How Do Construction Loans Work? From the First Draw to Your Finished Home

Key Takeaways

- **Construction loans finance the building process.** Funds are released in stages, called draws, as your home reaches specific construction milestones.
- **Your payments typically start with interest-only.** During construction, you generally pay interest on the funds that have been disbursed, rather than the full loan amount.
- **There are different ways to structure your financing.** A single-close construction-to-permanent loan combines construction financing and your long-term mortgage, while a construction-only loan requires separate permanent financing.

Building a home gives you the opportunity to make more of the decisions, from the layout and finishes to the location and overall design. But before the foundation is poured or the first wall goes up, there's one important piece to figure out: how will you finance the build?

Construction loans work differently from traditional mortgages. Instead of receiving the entire loan amount upfront, funds are distributed in stages as your home takes shape. And depending on the type of financing you choose, your construction loan may eventually become your permanent mortgage.

How Do Construction Loans Work?

A construction loan is a short-term financing option designed to cover the costs of building a home. This can include expenses such as land, labor, materials, permits, and other approved construction costs.

Unlike a traditional mortgage, which typically provides funds in one lump sum at closing, a construction loan releases money as work is completed.

Here's what that looks like from start to finish.

1. Start With Your Budget and Building Plans

Before applying for a construction loan, you'll need a realistic picture of what your project will cost.

Start by considering:

- The cost of purchasing land, if you don't already own it.
- Architectural plans, permits, and site preparation.
- Labor, materials, and contractor expenses.
- Potential changes or unexpected costs during construction.

Your lender will typically want to review detailed building plans, a construction budget, and an estimated timeline. They'll also evaluate your financial qualifications, including your credit, income, assets, and existing debt.

A little preparation goes a long way. Having a clear understanding of your budget helps you determine how much financing you need and what you can comfortably afford.

2. Choose Your Builder and Finalize the Project

Once you have a budget in mind, it's time to choose a builder.

Your lender will generally need to approve the builder and review the construction contract before financing can move forward. This helps establish

who is responsible for the work, what the project includes, and how much it should cost.

You'll also want to finalize your home design, materials, construction schedule, and estimated completion date.

The more details you have in place upfront, the easier it is to establish a realistic draw schedule and avoid unnecessary surprises.

3. Apply for Your Construction Loan and Close

With your plans, budget, and builder lined up, you can move forward with the loan application.

Your lender will review your financial information, construction documents, and the property's projected value once the home is complete. An appraisal is typically part of this process.

If approved, you'll review your loan terms and complete the closing process.

4. Construction Begins and Funds Are Released in Draws

Here's where construction loans really differ from traditional mortgages.

Instead of receiving all the money at once, your lender releases funds in scheduled installments called **draws**. Each draw corresponds to a specific stage of construction.

For example, your draw schedule might look something like this:

- **First draw:** Land preparation, excavation, and foundation.
- **Second draw:** Framing, roofing, and exterior work.
- **Third draw:** Plumbing, electrical, and HVAC installation.
- **Fourth draw:** Insulation, drywall, and interior finishes.
- **Final draw:** Remaining construction work and project completion.

Before releasing funds, your lender may require an inspection to verify that the work associated with the draw has been completed. Funds are then distributed according to the loan agreement, typically to the builder or other approved parties.

The number of draws and the timing of each payment will depend on your lender, construction budget, and project.

What about your monthly payments?

During construction, borrowers typically make interest-only payments based on the amount of money already disbursed. As additional funds are released, the outstanding balance grows, and so can your monthly interest payment.

This means you're generally not paying interest on the entire approved loan amount from day one.

5. Construction Wraps Up and Your Financing Transitions

The finishing touches are in place, inspections are complete, and your new home is nearly ready.

Now it's time to transition from construction financing to your long-term mortgage.

What happens next depends on the type of loan you chose at the beginning.

Construction-to-Permanent vs. Construction-Only Loans

One of the biggest decisions you'll make when financing a new home is how your construction loan will transition into permanent financing.

There are two common approaches.

Construction-to-Permanent Loan (Single-Close)

A construction-to-permanent loan combines your construction financing and long-term mortgage into one loan.

