Church Construction & Financing Manual

Church of God Benefits Board, Inc.
Post Office Box 4608
Cleveland, TN 37320

CHURCH CONSTRUCTION AND FINANCING MANUAL

(2015 Edition)

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PURPOSE

The purpose of this manual is to provide general guidance to churches and local congregations as they seek to obtain financing from a financial institution. This manual is not meant to be an all-inclusive directory of each step that a church should take in obtaining financing. However, it is hoped that the manual will stir interest in the church seeking financing to look beyond the surface issues to consider, and hopefully address, underlying issues that may prove critical during the life of the mortgage. In addition, the manual addresses the construction of new facilities and the potential problems involving expansion projects.

The Boards nor the staff of the Church of God Benefits Board, Inc. or the Church Loan Fund, Inc. are engaged in rendering financial advice, legal advice, or other financial planning services. If such advice is desired or required, the services of a competent professional should be sought.

FAITH STEP

Obtaining a loan to construct a church facility may be one of the greatest decisions that a church will ever face. Church construction is primarily a step in faith – the church is building a facility to meet expected growth in the future. If the church averages 100 in attendance per service, they are very unlikely to build a facility that will seat 100, but rather a larger facility in anticipation of additional growth in the future.

As the local church enters into the process of preparing for a larger facility, either by building a new structure or by purchasing an existing facility, the faith of anticipated growth must be cross-referenced against the local church's ability to pay for such a facility. Simply put, a church averaging 100 in attendance may have faith and a vision that they will be averaging over 1,000 in attendance within 10 years. However, they mostly likely do not have the resources to build or purchase a facility that would seat 1,000 now. In addition, the psychological impact of placing 100 people in a facility built for 1,000 may be devastating to the current congregation. The challenge of filling the 1,000-seat facility may look too great for the current membership to tackle. On the other hand, an interim facility seating 250 may provide for much needed space in the short-run, plus the opportunity for the church to grow incrementally.

While no one would ever want to stand in the way of a local church's faith and vision for growth, the church must count the costs of its expansion project. In Luke 14:28-30, the words of Jesus give us direction on this issue:

"Suppose one of you wants to build a tower. Will he not first sit down and estimate the cost to see if he has enough money to complete it? For if he lays the foundation and is not able to finish it, everyone who sees it will ridicule him, saying, 'This fellow began to build and was not able to finish.'"

COUNTING THE COSTS

"Counting the costs" goes much further than just going through a financial analysis to determine if the church has the ability to make the payments as they come due. Many churches have the financial ability to make the payments. However, some of those churches do not have the will to invest such a large percentage of their revenue into "bricks and mortar." The issue of ministry should be explored at length before committing to a massive expansion project. The church should at least ask the following questions:

- Does this expansion project (either construction of new facilities or the purchase of existing facilities) fit into God's plan for this local church?
- Does the entire congregation share the leadership's vision for growth? While everyone may not be completely behind the project, it is important for as many people as possible to share the vision. If not, those who do not share the vision will be gone at the first sign of trouble.
- Has a majority of the congregation committed to financially support the expansion project? Often members within a church will offer token verbal support of an expansion project. However, they are much more committed to a successful outcome of the project if they also commit their God-given financial resources to the project.
- Has the church implemented a stewardship campaign that will assist in paying for the expanded facilities? There are many companies and organizations that offer programs designed for Stewardship Capital Campaigns. A stewardship campaign should be implemented at least a year prior to the beginning of the expansion project. Such a program locks in contributors, both spiritually and financially, to the expansion project well before action is taken on the endeavor.
- What "fail-safe" measures can be taken by the church to meet the financial obligations of the church if the stewardship campaign is either unsuccessful or pledges do not come in as promised? While you may not be able to plan for every disappointment, the church should review the options available should pledges not materialize.
- If building fund/capital expansion pledges are not sufficient, does the church have other funds that they could draw upon? If not, what ministries of the church would have to be eliminated or greatly scaled back if previous operational funds for ministries were now needed to meet the financial obligations of the expanded facility? There is probably no greater source of controversy in a local church than when ministries have to be scaled back or eliminated so that those funds can be used to pay for new facilities. Generally when this occurs, multiple ministries within the church are impacted, creating much division.

- Once in the new facility, are the projections for growth – both numerically and financially – realistic? If the church over the past 10 years has averaged financial growth of 5% per year, it is unrealistic to believe that the average growth after moving into the new building will be 10%. While we can pray that such astronomical growth will occur, the statistics seem to suggest that it will not.

These considerations for "counting the costs" are not meant to negate the church's efforts to move forward with the vision that God has placed upon the leadership of the church. However, it is incumbent upon the leadership of the church to ask insightful questions to assure that all costs have been reviewed and calculated. Although a greater discussion on this issue will follow later in this manual, many churches do not plan for or anticipate cost overruns when constructing a new facility. If the church is constructing a $500,000 facility, they often wrongly assume that $500,000 will be the extent of their financial liability. However, "change orders" or other modifications to the plans may result in substantial cost increases. Those costs overruns could amount to 10% or more of the total project costs. Therefore, it is critical that those "added on charges" are carefully monitored to keep your project within budget.

HOME FINANCING VS. CHURCH FINANCING

Before a discussion can begin about plans and specifications for a new facility or the refurbishing of an existing facility, the church, working through the church council or through the church body as a whole, must determine how much they can spend on their expansion project. Again, faith often conflicts with the bank statement.

In contrasting personal loans, a personal home mortgage is based upon a percentage of the family's income. While the factors vary from bank to bank and from one locale to another, generally the bank will offer to lend money to an individual based upon the individual spending anywhere from 25% to 38% of their monthly income on house payments. The bank takes into consideration the fact that the individual is also going to spend another 10-20% per month of their income to operate the house – for things like insurance, repairs, and utilities. While the formula may not be easily understood by the individual borrower, before loaning the money the bank has rather good assurance that they will be repaid by the individual.

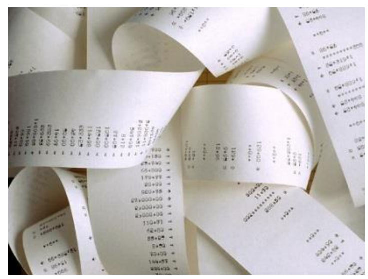
Church financing is totally outside the realm of consideration from an individual borrowing money for a home mortgage. Most importantly, the lender does not have a steady source of income that they can be assured of in a church loan situation. What if a couple of the big givers in the church lost their jobs, were transferred to another area, or decided to go to a church down the street? In questionable church loan situations, the lender may request a list of the church's contributors and how long they have been contributing to that church. Most likely, the lender would not request specific amounts given over the years but they may look for information to show that the current financial situation is long-standing and not just a short-term trend. In even more rare occasions the local lender may request that certain individuals in the church "co-sign" or "guarantee" the loan to the church. If individual guarantees can be eliminated, every effort should be made to do so.

AFFORDABILITY

Again, we are back to the issue of how much mortgage can the local church afford. In assisting churches in obtaining loans, the Church Loan Fund uses a rather simple formula to determine how much of a church's monthly income should be devoted to mortgage payments. Another formula is often used by banks to determine how much can be loaned on a particular project. The total project formula will be discussed later.

In assisting churches in obtaining loans, the Church Loan Fund recommends that the total monthly payment does not exceed 15-25% of the church's monthly income. Those recommended percentages are broken down as follows:

Annual Church Income	Percentage
Under $50,000	15%
Between $50,000 - $100,000	20%
Over $100,000	25%



So for example, if a church's annual income is $200,000, their payment should not exceed $4,166.67 a month ($200,000 ÷ 12 = $16,666.67 x 25% = $4,166.67). The church in this example could afford to construct or buy a facility costing approximately $500,000 to $550,000, depending upon the interest rate.

It is worthwhile to note that this formula takes into consideration all revenue received by the church, which would include tithes, offering, building fund contributions, etc. One time gifts or irregular contributions, as well as loan proceeds from other sources, should be subtracted out of the total to provide a better "affordability" ratio. Also, special designated giving, such as mission giving, should be excluded as the local church does its internal calculations. Since those designated funds cannot be used for any purpose other than what they are designated for, they should not be considered unless they are designated for the building fund.

Each bank or financial institution is going to use a different formula to determine affordability. The guidelines used above by the Church Loan Fund are for illustrative purposes and are not meant to be a guide for banks offering commercial church loans.

If the anticipated monthly payments exceed the percentages set out above, it should cause the church to pause and reconsider their expansion plans. Such is not to say that the church may not be able to afford slightly higher payments. However, as a rule of thumb, these maximum limits have worked rather well over time to keep churches out of the problem of over-extending themselves.

POTENTIAL AFFORDABILITY ISSUES

Adjustable Rate Mortgages

Affordability is often skewed in the current lending environment because of historically low interest rates. Because of this factor, churches should be extremely cautious in calculating adjustable rate mortgages.

Under an adjustable rate mortgage, or ARM, the borrower/church is subject to monthly (or even daily) rate fluctuations. Generally, such adjustable rate mortgages are for only a limited time period of three, five, or seven years and at the end of that time period, the remainder of the mortgage is “ballooned” into a final payment. For example, if a church chooses a five-year adjustable rate mortgage that starts at 6% (usually based upon the Prime Interest Rate or Libor Rate), their payments are set up on an amortization (or payout) schedule over a certain period of time, generally 20 to 30 years. However, during the life of the loan that adjustable rate can change as the prime or Libor rate changes, sometimes changing monthly. On month 60, the remainder of the note comes due. At that point the church either has to pay the total amount due or they have to refinance with the bank that previously made the loan or with another financial institution. At refinancing on month 60, the new starting rate is set based upon the current going interest rate. If rates change drastically, it may create an affordability issue for the church to make monthly payments.

For example, assume that a church borrows $500,000 for the purchase of a new facility and was able to get a short-term **fixed** rate mortgage. At 6% interest with a 20-year amortization and a 5-year balloon, the payments would be approximately $3,582 a month. Even after making payments for 5 years, the church would still owe approximately $425,000. If rates had risen only modestly and the church was forced to refinance the remaining 15 years at 8.5% interest, the payments would jump to approximately $4,186 a month – an increase over the previous payment of more than $600 per month. Even if the church decided to refinance for another 20 years at the higher rate of 8.5%, the payments would be $3,689 per month – an increase of over $100 per month over the previous payment, plus an additional five years on the life of the loan. With an *adjustable rate* mortgage, the church would be experiencing this volatility monthly.

From this simple example, it is obvious that adjustable rate mortgages can cause severe hardship on a church that has not adequately planned for rising rates. Even though rates have been at historical lows in recent years, a look at rates over the past 50-75 years gives a good indication that rates may very well trend upward quickly.

To assure that the church can afford an adjustable rate mortgage, the monthly payment should be looked at in terms of where the rate could realistically go. If the church can only afford the mortgage if the interest rate stays at 6% for the life of the loan, then it would not be prudent to select an adjustable rate mortgage that starts at 6%. On the other hand, if the church can afford payments even if the rate was 10%, it may be wise to choose an adjustable rate mortgage while rates are so low. However, in that situation the church should make additional payments while the rates are low to further reduce the principal amount prior to rates possibly increasing.

It is the recommendation of the Church Loan Fund that churches should seek as long of a fixed-rate mortgage as possible, rather than an adjustable rate mortgage. A fixed-rate mortgage allows a church to know their monthly mortgage costs now, five years from now, and even fifteen years from now. From a long-term planning aspect, a longer fixed-rate mortgage is extremely beneficial.

