The most mortgage for your money: VA, FHA or conventional?

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This is the second in a series on mortgage programs for veterans. This article compares U.S. Department of Veterans Affairs (VA)-guaranteed mortgages with Federal Housing Administration (FHA)-insured mortgages and conventional mortgages.

To learn about the various requirements of VA-guaranteed mortgages, see Part I of this series: VA mortgage basics.

Weighing mortgage options

First-time homebuyers have many mortgage options, especially if they are current or former active duty members of the armed services. What's the best way for a mortgage loan originator (MLO) to compare the various features of **U.S. Department of Veteran Affairs (VA) mortgages** with other mortgage options?

First, the **MLO** interviews the prospective homebuyer to find out their financial situation, then they survey the options available from lenders.

To read about VA mortgage qualifications, see the first article in this series: VA mortgage basics.

The MLO gathers information

A prospective homebuyer meets with their MLO agent to discuss purchase-assist financing options. Since the homebuyer has little knowledge of their mortgage options, the MLO begins by asking the homebuyer questions about their finances and other circumstances to ascertain what type of mortgage is best for the homebuyer.

The MLO asks the homebuyer several questions to obtain pertinent information for mortgage placement. The following information is determined:

- the homebuyer served in **active duty** for more than 180 days in the regular military;
- the homebuyer is a first-time homebuyer, and thus has no mortgage debt;
- the homebuyer's current rental payments are about $900 per month;
- the homebuyer has been employed at their current job for five years;
- the homebuyer's gross monthly income, averaged over the last two years, is $3,500;
- the homebuyer makes a $200 monthly car payment, and has made these payments on time;
- the homebuyer now keeps a balance of less than $100 on both of their credit cards, but had one 30-day late payment in the two years prior to the application due to a past financial difficulty;
- the homebuyer wants a **30-year fixed rate mortgage (FRM)**, and does not want to review adjustable rate options;
- the homebuyer wants to put as little down as possible to keep more money in their emergency household reserves;
- the homebuyer has a 640 credit score;
- the homebuyer has no other financial debts (e.g. student loans, alimony, child support, etc.); and
- the homebuyer has savings of $15,000.

The homebuyer also indicates a general geographic area they want to target in their home search.

Based on the information received, the MLO discusses possible mortgage options with the homebuyer. Since the homebuyer has limited savings, the MLO informs them after closing costs and reserve requirements, the homebuyer would only be able to make a small down payment.

Therefore, their options are limited to taking out:

- an **FHA-insured mortgage** with a minimum 3.5% down payment;
- a **conventional mortgage** with a minimum 3% down payment, as allowed by Fannie Mae and Freddie Mac; or
- a **VA-guaranteed mortgage** with no minimum down payment.

The MLO begins their calculations to give the homebuyer options.

Calculate mortgage options: FHA or conventional?

The MLO first determines the homebuyer's maximum **debt-to-income ratio (DTI)**. The MLO uses the FHA standard for total DTI, which is 43% of the homebuyer's $3,500 gross effective income.

Thus, the maximum total monthly expenditure allowed for all debts is approximately $1,500. The maximum monthly housing expenditure would be capped at 31% of the gross effective income, which is around $1,085.

Based on the homebuyer's preference for a 30-year fixed rate purchase-money mortgage, the MLO determines the homebuyer's **up-front mortgage insurance premium (UFMIP)** is 1.75% and their **annual MIP** is 0.85% of the mortgage balance for an FHA-insured mortgage.

Lenders require conventional mortgages with down payments smaller than 20% to be insured by **private mortgage insurance (PMI)**. Conventional mortgages requiring PMI are mainly different from FHA-insured mortgages in that they have:

- more stringent credit score requirements than FHA-insured mortgages;
- lower premium rates with higher down payments;
- higher (pre-insurance) mortgage rates than FHA-insured mortgages.

Additionally, unlike the FHA's MIP, PMI can be removed when the mortgage reaches an 80% loan-to-value ratio (LTV). For FHA-insured mortgages, the removal of the MIP depends on the original LTV:

- an LTV greater than 90% requires the MIP to remain for the life of the mortgage, or 30 years, whichever occurs first; or
- an LTV less than or equal to 90% allows the MIP be removed after 11 years.

Thus, a conventional mortgage with PMI offers homebuyers some additional advantages over the FHA's MIP. However, the MLO also reviews current PMI and MIP rates. As of the second quarter of 2015, these rates are:

- 0.85% for an FHA-insured mortgage; and
- 1.31% for a conventional mortgage.

