ConstructionLoanCenter.com

Your Comprehensive Guide to the Construction Loan Process

Congratulations on building your new custom home! It's exciting to make your family's dream come true!

www.constructionloancenter.com

Introduction

Congratulations on building your new custom home! It's exciting to make your family's dream come true!

But it's not a simple, fast, or straightforward process, so we've created this guide to help you gain a big-picture understanding of it.

From selecting a lot and a house plan to financing options, construction costs, timelines, and insurance requirements, we'll walk you through all of it so you can start to wrap your head around what will be required, when you'll have to work on each part, and what options you'll be choosing from.

Lot Selection

The location of your future home is one of the most important factors to consider. Think about your family's lifestyle, work locations, and schools, plus accessibility to your favorite activities.

Think long and hard about what life in each of your possible locations would really be like on a day-to-day basis before you make a choice.

Once you have an idea of what you're looking for, find a qualified **realtor** in your area who specializes in finished lots. If you are set on a specific area, you can also work with a private seller or development company.

Your Team

Your building team will consist of an Architect to design your home, a Building Professional to construct it, and a Construction Lender to help finance it.

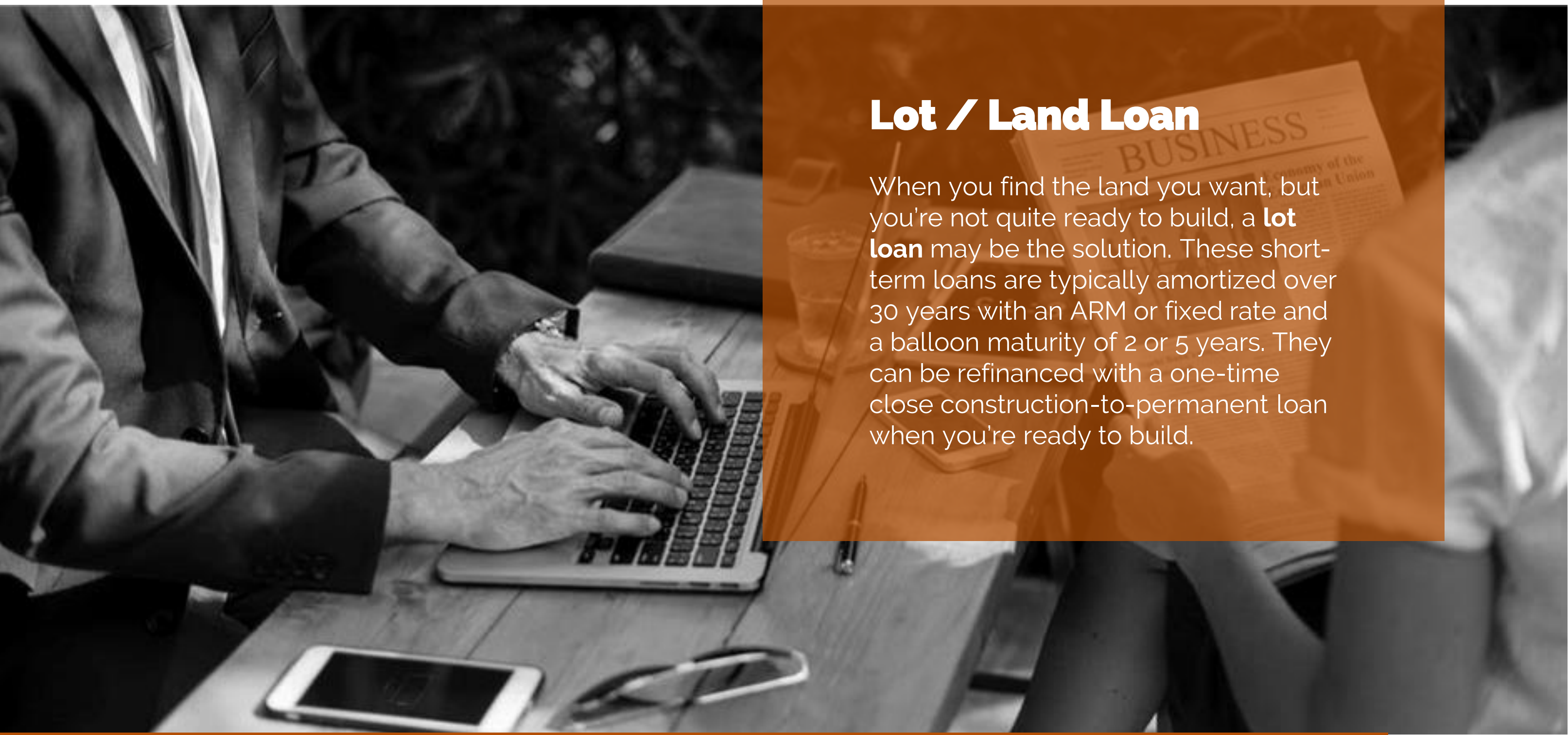
You can build your team in any order, but each member plays an essential role, and you will work with all of them for up to a year to bring your vision to life, so choose carefully—the success of your new home construction project depends on working with professionals that can provide you with insider insights and helpful information.

