



Financing the dream

When you buy a house, you make a down payment and borrow the rest of the money through a mortgage. But if you plan to build instead of just buy, it's a little more complicated. Mortgage lenders don't write mortgages on houses that haven't been built yet. So what to do? The answer is "construction financing" and the more you know about it, the better your chances of getting some, and at the right rate.

Four ways to finance

There are four common ways to finance construction of a new home.

1. Two Separate Loans: The most traditional construction financing is to take out two loans: a construction loan to get the house built, then a permanent mortgage that also will pay off the construction loan. A construction loan typically has a six-month to one-year term. The borrower pays monthly interest charges as they accrue, and the loan has a "balloon payment" - when all the principal is due - at the end of the term. The annual interest rate should be no higher than the current prime lending rate, plus 1.5 percent to 2 percent. There's also an upfront service charge on a construction loan, amounting to a certain percentage of the amount borrowed. Two to 2.5 points is usual.

When you get a construction loan, the money doesn't land in your lap all at once. The lender puts it in an account and disburses it in stages during construction. Typically, they make one payment after the foundation is poured, another after the framing is completed, and so on.

2. Combination Loans: These can save you big money because you only have to go through one closing. When the house is finished and you receive a certificate of occupancy from the municipality, the construction loan is simply converted into a permanent mortgage.

Interest rates on combo loans are about the same as those on standard mortgages. But, as with a construction loan, the service charge tends to be higher by a point or so than on standard mortgages.

3. Financing by the Builder: Some builders will finance construction using their own credit. You'll have to come up with a good-sized deposit, then cover other costs until the house is complete and you can get a regular mortgage. This arrangement is simple, but you'll need big bucks to get started. Sooner or later, you'll even have to reimburse the builder for any interest on the money he or she borrowed to build the house -- interest that's not tax deductible for you.

4. Personal Credit: A fourth option is to build the house using your personal credit, if you have enough. For example, if you have a lot of equity in your current home, you might be able to use an equity line of credit to finance the construction of another one.

If you're lucky enough to have a huge savings account or certificate of deposit, you almost certainly can borrow against that with no muss, fuss or closing costs at a rate usually about two points above the interest rate your institution is paying you on the money.

Sources of financing

Definitely shop around for a construction loan, but you should start where you do your regular banking. They'll know best what you can afford, and they might offer you a deal to keep your business.

Next, try local "savings and loan" institutions. Financing local housing usually is what they do lots of. Savings and loan staffers may even have advice for you about local builders. Some mortgage bankers also may finance personal construction loans, so don't rule them out.

Qualifying for a loan

Most lenders will want an estimate from the builder that specifies who will do the work and for how much. Before closing, you'll have to provide copies of signed contracts with the builder and any subcontractors you're hiring yourself. Be patient about all the paperwork: To make a loan with a minimum of risk, the institution must be able to appraise the completed value of an unbuilt home, and that would be impossible without detailed plans and specifications. Requiring signed contracts with the builder is simply the lender's insurance that the house will indeed be built.

Your down payment and interest

Lenders usually want up to 20 percent down on construction financing, and are willing to finance 80 to 90 percent of the anticipated worth of the finished house. Also plan to have enough money for the closing costs and any interest required during construction. It's also smart to have some extra cash for possible cost overruns that may come up during construction.

Be sure you understand how the interest on your construction loan will work. The best setup is when you pay interest only on the amount you've drawn out of the loan. In other words, if 10 percent of a \$100,000 loan has been spent on the house's foundation, you pay interest on \$10,000. If the lender charges you interest on the entire loan from day one, you're going to be forking over unnecessary bucks. Be sure to ask about this before signing on the dotted line.

Pin down that permanent mortgage

However you decide to finance your new home, be sure to apply for a permanent mortgage within 90 days after the house is finished. Only then will the mortgage be an "acquisition" -- debt whose interest is deductible from income taxes. If you apply after 90 days, you might be allowed to deduct only the interest you pay on the first \$100,000 you owe on the house - for as long as you own it, even if you refinance later.

Finally, don't be daunted! Financing a new home is the boldest financial venture most people ever make, but tens of thousands do it each year. There are always helpful lenders who will take you by the hand and get you through the process. The reward is the home of your dreams, and that's well worth the effort!