

Construction loans

A construction loan is used to finance the construction of a dwelling. Under this type of loan, funds are drawn down as the home is built rather than in one lump sum. The lender usually sets a time limit on the drawdown period, often about 12 months.

The maximum loan-to-valuation ratio (LVR) for a construction loan is usually 95%, depending on the lender. In general, the lender will require that any customer contribution is used before the loan funds are drawn.

Required documentation

Borrowers must supply verified copies of the following documents before a construction loan can be assessed.

- Tender or copy of a fixed-price building contract detailing all building specifications, variations, allowances and costs.
- Copy of the plans for the new property as approved by the local council or building surveyor. The plans will generally not have to be approved at the time of application, but they must be approved before drawdown.
- Evidence that construction is being undertaken or supervised by a registered and insured builder who takes full responsibility for the construction and can provide appropriate guarantees as required by the various state legislatures.
- Details of the builder's risk insurance policy.

Progress payments

The loan is usually drawn down in stages as the builder completes various agreed milestones in the building contract. These drawdowns are sometimes referred to as progress payments. They are generally made at the following stages (however, these may vary from state to state).

1. Preparation
2. Slab or base floor
3. Frame
4. Lock-up
5. Fit-out
6. Final

At each stage, borrowers must provide the lender with a completed loan disbursement authority and a builder's invoice. The lender may carry out an inspection of the work before making payment to the builder.

Fees

Lenders often charge two fees with each drawdown:

- Inspection fee: Many lenders require an inspection before each progress payment, to make sure construction is progressing at an acceptable rate and to an acceptable standard. When an inspection is made there is often a cost to the borrower, like a valuation fee. This fee varies between lenders but may range from \$200 to \$1,000¹.
- Drawdown fee: Some lenders charge a drawdown fee to cover the costs of making the money available to the borrower. This may be charged for each drawdown, while some lenders may charge a one-off fee at the start of the loan instead.

Alternatively, lenders may charge a one-off construction fee to cover both fees.

Repayments

The repayments required during the construction period generally cover only the cost of interest. Interest is usually calculated on the amount drawn down to date, not the total amount approved.

Full loan repayments covering the loan's principal and interest generally only begin once the loan is fully drawn down. However, some lenders will permit additional payments to be made during the construction period.

Insurance

Most insurance companies will not comprehensively insure a property that is under construction. The insurers that do generally charge very high premiums and include a host of exclusions in the policies.

Licensed and registered builders are required to hold insurance to protect against events such as non-completion, structural defects and public liability. It's usually the builder's responsibility to provide insurance cover for the building until handover, at which point the borrower needs to take out insurance.

Unexpected costs

The building costs should be fixed in the building contract. Before entering into a loan contract, it's worth seeing if there is potential to vary the loan amount if construction costs are under or over the expected amount. Some lenders may allow undrawn funds to be disbursed back to you. Check with your lender under what circumstances they will vary the amount of the loan.

Final documentation

Before the final payment is made, the lender usually requires a final valuation. The following documents must also be obtained and verified:

- Certificate of Occupancy or Survey Certificate, depending on the state
- Builder's final invoice
- Comprehensive building insurance policy with the lender noted as mortgagee (from the clients).

**For expert mortgage advice,
talk to your local broker today.**

1. Canstar, How much does a building inspection cost?, 16 January 2020, Accessed 10 January 2022.