You close once at the beginning of the project. During construction, the loan operates as short-term financing, with funds distributed through scheduled draws. Once the home is complete and the lender's requirements are satisfied, the loan converts into a permanent mortgage.

Potential advantages include:

- One closing instead of two.
- One set of closing costs, rather than paying for separate construction and permanent loan closings.
- Permanent mortgage terms established upfront, subject to your loan agreement.
- A more streamlined transition when construction is complete.

For borrowers who want to establish their financing before construction begins, this option can offer a simpler path from the first draw to the first mortgage payment.

Construction-Only Loan (Separate Permanent Mortgage)

A construction-only loan covers the building phase but does not automatically convert into a long-term mortgage.

Once construction is complete, you'll need to secure permanent financing to pay off the construction loan. This generally means applying for a separate mortgage, completing underwriting, and going through another closing.

What should you consider?

- You'll typically have two separate closings and sets of closing costs.

- You'll need to qualify for permanent financing when construction is complete.
- Your mortgage rate and available loan terms may differ from what was available when construction began.
- You'll need to account for the additional time and paperwork involved in securing your permanent mortgage.

This approach may offer flexibility depending on your financing needs, but it's important to understand what happens when the construction loan comes due.

The right choice depends on your financial situation, timeline, and long-term plans. Ask your lender to walk you through both options before deciding.

6. Welcome Home!

Once the final requirements are met and permanent financing is in place, you're ready to move into your new home.

If you have a single-close construction-to-permanent loan, your financing transitions according to the terms established at closing. With a construction-only loan, your new mortgage pays off the construction balance.

Either way, your payments transition from the construction phase to regular mortgage payments, which typically include principal and interest.

And just like that, the home you've been planning, budgeting, and watching come together is ready for its next chapter.

Building a home involves plenty of moving parts. Understanding your financing before construction begins can help you approach each milestone with greater clarity and confidence.

About Luminate Bank

At Luminate Bank, we believe your financial journey should feel simpler, clearer, and more rewarding. As a full-service bank and mortgage lender, we bring modern financial solutions and personalized guidance together to help you move forward with confidence. Learn more about our mortgage solutions and find the right path for your next chapter.

Frequently Asked Questions About Construction Loans

How much money do you need to put down for a construction loan?

Down payment requirements vary by lender, loan program, and borrower qualifications. Your required contribution may also depend on the property's value, total project cost, and whether you already own the land. Ask your lender what down payment options are available before finalizing your construction budget.

Do you make mortgage payments while your house is being built?

Construction loans typically require interest-only payments during the building phase. These payments are generally based on the amount of money already disbursed, rather than the full approved loan amount. Once construction is complete and permanent financing begins, you'll typically transition to monthly principal-and-interest payments.

How long does a construction loan last?

Construction loan terms vary, but the construction phase commonly lasts around 12 months, depending on the lender and project. Your loan agreement

will outline the construction period, deadlines, and any options if your project takes longer than expected.

What is the difference between a construction loan and a traditional mortgage?

A construction loan provides short-term financing for building a home, with funds released in stages as construction progresses. A traditional mortgage provides long-term financing for a completed home and typically distributes the loan proceeds in one lump sum at closing. Construction loans also commonly have interest-only payments during the building phase.

Can you use a construction loan to buy land and build a house?

Some construction loan programs allow you to finance both the land purchase and the cost of building your home. Others may require you to own the land before applying or handle the land purchase separately. Your lender can help you understand which options are available.

What happens if construction takes longer than expected?

Your construction loan will have a defined building period, so delays can create financing complications. Depending on your loan agreement and lender, an extension may be possible. It's important to discuss potential delays, extension fees, and completion deadlines before construction begins.

Is a construction-to-permanent loan better than a construction-only loan?

Neither option is automatically better. A single-close construction-to-permanent loan can simplify the process by combining construction and permanent financing into one closing. A construction-only loan provides separate financing for each phase, which may offer flexibility

but requires another mortgage application and closing. Compare the costs, rates, qualification requirements, and timelines before choosing.