price of the land sometimes can be added to the cost of the loan. Again, this depends on the lender, so originators will want to know which of their lenders can provide this service.

During the construction phase, the borrower's builder will need to make draw requests as work gets completed. A standard project may see five to seven draw requests before completion. The lender, as well as the borrower, will want to ensure the work is completed correctly and lien releases are executed to avoid mechanics liens from being filed against the home.

Although originators shouldn't need to deal with this part of the process, their borrowers will want assurances that the draw process will go smoothly so that bills get

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paid during construction. Originators should understand the lender's draw process and communicate this clearly to the borrower to allay concerns.

After construction is completed, the loan will convert to a permanent mortgage loan of the borrower's choice. Borrowers may need to provide updated credit documents prior to the loan modification, and any significant credit or income changes during the construction phase could impact the conversion process. Originators should be sure to prepare borrowers for these contingencies.

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As the saying goes, the only constant is change — and that is certainly true for the real estate industry. One thing that hasn't changed, however, is the American dream of homeownership.

Construction-to-permanent loans can provide frustrated and overwhelmed homebuyers with an empowering alternative in the competitive housing market, and give originators a product they can offer to offset recent declines in refinancing activity. Originators who capitalize on this offering will likely find themselves right at home among the industry's top performers. ■