

Everything you need to know (at first) about construction loans

By Laurie Kelley

If you want to buy a home that someone else built, you will have no trouble at all finding a lender.

Building your own home, though? That can be a bit more of a challenge. If you have your heart set on building your home, here is some of what you should expect.

Building your own home is fun and exciting, but it can also be a bit stressful. The best way to get the most from your loan is to be organized. Your lender can provide you with checklists and provide advice on how to make the process go smoothly.

First, understand the basics. Construction loans are short-term (one-year or less), interest-only loans that are designed to be replaced by a regular mortgage after construction is complete. Pay close attention to how much time you have, as construction must be completed during the agreed term.

Construction loans are generally handled in one of two ways.

- 1) A construction-only loan is sometimes called a “two time close.” This loan must be paid off after the construction is complete and is usually refinanced by a conventional mortgage loan.
- 2) An all-in-one loan “one time close.” This type of loan begins as a construction loan and then automatically converts to a standard mortgage once the building is complete. This type of loan can save you money since you only close on the loan once – thus saving a significant amount of fees, time and hassle.

Still, shopping around separately for construction loans and conventional mortgages does give the homeowner choices. If you have the time and expertise to do the homework, you will find a good fit for your situation.

What you’ll pay

Expect to pay 1% to 1.5% in loan origination fees and pay for costs related to the construction project, such as property inspections and title insurance. Typical closing costs are 3% to 3 1/2% of the loan amount.

Check with your lender for down payment requirements.

You’ll also need to know how much you can borrow and how much money you will need to put down on the project. For example, Members Cooperative will loan up to 80 percent

of a home's appraised value, but other lenders may loan to a different percentage or a percentage of the cost of construction (usually whichever is less).

Also, different lenders have different down payment requirements. Members Cooperative typically requests cash as a down payment, but will also accept previously owned land that the home is going to be built on as equity for the project.

Once you get started, your lender will need to know how progress is going. A construction loan has more risk for the lender because of the complexity of the transaction and because the asset has not been created yet. Expect to provide detailed lists of your expenses. Your lender will send an inspector out several times during the build process to monitor your progress. Of course, your progress will need to match the funds that you have been extended.

How you get paid

You also need to consider that you will not get the entire loan amount all at once. Instead, the lender will approve "draws" on the loan as the construction moves forward. The owner needs to provide to the financial institution with a sworn construction statement that will be used to compare what work has been done against the draw that has been requested. Usually, builders need between five to six draws to complete the home.

Typical draw points include: grading the site and pouring the foundation; framing; installing heating, plumbing and wiring; exterior work; completing drywall and other interior work; installing cabinets and trim; and interior painting and other finishing work.

Ask your lender if funds are released before or after the work has been completed. Typically, the work needs to be done before the funds will be released.

Many financial institutions require a construction project to be managed by a general contractor. However, some financial institutions, like Members Cooperative, will allow the owner to complete some of their own work, if the owner can provide evidence of their experience in the field of construction.

The most important part of any construction project is to accurately estimate total costs, complete a sworn construction statement, and then stick to the plan.

That's not as easy as it sounds. In such a large and personally important project it's easy for expenses to get out of hand.

Your lender can help with the planning and they will build some contingencies into the loan, but realize this: you will be tempted. It's easy to upgrade the faucets, carpet or every other surface, and costs can get out of your hands quickly. Don't run out of money before the construction is finished.

Again, building your own home can be a great experience. But you need to plan ahead. With a good plan and the right kind of financing you'll end up with a home you love at a price you can afford.

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