

GETTING
STARTED

FINDING & BUYING A
HOME

MOVING
INFORMATION

HOME BUYER'S
BLOG

FIND A BUYER'S
REP



THE PROS AND CONS OF AN FHA MORTGAGE

By: REBAC Staff **Posted:** 09/25/2017

An FHA mortgage is a loan secured by the Federal Housing Authority—a branch of the U.S. Department of Housing and Urban Development (HUD). Its goal is to help lower income individuals be able to purchase a home, by reducing upfront costs, credit requirements, and other barriers to homeownership.

Smaller Down Payment

Are you cash poor? FHA loans only require a 3.5 percent down payment, compared to a minimum down payment of 5 to 20 percent on conventional loans. The down payment can be made with a gift from a family member or even a close friend... so long as they don't expect the money to be repaid (and are willing to sign papers to that effect).

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Downside: Lower down payments may mean you will have to carry mortgage insurance for years, which can be expensive. If your down is at least 10 percent, your monthly insurance payment (MIP) can be removed after 11 years. Otherwise, it will continue for the life of the loan.

Mortgage insurance usually entails both an Up Front Mortgage Insurance Payment (UFMIP) of 1.75 percent of the base loan amount, as well as a Monthly Insurance Premium (MIP) thereafter. (MIP rates vary.) Be sure to consider these costs when calculating your budget to buy a home with an FHA loan.

Removing Other Barriers

FHA loans require that you have only ONE month of living expenses in reserve to purchase a single-family home. So, even if your nest egg is tiny, you may qualify.

If you've had a temporary issue with your credit score, or if your debt ratio is high, you may still be able to get an FHA loan. Find a lender that offers manual underwriting if an illness or extenuating circumstances has impacted your credit score, or, if you need consideration for a higher (up to 50 percent) debt-to-income ratio.

Downside: Homeownership tends to involve unanticipated costs; so buying a home with extremely limited liquid assets can be dangerous. When taking on a mortgage, it's best to have a few months of essential expenses in the bank (six months or more, if you can swing it).

Without this cushion, even a small financial setback can become a serious problem. This is even more important if your debt-to-income ratio was already high, prior to adding a mortgage. Also, be sure that past credit issues aren't something you expect in your future.

Flexibility With Closing Costs

Closing costs are another expense that has more flexibility with the FHA loan. If your seller is willing to help foot the closing costs, FHA lenders will allow that up to 6 percent of

the price of the home—which is usually enough to cover all the closing costs.

Downside: Realize there is no free lunch. If a seller is covering the closing costs, they are probably including that expense in the cost of the house, meaning that you will be financing a larger loan and will be paying more interest and more mortgage insurance on the life of the loan.

HUD Standards

Since the property serves as collateral for the loan, HUD requires that it meet certain standards for the health and safety of the inhabitants, as well as the soundness of the property. Minor cosmetic issues should not be a problem, but this depends on the individual doing the inspection.

An appraiser, using the [HUD Uniform Residential Appraisal Report](#), will inspect the property prior to loan approval. In addition to safety issues and structural concerns, the property could be rejected if it's too close to an airport, has gas or oil wells onsite, has heavy traffic noise, or is near high-voltage power lines or a radio/TV transmission tower.

Downside: If you're looking for a fixer-upper, this may not be the best loan type for you. (Instead, consider FHA's 203K loan, which is intended for the purchase of homes in need of significant repairs.) If the home you want doesn't pass HUD Standards, you can work with the seller to make the improvements. This might require raising the selling price to "reimburse" the seller at closing, which will increase your expenses for the life of the loan.

It's also important to note that HUD loans are limited, based on the sales price of properties, which varies based on the area where the property is located.

An FHA loan can get you into a house and out of the rental market—and it may be a great deal, depending on the interest rates. If you are unable to provide a sizeable down payment, you may want to consider refinancing your FHA loan, once your equity or your financial situation will allow—if only to eliminate the monthly mortgage insurance payment.

On the other hand, it may be a good idea to keep it (especially if interest rates rise), since FHA loans are assumable, making this an attractive asset to a potential buyer.

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