While the rate on a fixed-rate mortgage may be higher than an adjustable rate mortgage, the following should be noted:

- With a fixed-rate mortgage, closing costs, such as appraisal fees, filing fees, and attorney fees, are paid only once on a fixed-rate mortgage, compared to possibly many times on a short-term ballooning mortgage.
- Risk is reduced to the church because the rate is fixed, rather than subject to readjustment every one, three, or five years – or even monthly.
- Borrowers should also be aware that a financial institution may not want to renew the loan after the initial rate period. Some financial institutions are currently making loans to churches in order to satisfy federal banking regulation. If they have met those requirements through other avenues, the bank may not have the necessity to re-make a loan to a church.

Upon seeking to refinance, some churches have been told that they are too much of a credit risk for a new mortgage, even though they have had good performance on their loan during the initial loan period. Therefore, *caveat emptor* – proceed at your own peril – is the advice given to any church seeking a mortgage.

Projected Growth

To base ability to pay in the future on projected growth is risky at best. Some would say that such is foolish and unwise.

The "build it and they will come" method of church growth has never worked. To use such an approach to anticipate growth in church revenue is ludicrous. If the church's financial growth is essential to the ability to repay the church loan, the church should reconsider the expansion project.

Most churches use formulas that have been tried and tested over the years in that local congregation to show projected growth in the years to come – both numerical and financial growth. Those projections are usually the basis for the church's budget for the upcoming year. Even without a building program, those projections should be realistic. For example, if over the past ten years the church has experienced annual growth, both numerically and in revenue, of 6%, projected growth should be based upon 6%. While a new facility may temporarily attract new attendees, the sustained growth, with few exceptions, will track the historical growth.

Therefore, any projections on ability to pay should be based upon historical growth numbers and not on unrealistic "build it and they will come" numbers.

Operational Costs of Expanded Facility

In determining the church's ability to pay for an expanded facility, many calculations are done concerning the cost of the facility itself. Often overlooked, however, are the costs associated with operating and maintaining the larger facility, including added insurance costs. The greatest increase will come from the costs of utilities. Most power and gas companies can provide the church with a rather detailed approximation of the utility costs associated with the larger building well in advance of construction or occupation of the facility. Such estimates, based upon square footage, ceiling height, and other factors, can be invaluable in the early construction phase of a new building, even to the extent of changing utility components to reduce costs.

Besides the additional costs of heating and cooling the larger facility, maintenance and repair costs should be carefully estimated. If the larger facility is new, the repair costs are going to be minimal. However, the maintenance costs may go up substantially.

While operational costs may seem inconsequential, they mount up quickly and can end up taking a rather large bite out of a local church's budget. These costs should be carefully estimated to determine the affordability of the project.

TOTAL PROJECT FORMULA

Just as with home mortgages, church lenders will not lend more than a specific amount on a project with that amount generally determined based upon a percentage of the appraised value of the completed or the "to-be-completed" project. Most commercial and church mortgage lenders will lend between 50% and 80% of the total project cost. The percentage amount is determined by the local lender and generally is in conformity with local lending practices.

Assume for a moment that a lender will not lend more than 60% of the current appraised value of the project. This percentage, often called the "loan to value" amount, is based upon a certified real estate appraisal. So for example, if the new facility appraises for $1,000,000, a loan could be made up to $600,000. For such a loan to be made, the church would also have to be in compliance with the affordability percentage formula discussed above. The "loan to value" amount on church loans is generally less than what most commercial lenders will consider on other commercial loans.

For several years, some commercial lenders offered loans to churches with a greater "loan to value" ratio than 80%. Those lenders were speculating that the church property would increase in value exponentially. However, as property values have declined in the past few years, lenders are no longer willing to speculate that land values will increase. In fact, many are no longer willing to lend to churches at all.

In determining “loan to value” ratios, lenders face several formidable challenges. A few of those challenges will be discussed briefly here:

Single Source Building

The amount a lender will make available on a church facility is often limited by the intended use of the building itself. Most church facilities have little usefulness other than for a church facility. Often called “single source” buildings, churches are generally very difficult to sell in a competitive real estate market. The potential purchasers are often limited to other churches, which drastically reduces competitive pricing. Being a “single source” or “single use” building also potentially increases the time that the facility will be on the market if a sale is necessitated.

The “single use” designation greatly limits most lenders from considering more than 80% “loan to value” ratios on church buildings. The lender is simply aware that, should they have to take the property because of failure to pay, they may face some substantial challenges in liquidating the property at a sales price close to the appraised value.

Public Relations Disaster

The amount of funds that a lender will make available to a church is also based upon an unspoken analysis – what would be the public reaction if the lender had to foreclose on the property? If a lender believes that the church is “borderline,” meaning that if all goes well they will have no payment problems but if only one thing goes wrong it could create payment problems, the lender’s appetite to make a substantial loan to the church is diminished. The lender is well aware that foreclosure on a church facility will be a public relations nightmare. Not only is the lender repossessing a church building, their actions will impact dozens if not hundreds of current and potential depositors. A financial institution would rather walk away from the loan and not make it rather than end up alienating literally dozens of current or potential customers who attend the church if foreclosure is required.

Because of the public relations fallout, a lender will generally limit the loan to an amount that the lender feels the church can adequately handle. Again, the faith of the congregation and the realities of the lender may clash at this point.

BEFORE THE APPLICATION PROCESS

Before the church leaders even talk to a lender regarding a loan, much work needs to be accomplished. If more work is done before the initial consultation with a lender, the better the chances of the lender making the church a loan. Simply put, the church should do its homework. The following are just a few of the steps the church leaders should take:

- Seek approval from the State Overseer/Administrative Bishop to commence the project. The *Minutes* of the Church of God General Assembly at *S47* specifically require a local church to submit information for consideration and approval to the state overseer “before acquiring property, beginning or contracting for construction or purchase of a new church or educational building or a parsonage, or remodeling of such a building, if the cost will exceed 10 percent of its value…”
- Seek approval from the State Overseer/Administrative Bishop to hold a regular or called conference of the local church to discuss the expansion project. The *Minutes* at *S44* actually require that the standard Church of God Warranty deed (which will be discussed in detail later) contain a provision detailing that such a conference was held.

- After approval is granted and directions are provided by the State Overseer, schedule and conduct a conference of the membership of the local church.
    - All information concerning the expansion project should be disclosed at the church conference, including, but not limited to, the costs of the project, the projected construction time, the necessity of borrowing money to pay for the project, etc.
    - Approval should be sought specifically from the conference to proceed with the expansion plans. Two-thirds of all the members of the local congregation present and voting must approve such.
    - Specific approval should be sought from the conference to borrow the money necessary to fund the expansion project. Again, two-thirds of all the members of the local congregation present and voting must approve such.
    - Minutes of the meeting should specifically reflect the actions of the church conference. General statements that “the church discussed the building program and agreed to such” are insufficient. For loan purposes, the lender is going to require specific direction from the church before the loan is finalized. If the Minutes of the conference are in order, this process will be expedited.
- The above discussion presupposes that the cost of the expansion project has already been determined by the church. Affordability combined with the faith of the congregation must set the limits of the project.

Application Process

While preliminary discussion may occur with a lender prior to the church's approval to go forward, the primary discussions on terms and conditions generally should not occur until the church has committed itself to the project. Since there are generally costs involved in making a loan application, the leadership of the church should not incur those costs until the project is approved by the church body. But once approval is granted in a church conference, the church is now ready to explore their building and financing options.

Later discussions will concentrate on the relationship with the builder. Financing the project now becomes paramount. Generally, the church has an on-going financial relationship with a local bank. That bank will be extremely familiar with the financial arrangements of the church and the cash flow produced by the church. Because of that familiarity, the local bank should be the first contact made by the church.

By contacting your local bank about financing, several issues will be brought to the forefront. First, as mentioned earlier, the bank is familiar with your cash flow and will be in a position to advise you immediately if the project you are contemplating will work based upon your in-flow of cash. Secondly, your request for a loan from your bank will immediately establish a new relationship between your church and the bank. Some banks are content to provide checking and savings service to your church – but they may not be so willing to provide loan services. As mentioned previously, their reluctance may be based upon several factors, including making a loan on a single use building or a public relations problem if the loan goes bad. Regardless, you will see quickly how valued your banking relationship is to the bank.

You should not only get loan information from your bank but also from other banks (and commercial lenders) in your area, as well as the Church Loan Fund, Inc. Before a decision is finalized, a church should have at least three proposals for consideration. It should be noted that in some communities banks will not even consider making a loan to a church. For a number of reasons, those banks have determined that they will not enter the church mortgage market.

If a proposal cannot be obtained from local financial institutions, the church may want to consider contacting some of the larger church lenders in the country. A few of those lenders with contact information are included here:

- Bank of the West – (800) 405-2327; www.bankofthewest.com
- Evangelical Christian Credit Union – (800) 634-3228; www.eccu.org

In making application for a church mortgage from a local bank, the Church Loan Fund, or a national lender, you should expect the following:

Detailed Loan Application

The lender will request the representatives from the church to complete a detailed loan application. In the application, the directors (or trustees) of the church will have to be listed and may even be required to sign the application. These trustees should be duly appointed and recognized by the church. Deceased, departed, or incompetent trustees should be replaced well in advance of the loan application.

Information on the pastor's tenure will almost always be required. Further, if the project is a sizeable undertaking, the lender may even require the church to obtain "key man" life insurance on the pastor. Since "key man" life insurance is often costly, this factor should be taken into consideration in determining the cost of the loan.

Financial Information

The lender will generally require detailed financial information from the church for at least the last two years – and often for the past five years. The preferred information would be audited financial statements. However, most churches do not have an outside auditor review their books annually so such is not available. In the absence of audited financial statements, the lender will require detailed "profit and loss" statements. In the church arena, that is going to require the church to produce a detailed balance sheet and income statement since the church is a non-profit entity.

An analysis or breakdown of revenue (tithe, offerings, building fund, missions), as well as detailed information on expenditures (salaries, operational costs, benevolence), may also be required. Any unusual increases in revenue or in expenditures should be explained during the application process.

All assets and liabilities of the church are required by law to be revealed during the application process. Any effort to shield or hide assets or liabilities is fraud and could result in the loan being voided even if discovered later – and could result in prosecution.

A recent trend has developed among some commercial lenders where they have requested detailed information on the largest contributors to the church. Detailed contribution information on an individual should never be revealed to a third party, including a lender. Providing such information may subject the church to an invasion of privacy lawsuit.

A request to provide information on the number of giving "units" in a church is reasonable and should be provided. Even a request to provide the average amount given by each giving "unit" is reasonable. However, specific information on a particular individual or a list of persons who gave to the church over a specific period of time are unreasonable requests and such information should not be provided unless the church's legal counsel gives permission for the disclosure of such information.

As a note of caution, financial information provided to a lender should be accurate and not overstated. Inaccurate information provided to a financial institution may be considered as bank fraud and subject anyone signing the loan documents to possible criminal prosecution.

Appraisal

Having been accustomed to paying $250 to $500 for a residential appraisal, many within the church are shocked to learn that an appraisal on a church building could cost as much as $10,000. There are many reasons that contribute to the high cost of a church appraisal, including the size of the property, the single use purpose of the building, and generally the lack of volume comparatively to residential appraisals. Most importantly, church property is considered commercial real estate.

Most lenders, including the Church Loan Fund, are willing to accept a “limited and restricted” appraisal. A limited appraisal basically provides the pertinent details on the property without requiring the appraiser to submit volumes of comparative analysis, etc. A limited appraisal can cut the cost of an appraisal drastically. However, the church should still plan on spending between $800 and $4,000 for an appraisal acceptable to the lender. The specific cost will depend upon the geographical location of the church, as well as the valuation of the property, and the willingness of the appraiser to provide an appraisal other than a full appraisal report.

The cost of the appraisal is outside of closing and is an expense that the church/borrower will have to pay for out-of-pocket. Before ordering an appraisal, the church should contact the lender to make sure they have no objections to the selected appraiser and the type of appraisal being performed. If the appraiser is unfamiliar to the lender, the appraiser’s credentials should be submitted to the lender for approval.

