National Association of Home Builders

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Negotiating the Best Financing Package

Normal View

Small builders often ask: "Am I paying too much for my construction loans?" This section provides information small- and medium-volume builders should know about the cost of construction loans and suggestions on how these builders can get better terms on construction financing. Builders who are armed with the right information may be able to negotiate lower loan rates or shift to lenders who will give better deals.

According to NAHB surveys, about 90 percent of all loans for residential land acquisition, development and construction (AD&C) come from commercial banks or thrifts. NAHB's Quarterly Finance Survey provides information on AD&C lending terms and conditions.

Prime-Based Loans

The vast majority of construction loans are tied to the prime rate. Lenders typically add a margin of one to two percentage points per annum above the prime rate on construction loans. The percentage (or margin) over prime decreases as the size of the builder increases. In addition to builder size, the amount of the margin will vary depending on the builder's relationship with the lender, the riskiness of the project, and the size of the loan.

Lenders also charge up-front fees, or points, on the loan. A point is one percent of the loan commitment amount. These points are paid when the commitment is funded. Points typically represent a significant portion of the cost of borrowing on a residential construction loan because the contract interest rate is applied to funds actually drawn, while the points are applied to the full commitment amount. Since construction loans are drawn in stages as construction progresses, the lender receives interest on the full commitment amount only briefly, if at all.

Lenders may also charge a number of other fees on construction loans. The types of fees will vary with local jurisdiction, but some of the more common fees include appraisal, legal, title, inspection, wire transfer, etc. Lenders also charge builders fees when they opt to extend a loan. Like the margin and upfront points, these fees will vary according to builder size, the builder's relationship with the lender, the riskiness of the project and the size of the loan. Builders should carefully negotiate these fees with their bank.

The combination of interest and upfront fees pushes financing costs on the typical residential AD&C loan significantly above the lender's cost of funds. For example, commercial banks have maintained a three percentage point spread between the published prime rate and the federal funds rate (a proxy for a bank's cost of funds). Adding on a one percent margin and an additional one percent for fees, pushes the rate on a prime-based construction loan five percentage points over the bank's cost of funds. This spread is very large relative to the risk incurred, particularly for construction loans on pre-sold homes, which have risk characteristics almost as favorable as home mortgages. Despite the small difference in charge-off rates between residential mortgages and AD&C loans, borrowing costs on AD&C loans, including interest and upfront fees, are 50 to 75 percent higher than for home mortgages.

Alternatives To Prime-Based Loans

There are some alternatives to construction loans tied to the prime rate. Some lenders offer loans tied to short-term market rates, and larger builders often turn to the commercial paper market. However, there are drawbacks associated with these alternatives, and some of them may not be available to smaller-volume builders.

LIBOR-Indexed Loans

The London Interbank Offering Rate (LIBOR) is the most common alternative to the prime rate for construction loans. LIBOR is the rate on dollar-denominated deposits at commercial banks outside of the U.S. This rate is posted each day in The Wall Street Journal, and generally tracks the same trend as rates on Treasury securities.

Ultimately, the rate charged on LIBOR-indexed loans actually will be based on the difference between the prime rate and prevailing LIBOR. Lenders will adjust the rate on a LIBOR-indexed loan to be about the same as that on a prime-indexed loan through adjustments to the margin. For example, if LIBOR is 5.25 percent and the prime rate is 8.25 percent, the margin on the LIBOR-indexed loan could be set at 300 to 400 basis points above LIBOR to bring the rate up to the prime rate or prime plus one percent. Again, the size of the margin would vary in the same manner as a loan tied to prime (i.e., the relationship with the lender, the riskiness of the project, the size of the loan, etc.).

In addition to the rate, there are a number of fees and other factors to consider with a LIBOR-indexed loan that do not apply to prime-indexed loans. Unlike a prime-indexed loan where the rate floats with the prime rate, a LIBOR-indexed loan has a fixed rate for the term of the loan. Thus, in a LIBOR-based loan, the builder is required to buy a contract for a specified amount (referred to as a tranche), such as $1 million, at a specific LIBOR rate (plus margin) for a certain maturity (i.e., 30, 60, 90 days). Lenders also have limits on the minimum contract amount and the maximum number of contracts that can be outstanding at one time.

Administrative costs are higher for non-prime loans (for both the builder and the lender) since these loans must be monitored continuously. Lenders will charge higher administrative fees for non-prime-indexed loans since the lender has to write a specific contract for the loan. As noted, for a loan tied to LIBOR, a builder would buy a contract for a specific amount outstanding at a specific LIBOR (plus margin) for a specified period of time. The builder guarantees to keep the amount outstanding for the specified period of time at the agreed upon rate (LIBOR plus margin). When the loan matures, the lender will notify the builder and will write a new contract for the loan at the new LIBOR if that is what the builder wants to do. The higher administrative costs associated with the non-prime loans will be included in the points on the loan.

The most important difference between prime-indexed and non-prime loans, is that prepayment penalties apply to non-prime loans, while prime-indexed loans can be paid off early without a penalty. For example, in the case of a LIBOR-indexed loan, as noted above, the builder guarantees to keep the loan amount outstanding for the specified period of time at the agreed upon rate. If the loan is repaid prior to maturity, the lender will charge a prepayment fee based on the difference between the LIBOR rate on the contract and the prevailing LIBOR at the time of prepayment.

