Construction/Permanent Home Loans

1. Purpose. This Circular replaces Chapter 7, Topic 2, *Construction Loans,* in the Department of Veterans Affairs (VA) Pamphlet 26-7, *Lender's Handbook*.

2. Background. VA has received inquiries regarding the procedures to process construction loans. Although VA currently offers lenders the ability to originate new construction loans, the brevity of VA guidance has kept many lenders from offering the product. This guidance will allow lenders and builders to offer more opportunities to Veterans.

3. Policy. Title 38 USC § 3710 (a)(1)(3) provides VA the authority to guaranty loans for the construction of a home to be owned, and occupied by a Veteran. The loan is closed prior to the start of construction with proceeds disbursed to cover the cost to build, cost of the land, or balance owed on the land, with the remaining balance in escrow. The remaining balance to be disbursed during construction may also be referred to as a Loan in Process (LIP) account, or a Draw account. These funds are paid out to the builder during construction. The lender must obtain written approval from the borrower before each disbursement, or draw payment is provided to the builder.

a. Credit and Underwriting. Loans for construction/permanent are underwritten in accordance with Chapter 4 of the VA Lender's Handbook.

b. Property Eligibility and Appraisals. The property and appraisal requirements for proposed construction can be found throughout Chapter 10, and Chapter 16 of the VA Lender's Handbook. All VA minimum property requirements (MPR), as outlined in Chapter 12 of the VA Lender's Handbook, must be met prior to issuance of the Loan Guaranty Certificate, and the final inspection/certificate of occupancy.

c. Eligible VA Loan Types.

(1) One-time close (or single close) construction loans. These types of loans are used to close both the construction loan and permanent financing at the same time. The permanent financing is established prior to construction, and the final terms are modified to the permanent terms at the conclusion of construction.

(2) Two-time close construction loans. Two-time close loans generally involve an initial loan closing prior to the commencement of construction, and a second closing where permanent financing is used to take out, or replace the initial loan.

d. Transaction types in a Construction/Permanent Home Loan.

(1) Transactions in which a Veteran has signed a contract to build will be considered a purchase, regardless of the category shown on the closing disclosure, unless otherwise stated below. The lender must order the case as "new construction and purchase" in WebLGY, through the Veterans Information Portal (VIP). (See the VA Lender's Handbook, Chapter 10, Topics 5 and 8.)

(2) Transactions in which a Veteran acted as their own contractor, and/or hired subcontractors may be considered a purchase. All labor and material costs must be documented by receipts, work orders, and/or contractual agreements to establish the acquisition price. The case must be ordered as a new construction and purchase in WebLGY (See the VA Lender's Handbook, Chapter 10, Topics 5 and 8).

(3) Transactions in which construction was completed and at least 1 year has passed as evidenced by a Certificate of Occupancy (CO), or other evidence by the taxing authority will be treated as refinance. A new VA appraisal after the date of the CO is required, and should be ordered as a VA cash-out refinance in WebLGY. Construction exhibits such as plans, specifications, and contracts are not required.

4. The Process.

a. One-time close construction loan process.

(1) Verify the Veteran's eligibility and entitlement.

(2) Qualify the borrower(s).

(3) Order the appraisal in WebLGY. You may order the appraisal "based on plans and specs," as long as the appraisal would reasonably be completed before the completion of the foundation. If the project is farther along than the completion of the foundation, you must wait until construction is complete before ordering the appraisal and it must be ordered as "built less than 1 year and never occupied."

(4) Issue the Notice of Value (NOV).

(5) Pay the funding fee within 15 days of loan closing.

(6) Close the loan.

(7) Construction takes place.

(8) Final inspection or CO signifies the end of the project.

(9) Modify the loan.

(10) Guaranty the loan as a purchase.

b. Two-time construction loan process:

(1) Verify the Veteran's eligibility and entitlement.

(2) Qualify the borrower(s).

(3) Order the appraisal in WebLGY. You may order the appraisal "based on plans and specs," as long as the appraisal would reasonably be completed before the completion of the foundation. If the

project is farther along than the completion of the foundation, you must wait until construction is complete before ordering the appraisal, and it must be ordered as "built less than 1 year and never occupied."

(4) Issue the NOV as appropriate.

(5) Close the initial loan with non-VA financing.

(6) Complete construction.

(7) Qualify the borrower(s) again.

(8) Order the appraisal, if appropriate.

(9) Issue the NOV, if appropriate.

(10) Close the loan.

(11) Pay the funding fee within 15 days of loan closing.

(12) Guaranty the loan as a purchase.