Now let's talk about how to fund your project.

Construction-to-Permanent Loans

A **Construction-to-Permanent Loan** is a *one-time* close loan that's used to design and build your home from the ground up, or to rehabilitate a primary residence (of one to four units) or a second home. It also becomes your financing for the entire loan term (10 – 30 years).

To be clear, *one-time close* means that you only need one loan from start to finish. You sign one set of loan documents that covers the purchase of a property or the refinance of your existing property, the construction phase, and the permanent mortgage. This simplifies the loan process because it eliminates the need for multiple loans, applications, and closing fees to get you into your new home. There are multiple construction-to-permanent loan products, including **Fixed** and **Adjustable Rate Mortgages (ARM)** and a variety of rate lock options. The construction period can vary from 6 to 9 or 12 months; 15 and 18-month terms are also available.



Lot / Land Loan

When you find the land you want, but you're not quite ready to build, a **lot loan** may be the solution. These short-term loans are typically amortized over 30 years with an ARM or fixed rate and a balloon maturity of 2 or 5 years. They can be refinanced with a one-time close construction-to-permanent loan when you're ready to build.

The Construction Loan Process

The Construction-to-Permanent Loan process is very similar to a standard purchase or refinance transaction. One major difference involves determining the value of a home that doesn't yet exist.

To assist the appraiser and the lender in determining the value of the finished home, you provide information on the planned improvements, materials, and the total costs to complete the construction. Lenders also evaluate your contractor to ensure that he or she has the experience and expertise to complete the project and a good financial track record.

For a Construction-to-Permanent Loan, plan on gathering the following **required documentation** in addition to the standard credit and income documentation. Your lender may ask for additional documentation to fit your specific needs.

Final Plans and Specifications

This means a full set of architectural drawings (building plans) prepared by an architect and approved through city or county plan check. It typically includes a floor plan including all dimensions, a foundation plan including all dimensions, outside elevations, electrical and plumbing details, and other details of the planned construction. A future value appraisal can normally be ordered with complete plans prior to city approval.

Completed Construction Loan Budget Worksheet

This form outlines all the future costs together with your prepaid items. It enables your lender to calculate the maximum loan amount, the amount of equity you must have, and the amount of funds to be disbursed from the loan at closing. Your Construction Loan Specialist will help you complete this.

Builder Statement

This form ensures that your building professional is qualified, has a proven track record, and will be able to meet the contract terms.

General Contractor License

A copy of the contractor's license should be included with the Builder Statement, but this isn't required in all states or with an approved consultant.

Construction Project Costs

Following is a description of the costs that go into building a new home.

Soft Costs

These are the permit fees, engineering fees, architectural fees and other costs associated with building the home that are not direct construction costs. You may have already paid some of these costs. If so, they can be considered as equity, so be sure you can document the expense with a bill, a canceled check, or a paid receipt.

Hard Costs

This is the actual cost of construction, including all materials and labor. This number comes from your signed contract with your builder. Like a purchase contract for an existing home, this contract sets forth the scope of work and the costs associated with it.

