Finding *the* Funds

Negotiating the maze of home financing options

by Tom Stephani

Not many people have a pot of gold to finance the construction of a new home. For most of us, a construction loan and a mortgage are needed to provide the necessary funds. Securing financing isn't difficult as long as you know what you are looking for.

Financing can be a confusing aspect of building a new home because custom-home buyers need to obtain both a construction loan and a residential mortgage.

The construction loan acts as a short-term line of credit while the mortgage supplies funds on a long-term basis with an amortized payoff.

It's wise to investigate your borrowing capacity prior to embarking on the home-building process, but you probably won't need to secure your financing until you've purchased or reserved the site for your new home, approved the design, building plans and written specifications for your home and signed a contract with the builder.

How Construction Loans Work

Few subcontractors and suppliers can afford to wait until your home is completed for payment for the labor, materials or products they have provided. That's where your construction loan will come into the process. This credit line is used to pay the subcontractors and suppliers on a timely basis during construction.

Once each month or as specific stages of construction are completed, you or the builder will prepare a request for funds called a "construction draw," which is submitted to the lender or the title company to pay for work completed thus far. Partial payments may be made to major subcontractors whose work extends through several stages of the home-building process.

Subcontractors and suppliers typically agree to waive their lien rights against the home upon payment. Most lenders will require that you pay for extras and changes as those expenses are incurred. Expect to pay a portion of the builder's overhead and direct job expenses with each draw, unless your contract with the builder states otherwise.

Although it seems counterintuitive, you must apply for a residential mortgage and have the lender's commitment for that loan in hand before you will be able to obtain a construction loan. Very few lenders will approve a construction loan without being assured that a "permanent" mortgage will pay off or "take-out" the construction financing when the home is completed.

Get Your House in Order

The extensive documentation required for both the construction and mortgage loans will include verification of your employment (e.g., W-2 forms and paycheck stubs) or documentation of your self-employment income, verification of your assets (e.g., savings and investment account statements), your income tax returns for the last two or three years, your construction contract with the builder, the plans, specifications and cost breakdown for building your home and the purchase contract for or title to the site where your home will be built. The construction loan lender will require a "take-out commitment" letter to verify that you've applied for and obtained a "permanent" mortgage.

If you obtain both loans from the same lender, you might be able to minimize providing duplicate documentation; however, construction and permanent loans usually are handled by different departments, so you may still need to provide two complete sets of documents. It can be beneficial and easier to deal with one lender for both loans, but that's neither required nor always the best option.

Lenders are beginning to make construction-to-perm loans, which wrap both parts of the financing into a single financing package. The construction loan simply converts to a permanent mortgage when construction is completed. Although construction-to-perm loans can work well, they aren't necessarily the best option for every situation.

Try to obtain the best rate and terms available for your long-term mortgage, regardless of whether it's connected to a short-term construction loan. Once you have a commitment for a mortgage, a construction loan should be relatively easy to obtain.

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While it is recommended that you consult with a qualified financial advisor before making any financial decisions, a quick way to help you estimate the funding details of your real estate transaction is to visit www.homeplans.com and click on the "How much home can I afford" link. Enter your monthly income and expense information, and the calculator will give you an estimate of the monthly mortgage payment you can afford.

If you want to know what your monthly payment will be for a specific mortgage amount, click on the "Mortgage payment calculator" link and enter your home's purchase price, your down payment and annual property tax and insurance charges to bring back the number.