5. Loan Characteristics.

a. Acquisition Costs. May be included in the VA loan if evidence is provided of items listed below:

(1) The contract to build,

(2) Cost of the lot if acquired within one year from VA loan closing, or

(3) Value of the lot if acquired more than one year from VA closing, or

(4) Value of the lot if gifted to the Veteran and there are no liens on the lot, or

(5) Lots gifted less than one year from VA closing are limited to lot lien(s) if any,

(6) Interest reserve if not included in the contract to build,

(7) Contingency reserve, and

(8) Permits if not included in the contract to build.

b. Allowable Builders. The general contractor must be a registered VA builder. A list of registered VA builders is available in WebLGY. VA has no arms-length restrictions, provided the builder is registered by VA. For any property appraised for proposed construction, the builder or contractor must have a valid builder identification number prior to a VA NOV being issued. For information on obtaining a builder identification number, see Chapter 10 of the VA Lender’s Handbook. A builder report may be found at https://vip.vba.va.gov/portal/VBAH/Home. Instructions to become a registered builder with VA can be found at https://www.benefits.va.gov/HOMELOANS/appraiser_cv_builder_info.asp. Borrowers are free to choose their builder or contractor, subject to any additional requirements the lender may require. It is the lender's responsibility to ensure that the builder or contractor is licensed, bonded, and insured according to all state and local requirements.

c. Change Orders. Change orders/upgrades made after the appraisal cannot be mortgaged into the new loan. Borrowers are permitted to pay for upgrades out of pocket. Change orders must be approved, in advance, by the appraiser, to ensure no loss in value. If a new appraisal is required, the lender will contact the Regional Loan Center (RLC) of jurisdiction for assistance. The Veteran is allowed to pay for an additional appraisal if change orders are to be mortgaged into the new loan.

d. Escrows. VA requires the use of formal escrows. Escrows can be established for seasonal only items when you use VA Form 26-1849, *Escrow Agreement for Postponed Exterior Onsite Improvements*. It is the lender's responsibility to ensure escrow items are completed. If items are not completed, VA may adjust or cancel the guaranty. If any funds remain in escrow after construction is complete, they must be disbursed in accordance with the formal agreement. For more information regarding escrows, please see Chapter 9 of the VA Lender's Handbook.

e. Fees and Charges. Lenders may charge the Veteran a construction fee of up to 2 percent of the amount of the loan for its services, provided that the major portion (51 percent or more) of the loan proceeds is paid out by them during the actual progress of the construction. Such charges may be in addition to the one percent origination charge. Fees charged on a VA-guaranteed loan must comply with chapter 8 of the VA Lender's Handbook. On a construction/permanent home loan, the builder is responsible for:

(1) Interest payments during the construction period on a one-time close if not included in the interest reserve, and

(2) All fees normally paid by a builder who obtains an interim construction loan including, but not limited to:

(a) Inspection fees,

(b) Commitment fees,

(c) Title update fees, and

(d) Hazard insurance during construction.

(3) On a two-time close construction loan, the VA loan has not been established, therefore, the terms of the initial construction loan including the interest payments are subject to negotiation by the Veteran.

(4) Funding Fee. For a one-time closing construction/permanent loan, the funding fee is due and payable to VA within 15 days of loan closing. It is not tied to the commencement or completion of construction. While the intent of a two-time construction loan results in a VA-guaranteed loan, the construction loan is not a VA loan. For two-time close construction loans, the funding fee is due

within 15 days of the VA permanent loan closing. Both types of construction/permanent loans must be reported to VA within 60 days of receipt of the clear final compliance inspection report. For the purpose of reducing the funding fee, ownership of the land by the borrower(s) prior to construction is eligible to count as a downpayment for purposes of reducing the funding fee, provided that the appraisal assigns a value to the unimproved land, and the value will count only to the extent that the loan amount is less than the NOV value. Lots held as contracts for deed are not considered owned by the borrower.

f. Guaranty. Although the loan will normally be considered guaranteed upon closing, the guaranty on a construction/permanent home loan will not be issued until a clear final compliance inspection report has been received by VA. VA construction loans are eligible to receive the same guaranty percentage as VA purchase loans. If construction is not fully completed, and loan proceeds are not fully disbursed, guaranty will apply only to the proper pro rata part of the loan. The proper pro rata part of the loan, for VA guaranty purposes, is calculated as follows:

(1) Loan proceeds disbursed for construction purposes, plus any other payments made to the builder by or on behalf of VA.

(2) Take the lesser of the total determined in f (1) above, or 80 percent of the value of the portion of the construction actually completed, plus any loan disbursements made for the purchase of the land on which the construction is situated.

g. Housing Reserve. In cases where the borrower(s) will not occupy the property immediately after closing, underwriters must document the amount of housing and subsistence costs until occupancy. Actual cost estimates must be used. Underwriters must also document the manner in which the expenses will be paid.

h. Inspections.