The appraiser should always be independent from the church and should disclose, in writing, any conflicts of interest he may have in his appraisal. The appraiser should also be licensed and certified in the state in which the subject property is located.

Generally, the lender will require that the appraisal not be conducted more than 90 days prior to the loan application. They want to insure that the market value of the underlying collateral has not deteriorated. While replacement value information is good to have, the current valuation method of the property is what the lender will need.

Zoning Regulations

In conjunction with securing financing, it is imperative that any zoning obstacles be removed. Twenty years or more ago, there was very little discussion about zoning. Churches were able to basically build what they wanted and no one complained to the local authorities. However, today many communities have restrictive covenants that actually work to keep churches out of certain areas.

All requests for zoning changes for new construction or for an existing structure should begin early in the process. In some metropolitan areas, it may take upwards of a year to even get a hearing before the appropriate zoning official. If proper zoning cannot be acquired, the expenses of proceeding with a loan application should be saved. While such may be costly, legal representation is generally advisable in contested zoning situations.

Environmental Concerns

Just as with zoning, environmental concerns have arisen as major stumbling blocks towards expansion projects over the past two decades. Environmental issues are mostly prevalent when an older building is being renovated. Asbestos, lead paint, and a variety of other issues can cause major environmental concerns. The cost of abatement of such environmental problems can also be extremely costly.

Phase I Environmental Study

Most lenders are not going to commit to a project unless a Phase I Environmental Study has been completed on the expansion site. This study, conducted by a professional engineer, will provide information concerning any environmental impact that might occur as a result of the construction anticipated. Many churches contend that such a study is a waste of time because they have owned the property for years and know what is under the soil. However, those same people are often surprised to find that years ago, sometimes fifty or more years ago, their property was used as a landfill or a waste treatment storage area. New construction and digging may well uncover those long-forgotten areas, resulting in major costs to the church to abate an environmental problems caused by previous owners.

While not totally comprehensive, a Phase I study will, among other things, involve soil borings and a review of the water tables under the surface. Not to have such a study conducted could prove to be extremely costly in the long run. Again, most commercial lenders are not going to offer the church the option – they will simply require a Phase I environmental study. Costs for such a study will vary greatly but a church should expect to pay a minimum of around $500 up to a maximum of several thousands of dollars, depending upon the projected size of the facility to be constructed.

Environmental Protection Agency

If the intended construction site has previously been used as a gas station or for gas storage, a lumber treatment facility, or for a variety of other reasons, the Environmental Protection Agency (EPA) will make sure that the site meets certain standards before allowing for construction. Generally problems of this type will be pointed out before the church purchases the property. All potential problems of this nature should be researched extensively before the church makes a decision to buy the property. Often clean up of such problems costs in excess of the value of the property.

Wetlands

Another matter that must be addressed in the construction of a new facility is the issue of wetlands. If the new construction will in any way impact a wetlands area, special permitting from the U.S. Army Corps of Engineers will be required. This “404” permitting process is cumbersome, timely, and often a major hassle. While such is appropriate to protect our environment, many builders make the decision to change sites rather than try to obtain a 404 permit, which may require the builder to set aside other lands to replace what is being used in the construction process.

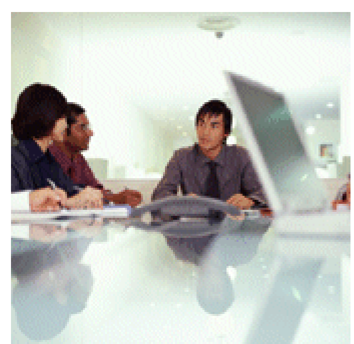
Land Survey

If the church is purchasing new property or if a recent survey has not been completed on existing property, the lender will generally require that a land survey be completed on the real estate. The survey is to establish clearly the property lines and to insure that there is no encroachment on the boundary lines by neighbors. It also insures that the church builds within their own property lines. The church can expect to pay as little as a couple hundred dollars for a survey up to a thousand or so dollars, depending upon the size of the property and its’ location.

Meeting with the Banker

Who Represents the Church?

Going to meet with the banker to discuss a loan is often one of the most frightening tasks that a minister ever undertakes. However, the pastor should not be alone in this endeavor. The pastor, the church treasurer (the church’s chief financial officer), and possibly even other members of the church finance committee should meet with the banker to discuss the needs of the church. There truly is safety in numbers.



If the entire finance committee attends the meeting, everyone hears the same story from the banker – and therefore, his or her words are not left to be muddled through an interpretation. If the banker speaks highly of the loan, everyone hears that praise. However, if he raises concerns, everyone also hears those concerns. If everyone does not attend the meeting with the banker, human nature is only to repeat the high points that the listener wants to hear. The whole picture is often left distorted.

Banker's View

Most potential borrowers want to know in advance what the banker is looking for when they meet with a potential borrower. Plain and simple, the banker is going to want to make sure that his bank gets repaid. There is no doubt that he wants to hear about the project, the church's projections for growth, both numerically and financially, as well as the church's vision for the project. However, the banker's primary concern is to assure that the loan made to the local church will be repaid in a timely manner.

As mentioned earlier, the banker does not want to ever have to consider the idea of foreclosure on church property. He had much rather deny the loan than face foreclosure down the road. The public relations problem of foreclosing on a church is disastrous.

The finance committee should do everything possible to alleviate any fears of possible failure to perform by the church. Any documents or financial statements to help in that process should be shared with the banker early on. The representatives from the church should not wait for the banker to ask for such information. The financial plan should be laid out up front.

The finance committee should never rely on "God to provide" when talking financial matters with a banker. While the church knows that God will provide, the banker needs more concrete evidence that the church has the ability to perform – and repay any loan made by the bank. If the church provides information early in the process to show their plan for performance, all subsequent meetings with the banker will go much smoother.

Quote vs. Letter of Commitment

Often you will hear a fellow minister or church official say that they have been quoted a rate of 3.5% or some other low interest rate. It is important to realize that a quoted rate is just that – a rate that has been quoted by the bank official. It is not guaranteed and the quoted rate may not be available when you go back a week, or even a day, later. To assure that the rate you have been quoted is good, the rate must be "locked in" by the bank official. This process assures that the bank will make the loan at the quoted rate. Generally, to get the rate "locked in," the church must have met all the pre-qualification requirements. To provide confirmation of the "locked in" rate, the bank will give the church, upon request, a letter of commitment. The letter of commitment, generally valid for 30 to 90 days, puts in writing the bank's willingness to make a loan to the church and specifies the terms of such loan.

Until the church has "locked in" a rate and has a letter of commitment (if such is requested), the quote of an interest rate is not guaranteed and may be changed. In times of rising rates, a change of as little as a quarter of a percentage point in interest rates may make a difference of several hundred dollars per month to the church. Therefore, the church should make sure that the attractive interest rate is "locked in."

The letter of commitment should not only detail the interest rate, it should also set out the other terms and conditions of the loan. Generally, items such as appraisals, surveys, environmental studies, collateral, pre-payment penalties, etc. are covered in the letter of commitment.

Costs and Fees

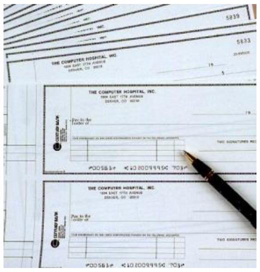
It is surprising to see churches enter into a borrowing relationship without knowing the costs and/or fees associated with the mortgage contract. Many churches have reached closing without a clue as to how much the mortgage is actually costing them. Often financing institutions will quote an exceptionally low rate as a "leader" – while making up the difference by charging exorbitant fees or closing costs. The major costs and fees associated with a mortgage will be pointed out here and a brief discussion of each will follow:

Points

In the mortgage business, a point is equal to one percent of the amount financed. "Paying points" up front generally provides you with a lower interest rate for the remainder of the loan. For example, a financial institution may quote you a rate of 7% with no points or a rate of 6.5% with 1 point. On a $500,000 loan, one point would equal 1 percent of the loan, or $5,000.

The general rule is that the payment of points is only helpful in long-term lending situations. The pre-payment of interest – another way to define points – is generally not beneficial if an adjustable rate mortgage is involved. If the church has the resources to pay points up front, they may well benefit from the reduced long-term rate that goes with the payment of points. However, the church should be well aware of their total interest costs before entering into any mortgage agreement. The total interest costs would include the amortized interest payments as well as the prepayment of interest through points.

Administrative Fees



Financial institutions use to have a charge for what they called "loan origination fees." Those charges are now often referred to as "administrative fees." Any organization making loans is going to have overhead costs. Those costs are passed on to the customers through the charge called administrative fees.

While a charge for administrative fees may sound reasonable, these costs can add up quickly. Most financial institutions will charge at least $250 in administrative fees and the range goes up into the thousands of dollars on a commercial loan. It is not unlikely to see administrative fees of 1% – 1.5% on a church loan.

The church should be aware that often these administrative fees can be waived by senior bank officials. Therefore, it is always wise to deal with a senior bank official who has authority to waive at least a portion of such high fees. The best way to get these administrative fees waived is to have an alternative proposal from another bank where the fees are lower or where they have been totally waived.

It has been said that “you get what you pay for.” In the area of administrative fees, that adage may not be correct.

Broker’s Fee

The influx of brokers into the mortgage business has flourished over the past decade. Brokers are now available not only to help you find a home mortgage but also to help you find a mortgage for your church. Several large brokers’ firms now seek to serve the church mortgage community. Basically, a mortgage broker looks at all products available in the marketplace and then, supposedly, offers the best products to the church. Brokers contend that they can obtain a better deal for a church because they have better contacts, better connections, and know where to look to find the best deal for the church. Of course, for their services the broker generally receives a fee from the church for an amount equal to 1% to 2% of the loan.

Again, brokers contend that the cost that the church pays them is saved many times over by the better mortgage deal that they find for the church. In most situations, the church does not need a broker to help them find a loan. Generally, the financial institutions that the church has had dealings with in the past are going to offer the church the best rate. In those situations, the broker’s service only adds additional costs to the church.

There are some very good and reputable brokers and brokers’ firms in the church mortgage market. However, as stated earlier, generally the local church will not need the services of a broker to obtain a good rate from their local financial institution.

Attorneys Fees/Title Insurance

Without doubt, the church should want to make sure that all documents are correctly prepared, executed, and filed in the public records. If not, then a multitude of problems could develop in the future. Therefore, the services of an attorney are going to be needed to assure that everything is done correctly in perfecting a lien by filing the appropriate legal documents. Generally, the mortgage company and the church will both have legal representation. One or both of the party’s attorneys may also be a representative of a title company.

Title Insurance (lender’s policy) assures the mortgage company that the church/borrower has clear title to the property and that there are no superceding liens to the one currently being filed. While the title insurance basically protects the mortgage company, it is an expense that is charged to the borrower.

The average title insurance policy on church property will cost approximately $1,500 to $2,500. In addition, the borrower’s attorney’s fees can add another $250 to $800 to the costs.

Recording Fees/Tax Stamps

Once all the documents are prepared, they must be filed in the local government office designated for recording such instruments. The filing fees, or "transfer fees" on new property, can be substantial in some jurisdiction, ranging into the multiple thousands of dollars. Further, if the property is undeveloped church property and cannot be set aside as tax exempt under state law, the church may also have to pay for "tax stamps." Tax stamps basically are a prepayment of taxes owed on real estate.

The Church Treasurer's Manual and the *Church as a Taxpayer Manual*, both available at the Benefits Board's web site, go into great detail in a discussion about property tax exemption. Before new property is acquired or a mortgage is recorded, a representative of the church should make inquiry about the recording fees and tax stamps costs. It is much better to be prepared for these costs than to find out way too late in the process.

