

FHA Mortgage Loans - Reference Sheet for Home Buyers

This fact sheet on FHA mortgage loans was prepared by the Home Buying Institute. It is designed to give first-time home buyers a better understanding of FHA home loans and how they work. This fact sheet was prepared on May 10, 2010.

FHA Mortgages Defined

Let's start with a basic definition. An FHA mortgage loan is simply a home loan that's insured by the federal government. This program is managed by the Federal Housing Administration, which is part of the Department of Housing and Urban Development (HUD).

Clarification: Many people believe that the FHA makes the loans, but this is not the case. The federal government does not lend money directly to home buyers -- they just insure such loans. The actual mortgage loan is made by a lender within the private sector, such as Wells Fargo or Citi. The government (through the FHA) insures these loans against losses that result from borrower default.

Benefits of FHA Loans

FHA mortgage loans offer several benefits for home buyers. The biggest benefits are easier qualification and smaller down payments. This is what makes FHA loans so popular among first-time home buyers. Here's the difference:

- **Qualification** -- Generally speaking, it's easier to get approved for an FHA mortgage than a conventional home loan (one that's not backed by the federal government). This is a direct result of the government insurance given to these loans. People with less-than-perfect credit scores frequently use FHA loans for this very reason. It opens a "side door" when other doors are closed.
- **Down Payment** -- You can get approved for an FHA home loan with less money down, when compared to a conventional mortgage. Under the current guidelines, borrowers can put as little as 3.5% down when using these federally insured loans.

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* If you have a credit score below 580, you might have to put more money down -- as much as 10%. So this particular benefit only applies to borrowers above a certain credit level.

These two things are obviously important to home buyers, and that's why FHA mortgage loans are so popular.

Possible Disadvantages

Every financing tool has certain pros and cons associated with it, and that applies to FHA loans as well. While there are certainly some big benefits to these loans, there are also some drawbacks. Or should we say *potential* drawbacks.

Borrowers who use FHA mortgage loans will typically have to pay an upfront mortgage insurance premium (UFMIP). This is similar to private mortgage insurance / PMI, but it's a single lump-sum amount that's added on to your closing costs. This premium is usually equal to 2.25% of the mortgage amount. *Example:* on a loan of \$250,000, the UFMIP would equal \$5,625.

If you use an FHA mortgage loan to buy a house, you'll be required to pay mortgage insurance on the loan (in addition to the UFMIP mentioned above). You will have to pay for this insurance regardless of how much money you put down. This will increase the size of your monthly payment. With a conventional loan, on the other hand, you can avoid paying mortgage insurance by keeping your loan-to-value ratio below 80%.

In a seller's market, where the homeowner is likely to receive multiple offers from buyers, an FHA loan could put you at a disadvantage. This is because the Federal Housing Administration has stricter requirements for the condition of the property (when compared to a conventional loan). This means the seller might be required to make more repairs to the property, in order for your loan to be approved. If a seller gets an equal offer from a buyer with a conventional / non-FHA loan, they may very well choose that offer over yours.

People who use FHA mortgage loans generally pay a higher interest rate than borrowers who use conventional loans -- with all other things being equal. Since the interest rate is part of the monthly payment, this would increase the total monthly cost of the loan.

Summary of Pros and Cons

So let's recap what we have discussed so far. The key *advantages* of FHA loans are (A) easier qualification and (B) a smaller down payment. These are strong incentives for people with shaky credit and/or little money to put down.

The *disadvantages* include higher insurance costs, in the form of the upfront mortgage insurance premium as well as the annual premium. In a seller's market, an FHA mortgage loan could also put the buyer at a disadvantage, by increasing the repair costs for the seller. Some listing agents go so far as steering their clients (sellers) away from buyers with FHA loans. Of course, if yours is the only offer, this becomes less of a concern. Additionally, you may have to pay a higher interest rate on your loan, when compared to a conventional loan.

Note: These are not the *only* pros and cons associated with FHA mortgage loans. They are simply the ones we feel are most important for home buyers to understand. Every home-buying scenario is different, so you may encounter other advantages or disadvantages not listed here.

Loan Requirements

If you're thinking about using an FHA loan to cover a home purchase, you must also be familiar with the guidelines and requirements for these loans. Here they are in a nutshell:

Lending limits: FHA mortgage loans have lending limits that vary by region. These limits are also based on whether the home is a single-family or multi-family residence. You can find mortgage limits for your area by visiting this section of the HUD website:

<https://entp.hud.gov/idapp/html/hicostlook.cfm>

Down payment: As mentioned earlier, you will be required to make a down payment of at least 3.5% of the purchase price. During the course of your research, you might find websites that still mention 3% as the minimum down payment. This used to be the case in the past, but the FHA raised the minimum down-payment requirement to 3.5% in 2009.

Credit score: Historically, the FHA did not have a minimum credit score requirement. But in January 2010, they announced a change to that policy. Going forward, borrowers must have a FICO credit score of *at least* 580 to qualify for the 3.5% down payment. Borrowers with scores *below* 580 will have to make a down payment of at least 10%.

Mortgage Application Process

So how does one apply for the FHA mortgage program? The first thing you need to do is locate an FHA-approved lender in your area. In order to participate in this program, a lender must be approved by the Federal Housing Administration. You can find one by doing a city search on the HUD website. Here is the link:

<http://www.hud.gov/ll/code/llslcrit.cfm>

If you don't want to type that long web address, you can simply do a Google search for the phrase "find FHA lenders." You'll find the relevant section of the HUD website at the top of the list.

As with any mortgage application, you'll be required to provide certain financial documents when you apply for the FHA program. These documents may include the following:

- Your pay stubs for at least the last month. They need to show your year-to-date earnings.

- Your W-2 / tax filings for at least the last year. Some lenders require two years.
- If you're collecting Social Security or pension payments, you'll need to provide documented proof of that income.
- Your bank statements for at least the last two months. The lender will also want to see your current bank balance, to make sure you have sufficient funds to cover your first few mortgage payments.
- If you have any investments, the lender will want to see account statements. If you earn supplemental income from your investments, it will help you get approved for the loan.
- A copy of the purchase agreement / sales contract for the house you are buying. It should include the listing agent's name and contact information.

This list of documents is a bare minimum. Depending on the lender you work with, you might have to provide additional documents. But if you can round up all of the items listed above, you'll be off to a good start.

Tips from the Home Buying Institute: Before you apply for an FHA mortgage loan, we recommend that you establish a [home-buying budget](#) for yourself. This will prevent you from taking on too much mortgage. Believe it or not, it's possible to be approved for a loan that's too big for you. It happens all the time.

It's also a good idea to start saving money for your closing costs and other expenses. Most lenders will review your bank statements to see how much cash you have in reserve. They want to make sure you can cover your first payments, among other expenses.

Where to Learn More

If you are considering an FHA mortgage loan, you owe it to yourself to do plenty of research. The more research the better. Here is some recommended reading to get you started:

<http://www.hud.gov/buying/loans.cfm>

<http://www.homebuyinginstitute.com/mortgage-types-26.php>

Disclaimer: This information is intended for a general audience. This document should not be viewed as specific financial advice. Please do not make any financial decisions based solely on this document. We encourage you to continue your research well beyond this website / fact sheet.

