

Your Guide to FHA Loans - Making Mortgage Approval Easier

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Chapter 1 - What are FHA Loans?

If you're looking to buy a home but have a poor credit rating, or you can't get together enough cash to pay a substantial down payment, then you might find you're denied access to mainstream mortgages from most lenders. However, there is another option available that can help you to finance your new home, and that is a popular product known as an FHA loan.

FHA stands for Federal Housing Administration, the branch of government that set up this kind of loan way back in the 1930s, when the Depression meant that foreclosures and defaults were extremely common. Loans taken out under FHA rules provide insurance to protect the lenders from losing out if a borrower fails to pay back the mortgage, and this means that lenders are willing to grant loans to a wider range of people.

The upshot of this is that you don't need to have a perfect credit rating to enjoy the benefits of home ownership, so long as you can meet the other restrictions and requirements to apply for an FHA mortgage, and these requirements are covered in this ebook.

Chapter 2 - Benefits and Disadvantages of FHA Loans

Although in theory FHA loans are suitable for people of all backgrounds and circumstances, their unique features make them particularly attractive to first time buyers and those with poor credit ratings. This is mainly down to the following benefits.

Small Down Payments

Conventional home loans often require a down payment or deposit of around 20% of the property's sale price, and this can be difficult to raise for many people. It is especially a problem for people buying their first property, who do not have the benefit of equity built up through price rises on an existing home.

FHA loans, on the other hand, can be taken out with a down payment of just 3.5%, making buying a first property a much more achievable aim. However, making such a small down payment is not necessarily recommended for various reasons, as will be covered a little later.

Relatively Relaxed Credit Score Requirements

The major feature that distinguishes FHA loans from conventional ones is the legal requirement to have sufficient mortgage insurance in place as part of the deal. This means that issuers of FHA loans are taking much less of a risk than with conventional lending - if the customer fails to keep up with their payments for whatever reason, the insurance will cover any loss to the lender. This safety net makes the loan companies much more relaxed about which applications they will approve, and so people with lower credit scores still have a good chance of being successful.

Under the most widely used credit scoring system, known as FICO, a credit score can lie within the range of 300 to 850, with the higher end indicating a better credit rating. Around a third of Americans have a score of 750 or above, with the average generally lying between 700 and 750 although this changes from year to year. People with scores below about 620 are considered to have less than prime credit ratings and can struggle to be approved for conventional finance. With FHA loans, applicants with scores as low as 500 can still be approved, as long as the other criteria are met.

An Assumable Mortgage

A final benefit of FHA loans is that they are 'assumable'. This means that if you come to sell your home, the outstanding mortgage can be sold as part of the deal, with the buyer taking on the remaining debt and repayments (if the lender agrees). This can make it easier to sell a property, as it removes the need for a buyer to arrange a new mortgage, potentially saving thousands of dollars in fees as well as making the closing process more straightforward.

The Disadvantages of FHA Loans

If, so far, an FHA loan seems like an ideal solution to your home financing needs, it's only fair to point out that this type of finance does, unfortunately, have several drawbacks to set against the positive aspects.

Mandatory Mortgage Insurance

Every FHA loan needs to have mortgage insurance taken out to protect the lender. While conventional mortgage lenders will usually also require some form of insurance to be taken out, under the FHA system the details are more strictly controlled, and the costs can be higher. Under most conventional loans, the insurance can be cancelled once a certain level of equity has been achieved, but this isn't so with FHA loans. Depending on the size of the down payment made, the insurance policy must be kept up for either 11 years or for the lifetime of the loan, regardless of equity. The next chapter will cover mortgage insurance in more detail.

The Downside of Low Down Payments

Although the ability to make a down payment as low as 3.5% can be seen as a powerful benefit, doing this isn't necessarily a good idea for your long term finances. A low initial deposit means that more of the loan principle needs to be paid off in installments, which will take longer and

attract more interest. Over the life of a loan, these extra interest charges can add up to a considerable sum. Making the higher 10% down payment will reduce this effect, but it will still work out considerably more expensive than making the traditional 20% payment many conventional loans demand.