Therefore, it is less expensive to take out an FHA-insured mortgage than a conventional mortgage with the same 3.5% down payment. Now the MLO can narrow the veteran's mortgage search to FHA or VA.

FHA-insured or VA-guaranteed mortgage?

The MLO uses a 1.5% estimate to determine taxes and insurance on the property, and a 3.75% interest rate based on interest rates available from the lenders the MLO does business with on a no-points, no-fees FHA-insured mortgage.

The MLO then calculates the homebuyer's maximum purchase price at $160,000. With a 3.5% down payment of $5,600, the base mortgage amount would be $154,400. After financing the up-front MIP of $2,702 ($154,400 base mortgage amount x 1.75% up-front MIP), the **final FHA-insured mortgage amount is $157,102**. The resulting payment is around $1,037, slightly below the 31% housing DTI.

With the maximum payment of $1,037, the $200 car payment, and their minimum $40 monthly credit card payments, the homebuyer's total monthly debt would be $1,277 at a 37% total DTI.

Under the FHA-insured mortgage, the homebuyer down payment of 3.5%, or $5,600, plus the estimated **closing costs** of approximately 4%, or $6,400, will leave the homebuyer with a $3,000 cushion in their savings.

The MLO then completes a similar analysis for the *VA-guaranteed mortgage*. The maximum total DTI guideline for a VA-guaranteed mortgage is 41% of the homebuyer's income, which is $1,435. However, since VA-guaranteed mortgages give qualified homebuyers the ability to purchase a home with no down payment and no mortgage insurance, the homebuyer's **purchasing power** has increased.

On a VA-guaranteed 30-year fixed rate mortgage with a 3.75% interest rate, and no discount or origination fees, the homebuyer has a **maximum VA mortgage purchase price of $178,000.** However, the VA **funding fee** is usually financed (but can be paid in cash at closing). Since the homebuyer chooses to finance the funding fee, the monthly mortgage payment is roughly the same as the comparable FHA-insured mortgage: $1,047.

The MLO then checks to make sure the homebuyer still qualifies under the second prong of the VA income qualification standard: **residual income**, defined as the income remaining to cover family living expenses (e.g. food, gasoline) after subtracting monthly shelter expense. [VA Pamphlet 26-7 Chapter 4.9.e]

The homebuyer lives in the West, and is unmarried, without children. Thus, the veteran needs to have a *residual income* of at least $491.

Since the homebuyer's **gross income** is $3,500, their total monthly debt, including estimated federal and state taxes, will leave them around $1,500 in residual income.

Based on the MLO's review of the homebuyer's files and their discussion with the homebuyer, the MLO believes there are no additional expenses to significantly reduce this residual amount and cause the homebuyer to no longer qualify.

Under the VA-guaranteed mortgage, the homebuyer will have to pay a VA **funding fee** of 2.15%, or $3,827 ($178,000 mortgage amount x 2.15%), which the homebuyer chooses to finance, including it in the monthly mortgage payment. Just like the FHA-insured mortgage, the veteran will also have to pay *closing costs* of roughly 4%, or $7,120. This leaves the veteran a total cushion of $7,880 in savings.

The MLO knows the total payment is reduced if the homebuyer determines they will purchase a home for less than the $178,000, or if the homebuyer negotiates with the seller to pay some of the closing costs, options any buyer's agent needs to consider when preparing a purchase offer.

Multiple mortgage applications find the best terms

The MLO surveys the options available from three lenders the MLO regularly does business with, in accordance with the rules prohibiting steering. They come up with several different options for their homebuyer, and present them, along with their logic in the analysis for an FHA-insured mortgage vs. a VA-guaranteed mortgage.

It is best for the homebuyer to submit mortgage applications to at least two lenders to ensure they receive the best mortgage terms. Just like consumers shop for the best deal on a car, shopping around for a mortgage yields the best and most competitive mortgage terms available. Further, without a backup application concurrently processed by another lender, the buyer is left with no opportunity to reject any lender changes.

Our homebuyer reviews the neighborhood in which they are shopping and finds a home with a list price of $170,000.

The homebuyer thus chooses the VA-guaranteed mortgage, since at a $170,000 purchase price, they are able to afford more property at a lower monthly payment. With the FHA-insured mortgage, the homebuyer would have only qualified for $157,102, far below their eventual purchase price.

For more on VA-guaranteed mortgages, see ***Part I*** *of this article series.*

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