WHEN DOES USING A CONSTRUCTION LOAN MAKE SENSE FOR A NEW RESIDENCE

By Brian Watkins and Greg Benton

You've dreamed about it for years – you've always wanted to build a custom home based on your family's unique desires. "Homesteading" from scratch on a piece of undeveloped land can be a challenging yet still reachable goal for those ready for the adventure. According to a Federal Reserve report late last quarter, continuing strength in the labor market and continued low mortgage rates are contributing to a favorable building environment. Commerce Trust Company's Director of Private Banking Brian Watkins and Commerce Bank Mortgage Banker Greg Benton often collaborate on starting the home building process with clients. They combined to author this commentary on navigating a path for obtaining the financing needed to make your dream home a reality.

A construction loan may be the only loan you will ever apply for on an asset that does not exist – yet.

However, a construction loan is a legitimate financial tool to turn your dreams of having a custom-built home into a reality. So where does one begin?

It takes an experienced "guide" to navigate a path from envisioning a new home to finalizing the last of your punch list items on the final walk-through with your builder. Building a home can get very complicated, especially if you need to take out a short-term loan for construction and a second longer-term mortgage to permanently finance your new home once the project is complete.

Everything starts with a construction loan, a short-term loan that provides both the financing necessary to build the house and the safeguards to ensure expenses are measured and monitored throughout the process. From a business standpoint, banks consider construction loans more of a lending risk than traditional mortgages. That's because your completed home acts as collateral with a traditional mortgage. In the case of a home construction loan, the bank has no collateral to claim, since your house is still under construction.

Construction loans are usually for higher value primary residences or vacation homes. As one banker put it, "it's either skiing or the beach." However, construction loans can also be used for local tear-down/rebuild projects, which are popular these days as well. We've all seen larger homes or houses with more amenities built to replace older structures in highly sought-after locations and premium neighborhoods.

To acquire a construction loan, aspiring home builders usually start off with architectural plans as the basis for estimating the projected value of the finished home. When the plans are approved and accepted by all interested parties, construction loan providers generally offer a loan based on a percentage of the completed projected value of the house. Typically, a 20% percent down payment by the borrower is contemplated, requiring a remaining loan value of approximately 80% of the projected value, to provide all the funds necessary to build your new home.

That's where the road can get complicated. Construction loan providers don't hand over a lump sum; rather, they disperse the loan in installments called "draws" as needed during various stages of your construction project. For instance, a concrete contractor will likely request payment after foundations are poured and set. As the construction progresses, other building trade contractors, like brick layers, carpenters, roofers, plumbers, electricians, and painters, will want payment for their services. Then there are costs for extra items, like titling, inspections, appraisals, landscaping, and interior finishing millwork.

A typical custom-built home can take six to 18 months to build. There will be many check points to navigate payment dispersals, designed to ensure no stalls or delays in progress. Your construction loan provider should be your partner from the first building blueprints to the final walk-through of your completed home.

When the building phase is completed, the construction loan is paid back immediately when a more traditional long-term mortgage is put in its place. Provided you had no cost overruns and your home appraises at the original projected value, obtaining the mortgage loan financing is not nearly as arduous a process. Some loan providers offer a financing package that includes both the construction and mortgage loan. Some providers may offer to lock in the interest rate for the long-term mortgage financing in advance, while the home is being built. With this feature, if interest rates rise during your construction phase, you will already know that your mortgage financing remains stable.

Homesteading is a journey involving many partners along the way, and it's good to have an experienced advisor to help navigate the financial crossroads on the way to making a dream home a reality. For those interested in discussing a construction loan as an option, they are welcome to call either Brian Watkins or Greg Benton at 1-855-295-7821.

Commerce Trust Company is a division of Commerce Bank.

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Brian is senior vice president and director of private banking for Commerce Trust Company. He is responsible for the system wide oversight of all private banking activities for Commerce Trust. He joined Commerce in 1995 and served as a commercial lending manager prior to transitioning to his current role with Commerce Trust in 2013. Prior to joining Commerce in 1995, Brian was a branch manager with Boatmen's Bank. Brian attended Saint Louis University, where he received his bachelor of science degree in finance as well as his master of business administration degree. He serves on the Alumni Board and Father's Club Board for St. Louis University High School. Brian is also active in his parish with Mary Queen of Peace in Webster Groves.