Insurance Costs

No mortgage company is going to provide funding on a facility that does not list the mortgage company as the loan loss payee. Basically, the church will be required to provide proof of insurance before the loan proceeds are released. In addition, that proof of insurance will have to reflect that the new mortgage company is listed as the mortgagee on the policy. This assures the mortgage company that they will get paid in the event of catastrophic damage to the property.

Oftentimes, the mortgage company will require that at least one year's insurance premium be paid at closing. It is becoming more and more prevalent for mortgage companies to require that the insurance premium for several years, sometimes up to three years, be paid in advance at closing. Again, depending upon location, size, and cost of building, the insurance prepayment costs will run into the thousands of dollars.

In considering insurance, a local church may be limited in which companies will write a policy on church property. There are several large and reputable insurance companies that provide coverage. However, a local agent may also be able to provide coverage through one of his or her underwriters. In obtaining coverage, the church should only consider a policy that provides replacement value of the structures. For example, if you have a $500,000 loan and have a $500,000 insurance policy, the mortgage company is covered in case of a loss. However, if the replacement cost, due to inflation or other factors, is now $750,000, the church does not have sufficient coverage to rebuild the facility. The mortgage company is paid off but the church has no where to worship. Therefore, replacement cost coverage is essential.

As a side note to this issue, the church should also carry additional insurance to provide coverage for musical instruments and other type of equipment that belongs to those that attend the local church but that is left regularly in the church. Regular fire and casualty insurance does not normally cover such personal items unless specifically addressed in a rider or addendum to the policy. The additional coverage is inexpensive compared to the peace of mind that it can provide the leadership of the church.

Pre-Payment Penalty

A pre-payment penalty is something that you often learn about way too late in the process. As interest rates trend downward, many churches look at the possibility of refinancing. However, they often find out that their current mortgage documents have a pre-payment clause, requiring the church to pay thousands of dollars to pay off the mortgage. Banks are often unwilling to waive the pre-payment penalty, especially if you are refinancing elsewhere.

To accommodate the church market, some banks are now offering a bifurcated pre-payment penalty clause – a pre-payment penalty is applicable if the church refinances but the penalty does not apply if the early payment comes from church-generated income. These provisions are beneficial to churches that want to pay down their loan quickly and have instituted a stewardship program for that purpose.

Before signing loan documents, the church leadership should be well aware of any pre-payment penalties. While going into the loan the church may have no intention of paying it off early, it is still wise to have an understanding of what type costs would be involved if you did have the opportunity to pay the loan off early or if refinancing was necessary.

CHURCH OF GOD - SPECIFIC ISSUES

While the majority of this manual covers issues applicable to all churches seeking to borrow money or to expand their facilities, there are a few matters that are just specific to the Church of God denomination. The following is a discussion of a few of those specific issues:

Warranty Deed

The *Minutes of the General Assembly* at *S44* and *S48* require that any real property owned by a church must be titled or held on what is commonly called a "Church of God Warranty Deed." This deed requires certain language that basically states that the local church property is held in trust for the Church of God, Cleveland, Tennessee. Therefore, should a local church seek to leave the denomination or take actions contrary to the polity of the denomination, the real and personal property of the church remains with the Church of God. If the *Minutes* are followed, no bank should make a loan to a Church of God congregation without the property being on a "Church of God Warranty Deed." Therefore, if the warranty deed language is not correct, the bank or financial institution may require a quitclaim deed or some other corrective action to insure that a "Church of God Warranty Deed" is in place on a church-owned property before funding is provided on a church mortgage.

The "trust" language in the "Church of God Warranty Deed," often referred to as "reverter" language, causes some concern among bankers. Underwriting or guaranty agreements by the state/regional office and/or international office of the church are often required by those bankers to help alleviate some of their concerns.

Guaranty/Underwriting by State or Regional Council

The primary collateral on any church loan is the real property itself. However, a bank or financial institution may request that the state or regional office serve as a secondary guaranty. That guaranty is obtained by the state/regional council signing an underwriting or guaranty agreement. When a state council underwrites a loan to any financial institution, they should be aware of the implications of taking such a step. The underwriting certificate provides that the state council will make the payments on the loan if the church is unable or unwilling to make such payments. Further, in the event of default by a church and the subsequent sale of the property at foreclosure, the underwriting or guaranty agreement assures the lender that the state council will make up any deficiency between what the foreclosure sale brought and what is owed on the outstanding mortgage.

While most banks require such underwriting from the state/regional council, that body should be very cautious before agreeing to underwrite every loan placed before them. Many states and regions show tens of millions of dollars underwritten by that body with very small amounts of available assets. While they might not prevail, it seems feasible that an argument could be made that a state/regional council committed fraud by signing an underwriting agreement when their previous underwriting greatly exceeded their assets. Again, state/regional councils should exercise extreme caution in underwriting loans. Broad underwriting guidelines for state offices are provided later in this manual.

Executive Committee/Council Underwriting

In certain situations, primarily involving large loans, a bank or financial institution may require that underwriting be obtained from the Church of God International Offices through the action of the Executive Committee or Executive Council. Executive Committee/Council underwriting may also be required by a bank if the loan is to a church in a mission state or borderline mission state, or the loan is to a department of the international church. It should be noted that Executive Committee/Council underwriting is in addition to a lien on the real estate and underwriting by the state or regional office, basically providing the bank with a third avenue for collection.

Resolution by Local Church

The *Church of God General Assembly Minutes*, at *S44*, paragraph V(3)(A), requires the local church to convene a regular or called church conference before the church can "borrow money and pledge the said real estate for the repayment of the same." Approval for such action must be by two-thirds of the "members" present and voting. A certified resolution of that meeting should be a part of the file before the local church approaches a bank, in earnest, about borrowing money. This requirement of the *Minutes* assures the bank that the church has taken action to obtain financing and that such is a church decision.

It is important that the local pastor receive appropriate permission from the state administrative bishop to hold such a conference and that proper notice of the conference is given to the membership of the local church. If the pastor does not follow the procedure clearly set out in the *Minutes*, the conference could later be invalidated.

TERMS OF LOAN

There is much discussion earlier in this manual about adjustable rates and their pitfalls. Those arguments will not be remade here. Suffice it to say, church mortgages generally fall into three different categories: interest only loans (to be discussed later under construction loans), adjustable rate loans - including fixed-rate short-term loans with a balloon payment due in a certain number of years, and permanent or fixed rate loans. Regardless of the type of loan, the loans are generally amortized over a period of 20 or 25 years - or maybe even over 30 years. Therefore, the payments look like you will be paying the same amount each month for that term. Of course, if the mortgage rate is adjustable, the payment will be readjusted each time the underlying index (Prime or Libor) changes.

As noted earlier, the old 20-year fixed rate mortgages were by far the most superior instruments available for providing a church with funds – and reducing the risks associated with the church borrowing money. However, 20-30 year fixed rate commercial mortgages are almost impossible to find now. With any other option, a church assumes potentially tremendous market volatility, especially a short-term adjustable rate product.

Construction Financing

Obtaining financing for a completed structure is simple when compared to the joys of financing new construction. Many churches only seek financing when they are ready to enter into a building process. While all the general rules mentioned above apply, there are some additional rules that apply to construction financing as well. Some of those issues will be looked at here.

The greatest difference between permanent financing and construction financing is that construction financing is like shooting at a moving target. For example, the church wants to build a $500,000 building and seeks financing for the construction of such a building. However, by the time the architect and the builder finish with the plans, the costs have risen to $650,000. Then by the time the building is completed and the church makes additional changes to the plans to satisfy their taste, the costs have escalated to $750,000. While this example may be an exaggeration, similar situations arise almost weekly. To hopefully reduce the likelihood of such occurring, this manual will address issues that need to be monitored closely in the construction process.

Interest Only Construction Loans

Most construction loans are set up as interest only. Under this procedure, the church pays interest only on the draws that are made and not on the total amount expected to be borrowed for construction. So for example, a church plans to borrow $500,000 for construction and they enter into an interest only construction loan. The first draw off of the loan proceeds is $50,000 for site preparation and foundation work. After that first draw of $50,000, the church only has to pay interest on the $50,000 – and not the total amount expected to be borrowed. Of course, as additional amounts are drawn down the interest only provision applies to those proceeds.

The interest only construction loan feature allows the church to build up revenue through a stewardship campaign or other means while also beginning the building process. If the stewardship campaign is successful, hopefully the church will be able to use some of their own funds for construction, thereby reducing the amount that has to be borrowed.

"One Closing" Concept

Until the last few years, most financial institutions required a church to obtain a construction loan for the new construction and once the construction was complete and a certificate of occupancy was issued, the church then had to obtain a permanent loan. Such process required the church to go through two separate closings, incurring additional costs each time.

The "one closing" concept has now become more acceptable in situations like this. Under this concept, the church can lock in their long-term rate at the same time that they get the construction loan. By following this pattern, the church saves on closing costs since there is only one closing, and secondly, the church knows what their permanent financing costs are going to be on the front end. The church limits their risk by locking in the long-term financing up front, rather than allowing market rates to possibly increase during the construction process.

The "one closing" program is generally beneficial to the church in all situations. However, the church should be aware that the construction period, even though interest-only payments are being made, counts towards the amortization schedule of the loan. For example, if the amortization schedule is for 20 years and the construction period is 12 months, the loan will be interest-only for 12 months and then the permanent financing will then be amortized over the remaining 19 years. In other words, the church generally does not get a new 20-year amortization schedule once the construction is completed under a "one closing" program.

Permits and Zoning

Any minister who has led a church construction project will agree that permits and zoning issues are generally the most difficult encountered. Some municipalities seem to throw up every conceivable barrier possible to keep a church from building in their city. The zoning laws are generally used for this purpose.

Before construction begins and before any money is spent on planning for construction (or refurbishing an existing building), church officials should contact the local zoning board to determine if the property can be used for a church facility as currently zoned. If not, the zoning changes need to be obtained before any funds are expended on planning or construction.

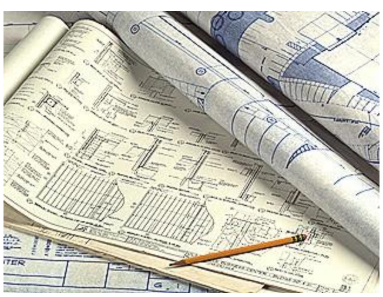
Many church officials assume that if they are in the "Bible Belt" there will be no problems concerning re-zoning property for use by a church. They are often surprised to find that opposition to such can arise overnight. For any change in zoning, public notice must be given, generally by placing a sign on the property and by providing some form of notice in a local newspaper. Every person in the community that has some type of contention with your church is subject to filing an objection. Often even the city planning officials will object for one reason or another.

Should the property need to be re-zoned, a group of church officials should schedule a meeting with the local planning officer to discuss the process. Making a friend of this public official before notice is given to the general public can be vital in securing the new zoning. If you can convince the zoning professional of the need to re-zone the property, he or she can become a great ally in dealing with others in the community that may want to stop the church's expansion project for personal reasons.

In some situations the services of an attorney to assist in the re-zoning effort may not be needed. However, if any opposition arises to the request, the church should secure an attorney that is knowledgeable about zoning disputes. In addition, the church should be aware that zoning boards or commissions have a reputation of moving slowly. It may take six months or more to resolve a simple zoning dispute, and multiple years to resolve a protracted and complicated dispute. A long dispute not only costs the church in legal fees but it delays the project and may increase the cost of the overall project. Some churches have spent upwards of $400,000 just to fight zoning disputes.

