

Construction Loan

Building a house is a complex process which can be a great challenge for your time and attention to detail. Here are some information that we have gathered to help you understand more about getting a loan for construction.

What purpose can construction loan be used for?

Construction loan can be used for the construction of a new house, renovations to existing property or knock down and rebuild. Construction loan is generally not available for constructing a property for immediate resale (classified as in the business of property development) or for building multiple units (more than 2 or 3 depending on the lender) on one title.

What are the features of a construction loan?

Construction loan has a progressive drawdown feature to meet the progress payments during the construction phase. The loan will be on interest only repayment basis for the first 12 months or during the construction period and will revert to principal and interest repayment basis after the loan is fully drawn down. Construction generally needs to commence within 6 months from the loan contract date and be completed within a specified period (for example 12 or 24 months).

How do progress payments work?

Once a construction loan has been approved and the construction of the property starts, there will be progress payments throughout the stages of construction. An example of an Industry standard progress payment schedule is as follows:

| Stage | Description | Percentage |
|------------------------|---|------------|
| Slab including deposit | Completed the foundation of the building and underground connections | 15% |
| Frame | Completed house frame | 15% |
| Lockup | Completed walls, windows, doors, roofing and insulation | 35% |
| Fixing | Completed plaster, tiling, fixtures and fittings, plumbing, electrical and painting | 25% |
| Final / Completion | Completed finishing touches, installed appliances, clean up, fencing, landscaping etc | 10% |

You will need to use your own funds first for the progress payments before tapping into the loan funds approved by the lender. For example, for a fixed-price building contract of \$250,000 and your construction loan amounts to \$200,000 (80% of the construction cost), you must first use \$50,000 of your own funds to pay the slab (including deposit) and part of the frame stage progress payments before the lender will release any funds from your loan account to continue to the progress payments.

Progress payments may attract progress drawdown fee as well which vary between lenders. The lender also has the right to engage an independent valuer to inspect the property construction status before approving any progress payments.

How much construction loan can I get?

The amount of loan you can get will depend on your financial situation and the valuation of the property. The valuation will be done based on land value plus construction cost on an "as if complete"

basis. The lender will take the valuation result or cost whichever is lower. Hence it is important for you to keep in mind the market value of comparable properties around the area of your property and not be carried away by emotion when you commit to the design and cost of the construction. If the valuation of the “as if complete” property is lower than your building cost, you will need to make up the shortfall with your own funds.

What type of construction contract should I enter into?

Most lenders will only approve construction loan for a fixed price building contract. To lower the risk of an under-valuation, it is also highly recommended that you enter into a turnkey building contract and to have fencing and landscaping included.

Land and building contracts classified as split contracts are not acceptable by lenders. The characteristics of split contracts include:

- The builder is nominated in the land contract
- Sharing of common walls or slabs with other properties
- Restrictions imposed on sale or mortgage of land, construction, builder to be used, resale price of land etc

It is also important to ensure that the progress payment schedule is within industry standard. For example, it is outside of industry standard for the slab plus deposit to exceed 20% and the final / completion stage to be less than 10% of the building contract price.

First Home Owner Grant (FHOG)

If you are eligible for the FHOG, the lender may be able to lodge the FHOG application on your behalf and once approved, apply the grant amount at the slab or frame stage of the progress payment.

Tips

1. Obtain a loan pre-approval will provide you with more certainty over how much you can borrow from a selected lender based on your financial situation.
2. If you are about to commit to a building contract and want to ensure that the “as if complete” valuation result will stack up, certain lenders can allow upfront valuation to be ordered using the final (but unsigned) version of the building contract. While there may be valuation fees applicable, this can provide you with peace of mind and certainty over your potential loan amount, especially if you have limited own funds to contribute in the event of a shortfall.
3. In Victoria, industry standard building contracts provides you with five business days after receiving a signed copy of your major domestic building contract to withdraw from the contract without penalty. However, do note that you do not get a cooling-off period if you:
 - i. previously entered into a major domestic building contract with the builder on the same terms for the same home or land, and cancelled the contract during the cooling-off period
 - ii. engaged a lawyer to review the contract before you signed.
4. You are able to enter into the building contract with a “Subject to Finance” clause. Having this clause will give you time to organise for the approval of the construction loan.
5. Engage a lawyer to review the building contract before you sign the contract.

Disclaimer: Please note that this guide is developed without taking into account your objectives, financial situation or needs. It should not be used, relied upon, or treated as a substitute for specific professional advice.