Development finance vs bank loan

Blog

12.05.22

If you're looking for a property project, or you have a property within your portfolio that requires some attention, then the type of funding you choose will be an important consideration. You might have known that a bank loan is available to you, but have you considered residential development finance?

Before we discuss the differences between the two forms of funding, we must first establish what they both are.

What is a bank loan?

A bank loan or personal loan are types of loans taken from a commercial or high street bank. A bank loan is a one time payment of funds to the borrower rather than an instalment based funding programme, often seen in alternative finance. Whereas development finance is intended to enhance the value of an asset through refurbishment or expansion of a property, a bank loan can be used for almost anything, be it a wedding, home improvements, purchasing a car or even emergency circumstances.

What is development finance?

Development finance is a form of specialist funding that can be used to assist with property development. The funding allows a borrower to enhance the value of the asset or land, either through construction, refurbishment or conversion. The loan is advanced directly against the asset or property being offered as collateral, and further funds are provided to assist the borrower with paying for the costs such as the builder or even the kitchen supplier. The loans are often considered against the potential future value.

Acton, London is a good example of a residential property that’s value is predicted to increase through the construction of an air space development.

What is the difference between development finance and a bank loan?

When comparing development finance to a bank loan, one major difference often discussed is lending criteria. When specialist lenders are determining whether or not to provide funding, they base their decision on Gross Development Value (GDV).

GDV is the potential future value of the asset once the construction or refurbishment has been completed. One of the main challenges of GDV is that it is an estimate mainly based on average prices in the area, historical value and current trends. Although these metrics provide insight, they are subject to change based on different economic factors.

Although high street banks may also look at GDV when lending against a specific project, standard commercial banks can be more prudent on development finance projects as they take a more risk averse approach. This means it can be more difficult to secure a bank loan for a development as the funding you require is not based on present value. Specialist lenders on the other hand, usually have bespoke lending criteria and will lend on the future value of a development finance project meaning they can be more favourable to provide funding for refurbishment or construction.

What are the benefits and challenges of development finance?

As with most financial commitments, there are benefits but, there are also risks. The right option for you will depend on your circumstance and development objectives. It's important to ensure you have a good idea of your plan, its timings and costs. The risks and benefits that are listed below will hopefully be a starting guide to finding you the right finance solution.

Drawbacks of development finance

As with any form of lending, development finance has many risks associated that need to be fully considered. The biggest difficulty with development finance is that it can be higher risk than taking out a standard bank loan, as the property or asset is used as collateral and can be repossessed.

One important criteria used when determining whether to provide financing is GDV. As noted above, the GDV is based on future value and properties are subject to appreciation or depreciation based on various factors. This is more problematic if your project is long term as you may have an estimated value in mind however unexpected costs, macro economic changes, construction issues and other factors may affect the value of your property, leading to a developer having to pay more than first intended. GDV can be volatile and because of this development finance can be more expensive to obtain from a specialist lender. The amount you can borrow or LTGDV (loan to GDV) are usually not as high as standard LTVs (loan to value) due to the volatile nature of the future property market, this means although specialist lenders will provide higher levels of funding, you may still not receive your required loan amount. Lenders will generally charge more to borrowers because of the added risks involved, making development finance to be more expensive than standard bank loans.

Although specialist lenders have a more flexible lending and repayment policy, there is an expectation that the loan will be repaid to the lender, however, if repayments aren't made, then the threat of repossession becomes a serious possibility and there is a risk that the property you have secured the loan against, will be repossessed by the lender.

Benefits of development finance

As well as the risks associated with development finance, it can of course provide great value to a borrower once secured. Mainly the benefit of development finance is that as a borrower you can secure higher levels of funding than what you usually would receive from a high street bank loan because of the lender's more flexible lending policy, which looks at the future value and what the potential of the asset will be. As well as the availability of higher funds, development finance also uses rolled interest repayments. Normally when taking out a bank loan such as a mortgage, the borrower will pay a monthly interest repayment on top of what they already owe to the bank. With rolled interest, rather than paying monthly, the interest charge is accrued and full payment is due only when you redeem the loan.

For example, if you had an interest charge of £12,000 for a 12 month loan, rather than paying £1,000 a month interest repayment, you would have one repayment of £12,000 at the end of the loan repayment period (unless the interest is compounded in which case it will be slightly higher). Of course, this can be a negative if you prefer to pay your interest repayment gradually, however it allows for you to accumulate funds to pay back that interest later down the line.

Another benefit of development finance is that specialist lenders have the flexibility and speed to change your product type. For example, your development finance funding could be refinanced swiftly into a residential bridging loan if the security type has changed and this type of financing suits your needs. High street banks, on the other hand, do not have the speed or efficiency to switch between products in this way. If you are obtaining a mortgage, it's very difficult to change it to another bank provided product if the type of funding you need changes.

TAB is a lender that prides itself on five key values and by working with you to help you achieve your goals we actively demonstrate them. Our offices are open Monday to Friday and you can contact us anytime via email or our enquiry form.

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You are advised to obtain appropriate tax or investment advice where necessary. Understand more about the key risks here.

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