FHA Loans vs. Conventional Loans

It may not always seem clear whether to apply for a FHA loan or conventional loan. FHA loans have typically been known as loans for first-time homebuyers, filled with extra paperwork and complexity since it's a government-insured program. But borrowers can use multiple FHA loans for purchasing or refinancing a home loan. However, FHA loans may not be used for second homes or investment properties.

As a borrower, the additional paperwork for FHA loans is minimal and probably undetectable. The appraiser does have an additional duty to point out any health and safety hazards that are present and require them to be fixed prior to closing. The difference in processing time required for FHA loans — as compared to conventional loans — is negligible.

The major advantage to selecting an FHA is that easier credit standards must be met to obtain financing. Typically, FHA requires a lower down payment amount, lower credit scores are allowed, less elapsed time is needed for major credit problems (foreclosures and bankruptcies) and, if needed, you can use a non-occupant co-borrower (who is a relative) to help qualify for the loan using blended ratios. Blended ratios are debt-to-income ratios that equally blend the borrower's and non-occupant co-borrower's income and monthly payments to qualify for the loan. Conventional loans do not allow non-occupant co-borrowers.

FHA loans also have some nice features that conventional do not. FHA loans are eligible for "streamline refinances" — which is a cheaper and quicker way to refinance your loan in a low interest rate period. FHA loans are normally priced lower than comparable conventional loans.

Also FHA loans are assumable loans; this may be a particularly good future resale point if the borrower would have an existing low interest rate on the home they are selling. That interest rate and mortgage balance can be assumed by a new buyer. Conventional fixed rate loans do not offer this feature.

Conventional loans also have advantages in certain situations. If you make a 20 percent or more down payment for your home, you will not have to pay mortgage insurance to obtain your loan. An FHA loan -– no matter the amount of down payment — requires an upfront premium and also a monthly premium. Even if you put down less than 20 percent, the private mortgage insurance (PMI) charged to obtain the loan is a lot less than the FHA premiums and even less if your credit is good.

Private mortgage insurance is not only credit-sensitive, but it drops off much more quickly than FHA insurance at lower loan-to-value ratios. Conventional mortgage insurance will fall off automatically when the loan is paid down to 78 percent loan to value (LTV), whereas the FHA premiums will exist throughout the life of the loan.

Source: Zillow

Conventional loans can also be used to purchase investment property and second homes. Conventional loans are also used to do jumbo loans — which are loans that exceed the statutory limits. Currently the maximum county limit in high-cost areas is $625,500.

The following examples will give you an idea of the differences in interest rates, monthly payments, mortgage insurance charges, and down payment requirements for different loan-to-value ratios and FICO scores.

FHA Loan Advantages

- Less down payment required (3.5 percent minimum vs. 5 percent minimum)
- Can go as low as 500 credit score (620 minimum for conventional)
- Not limited to 43 percent for debt-to-income ratio (qualified mortgage rule applies for conventional loans)
- FHA loans are assumable
- FHA loans are eligible for ”streamline” refinances
- Shorter timeframe following major credit problems (3 years vs. 7 years for foreclosure and 2 years vs. 4 years for bankruptcy)
- FHA loans typically will have a lower base interest rate than a comparable conventional loan
- Non-occupant co-borrower (relative) may be used for qualifying by blending ratios

Conventional Loan Advantages

- Mortgage insurance is required for loans exceeding 80 percent loan-to-value (Mortgage insurance is required on all FHA loans regardless of the loan-to-value)
- Conventional mortgage insurance is only monthly or single premium (FHA is upfront and monthly premiums)
- Conventional mortgage insurance will automatically end at 78 percent loan-to-value (FHA will stay for the entire life of the loan)
- Conventional mortgage insurance is credit sensitive (For FHA, one premium fits all)
- Conventional loans can cover much higher loan amounts (FHA over county limits)
- Conventional loans cover more types of loans (FHA doesn’t do investment or second homes)
- Even though conventional loans may have higher interest rates, their monthly payments may still be lower

Source: Zillow