Closing Costs

These are costs associated with closing the loan, such as title costs, loan fees, discount fees, inspection fees, and appraisals.

Contingency Reserve

This is a reserve account to cover unforeseen cost overruns during construction. Normally 5% of the hard costs will be established in a Contingency Account, but your builder may hold an additional reserve over and above what the lender requires.

Interest Reserve

An interest reserve account may be established to pay the estimated interest costs during construction, which keeps you from having to make out-of-pocket housing payments during construction. The formula for the interest reserve estimate is provided below:

(Loan Amount x .60) x Interest Rate ÷ 12 = Monthly Interest x Construction Term

Formula

Here's what that would look like for a $329,000 loan for a 9-month construction term:
Loan Amount $329,000 x .60 = $197,400
$197,400 x (Interest Rate) 6.0% = Annual Interest $11,844
$11,844 ÷ (12) = Monthly Estimated Interest $987
$987 x (Construction Term in Months) 9 = Interest Reserve $8,883

Land or Existing House Value

If you have purchased the property within 12 months, the purchase price will be used to determine the site value. If you have owned property for more than 12 months but less than five years, lenders will still generally use the purchase price to determine the site value. However, if the estimated site value is strongly supported by recent and proximate comparable sales, most lenders will consider the appraiser's estimate of value subject to underwriter review. If you have owned the property for more than five years, the appraiser's estimate of the site value will be used. A copy of the HUD-1 from the land purchase may be required. In which case? Or all of them?

Loan-to-Cost Ratio (LTC)

In a regular purchase or refinance transaction, the maximum loan amount you can have against the property is based on **Loan to Value**, meaning the value of the property. For Construction to Permanent loans, the ratio used to calculate the maximum loan amount is **Loan to Cost (LTC)**, meaning total project costs. Following is an example of the LTC calculation using the same loan information in the Interest Reserve Formula previously provided.

Example:
Land value/ house cost: $80,000
+ Total cost of construction: $275,000 = $355,000
+ Total closing costs $10,000 = $365,000
+ Interest Reserve $8,883 = $373,883
+ Contingency Reserve $xx,000 = $xxx,xxx x
Maximum LTC 95%
Loan Amount = $xxx,xxx
There needs to be some context here about why this matters to the borrower.I was trying to update these numbers to look more current. I did an okay job on the numbers above, but I'm sure I'm messing this up. Correct as needed so they look like an average construction loan today.

Drawing Funds From Your Construction Loan

In the construction process, there are specific times when money transfers from the mortgage company. Typically, this happens monthly, and each disbursement is a set amount that has been agreed on before the process starts.

Each disbursement is made on a reimbursement basis, meaning that you or your building professional are required to advance funds into the project. Disbursements occur based upon the percentage of work completed on the home as determined by the lender.

Open a bank account just for this purpose. Your disbursement funds will either be wired directly to this account or checks will be issued for you to deposit. You may submit draw requests directly to the lender or your contractor may submit them with your authorization.

Once a draw request is made, the lender requests a progress inspection and an update to the title insurance coverage. Assuming that the inspector, title company, and/or the lender find no problems, funds will be wired into the established account or a check will be mailed. The typical timeframe for reimbursement is 3-5 business days.

I'm remembering this from other work I've done for you. Fill in the gaps or correct as needed to explain the process.

Initial Disbursement

The initial disbursement at closing covers the payoff of the lot or the existing mortgage (if applicable) and related closing costs, minus your required equity. It never exceeds the amount allocated in the Loan Budget Worksheet for closing costs and/or lot payoff.

You must pay any additional costs out of pocket at closing, and you must have an adequate down payment (equity) available then. Equity is defined as cash paid towards the lot, construction improvements (both hard and soft) and cash paid at closing, if required.

If you own the lot free and clear, you cannot get a check for your equity that has been applied to the lot purchase until the project is 100% finished.

Hard Costs

The direct costs for material and labor are disbursed based on the percentage of completion at the time of the draw. Up to 50% of the costs of these line item may be paid when accompanied by an invoice:

- **Windows/Doors**
- **Bathroom Fixtures**
- **Countertops**
- **Rough Framing Materials**
- **Cabinets/Appliances**
- **Flooring**
- **Custom Lighting**

Soft Costs

These are indirect costs that aren't directly related to labor or materials, and are not subject to inspection . There are two types of soft costs: x and y.