(1) There are three options allowable to satisfy the inspection requirement for cases ordered as "Proposed." Construction must be completed according to local building codes.

(a) If the local authority performs the required foundation, framing, and final inspections and issues a CO or equivalent, VA will accept the CO for the property as evidence of local authority inspections and satisfactory completion of construction. Please note that framing inspection is not required on manufactured, or modular homes.

(b) If the local authority performs the required foundation, framing, and final inspections, but does not issue a CO or equivalent, VA will accept copies of the inspection reports, which verify full compliance with local builder codes, or a written statement from the local authority that states that the required inspections were performed satisfactory.

(c) If the local authority does not perform the required inspections, the property must be covered by a 10-year insured protection plan that is acceptable to the Department of Housing and Urban Development (HUD), and a 1-year VA builder's warranty.

(2) Final inspection. When the property is 100 percent complete, the lender will contact the original VA appraiser to complete the VA final inspection. If the original VA appraiser is not available, the lender will contact the RLC of jurisdiction for another VA appraiser to complete the

VA final inspection. The VA final inspection is to certify all VA MPRs are met and the house was built to the original plans, specifications and approved change orders, and that the as-completed value from the appraisal was maintained.

(3) It is the lender's responsibility to negotiate an inspection schedule with the general contractor, and it is the lender's responsibility to ensure the schedule is followed.

i. <u>Interest Rate</u>. Lenders may offer a “ceiling-floor” option where the Veteran “floats” the interest rate during construction. The agreement must provide that at lock-in, the permanent interest rate will not exceed a specific maximum interest rate, yet also permit the borrower to lock-in at a lower rate based on market fluctuations. The borrower(s) must qualify for the mortgage at the maximum rate.

j. <u>Cash Back to Borrower</u>. In instances where downpayment funds came directly from the borrower, or the borrower purchased a lot in cash, or has unencumbered ownership of the lot being used as a downpayment, the borrower may receive cash back at closing for the amount paid provided that the final loan amount does not exceed the NOV value, and evidence of the funds provided by the borrower are documented in the loan file. The borrower cannot receive cash from equity in the project, or funds provided by another party.

k. <u>Loan Amortization</u>. The borrower begins making payments on a one-time construction loan only after construction is complete. Therefore, the initial payment on principal may be postponed up to one year if necessary. The loan must be amortized to achieve full repayment within its remaining term. For example, if it takes six months to complete construction, the payment schedule for the borrower obtaining a 30-year mortgage must provide for full repayment of the loan in 29 years and 6 months. Rather than requiring a balloon payment, it may be preferable to set up equal payments (beginning after construction is complete) which are large enough to repay the loan within the original maturity without a balloon payment.

l. <u>Maximum Loan Amount</u>. The maximum loan amount for construction loans is limited to:

(1) the lesser of the VA reasonable value, or the acquisition costs (see 5(a)(1) above), plus

(2) the cost of any energy efficiency improvements up to $6,000, plus

(3) VA funding fee.

m. <u>Contingency Funds</u>. Contingency funds are to be negotiated between the borrower and builder.

n. <u>Project management</u>. The lender is responsible for all aspects of establishing the account containing the construction funds. The lender must ensure that funds are accounted for, and disbursed according to the progress completed. The lender should have the specialized experience to process, underwrite, close, and set-up the LIP account, or draw account. Any remaining funds in the LIP account upon completion should be disbursed according to the contract. If the remaining funds are the borrowers, re-imbursement is acceptable up to the verified amount that has been paid in advance; otherwise the funds must be applied to the loan balance. In addition, the lender has the responsibility to evaluate, monitor, and manage the project. It is the lender’s responsibility to ensure that the project is completed per the plans, specifications, and /or contract documents, so that the value of the home is preserved. If the project requires permitting and local authority inspections or requires detailed construction exhibits to be provided to the appraiser, the lender “must” condition the NOV for appraiser re-inspection/certification. This ensures compliance with exhibits and information used in the preparation of the subject's value. Specifications for materials to be used in projects must be provided to the appraiser for consideration in the preparation of the appraisal report. These exhibits along with any materials specifications "must" be provided to the appraiser at the time of the appraisal order to be utilized in the preparation of the appraisal report for valuation purposes. Appraisers will "hold" appraisal assignments until the appropriate exhibits are received. The appraiser should contact the point of contact if not received in one day of appraisal order and "must" put notes in the case in WebLGY. Any re-inspections by the appraiser must ensure that the completed construction meets at least the minimum specifications originally utilized in preparing the appraisals final value. The use of any lower grade materials or deviations that may lower the original value provided in the appraisal report must be noted as to the specific deviation and its impact.

6. Rescission: This Circular is rescinded April 1, 2020.

By Direction of the Under Secretary for Benefits

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