Due to the additional fees and other factors associated with LIBOR-indexed construction loans, these loans are generally only offered to large builders (those producing 400-500 units per year). Lenders will require these builders to have some portion of their construction financing tied to the prime rate in addition to the LIBOR-based loans. For large builders with a large volume of prime-based construction loans, the lender may waive the prepayment penalty on LIBOR-based loans.

Builders should be aware of the additional fees associated with non-prime loans that could make these loans more expensive and less flexible than loans tied to the prime rate, especially for smaller-volume builders. While there may be some initial rate advantages to non-prime loans, the additional administrative fees and penalties associated with non-prime-indexed loans could easily negate that advantage.

Commercial Paper Market

Large volume builders often can negotiate below-prime construction financing or raise funds in the commercial paper market. Unfortunately, these alternatives are not available to smaller builders who do not have the volume to leverage with their lender or to tap the commercial paper market.

By definition, commercial paper consists of short-term unsecured promissory notes issued by well-known companies that are financially strong and carry high credit ratings. Maturities range from 2 to 270 days. Commercial paper is generally issued by large corporations, bank holding companies and finance companies to investors with idle cash, either directly from the issuing company or through a broker. Commercial paper sold through a broker is called "dealer paper," and paper sold directly through the issuer is called "direct paper." Although commercial paper is unsecured, in almost every case the issuer is required to back up the obligation with a line of credit from a commercial bank. The minimum denomination for commercial paper is $25,000, and new issues average around $2 million. Commercial paper must be issued in large volumes to cover the costs of marketing and distributing funds. Issuers of commercial paper generally have $600 - $700 million outstanding at any given time and as much as $1 billion in a month.

Using commercial paper to raise funds has several advantages for both the issuer and investor. A company issuing commercial paper gets the benefit of flexible maturities and marginally lower rates than they would have to pay on a comparable loan or line of credit from a bank. A disadvantage is that commercial paper cannot be paid off early or refinanced like a bank loan, but must be held to maturity. Market volatility has been a deterrent to many would-be issuers of commercial paper as commercial paper rates can swing from very high to fairly low during periods of tight and loose credit.

The commercial paper market is very difficult to participate in on the issuing side. Any company wishing to enter the commercial paper market generally must be highly rated by at least two credit agencies and should have access to large lines of credit from a commercial bank. Additionally, the sheer size of the offerings in the commercial paper market requires that the issuer be a large company that can put that money to use.

Tips for Reducing Your Construction Financing Costs

There are several strategies small builders can use to negotiate better loan terms to reduce their construction financing costs.

If you have a construction loan with the rate marked up over prime, and prime is running abnormally high relative to other rates in the market, try to renegotiate your rate. Point out to your bank that it is hard to imagine a risk premium that justifies a construction loan rate of four to five percent above the rest of the interest rate structure. Question your lender on why they are charging you such a high markup over their overall cost of funds (not just over the cost of overnight money in the federal funds market).

Bargain hard on loans to construct pre-sold homes. Point out to your lender that construction loans on pre-sold homes have a much lower risk-based capital requirement to the bank than loans for speculative construction.

Reducing upfront points is also an avenue worth exploring. Success in this area will depend on the builder-lender relationship, perceived riskiness of the project and the size of the loan.
While builders certainly should try to negotiate lower rates and points on construction financing, they should

expect only moderate results. Builders should be aware that lenders have funding constraints of their own, as well as regulatory requirements and management objectives, that limit their ability to negotiate lower rates. Also, the lender's willingness to offer lower loan rates, especially below prime, will depend on the lender's relationship with the builder and the lender's perceived risk of the project. Some builders have reported success in getting the mark-up over prime on their construction loans reduced or eliminated. However, builders should be aware that the cost savings from reducing just the interest rate can be modest.

Negotiate Lower Ancillary Fees and Charges

A more productive area for negotiating construction financing cost savings can be in the ancillary fees and charges that accompany a loan. Many fees and charges may be pass-through expenses, so negotiation must be done before the expense is incurred. Fees necessary to document the loan, such as appraisal fees, lender's attorney fees, and inspection fees may be negotiated in advance of the loan. Similarly, closing statements will typically include charges for courier fees, wire transfer fees, loan processing fees and document preparation fees. Often these charges are estimates of what may be incurred during the term of the loan. If the relationship with the lender is strong, the builder might be able to obtain substantial cost savings by negotiating to pay the lender the actual cost of such items as they are incurred.

Builders should scrutinize loan costs with the lender and the lender's and builder's counsel. For example, if building is to take place in a newly platted subdivision, it might be possible to negotiate a waiver of the requirement for a boundary survey at closing. Since a newly platted subdivision is unlikely to have significant boundary line disputes or encroachments, the lender's concerns might be addressed by the foundation survey after construction has started. Similarly, an analysis of title insurance coverage requirements and endorsements may yield savings. However, like other forms of insurance, title insurance regulations and practices vary widely by jurisdiction, so local counsel should assist in the analysis. Some fees and charges will not be negotiable. For example, recording fees, documentary excise taxes, intangible taxes and other taxes and impositions on the loan documents must be paid according to local laws.

Carefully Manage Draw Schedules and Job Completion

Often builders focus on haggling over the loan rate and fees when the builder could more than make up for the cost savings from a lower interest rate through scheduling and job completion. For example, builders can save on interest costs by selling homes promptly after taking their final draw. Builders can also save more in interest costs by drawing more heavily later in the loan term since interest expenses would be accrued over a shorter period of time.

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