Property Approval Requirements

A final drawback to FHA loans is that the mortgaged property must meet a certain standard and needs to pass an assessment by an approved appraiser. While most of the requirements are sensible and are concerned with health, safety, and the overall soundness of the property, the restrictions do mean that it's more difficult to pick up a run-down property at a bargain price and then carry out improvements yourself over time. It can also complicate and extend the buying process, so a seller who needs a quick sale may be reluctant to deal with a buyer using an FHA loan for finance.

Chapter 3 - Mortgage Insurance

It is the requirement for mortgage insurance that sets FHA loans apart from conventional mortgages, and makes them available to a wider cross section of applicants. While the exact rules covering what kind of insurance is required are a little complicated, the basic requirement is that two forms of insurance need to be taken out with every FHA loan.

Upfront Mortgage Insurance Premium (UFMIP)

This first type of insurance is a one-time lump sum paid when the loan is taken out. It is calculated as 1.75% of the property value, and this figure doesn't change according to credit score. This fee can either be paid in full during the closing process, or it can be folded into the loan amount, although this will be more expensive as interest will be payable on it.

Annual Mortgage Insurance Premium (AMIP)

Despite its name, this premium is actually paid monthly as part of your regular loan repayments. The exact amount charged will vary according to the size of the loan, the term of the loan, and the size of the down payment made. Typically, the charge will work out at around 0.8% of the loan amount each year, which is then split across 12 monthly payments. Be sure to check with your loan adviser how much your monthly premium will work out at, as it can be a significant addition to your basic mortgage payment amount.

FHA loans taken out since June 2013 will need the AMIP to be paid for a minimum of 11 years, with shorter terms and smaller down payments meaning the insurance needs to be kept up for the life of the loan.

As well as compulsory mortgage insurance, FHA loans have several other requirements which need to be met, and these will be outlined in the next chapter.

Chapter 4 - Standard Approval Criteria

Although FHA loans are a lot easier to be approved for than conventional mortgage loans, there are still several fixed criteria which need to be satisfied for an application to be successful. These requirements are laid down by the Federal Housing Authority, and are the same whichever lender you choose to take your loan from.

Some of these conditions apply to people with less than perfect credit ratings, and are an important part of what makes FHA loans so attractive in some situations. These will be examined in greater depth in the next chapter.

Other requirements apply to all applicants, and include the following.

Your Employment History

To make a successful application, you should have a steady, consistent employment history to show that you are likely to be able to keep up with the loan repayments. If your employment record has been a little patchy in the past, this can be overcome by having been working for the same employer for at least the last two years.

Your Legal Status

To qualify for a FHA loan, you must be a legal resident of the United States, you need to have a valid social security number, and you must be of the age of majority for your state and be legally able to take out a mortgage.

Making a Down Payment

All FHA loans require a down payment to be made before the loan is paid out, but the required amount is a lot less than with conventional finance. The minimum figure is 3.5% of the property purchase price, but it is generally recommended that 10% is paid as this gives several advantages, such as less stringent mortgage insurance requirements and a lower interest rate.

Affordability

With the emphasis of FHA loans being so firmly on providing finance to people denied conventional mortgages, there are some strict affordability tests in place to help prevent people from over-extending themselves by taking out an FHA loan.

Firstly, you must be able to show that the combined costs of your FHA loan repayments, property taxes, mortgage insurance, home insurance, and other charges directly related to your home ownership together account for no more than 31% of your gross income. In some circumstances, this figure can be raised as high as 40% of gross income, but the lender must provide a written statement to the FHA explaining why they consider this to be an acceptable risk.

Similarly, when your other debt is taken into account as well (credit cards, student loans, car finance etc), your total monthly repayments must come to no more than 43% of your gross monthly income. This can be raised to 50% in some cases, but again this will rely on the FHA accepting the lender's written reasons why easing this restriction is justified and how it poses an acceptable risk.

Property Approval

As previously mentioned, the property the loan is secured on must meet certain standards defined by the FHA, and must pass an inspection by a qualified assessor. The purchase price of the property should also be below a figure that varies from state to state, and should be at a reasonable level compared to other properties on the market.