As to permits, often the general contractor will assume the responsibility of obtaining the appropriate building permits. This relieves the church of that responsibility and also allows someone who is more familiar with the process to obtain the necessary permits. However, it should be clearly pointed out in the contractual agreement with the contractor as to who is responsible for obtaining such permits. The church should never assume that the permits have been obtained by the contractor if such is not specifically set out in the contract. Proper permits are critical before financial institutions will provide draw downs on construction funds. As a final note, most jurisdictions require the appropriate permits to be posted on site during construction, generally in the contractor's office trailer.

Plans and Specifications



Plans and specifications (or "specs" for short) are what the contractor and sub-contractors will use to construct or refurbish the church's building. The plans and specs are drawn by architects and engineers. The architect and engineers may be hired separately from the general contractor or may be provided in the overall agreement with the general contractor.

No matter how the plans and specs are created, the contractual documents should clearly state that they are the property of the church once they are completed and/or paid for. The reason for this suggestion is so obvious that it is often ignored. Should conflict arise between the church and the contractor during construction, the church will need the plans and specs to pass on to the replacement contractor. If the church does not have ownership of the plans and specs, the contractor upon being terminated can take those documents with him when he pulls off the construction site. If that occurs, the church will then have to pay the costs of having new plans and specs created for the building, incurring additional costs.

It is also important that the church be entitled to whatever work product goes into the creation of the plans and specs from the architect and engineer. Again, controversy may arise between the church and those professionals. The church must be assured that they will get whatever they have paid for. As an example, if the church has paid for half of the architect's fee when the conflict arises, they should be entitled to get whatever drawings, schematics, etc., he has created as of the time he was terminated. In some limited situations, architects, engineers, and contractors will use contracts that entitle them to keep documents, such as plans and specs that are not completed should they be terminated. The church should make sure that they are entitled to get what they have paid for.

Most financial institutions will request to review the plans and specs before advancing construction money to the church. In addition, if the church is using an "as built" appraisal, the appraiser will need to review the plans and specs before offering his appraisal.

A cardinal rule of construction is to have the plans and specs complete before construction begins. While that statement sounds obvious, many construction projects begin before the plans and specs are complete. It is critical to know what you are supposed to get for the agreed upon price. If you do not have such knowledge, everything becomes a "change order" – which is costly and will be discussed at length later.

If possible, any major modifications to the plans or specs should be made before construction begins. Simply moving one wall may appear to be a minor adjustment but may greatly impact the design of the building. Those structural type changes are much easier and more cost effective to be made before construction begins than afterwards.

It is critical that the church building committee work closely with the architect and engineers to get the building they desire. If not supervised closely, the church may end up with a building the architect desires but does not meet the functional needs of the church. The building committee is reflective of the church and should clearly point out the desires of the church, as well as the budgetary restraints the church is working under. There is certainly no harm in telling the architect or engineer that the church cannot afford what he or she has proposed. It is much better, again, to raise these objections on the front end than to wait until the project is underway and realize you cannot afford what the architect has proposed. At that point, the change orders may be as costly as proceeding with the plans as drafted.

The plans and specifications, and their associated documents, are the road map for your construction project. Do not start on the construction journey until you are completely comfortable that you know what you are going to build, that you know how much it is going to cost, and you know how you are going to pay for it.

Draw Schedule

Associated with the plans and specifications are documents that basically show a time line for the construction project. The graph of the time line is generally referred to as the "critical path." Most contractors will have the critical path posted within their construction trailer so that at a glance they can determine if they are on schedule with the construction project.

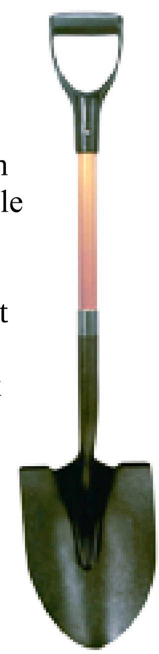
By following the critical path, the contractor can provide a close estimate of the need for funding of the project. While it may be simplistic to some, it is important to go over the funding mechanism of a building project. First of all, you do not pay for a project on the front end. Secondly, you do not wait until all the work is completed to pay for a large construction project.

Payment is made upon the presentation of draw request, or in other words, as the project progresses.

For example, assume that the total project is estimated to cost $1 million and take 12 months to complete. The first draw request will probably be to pay the architect and engineer’s fees. The second request may be to pay for the site preparation. The third draw request may be to pay for the foundation work. The next request may be to pay for the steel and so on. Upon the receipt of each draw request, the church will use loan proceeds or money raised through a capital stewardship campaign to meet the obligation. Again, simply stated, the system is a “pay-as-you-go” process.

It is important that the church knows in advance a projected draw schedule. Such allows the church to better calculate their interest-only construction costs during the period the building is going up or being refurbished. The church should also set up a review process of the draw request, maybe to the extent of hiring an unbiased third-party professional to review the request before payment is made. While the draw request will generally exceed the obvious progression of the building, that ratio should never get too far out of line. For example, if it is obvious that only 20% of the work is completed or materials on site, the church should not be paying draw request that certify that 70% of the work is completed. Such is the recipe for disaster if you have an unscrupulous contractor.

The simple thing to remember on draw requests is that you must pay as the building progresses and as materials are purchased. It also is important that the draw requests are paid on time or that a contest to such is filed timely. If not, the construction contract most likely provides for substantial penalties if the draws are not paid promptly.



Contracts with Building Professionals

It is imperative that the church have in place contracts with the professionals involved in the construction or refurbishing of the church’s property. In our litigious society, a simple handshake deal is no longer safe or advisable for the church. The church should have a written contract with the contractor and the engineers and/or architects if they are hired separately from the general contractor. The contract should state at least the basics: what work is expected, a time frame for the work to be completed, and the costs of the projected worked. Again, the contract should be in place before the work begins, not six weeks or six months into the project.

Obtaining legal assistance in entering such a contract will save the church countless dollars over suing a contractor to enforce a poorly drafted or ambiguous contract later on in the process. Besides the basic contract provision, the contract should also include a venue for the resolution of disputes (either an arbitration provision or an agreed upon court jurisdiction), a provision detailing how the church can contest draw requests, a provision telling the church how long they have to pay draw requests before they become past due with penalties, a process to implement change orders, clarification on who can bind the church and/or the contractor in decisions made during construction, and the role of the owner’s representative on the construction site (an issue that will be discussed at length later).

The contract should also address which party is responsible for obtaining permits and licenses required for the construction, as well as which party is responsible for assuring that an "occupancy permit" is issued upon completion. The contract should always bind the contractor to the job site until all final, small tasks (or "punch list" items) are completed and a "certificate of occupancy" or an "occupancy permit" is issued. The contract should also specifically state that the contractor will not be paid his final draw, or "retention", until the punch list items are completed and the certificate of occupancy is issued. In a rush to get in a new facility, some churches have made the final payment to the contractor, only to find out that the local authorities would not issue an occupancy permit until certain changes were made in the building. The contractor should guarantee you a building that meets all applicable codes and regulations for your jurisdiction. Until the building meets those regulations, he has not fulfilled the contract.

Depending upon your jurisdiction, there may be many other provisions that should be included in your contract with your building professionals. Seek the advice of an attorney who specializes in construction matters to assist you in the early stages. Preventative steps early on will save many disagreements and headaches later in the process.

Owner's Representative

For a construction project of any magnitude, it is imperative that the owner (or church) have a representative on site. This person, alternatively called either the "owner's representative" or the "clerk of the works" does not have to be on the construction site constantly. He or she may visit the site only periodically to check on the progress of the work and to assure that work and materials that are being paid for are actually there.

Clerks of the work are generally knowledgeable about construction and may even be construction professionals. Retired builders and contractors make excellent clerks of the works. This owner's representative can be given as much or as little authority as the church governing body feels comfortable in granting. Mainly, however, the owner's representative should be the eyes and ears of the church on the construction site. He or she should document and report back to the church any problems, mistakes, or potential changes that need to be dealt with by the church's governing body.

If the church does not have a representative on site, the church will have to rely solely upon the representations made by the contractor. Therefore, the costs of having a clerk of the works pails in comparison to what may arise without the church having its own overseer on the project. As a broad guide, a church should expect to pay from 1% to 3% of the total construction cost to a clerk of the works. The costs will depend upon how much time the clerk spends on site and what type of authority he or she is given. A conscientious clerk of the work will generally save the church many times over his salary.

There is certainly no intent to allege that all contractors are crooked and out to drain the church of their resources. While there always are some bad actors, generally you will find that most contractors are reliable and trustworthy. However, you must understand that contractors have to protect their self-interest. Having a clerk of the works on site provides someone to protect the church's self interest and someone to keep the contractor honest and accountable.

Design/Build Construction

As earlier mentioned, some contractors have the ability to provide everything under one contract – design, engineering, and construction. There are both advantages and disadvantages to this type of approach. Under the design/build approach, the general contractor, using his in-house architectural staff, designs the building and then constructs it. In this "cradle to the grave" approach, the entire project is under the direction of the contractor. While the contractor may have subcontractors on site assisting in the project, the church looks only to the contractor for performance. All subcontractors are the responsibility of the general contractor.

Under a design/build approach, the church only has to deal with the general contractor and does not have to worry about getting separate bids on each phase of the project. Further, the design/build contractor can provide a fixed price for the construction of the building once the design is approved by the church. Of course, the fixed price is always subject to change if the owner/church makes changes in the original design.

The church may be at a disadvantage in a design/build situation if they have not shopped the costs of construction. While having a general contractor to overseer all the work, the church may save money by having each phase of the construction put out for bids. Having several bidders placing bids on the steel contract or the HVAC contract (or any other phase of the work) may lower the costs of the entire construction. Alternatively, costs could be greater.

Some churches have had great experiences using design/build arrangements while probably an equal amount have paid too much by using such. There is also no set rule that a design/build contract will save the church money over a job that is bid out to the lowest bidder.

If a church is considering a design/build arrangement, the building committee should talk with several design/builders before settling on one. All references should be carefully checked as well. Basically, the design/build contract should be bid out to the contractor that the church feels can build the building, to the one that they are comfortable in working with, and to the contractor who can provide them the best price. All those factors are equally important.

Cost Overruns

Too often churches get towards the end of their construction project only to realize that they have run out of money to complete such. What happened? Was the planning so badly flawed that they did not adequately "count the costs?" Usually the answer boils down to one issue – unexpected expenditures or "change orders." A change order is a modification of the original design generally requested by the owner/church. To accomplish the requested change, the contractor completes a change order request form and asks the appropriate church official to approve such. By signing the change order request, the church is then bound to pay any additional costs associated with the change order. In limited situations, a change order request might actually save money. However, in most situations the change order will cost the church additional money – many times significantly more than expected.

While in a few situations it may be impossible to ascertain the exact cost of a change requested until such is actually accomplished, the church should strive to know the costs in advance, and even have the cost of the change included on the change order request form, before the change order is approved. If not, the construction costs can soar without any real knowledge of such on behalf of the church. Often times to continue the progress of work, the contractor will suggest that the church sign the change order request and the "cost will be worked out later." The church should never allow that to occur.

Contingencies are often built into the contractor's projected cost to cover cost overruns from change orders or unexpected problems. To get the job, most contractors will bid on a job with as small a contingency as possible since a larger contingency amount would run up their overall bid. Therefore, a few simple changes may deplete the contingency reserve amount.

Most construction journals will agree that cost overruns will generally exceed 10% on a project over $1 million. Using that assumption, an expected $1 million project might actually end up costing the church $1,100,000 – a substantial cost overrun for any church's budget. Further, most contractors are only going to include a contingency reserve of 1%-3% in their bid. On a $1 million project, the contingency reserve may be as little as $10,000 to $30,000 – amounts that can be gobbled up with the smallest of changes.

