

To Build or Not to Build, That is the Question!

By Beth Worrick and Betsy Sullivan

The term “buyers’ market” has re-entered our real estate vocabulary and today we find ourselves in an altogether different real estate environment than earlier this decade. Flat values or, in some cases, declining values have changed the way we make decisions regarding the buying or selling of our homes. And as dumpsters and builder’s signs increasingly replace “For Sale” signs in front yards, it appears that many of us have decided that it’s not the location but the house we need to change. This shift has ushered in an increased demand for construction loans.

This product varies in many ways from a traditional residential mortgage loan. The construction loan’s most distinctive features are the ability to borrow against the future value of the completed project, to secure interest rate protection beyond the construction phase, and to pay interest each month only on the money that has been “drawn,” or used at that point in time.

A construction loan is a financing tool generally used in three scenarios: to acquire land and build a new house, to extensively renovate an existing house, or to acquire an existing house, tear it down, and build a new house.

Acquiring Land and Building a New House

Mary Smith approaches her bank to secure a loan to buy a piece of oceanfront land for \$1,000,000 and plans to construct a house with a projected cost of \$1,000,000. The first step is for the lender to order an appraisal, which includes a valuation of the land along with a valuation of the finished house based on “specs and plans” provided by an architect.

Assuming that Mary is financially qualified and that the appraisal indicates that the completed house will be worth not less than \$2,000,000, Mary could borrow up to 75 percent of the projected value of \$2,000,000, in this case, \$1,500,000. Mary would have to put her 25 percent equity, i.e., \$500,000, into the transaction at the time she acquires the land and the lender would release \$500,000 at the same time to complete the land purchase. The remaining \$1,000,000 of the initial \$1,500,000 loan would be “disbursed” throughout the construction process, released to the builder as specific construction benchmarks are accomplished.

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Renovating an Existing House

Frank Jones comes to his bank looking to finance an extensive renovation of his home in Duxbury. His current house, a four bedroom colonial, lacks a family room and his kitchen needs a complete renovation. Frank is certain that these changes will increase the value of his home and make it much more functional for his growing family. The house in its current state is appraised for \$800,000 and Frank has cost estimates for his addition and renovation of \$200,000. Once again, an appraisal based on the “specs and plans” is obtained and the projected value of the completed home is \$1,000,000. Frank has an existing mortgage of \$600,000 that will have to be paid off so that the new construction loan can be in the first lien position. In this case, the bank is willing to lend Frank the \$800,000 he needs; \$600,000 to pay off his existing mortgage and \$200,000 that will be disbursed as he completes his addition and the kitchen renovation.

Tear Downs

In the past few years it has become quite common for someone to identify a “tear down,” a small or dilapidated house in a good neighborhood, and to buy that house, knowing that he or she will tear it down. If the potential buyer were to finance the acquisition of that house with a traditional loan, he or she would violate the mortgage covenants by tearing down the Bank’s collateral. Instead, the buyer can obtain a construction loan to acquire the existing house, tear it down, and complete the new house with the remaining construction funds.

“Honey, we spent too much”

Almost anyone who has built a house will tell you a painful story about how, much to his or her surprise, the project ran over the initial budget—sometimes by astonishing percentages. The borrower must have a strong financial profile and additional liquid assets to deal with any cost overruns. Extremely detailed architectural plans can minimize cost overruns, but some issues cannot be foreseen. Hitting ledge when digging a foundation and weather problems can increase your project’s cost.

However, the most common cost overruns are changes and additions to the project as it progresses. You may have thought you were perfectly content to use those old radiators until your neighbor convinced you that you really “have” to have radiant heat installed under your new kitchen floor. Or perhaps you didn’t discover until the wallboard was up that there was room for a full bath as opposed to a half bath off the kids’ new playroom. A borrower with extra

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cash assures a lender that cost overruns won't slow the progress of the construction and, most importantly, that the project will be completed on time.

Understanding the Costs

Be sure to ask your lender for a breakdown of all costs associated with construction financing in the form of a Good Faith Estimate of Closing Costs. Be diligent about identifying whether the loan has "points" or origination fees that drive up the cost of borrowing. Because these loans are inherently more risky, the interest rates on a construction loan may be higher than those on a traditional loan. These loans usually have some additional closing costs. For example, the lender will charge to have an appraiser inspect the property each time funds are disbursed and it will also charge for a title rundown by an attorney to determine that no sub-contractor has placed a lien on the property because he or she was not paid by the General Contractor.

At the end of the construction phase, the loan converts from a construction loan to permanent financing, without the cost of a refinance or a second closing. The borrower then begins to make payments on the fully drawn, permanent loan each month.

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Reviewing architectural plans, choosing a builder, selecting lighting... those tasks are some of the pleasures (or headaches!) of building or renovating a home, but in the long run the most important undertaking may be to find the right bank and the right construction loan. Choose a trusted lender to help you through the process.

For further information about Boston Private Bank and Trust Company's mortgage products and other Bank services, please contact Betsy Sullivan, Vice President at the Bank's Hingham office at (617) 646-4812 or Beth Worrick, Vice President at the Bank's Newton office at (617) 646-4853.

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