If you satisfy the above requirements and have a fair credit rating, then you can make your application with reasonable confidence of success. However, if you have some serious negative information on your credit file, then some further time limits and conditions apply, as discussed in the next chapter.

Chapter 5 - Bad Credit Considerations

One of the attractive features of FHA loans is their relative accessibility to people with poorer credit ratings. Unlike mainstream mortgage loans, a FICO score of 500 and above can be enough for approval, providing a down payment of 10% can be made and all the other necessary criteria are met. However, the benefits for those with damaged creditworthiness go beyond that, and even serious black marks on your record needn't rule out approval.

Foreclosures in the Past

With a conventional mortgage loan, having previously been subject to a home foreclosure is more or less a kiss of death - few lenders will be interested in a borrower who has defaulted on a property loan recently enough for this to show up during a credit search. Even if you can find a loan provider who is willing to accept your application, the interest rates and other terms and conditions are likely to be very unattractive indeed.

With FHA loans, the situation is a little different: if the foreclosure was completed at least three years ago, and your credit file contains no major negative entries in the meantime, then an FHA loan can in principle be approved. It is even possible to have this three year limit reduced if you can show that the foreclosure was caused by exceptional events that the FHA consider to be a reasonable explanation.

Such circumstances include the serious illness or death of the primary wage earner, although repossessions brought about by relocation, divorce, or simple financial misfortune are generally

not treated as extenuating circumstances. Even if the FHA accepts the mitigating circumstances provided, a good credit history needs to have been re-established in the meantime.

Bankruptcy

Similarly to foreclosure, a bankruptcy in the past is not necessarily an end to your chances of approval for an FHA loan. If you're two years clear of bankruptcy, and have acted in a responsible way with your finances since then, your former insolvency will not count against you. This two year clearance period may be reduced to just one year if the bankruptcy was genuinely caused by exceptional circumstances beyond your control, although this is something of a grey area that needs to be considered on a case by case basis by the FHA.

Credit Counselling

A similar situation applies when it comes to being part of a credit counselling program. So long as you have kept up with your payments under the plan for at least a year, this form of poor credit history will not normally be considered as a serious black mark against your application.

However, even though the FHA loans criteria allow for applications to be approved in all these circumstances, there is no guarantee that a particular lender will be willing to issue a loan regardless, and the interest rate offered will likely be higher on any approved applications.

CHAPTER 6 - Applying for FHA Loans

Only federally approved lenders are allowed to offer FHA loans, and so to begin the process of applying you need to find a lender in your area using the tool provided by the United States Department of Housing and Urban Development (HUD) website at <http://www.hud.gov/ll/code/llslcrit.cfm>

Note: the FHA does not offer loans itself, it only sets out the framework under which the loans are provided. Different lenders will offer different rates and conditions, with different options such as fixed or variable rates. Just as with conventional mortgages, it pays to shop around before making a choice, comparing the quotes from several individual lenders. This can be done online, or by using the services of a reputable loan agent in your area.

Before you start the loan application, make sure that you have met all the criteria covered in earlier chapters, and can provide the necessary down payment. At this stage, it is not necessary to have found a property to buy, as you can apply for pre-approval, which means that you'll be granted a loan in principle for a certain amount, giving you a good indication of what level of property you can look for.

Once you're ready to make your application, your loan adviser will provide you with the necessary forms and will help you to fill in the application correctly, as well as making sure you supply all the documents you need to support your application. When filling out the form, take

great care to answer everything truthfully and accurately. If you're unsure about anything, check with your adviser - knowingly supplying incorrect information on any federal form is a criminal offence.

If your application is approved, and the property you want to buy passes its appraisal, you'll be given the final documentation to sign. Take a moment before doing this, as once you've signed you'll be committed to the mortgage, and can only have it cancelled by either paying it off in full or going through foreclosure, with all the problems that will cause.

Although the full list of requirements and rules surrounding FHA loans can seem complicated, if your credit history or financial status means that getting a regular mortgage is difficult, then an FHA loan could be a solution that lets you enjoy the benefits of home ownership, and can be a stepping stone towards a more mainstream mortgage in the future.