To keep cost overruns under control, the church should do at least the following:

- Review the plans and specifications carefully before proceeding with constructions. While some changes may be inevitable, all changes that can be made before construction gets underway will be less costly generally than those made in the midst of construction.
- Change order requests should be priced before the church commits to the change. While having marble floors may sound more attractive than tile, the church must question whether the additional cost is a good use of God's money.
- The church should designate only one person (and possibly an alternate if that person is out of town) that has authority to approve change orders. Generally, that person should not be the pastor. While the church should set up a building committee to review and approve all changes, only one person should have authority to sign the change order request.
- All information concerning the change order should be documented. If such is not documented, controversy may arise as the church is billed for items that may not have been fully discussed. In addition, a discussion about a change order early in the construction project may be forgotten by all concerned 10 or 12 months later when that change order request has busted the construction budget.

Most litigation arising out of construction projects either involves cost overruns or delays. The simple steps listed above can prevent much of the litigation involving cost overruns.

Delays

As mentioned earlier, the contractor will provide the church with a projected completion date before the work on site actually begins. Many factors may alter that date. “Acts of God” are normally exceptions to the projected date. Therefore, for every day that rain, snow, or some other “act of God” keeps the contractor from working an additional day is added to the projected completion date. Other factors such as labor disputes or material shortages may also delay the project, but are generally not included in the delay provision.

If the contractor for one reason or another, other than for the exception for an “act of God,” delays the projected completion, he may be subject to paying the church liquidated damages. On the other hand, should the church fail to perform their portion of the contract, generally by delaying payment on draws, they may also be subject to liquidated damages. If included, these provisions will all be set out in the contract. The church’s attorney should clearly go over the liquidated damages provision to make sure it best meets the church’s needs.

It also must be noted that change orders may include additional days for the completion of the work contemplated. It would not be unusual for change orders to add 20-45 days to the completion date of a contract.

It is vital that a completion date be included in the contract with liquidated damages owed if the contractor fails to complete the project on time. If not, the contractor may work at his leisure as your construction costs escalate.

As another word of caution, no major events such as a dedication service should be scheduled around the projected completion date. The chances of the building being completed on the projected date are miniscule. Therefore, special services such as dedication events should be scheduled well after the congregation has worshipped in the new or renovated facilities for a while and worked out all the “bugs.”

Certificate of Occupancy

The certificate of occupancy (or CO), or occupancy permit in some jurisdictions, is the final step before the church can worship in their new or renovated facility. The CO is issued by a local governmental entity, generally the building inspection division of the municipality. If the building meets all applicable building codes and regulations, the CO will be issued for the intended purpose of the facility.

For fire hazard reasons, the permit will generally provide a maximum occupancy limit for the facility and set out any other restrictions. Before granting the permit, all exits will have to be properly marked, proper fire retardant systems will have to be operational, and a variety of other tests will be performed to assure that the facility is safe and habitable by large groups of people. Handicap accessibility will also be reviewed.

As mentioned earlier, it is imperative that the general contractor is not released from the job and finally paid until the certificate of occupancy is granted. The contractor has committed to build you a building that is habitable and useable for church purposes. If the building inspector cannot grant a CO because of some default in the construction process, the contractor has not fulfilled his duty.

Again, no activities should be scheduled in the building until the occupancy permit is granted. There are many horror stories of a church frantically trying to get a certificate of occupancy only hours before a major meeting is scheduled in the new facility. The construction process is challenging enough. It should not be capped off with a frantic attempt to get an occupancy permit.

Loan Problems and Issues

There are many issues that can turn a church loan into a nightmare for the local congregation. Some of the issues are bothersome while others can be costly to the church. Regardless, a cursory overview of some of these issues will hopefully save the church from the headache of having to resolve these issues in the future. The following list of problems is not meant to be inclusive or exhaustive. However, the list includes some of the major issues encountered in the church loan market.

Adjustable Rate Mortgages and Libor

Considerable discussion has already occurred in this manual regarding adjustable rate church mortgages. Those arguments will not be restated here; however, those arguments should be reviewed again by any church looking to secure an adjustable rate mortgage. Depending upon the lender, adjustable rate mortgages may be referred to as ARMs or “balloon” mortgages.

Adjustable rate mortgages come in many packages but most generally adjust based upon changes in the underlying index (Prime or Libor) and may adjust monthly. Although briefly mentioned earlier, Libor stands for the London Interbank Offered Rate. Ten years ago, most people in the banking industry in the United States had never heard of Libor, and certainly had never used it as an index for lending. However, it has become more common for larger financial institutions to quote rates at “Libor plus”.

While “Libor plus” rates may look attractive, potential borrowers should be aware of how the Libor rate moves. While the “prime rate” generally moves based upon decisions made by the Federal Open Market Committee of the Federal Reserve, the Libor rate is strictly market driven. Therefore, Libor can move rather quickly within a short time, and often fluctuates from one day to the next. For example, a Libor plus 3 points today might give you a rate of 3.16%, while that rate might increase to 4.00% next month. Most Libor plus rates are based upon the thirty-day Libor rate and therefore can change monthly.

Even with most Libor plus rates, there is still a balloon feature that limits the loan to a total number of years, generally five to ten years. That feature allows the financial institution to recalculate the amount that they are charging in addition to the Libor rate. As with any adjustable rate, the financial institutions are not willing to extend their risk much beyond five years.

However, that means that the church has to assume all the risk of market rate fluctuation. If a church is anticipating that it will take 20 years to pay off a loan, the church can pray that rates remain low but the chances of that happening are rather slim.

It is recommended that churches attempt to secure long-term, fixed-rate mortgages. With such, the church eliminates the risk that their mortgage rate may go up. While a short-term loan based upon Prime plus may make sense, long-term permanent financing should be pursued as first choice. Many churches decide to go with adjustable rate mortgages to provide additional cash flow in the short-term. However, in the long-term those adjustable rates may very well end up costing the church substantially, not to mention the costs and time associated with having to refinance every time the balloon matures.

As the church officials talk with bankers, they should ask the bank if it were him or her borrowing the money, knowing that they were going to need at least 20 years to pay it back, would they choose an adjustable rate mortgage or a fixed rate mortgage. Without a doubt, the banker will invariably choose a fixed rate mortgage. That admission by the banker should guide the church in their decision.

From a philosophical debate standpoint, a company whose business mirrors the economic cycle should look more towards a floating rate environment. Therefore, when the economy begins to drop, rates also will likely drop. When the economy takes off, rates will go up. In either case, the floating rate is beneficial to the business because they are mirroring the general economic sense. When their business is off, their cost of borrowing has also dropped.

On the other hand, a company that is highly leveraged or has a static flow of revenue should choose a fixed rate environment. If the general economic conditions will not adversely impact the revenue, either positively or negatively, a fixed rate helps control the risk. Churches generally fit into this category. While dire economic times may somewhat impact revenue into a church, the church is not going to go out of "business" because of the economic conditions.

To try to bridge the gap between the floating rate and the fixed rate environments, derivative financing arrangements have become more acceptable. The "swap" agreement, discussed below, is one of those derivative products.

"Swap" Agreements

A "swap agreement" is defined by Bank of America in their loan documents as follows: "An interest rate swap is an agreement between two parties to exchange interest rate payments periodically based on a principal amount called the notional amount. Typically, one party exchanges fixed-rate payments for floating-rate payments based on an underlying index such as Libor or Prime." While the Bank of America definition may not be explanatory, it is as good of a definition as can be simplistically stated. Suffice it to say, swap agreements are extremely complicated and should only be entered into by the most sophisticated of borrowers.

In layman's terms, a swap is noting more than a "hedge" on interest rates. For example, assume that a bank is offering a ten-year swap arrangement to a church. On the face of the deal, it looks as though the arrangement is for a fixed-rate loan, since the payments are fixed over that ten-year period of time; in other words, the church is required to pay the same amount each month for ten years. As mentioned in the definition above, the rate is generally arrived at by using prime or Libor plus the costs of borrowing. To arrive at the rate, the bank would look at the projected "forward yield curve," which essentially is the average of the 120 future rate settings of the 1-month Libor rate, plus the costs of borrowing. That projection provides the loan rate. Again, assume that for the next 120 months (10 years), the forward yield curve projects that the one-month Libor rate is going to average 0.16%. If the cost of borrowing is 3.50%, the swap rate would be 3.66% (or 0.16% Libor + 3.50% borrowing cost) for 10 years.

Continuing with the same example, the loan would be amortized and the interest rate would be set at 6.75% for the 10-year swap period with a balloon payment at the end of such. If the church stays in the agreement for the 10 years, the agreement will look and work just like a fixed-rate mortgage. However, should the church seek to pre-pay the swap mortgage with funds from contributors or a refinancing bank, the costs of getting out of the swap would be determined based upon the current market rate for the remaining term of the loan. If the Libor rate used in the example (4%) has gone up over the average estimated in the forward yield curve, the bank would actually make a payment to the church for the "swap differential." On the other hand, and much more likely to be the case, if the projected rate is lower than anticipated, the church is liable for the "differential." Banks are quick to point out that the "differential" is not a penalty but the difference between the projected rate and the current swap rate multiplied by the principal balance.

Some would contend that a swap rate would be attractive especially in a rising interest rate environment. However, a church should realize that the forward yield curve takes into consideration that rising environment. Using the forward yield curve, it is much more likely that rates will be under that rate than over it – meaning the church/borrower would be responsible for the differential. The differential has run into the hundreds of thousands of dollars for churches within our denomination that have sought to terminate these arrangements.

Many churches have entered into swap arrangements with the idea that they were reducing their interest rate costs. However, any borrower must recognize that hedging interest rate risk through swaps does not necessarily lower the overall interest costs. What such an arrangement does is make the amount of the expense more certain – as long as the borrower does not seek to prepay the swap mortgage.

In addition to the regular swap agreements discussed above, some institutions are also offering cancelable swap deals. Under such arrangements, for example, the church might enter into a ten-year swap arrangement that is cancelable after seven years. While such provides a better rate than a full ten-year swap for instance, the bank can also cancel the agreement after seven years, putting the church at the mercy of higher rates. In addition, if rates are lower to the benefit of the church after the seven-year period, there is still a termination fee that may be as costly as the differential fee discussed above.

In summary, "swap agreements" should be entered into only by the most sophisticated borrowers. Sadly to say, most, if not all, churches do not fit into that category. Generally, swap agreements will require that the church provide "certified" annual financial statements to the lender. While most churches have some type of year-end financial statement, very few have their financials certified through an independent audit. While the lender may not require such on the front end, they may very well use the lack of certified financials later to put the church in default – and subject to the differential penalty – even though the church has performed in all other respects.

Simply put, it is highly recommend that churches not use “swap agreements.” The risks are too great for most churches.

Personal Guaranties

A recent trend has been for financial institutions to seek the personal guaranties of certain members of the congregation when making a loan to a church. As stated earlier, banks are concerned about loaning money on a “single use” building, as well as to a congregation that may not have an established credit history. To compensate for those shortfalls and to prohibit the potential need to foreclose on a church property, some banks are demanding that well-heeled individuals in the church basically guarantee the note.

A personal guaranty or guaranties provides the financial institution with an additional comfort level that they have individuals that they can turn to for payment if the church fails to perform. In addition, the bank saves itself from the public relations disaster of having to foreclose on a church. The same principle applies to underwriting by the state/regional office and/or the international office of the denomination, all of which will be discussed later.

Some financial institutions will go to almost any extent to make a loan. However, if the financial institution is demanding personal guaranties, it is a good sign that they have little confidence in the ability of the church to repay the indebtedness. In turn, that should be an indicator to the church that they should reconsider their expansion project. If the church cannot qualify for a loan without personal guaranties, then the expansion project may need to be delayed until they do qualify.

