A Loan for Building Your Dream Home

Designing a new home from scratch has appeal. The trick is how to pay for it during the period when there is no finished structure to serve as collateral for the mortgage.

One option: a so-called construction-to-permanent loan. Such loans are available at Bank of America Merrill Lynch, Regions Financial and SunTrust Banks, among others.

Borrowers can apply before construction begins and the lender will gradually release funds as work progresses, often directly to the builder. While construction is under way, the borrower typically pays interest only on the amount withdrawn. Most lenders allow this arrangement for about 12 months, though it can stretch to 18 or 24 months.

Construction-to-permanent loans often are used when homeowners hire small builders that don't provide financing. Large home builders such as NVR, PulteGroup and Toll Brothers have their own mortgage departments.

The advantage of construction-to-permanent loans is that borrowers often face only one set of closing costs, rather than paying such costs for both a construction loan and a subsequent mortgage. EverBank Financial says it will begin offering this option in the coming months.

Closing costs can equal about 2% of the loan amount, says Keith Gumbinger, vice president at mortgage-information website HSH.com, so borrowers can save thousands of dollars.

Paul Goff, 64 years old, says he and his wife, Rhoda, received a construction-to-permanent loan of $417,000 from Zions Bank in December, which they are using to build a 5,400-square-foot four-to-five-bedroom house in Millville, Utah.

Mr. Goff says the loan, which currently has a 3.89% interest rate, allows him to make interest-only payments until December, which he expects will be enough time to complete the home. He says landscaping is under way and he expects to break ground this coming week.

"When we're barely getting going, we just pay the interest on the unpaid amount that we've drawn out," says Mr. Goff, an electrician. "It's very flexible."

But be aware of how the interest rate on the loan is set and how it can change. Some lenders charge a variable rate, often pegged to the prime rate, during the construction phase. When the loan converts to a regular mortgage, borrowers can lock in the current interest rate—so if rates have risen by then, borrowers could face higher monthly payments.

One option: If interest rates begin to rise while the home is in the construction phase, borrowers can ask lenders if they can lock in the rate at that point.

Some lenders offer an adjustable-rate loan with an initial fixed-rate period that can range from three to 10 years. An adjustable-rate construction-to-permanent loan can make sense since borrowers will be able to lock in the rate from the start. But if they don't end up selling during the fixed-rate period, they face the risk of steeper monthly payments when that period ends.

—AnnaMaria Andriotis