If your lender allows it, these costs are automatically funded within 24 hours of your loan funding (at the closing in the beginning of the construction process) if wire instructions were provided at closing.

However, soft costs such as builder overhead/supervision are disbursed in proportion to the percentage of completion of your home.

Construction Timeline

This timeline will help you plan your project realistically. It is based on a 12-month construction phase, but of course, no two projects are alike. Custom home construction usually takes 6 to 12 months, and larger projects may take longer.

If you're looking for a shorter timeline, systems-built homes go up in as little as three months. These "modular" or "panelized" homes are custom homes whose major components are constructed in sections in a factory and assembled on your lot. Energy efficient homes comprised of structural insulated panels and insulated concrete forms also utilize systems-built technology.

Months 1 – 4

Get a Plan
Your first step is to get a home plan by purchasing plans from a home plan website or selecting an architect to design your home. Be sure to interview several architects before making your final selection. They'll be involved in the construction process from start to finish, so you'll want to make sure you work well with them and they share your vision for your new home.

It's wise to have an interior designer working with the architect from the beginning. You'll get a better end result on location of windows and doors, appropriate room size, lighting plans, and many small finishing details that pull the entire project together.

Choose a Builder
While selecting a builder, look for an experienced professional with a history of delivering high quality finished products on time and within budget. Be sure to check references. Once you've narrowed down your list, consider asking for bids.

Month 1
- Loan closing - Your construction term begins the day the you sign your loan documents. To help you get started, IndyMac Bank will automatically fund all of the soft costs plus 5% of the hard costs, excluding your builder's overhead. Draw requests may be made online.
- Groundbreaking
- Foundation

Months 2 - 4
- Framing

Months 5
- Roofing

Months 6
- Rough plumbing
- HVAC
- Electrical
- Other mechanical work

Months 7 - 10
- Drywall and insulation
- Flooring
- Stairs
- Cabinets
- Painting
- Final mechanical work

Months 11
- Final sanding
- Sealing
- Carpeting
- Closet shelving

Months 12
- Final inspection
- Final closing
- Releasing the contractor
- Final Draw Request
- Construction loan rolls to permanent loan

Move In
- Move in and plan a housewarming party to show off your new digs!
- Update reference

Construction Loan Insurance Requirements

Construction-to-Permanent Loan

During the construction of your home, you have additional risk, which is reflected in more complex insurance requirements. There are three main ones:

01

Course of Construction Casualty Insurance

This policy is an "all risk" policy that includes coverage for fire, extended coverage, builder's risk, replacement cost, vandalism, and malicious mischief. The owner is named as insured with the insurable value equal to the replacement cost of the improvements or the loan amount, whichever is lower. The lender is named as the mortgagee under the policy. Once the improvements are completed and the permanent loan phase begins, the course of construction policy is usually converted to a standard "all risk" homeowner's policy.

02

Workers' Compensation Insurance

This endorsement covers the general contractor, subcontractors, and others who will be working on the property. The builder typically provides this policy, so they are named as the insured. In states where Workers' Compensation Insurance is not required, or you are acting as your own building professional, you'll need a waiver.

03

General Liability Insurance

This is a comprehensive general policy or included as a broad form liability endorsement . You or your builder can provide this. If you provide the insurance, a minimum amount of $300,000 for each occurrence is required, extended to both property and personal injury. If your builder is providing the insurance, they are required to have a comprehensive general policy of at least $1,000,000, or a policy including a broad form liability endorsement.

Remodeler, Second Mortgage Loan

If you're renovating your existing home, you'll need a standard homeowner's policy that includes Workers' Compensation, General Liability Insurance, and Personal Liability Insurance.

Flood Insurance

Flood insurance is mandatory on all loans if any of the subject property is in a specified Flood Zone. Flood insurance is not required if the subject property is in Flood Zone X, or if you get a letter from FEMA stating that the applicable maps have been amended and your property no longer lies in a flood zone.

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Get In Touch

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