A similar but slightly different twist to requiring personal guaranties is a recent demand by some financial institutions for the church to submit a list of their largest annual contributors. Generally, they request the name (or at least the initials) of the contributors and how much they have given annually over the past three to five years. While the institution may not require personal guaranties, they will request that the financial statements required each year also contain an updated list of the largest annual contributors. The idea of the institution is to assure that the best givers in the church have not “voted with their pocketbooks.” Much care, including discussing such with the church’s legal counsel, should be taken before any specific financial giving information on an individual donor is provided to a lending institution. While specific privacy laws within your state may not be broken by the sharing of such information, the church does have a moral and ethical obligation to protect the anonymity of its donors.

Personal guaranties and divulging personal donor information should be avoided. Only on the specific advice of legal counsel should the church’s governing body even consider such.

Underwriting or Co-Borrowers

Any lender familiar with the requirement that Church of God, church-owned facilities be on an approved Church of God warranty deed, as discussed earlier, may very well require a guaranty (or underwriting) from the state/regional office of the denomination, as well as the international office of the denomination. By obtaining underwriting, the lender is seeking two things. First, the lender is looking for "deep pockets" – in other words, an entity that has resources to pay off the loan if the primary borrower gets into financial difficulties. Secondly, since the Church of God warranty deed contains language that the property reverts back to the denomination if it ceases to operate as a church, by requiring underwriting the lender is basically seeking to lock in all the potential holders of the property to the mortgage obligation in advance.

A church seeking a loan should not be surprised (or hurt) when the lender asks for a guaranty agreement from the state/regional office and/or the international office of the denomination. Such is a common request and is now made more than not. Further, because such underwriting requests have become more common, most states have set up underwriting committees to review such proposals. Generally, these committees can expedite the consideration of such a request for underwriting if such is needed. The international office, working through a committee appointed by the International Executive Council, also is familiar with requests for underwriting and can consider such expeditiously. (*NOTE: For several years, there has been a moratorium on new guaranty agreements by the international and state offices, except in cases of dire emergency*.)

As credit has tightened, some lenders are moving beyond underwriting and have started requesting that the state/regional office and/or the international office of the church become co-borrowers on the loan. A co-borrower is in a much different legal position than an underwriter. To overly simplify the distinction, an underwriter only has an obligation to perform if the primary borrower fails to perform while, on the other hand, a lender can call on a co-borrower to perform (i.e. to make payments) without making any demands on the primary borrower. If the lender suspects any problems with the borrower, they may immediately ask the co-borrower to make the payments without even informing the original borrower of the demand. In a co-borrower situation, both borrowers (the church and state/regional/international office) stand equally liable for the obligation. Because of such, the lender has authority to ask either to make payments.

From a legal and accounting standpoint, the state/regional office, as well as the international office, should avoid co-borrower situations. While an underwriting agreement is listed as a contingent liability on the state/regional/international office's financial statement, a co-borrower relationship must be listed as a primary liability.

A local church should also avoid a co-borrower situation because the actions of the state/regional/international office could cause the loan to go into default. For example, some co-borrower notes limit the amount of debt that an entity can take on, whether such is a contingent or primary liability. If such a limitation is in place, the underwriting by the state office of another church across the state may place your loan in default.

Again, while the church polity on property issues may dictate that most lenders are going to require underwriting on church mortgages, a co-borrower arrangement should always be avoided. Such is not in the best interest of the church or the state/regional or international offices.

Financial Statement Updates

It cannot be emphasized enough how important it is to thoroughly review all loan documents, with legal counsel, before they are signed. Most churches assume that once they have obtained a loan, even an adjustable rate loan, they are set for the term of the loan. The church is often shocked when the lender asks for their financial statements after they have been faithfully making payments on the loan for a year or more. However, it is becoming almost standard for financial institutions to include a provision in their loan agreement with a church that requires the annual submission of their financial statement. In "swap" agreements as discussed above, the lender will almost always seek "certified" or audited financial statements – again a provision that places most churches out of compliance.

The financial institution seeks the annual statements so that they can review the trends of the church and hopefully head off any potential disasters. If revenue to a church has dropped drastically over a few months, the lender wants to know about that sooner rather than later. The financial statements should provide the lender with that information.

If the church is required to submit annual financial statements, they should be submitted in a standard format year after year. Such allows for easy comparison by the banker. In addition, the financial statements should be accurate and concise. Submitting false or misleading financial information is not only morally and ethically wrong, it also is a federal crime, punishable by imprisonment.

As a note of caution, most banks that are currently making church loans are including a provision that requires the church to maintain their checking and other banking accounts with that bank. If the church moves those accounts to another bank, the bank could put the loan in default for violating a term of the note. Therefore, if this is a condition of the loan, you should make sure that you are happy or can be content with the checking and banking services offered by the lender. Such a required banking provision is probably in any loan made over the past three years.

Requirement to Incorporate

Some banks and lending institutions have taken the position that they will not loan money to an unincorporated religious association or church. These lenders require the church to incorporate before seeking a loan. Therefore, it is necessary to briefly review the matter of incorporating a local church.

Beginning in the 1950's, the Church of God denomination, working through the General Assembly, took the position that churches should not incorporate. However, in 1994 the church lessened that out-right prohibition and recognized that in some states churches are required to be incorporated to comply with state law. The 1994 edition of the *Minutes* of the General Assembly, now at *S46 - Incorporation of Local Churches*, set out the procedure that a church had to follow if they wanted or was required to incorporate. However, the position of the church at that time was still that incorporation was not encouraged.

However, at the 68th General Assembly in 2000, the church modified its' no incorporation policy and said in the explanatory notes to the *General Assembly Minutes* that "it is recommended that local churches seek competent local legal advice regarding the advantages of incorporating under their respective state laws." In an article on this subject, the General Counsel for the Church of God, the Honorable Dennis W. Watkins, stated that "this language does not mandate immediate incorporation of your local church, but it basically says: 'Check this matter out.'"

Before a church proceeds to incorporate, competent legal advice should be sought. It is important for a church to realize the reporting requirements and the officer/director requirements under most state laws. Further, if annual reports are not filed, the corporate "veil" of the church could be lifted. Again, corporate laws vary by state so specific direction cannot be provided in this forum.

However, should a lender require the church to incorporate, the church should have a clear understanding of what the new status means. An incorporated body becomes a separate legal entity under the law, which is what the lender is seeking. That legal entity can borrow money, pay salaries, etc. In most states, incorporating provides a heightened level of legal protection to the church. Therefore, incorporation might be a valid endeavor, and should not be immediately dismissed by the church. As an additional note, it should be noted that some states require churches to incorporate while others prohibit churches from incorporating. The church should check with their local counsel to see if incorporating is warranted for them.

Bond Programs

Bond offerings to finance church construction programs have been around literally for hundreds of years. Just as with commercial lending, the viability of a bond program to finance a church expansion project will vary based upon the situation and the needs of the church. The general principle of a bond program is that a bond underwriter, using investors' money raised through the sale of bonds, loans that money out to a church, with a contractual promise from the church that it will repay the money to the investors with interest. For their services, the bond underwriter receives an upfront fee plus administrative fees during the life of the bond program. It is important to understand that all bond programs are not created equal.

Types of Bond Programs

While there are different variations of each, there are basically two types of bond programs:

> *"Best Efforts" Bonds*: Under this approach, a bond company is brought in to administer and sell bonds to local church members to finance the construction project. Of course, all the interest paid by the church goes to those church members – the purchasers of the bonds. The bonds are not given wide distribution but are sold just to the congregation. The costs of a "best effort" approach are lower because the church basically assumes the risk of the bonds not selling. However, if they do not sell, then the amount the church needs for the expansion project is not available. The "best effort" approach may work in larger congregations but generally does not work in a smaller congregation.
>
> *"Firm" Bonds*: Under this approach, a bond underwriter sells the bonds to outside investors under a firm guarantee. The guarantee assures the church that all the bonds will be sold, or if they are not, they will be purchased by the bond underwriter. While church members may buy the bonds, they are not required to under this approach. However, for the guarantee that all the bonds will be sold (or purchased by the underwriter), the upfront costs of a "firm" bond program are generally rather high.

Most churches that use bond programs generally choose to use the "firm" approach. This approach assures that the church obtains all the monies necessary to fund their expansion project. It should be noted that once the bonds are offered in the marketplace, the church has no control over who purchases those bonds.

Costs

The upfront costs of a bond program are substantially higher than a conventional commercial loan. The legal costs of creating the bond issuance, along with the upfront fee charged by the bond underwriter to guarantee that all the bonds are sold, are required to be paid before the bonds are placed in the market. These costs can be substantial, often 3% or more of the total bond financing. When compared to the origination costs on most conventional loans, which generally run in the .5% to 1% range, the additional costs of a bond program can be prohibitive. However, other factors such as the loan terms must be considered.

Terms

As discussed earlier, most financial institutions are only offering adjustable rate mortgages, or in rare instances short-term fixed-rate mortgages, with terms of no longer than five years. Under such a mortgage, while the loan may be amortized for 20 years, your rate is at best fixed for five years. On the other hand, most bond programs are for 20 years with a fixed rate. However, securing the bond offering fixed-rate comes at a premium, due to the upfront costs, as well as the costs of unwinding a bond program prior to the end of the term. Practically speaking, the cost of a bond program versus the cost of a fixed-rate mortgage makes the bond program financially unfeasible. However, other factors must also be considered.

Positive Features

There are a few unique features of a bond program. Some will be addressed here:

Future Borrowing: One of the best features is the ability for future borrowing. Not only is this feature important because it allows the church to obtain additional funds, but it also does not require the church to refinance the current bond indebtedness at potentially a higher rate. An example will best illustrate this feature. If a church borrows from a conventional lender and later determines that they need additional funds for other expansion, the conventional lender will generally require that the new amount plus the amount owed on the previous loan be rolled together into a new loan. Often the new loan is at a higher interest rate. However, under a bond program, the bond underwriter, after charging the appropriate fees, would issue additional bonds at the prevailing interest rate without any changes to the initial bond offering.

Fixed Debt Service: After the bonds are issued, the church knows without a doubt what its debt service costs are going to be for the next year, as well as for the next twenty years. From a budgetary planning standpoint, knowing your debt service costs in advance is vital.

Less Restrictive Covenants: Bond underwriters promote the fact that they impose fewer restrictions on a church than a conventional lender. For example, a conventional lender may have a covenant in their loan documents that prohibits the church from borrowing additional money for capital improvements in excess of say $50,000 (and this amount varies by lender) without the expressed written consent of the lender. Bond agreements will typically not have such covenants, although they may include a provision that requires additional borrowing to be done through a supplemental bond offering. Other covenants included in conventional lending arrangements often require a certain debt to equity ratio or debt to revenue ratio. After reviewing the church's financial statements and determining that those ratios are out of balance, the mortgage documents often allow the bank to "call" the loan and renegotiate the terms. In times of great financial difficulties in a church, the last thing needed is for their mortgage payments to be increased by the lender. In bond arrangements, you generally do not see such financial performance ratios included.

Negative Features

Along with the positive features of a bond program, there are also some rather substantial negative features. Some have already been discussed but will be readdressed briefly again here:

Costs: Without question, the upfront costs associated with a bond offering are substantially higher than a conventional commercial loan. Legal fees and the bond underwriter fees are often 3% or more of the entire bond offering. Generally, these fees are required to be paid in advance in cash, i.e. they cannot be financed as a part of the bond offering. In addition to the upfront costs, there are generally yearly "management" costs assessed by the bond underwriter, which may be hidden from the church, especially in firm bond offerings.

Bond Sellers: If the church chooses the "best efforts" approach to bond underwriting, the church is responsible for selling the bonds. If the church does not sell the bonds, then the funds are not available for the expansion project. For example, if a church needs $1 million for expansion but only sells $600,000 worth of bonds, they will be $400,000 short of what they need for expansion. Most churches do not like to assume the risk that they will not sell all the bonds, nor do they like to be placed in the situation of being bond salesmen.

