A First-Time Buyers Guide to Understanding the Construction Loan Process

By Sue Durio

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New to the homebuying process? A construction loan will help get you started on the journey to your dream home.

Building that perfect home you've sketched on napkins for years can be an exciting, yet stressful experience, particularly if it is your first time building a home.

Lots of decisions play into making your experience a positive one: choosing the right floor plan, the location, the builder, the unending design choices, to name a few. But without construction financing, none of those decisions will be necessary.

Constructions loans work differently than mortgages. A construction loan is a short-term — no more than 12 months — financial commitment by a lender to finance the cost of building a home. This loan often includes the cost of acquiring the lot.

You can expect to pay a portion of the funds, usually 10 percent to 20 percent, as equity. By doing this, the homeowner is sharing in the risk of the project with the lender and builder. Construction loan rates are typically variable and adjust with the prime rate.

One-Time Close Option

One option that some lenders offer is a "construction-to-permanent" loan or "one-time close." These loans may enable you to avoid paying duplicate closing costs.

However, consider the potential downsides as well. "While there is definitely some financial benefit, it does not take into account cost overruns that may be incurred later in the construction process," notes Jeff Brinkley, president of Monterey Oaks, First State Bank Central Texas in Austin. "Adding these costs to the original one-time close loan can be a challenge for all parties involved."

A one-time close also may require additional equity, and a stellar credit score, to offset the lender's higher risks.

Getting Your Loan Approved

A lender will want to see several documents in evaluating your loan. As with a mortgage, you'll need to gather recent tax returns, employment income records, revolving credit balances and bank account statements. For a construction loan, however, you'll also need to provide paperwork that gives the lender confidence that the project can be completed on time, at a high quality and within the loan amount you are requesting.

For that, you'll need to provide your builder contract and detailed architectural plans, as well as the builder's budget and specification sheet, track record in building similar properties and construction schedule. Because your home's construction is contingent on the builder's ability to perform, the builder's reputation and track record are key factors in your loan application package.

"The bank must also approve the builder so additional financial information from the builder often is required," says Brinkley. "The bank also may contact some of the builder's suppliers and sub-contractors to be sure they are being paid in a timely manner."

Avoid Delays, Surprises

The loan approval process can span as much as 45 days. During that time, the lender will request an appraisal, which itself may take up to three weeks to complete. Do your part to help speed the approval and closing process. Respond promptly to requests from the lender or title agent closing your loan. Review closing documents as soon as you receive them and address any questions you may have long before the closing date. The closing table is not the time to begin reading the fine print!

How Do I Get My Funds?

Payments to your builder are made through construction advances under the loan. As each stage of work is completed, the builder will submit a draw request to the lender to pay those costs. Both the property owner and builder are required to sign each draw request.

Before funds are advanced, the bank will send a third-party inspector to view the progress of the home and determine whether the payment is justified. The draw process protects the lender and the property owner from paying draws for work that was not completed. It also ensures that the builder can pay subcontractors in a timely manner, which is essential for keeping subcontractors happy and on your job.

Converting to a Mortgage

Approximately 45 days before the home is scheduled for completion, contact your mortgage lender — the one with whom you were preapproved early in the process. Some lenders do both types of loans; in other cases, you may be working with an entirely different lender on each loan.

"The mortgage lender will pull credit one last time (to insure there are no new financial obligations adversely impacting qualifying) as well as order a final appraisal and survey," says Brinkley.

Current bank statements may be requested to insure you have sufficient funds to close. For those reasons, lenders advise that you make no changes to your credit or employment during the construction process. A new car loan, major credit card charges for the new home's furnishings or a decision to leave a long-held job to become self-employed could be triggers to keep you from getting that mortgage loan you expected.

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