

# WHAT IS A **CONVENTIONAL LOAN?**

EVERYTHING TO KNOW ABOUT  
AMERICA'S FAVORITE MORTGAGE





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# Conventional Mortgage

## What is a Conventional Loan?

A conventional loan is a mortgage that's available through and backed by a private sector lender. Government-insured loans, by comparison, are backed or guaranteed by a federal agency. These include *FHA loans*, *VA loans* and *USDA loans*.

Conventional mortgages are available through different types of mortgage lenders, including banks, credit unions and online mortgage companies. They come in two main types: *fixed-rate* or *adjustable-rate*.

- **Fixed-rate mortgages:** Your interest rate never changes. You have the same monthly principal and interest payment for the length of the loan.
- **Adjustable-rate mortgages:** You'll have a fixed introductory rate for the first three to 10 years of the loan. Then, the rate will change at preset intervals, such as every year or six months, based on an index rate plus a margin determined by the lender.



# Conventional Loan Requirements

To be approved for any type of mortgage, you'll need to meet the lender's requirements around your financials, including your credit score, income and debts. Conventional loan requirements tend to be stricter than government-backed loan requirements. Specific qualifications include:



**Credit Score:** Mortgage lenders require a minimum score of 620 to qualify for a conventional loan. With a higher score, you're more likely to get a better interest rate and terms.



**Debt-to-income (DTI) ratio:** Your DTI ratio factors in other debts you have to pay each month, such as auto loans, student loans and credit card debt. Most lenders don't want this ratio to exceed 43 to 45 percent.



**Down Payment:** While 20 percent down is the standard, many fixed-rate conventional loans for a primary residence allow for a down payment as small as 3 percent or 5 percent.



**Private Mortgage Insurance (PMI):** If you put down less than 20 percent, you'll have to pay PMI, an additional fee added to your payments. The average monthly cost of PMI is 0.46 percent to 1.5 percent of the loan amount, according to an analysis by the Urban Institute.



**Loan Size:** Most conventional loans are also conforming loans: that is, they conform to *Federal Housing Finance Agency* (FHFA) limits on how much you can borrow. These limits vary based on where the property is located. In the majority of the U.S., the limit for 2023 is \$726,200. Certain states (like Alaska and Hawaii) and higher-priced areas (including parts of California) have limits of \$1,089,300.



# Type of Conventional Loans

## Conforming Loans

Mortgages that fall within the FHFA's limits are called conforming loans. This means that they are able to be bought by *Fannie Mae* and *Freddie Mac*, two *government-sponsored enterprises* (GSEs), through the secondary mortgage market. By selling these types of loans to Fannie Mae and Freddie Mac, lenders obtain the capital to continue to make new mortgages.

## Jumbo Loans

Mortgages that exceed conforming limits are called jumbo loans. A type of nonconforming loan, these are loans that can't be sold to *Fannie* or *Freddie*, but they are still available to well-qualified borrowers who need a more flexible financing option. Jumbo loan rates tend to be higher than what you'd see with a smaller mortgage, though the gap has been closing in the last few years.

## Non-qualified mortgages

Non-qualified mortgages, or non-QM loans, also cannot be purchased by Fannie or Freddie, but they can be an option for those who are able to afford a mortgage but maybe are unable to meet the credit or DTI requirements. These borrowers tend to fall outside of the *“ability to repay”* guidelines established by the *Consumer Finance Protection Bureau* after the 2008 financial crisis, which indicate whether a borrower is likely to repay a mortgage.

One type of non-QM loan could be a portfolio loan. With this kind of loan, a lender keeps the mortgage on its books, rather than sell it. Because it doesn't have to meet conforming loan standards, the lender can be more flexible when qualifying a borrower. It's important to note, though, that non-qualified mortgages often come with higher interest rates.