Discontinuation Costs: To discontinue or pay off a bond program is often much more complicated and potentially much more costly than paying off a conventional mortgage. In a bond program, you have investors that are expecting to receive a specific rate of return for a specific period of time, generally 20 years. At the end of that time, the investor receives the par value, i.e. the actual value, of his investment. In simplistic terms, the church is paying the investor interest only during the life of the bond program and then returning the entire principal upon the maturity of the bonds. In order to have the principal payments available at the maturity date, the church is generally required to make deposits into a designated fund, or "debt sinking" fund, that is controlled by the bond underwriter or a separate trust.

If the church seeks to pay off the bond program early, either through internal stewardship funds or refinancing through a conventional mortgage, the church will be faced with a difficult task. Generally speaking, bond programs do not allow for prepayment. If the church proceeds towards prepayment, most likely they will be assessed the interest through the maturity of the bond program – even though they are paying off the indebtedness early. These costs can be substantial. Any church considering a bond program should get specific instructions in writing about how, or if, the bond program can be paid off early.

Bond Program vs. Conventional Mortgage

Without question, the bulk of church lending is done through conventional lending institutions. However, bond programs have been, and continue to be, a viable alternative source of funds. In the discussion above, the different features of each program have been discussed at length. Both programs have their advantages and disadvantages. A church considering an expansion project must consider the nuisance of each program in light of their individual circumstances.

However, without doubt it can be stated that a bond program is not for a short-term debt. The upfront costs, along with the discontinuation costs, are too great to be spread over a short term. So if the church has reason to believe that they will need the money for only a short period due to a strong stewardship campaign or some other reason, the church should seek a conventional loan rather than a bond program. However, if the church realistically believes that it is going to take 20 years or so to eliminate the debt, then the long-term costs of a bond program should be weighted against the costs of a conventional commercial mortgage. No simple formula can provide the best program for a specific church. All factors should be considered before a final decision is made on which option to pursue. Additional information on bond programs can be found on the Internet, specifically at www.zieglerloan.com.

RETURNING BUILDING FUND CONTRIBUTIONS

Many, if not most, churches have established a specific fund to receive building fund donations. This fund is designated solely for building purposes and accumulates money until the project is completely funded. In limited situations, the building project is never started or not started in a timely manner based upon the donor's understanding. The question then arises as to whether or not the church has a legal obligation to refund those designated contributions to the donor. Courts have skirted around this issue for years without providing any clear direction.

However, in the summer of 2003 a state appeals court in Michigan directly addressed this contentious issue. The trial court ruled that the church had a legal obligation to return building fund money that was not used in a timely manner. However, the appeals court reversed the trial court and stated that the dispute was "ecclesiastical" in nature and that the first amendment prohibited a trial court from intervening in such a dispute between a church and its member. The appellate court went on to state that "the decision of when and where to build a church building is exclusively within the province of the church members and its officials…" For more information on this specific case, see *McDonald v. Macedonia Missionary Baptist Church, 2003 WL 1689618 (Mich. App. 2003).*

It should be noted that the above-mentioned Michigan appellate court decision has limited applicability outside of a few counties in Michigan. However, the decision could provide guidance to other courts across the country faced with this issue. Further, it is important to point out that the court's decision only dealt with the legal obligation of a church to return designated funds when the project was not started within a timely manner or not started according to the projection provided to the donor when the donation was given. The case does not go into the ethical or moral obligation that a church might have to refund donations under such circumstances.

It is suggested that churches adopt an internal policy to refund any contributions not used in a timely manner for the specific designated purpose. While the church may not have a legal obligation to refund the money, a church never wants to get involved in litigation with a member over matters such as appeared in the Michigan case discussed above. The church leadership may decide that the project previously planned is now not in the best interest of the church or, another, and more attractive, opportunity may arise that the church decides to pursue. If the designated funds are not given under a broad designation to cover the new opportunity, then the funds should be returned to the donor with the suggestion that they be re-designated for the new project.

For example, money designated for a new sanctuary should not be used to buy a recreational facility for the church's sport teams. The donor should be given the opportunity to re-designate the funds or they should be returned to the donor if the sanctuary project is not going to move forward in a timely manner.

The direction of a church may change due to a leadership change or due to new opportunities presenting themselves to the congregation. While a church may not have a legal obligation to refund designated monies that will not be used in a timely manner, it is suggested that a moral and ethical obligation exist that should dictate the refund of those gifts. A church never likes the idea of refunding contributions. However, in the long run, a simple refund of a designated gift can save the church a lot of grief.

STATE/REGIONAL OFFICE GUARANTY/UNDERWRITING

As mentioned earlier, it is now almost common practice for all lenders to require a guaranty agreement (commonly called underwriting in the church world) by the state or regional office of a loan to a local church. Because of this required involvement by the state office, many state officials have started asking questions about their ability to continue to underwrite or guarantee loans – "How much can a state office feasibly guarantee?" As with most matters involving church construction and financing, there is no simple formula that can be given to state officials to answer this most complicated question.

There has been discussion by some state officials that they should set a total dollar amount for guaranties and not exceed that amount. However, whatever the amount decided upon, the state officials quickly realize that they do not have the resources to cover that amount. Although it should be considered in the mix, a total cap on the amount guaranteed is probably not the best indicator to use.

For discussion purposes, assume that a state adopts a total cap approach of say $10 million. Once the cap is reached, the state has then limited itself from guaranteeing even an almost perfect loan. If a church with $5 million of assets, no debt, and solid cash flow needs to borrow $100,000 and the bank requires a guaranty, the church would be stifled in their borrowing because of the state's self-imposed cap.

Instead of setting an overall cap, it is suggested that the state consider a formula approach to its' guaranties. Unless the entire economy collapses, it is safe to assume that every loan guaranteed by a state will not go into default at once. Therefore, instead of concentrating on the total indebtedness covered under the guaranty agreements, it is suggested that the state concentrate on the percentage of that total amount that might default in any one month. By default, it is not meant foreclosure but rather the inability to make the payment that comes due that month.

An example will better explain the above suggestion. The assumption is that the state has guaranteed $10 million in loans to local churches. Of those loans, seventy percent have always been current and never missed a payment. While one or two of those loans may experience difficulties in the future, the state's primary concern is the other 30% that have a history of delinquencies. Assuming an equal division, those loans would represent $3 million, or monthly payments of approximately $25,000. If all the loans in the 30% category were delinquent, could the state afford to make the payments for at least six months? The six months time period is used because that is the minimum time that would elapse before the state administrative bishop could remove the pastor and possibly the local trustees and proceed to a sale of the church property.

Under the worst case scenario just stated, the state office would have to make $150,000 worth of payments over the six month period. While that amount seems substantial to any state office, it is more realistic than contending that they would have to come up with $10 million.

Therefore, it is suggested that states developing a formula to deal with guaranty agreements consider the following:

- The total amount of guaranty agreements already in place
- The amount of loans in place that are currently 10 days or more delinquent, as well as the amount of loans that have been 10 days or more delinquent in the past 24 months
- The monthly payments of those loans that are or have been delinquent in the past 24 months
- The ability of the state office to service the debt for at least six months on those loans that are or have been delinquent in the recent past
- The market for single use church facilities in your state - if church property in your state takes longer to move than six months, the six-month period mentioned above may need to be expanded to twelve months or even eighteen months.
- The ability of the state office to service the debt must be looked at in light of the direct indebtedness of the state office for things such as campground facilities, state office buildings, state parsonages, etc.

Again, it is highly unlikely that even all the "slow payers" in a state will be delinquent in any one month. However, a state needs to be prepared if that should happen. At the very least, the state office should be aware of what their potential liability would be if those slow paying churches were delinquent. Once the state office understands the liability, then they can better assess their risk. While the state office can never eliminate the risk in guaranteeing loans, certain steps can be taken to lessen that risk:

Church of God Warranty Deed: It is imperative that any property covered by a loan guaranteed by a state office be on a Church of God Warranty Deed. Although the *Church of God Minutes* at *S44* require that all church property have standard deed language, many churches over the years have purchased property and have failed to include the standard language in the deed to that property. If the "in trust" language discussed in detail in the *Minutes* is not included in the deed, the state officials may have a difficult, if not impossible, time in maintaining control over a church that is seeking to go independent. Technically, if the state had guaranteed a loan to a church that later went independent, the state would still be liable for the debt even though the church was no longer a part of the denomination. Therefore, it is essential that guaranty agreements only be given on property that is on a Church of God approved deed. If such a deed is not in place, the guaranty should be withheld until the deed corrections are made.

Ability to Pay: Before underwriting or guaranteeing a loan, the state should also ascertain the church's ability to make the mortgage payments. This determination should be based upon an examination that goes well beyond just what the church reports to the state office. The state council, or the underwriting committee appointed by the state, should carefully review and make an assessment of the credibility of the financial information on the church for at least the last 24 months.

Loan to Value: The higher the loan to value, the greater risk the state is taking in potentially having to come up with payments and deficiencies that might occur if the property went into foreclosure. Any loan request that exceeds sixty percent of the appraised value of the church's total property should be subject to greater scrutiny.

First Mortgage: Underwriting should not be given by a state unless such is guaranteed by a first mortgage. If there are previous liens or mortgages that have priority over the mortgage that is being guaranteed, the state's risk jumps substantially. A mortgage or lien that has preference position can foreclose and eliminate any claim that subsequent lien holders may have on the property.

Insurance: The guarantor has an obligation to make sure that the church maintains proper insurance on the property, at least in an amount that would pay off any debts on the property. In case of a loss where no insurance is present, the church could walk away leaving the state guarantor owing an obligation without a facility to back up the debt. All lenders will require adequate insurance. But churches often allow policies to lapse. The guarantor must take every precaution to make sure that those lapses do not occur. A loss of the property during a lapse would be devastating to both the church and the guarantor. Churches located in hurricane, tornado and ice prone areas should be most carefully watched.

Contingency Fund (Loan Loss Reserve): The state should consider the establishment of a contingency fund that is dedicated to the repayment of delinquent church loans that have been guaranteed. Having such an account would certainly help eliminate the burden of the guarantor making payments in the event of default on several loans.

As stated earlier, it is impossible for a state/regional office to eliminate the risks of underwriting. However, diligence on behalf of the state administrative bishop and the state council can certainly lessen the exposure that a state might have through its' guaranty process.

CAVEAT EMPTOR

The legal term caveat emptor means let the buyer beware. In church construction and expansion projects, as well as in financing that expansion, no better advice can be given. As the "buyer" of the product, the church should be extremely aware of the potential pitfalls. While all the hurdles and difficulties will not be removed, the church can eliminate many of the problems by just being aware of the problems and taking steps in advance to deal with them. Problems always arise in building projects, as well as in securing financing. The goal of this manual is to help the church identify the potential challenges in advance.

While lengthy, this manual is in no way inclusive of all the issues that will arise in a church construction or expansion project, or in the financing of that facility. Although many matters are discussed at length, the final conclusion revolves around two issues:

- The church must have a strong and dedicated building committee that can deal with the challenges of the expansion project, as well as a strong finance committee that will seek terms most favorable to the church in the lending agreement, and
- The church must have a knowledgeable attorney that they can turn to when professional advice and counsel is needed.

All the information provided within this manual will be useless without these two factors.

CONCLUSION

If you have any questions regarding issues raised in this manual, you may contact the Church Loan Fund. Our desire is to help each of you succeed in this important labor for the Lord!

The information in this paper is provided as a service by the Church Loan Fund, Inc. For more information, you may contact the Church Loan Fund as follows:

Church Loan Fund, Inc.
4205 North Ocoee Street
Post Office Box 4608
Cleveland, Tennessee 37320-4608
(423) 478-7131 local
(877) 478-7190 Toll-free
Web Site: www.churchloanfund.com
E-mail: aconine@churchloanfund.com

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