

Construction Loans

A Comprehensive Guide to Short-Term Building & Renovation Financing

A **construction loan** is a short-term, higher-interest mortgage product used to finance the building of a custom home, a major residential development, or an extensive property renovation. Unlike standard mortgages that disburse a lump-sum payment at closing to buy an existing home, construction loans payout funds in stages as building milestones are met.

Because the asset (the house) does not fully exist when the loan is approved, lenders take on significant operational risk. Consequently, construction loans have stricter approval criteria, require detailed project vetting, and typically feature variable interest rates that require **interest-only payments** during the construction window.

How Construction Financing Works: The Draw Schedule

Instead of receiving all the money upfront, the funds are held in an escrow account. The lender releases portions of the loan balance over time according to a legally binding **draw schedule** synchronized with building phases.

The Operational Draw Flow: A typical project includes 4 to 6 distinct draws matching milestones (e.g., pouring the foundation, completing the framing, installing the roof, and final interior finishes). Before each draw is authorized, a professional inspector hired by the lender visits the job site to verify the contractor completed the work to code.

The Two Primary Types of Construction Loans

Borrowers must choose how their construction debt transitions once the property receives its Certificate of Occupancy:

1. Construction-to-Permanent Loan (Single-Close)

The lender finances the construction phase and automatically converts the remaining balance into a traditional 15- or 30-year fixed mortgage once the home is built. The primary benefit is that you only close once, meaning you pay **one set of closing costs and underwriting fees**.

2. Construction-Only Loan (Two-Close)

A short-term loan (usually capped at 12 months) designed purely to get the home built. Once construction concludes, the borrower must either pay off the debt in full or apply for a completely separate standard mortgage to refinance it out. This setup requires **two distinct closings**, doubling

your processing paperwork and transaction fees, but can offer flexibility if you plan to sell your current home later to clear the debt.

Typical Requirements to Qualify

Because there is no standing structure to secure the bank's investment, underwriting looks beyond your personal credit to analyze the logistics of your project:

- **Vetted General Contractor:** Lenders will not allow you to build the home yourself unless you are a licensed professional builder. Your general contractor must submit corporate tax records, proof of licensing, liability insurance, and a portfolio of past projects for bank approval.
- **The "Blue Book" (Project Blueprint & Budget):** You must supply complete architectural designs, line-item material budgets, construction contracts, and a structured timeline down to the specific finishes.
- **Higher Credit Score Baseline:** Because of the volatility of construction projects, most financial institutions mandate a minimum credit score of **680 to 720**.
- **Larger Down Payment Equity:** Most standard construction programs require a down payment of at least **20% to 25%** of the projected "as-completed" value of the home. (If you already own the parcel of land, your existing land equity can often count directly toward this down payment requirement).

Pros and Cons of a Construction Loan

Advantages (Pros)	Disadvantages (Cons)
<p>Interest-Only Payments During Construction</p> <p>You only pay interest on the money that has actually been drawn. For example, if your budget is \$400k but the builder has only drawn \$50k for foundation work, your monthly bill is calculated solely on that \$50k.</p>	<p>Higher, Variable Interest Rates</p> <p>Construction loans typically feature variable prime-plus interest rates that sit higher than standard consumer purchase mortgages, leaving you vulnerable to rate spikes.</p>
<p>Inbuilt Contractor Oversight</p> <p>The bank's mandatory inspection schedule protects you. If your builder does poor work or walks away, the bank pauses disbursements, preventing contractors from running away with unearned funds.</p>	<p>Extremely Rigorous Underwriting</p> <p>The approval process is long and tedious. Delays are common while the bank vets blueprints, matches local zoning permits, and reviews builder balance sheets.</p>
<p>Ultimate Design Flexibility</p> <p>Enables you to craft a completely customized home tailored specifically to your design aesthetics, energy goals, and spatial needs.</p>	<p>Out-of-Pocket Contingency Costs</p> <p>Material cost overruns or weather delays can easily push you past your loan budget. Lenders require you to carry a cash contingency reserve to cover unexpected overruns out-of-pocket.</p>

The Bottom Line: A construction loan is a highly specialized financial tool that turns the dream of building a completely bespoke home into reality. While it demands excellent credit, a sizable down payment, and patience through a complex drawing process, a Single-Close (Construction-to-Permanent) loan offers a predictable and streamlined transition from raw ground to homeownership.