**Conventional Loans**

**vs.**

**Government Loans**

## **How Do They Compare?**





## Conventional vs. FHA Loans

FHA loans, insured by the Federal Housing Administration (FHA), are ideal for borrowers with less-than-perfect credit, but they come with a less-than-ideal cost: mortgage insurance that cannot be removed – unless you make a down payment of 10 percent or more. Even then, you'll have to wait 11 years until you can cancel it. (This applies to loans originated after 2013. The rules are different for older loans).

CONVENTIONAL LOAN	FHA LOAN
3% down payment minimum	3.5% down payment minimum
620 credit score minimum	580 credit score minimum with 3.5% down (500 credit score minimum with 10% down)
45% DTI maximum (in most cases)	50% DTI maximum
Can cancel mortgage insurance with 20% equity	Mortgage insurance includes one-time premium upfront and annual premiums



## Conventional vs. VA Loans

VA loans — guaranteed by the U.S. Department of Veterans Affairs — are available to military service members, veterans and their spouses. There are some additional steps to obtaining this type of mortgage, though, including getting your certificate of eligibility from the VA.

CONVENTIONAL LOAN	VA LOAN
3% down payment minimum	No down payment required
620 credit score minimum	620 credit score or higher (depends on lender)
Can cancel mortgage insurance with 20% equity	Must pay VA funding fee ranging from 0.5% to 3.6%
Can be used for second or vacation homes and investment or rental properties	Can only be used for primary residences



## Conventional vs. USDA Loans

USDA loans — guaranteed by the *U.S. Department of Agriculture* — can be a viable option if your annual income doesn't exceed a certain amount and you're looking to buy a home in an area that meets USDA guidelines.

CONVENTIONAL LOAN	USDA LOAN
3% down payment minimum	No down payment required
Available to anyone who qualifies, regardless of income	Available to low- to moderate-income borrowers (in most counties, the income limit is \$90,300)
Can cancel mortgage insurance with 20% equity	Must pay 1% guarantee fee upfront and annual fees (currently 0.35%)
Property can be located anywhere	Property must be located in a USDA-approved area



## How to Apply for a Conventional Loan

- 1 Check your credit:** Check your credit report, looking for any errors or missing information. Also, review your credit score and take steps to improve, such as paying down debts.
- 2 Save for a down payment:** Conventional loans require a minimum of 3 percent down. For a \$300,000 mortgage, that's \$9,000. Remember, the higher the down payment you have, the more likely you are to get a better deal on your mortgage rate.
- 3 Review your debt-to-income (DTI) ratio:** Your DTI ratio is a measure of how much income you have versus how much debt you owe every month. A good DTI is 36 percent or lower. Some lenders will allow you to have up to 50 percent DTI, but most set a cap of 43 to 45 percent.
- 4 Compare mortgage lenders:** Shop around to at least three different lenders, comparing mortgage lenders to get the best deal.

- 5 **Get preapproved:** Before shopping for a home, you'll need to get preapproved for a loan. A lender will run a credit check and require you to submit documentation proving your income, assets and debt. Preapproval is an agreement in principle to loan you a certain amount of money.
- 6 **Get an offer on a house accepted:** Find a home you like, submit an offer and get a signed purchase and sale agreement.
- 7 **Go through underwriting:** The time between having your offer accepted and closing on your home is for underwriting. This is the process in which you are formally reviewed for the mortgage — a specific sum on a specific property. Your lender analyzes all of the documentation you submitted for the preapproval — sometimes requiring additional information — along with getting the home appraised.
- 8 **Close on the house:** The final step is to meet the seller and the lender at the closing table, where you finalize your home purchase and the mortgage, pay your closing costs and get the keys to your home.

## What are the advantages of a Conventional Loan?

- **Cancellable mortgage insurance:** One of the big pros of a conventional loan is that, even with a small down payment, you won't have to deal with PMI for the duration of the mortgage. Once you have 20 percent equity in the home, you can request to cancel PMI. Also, your mortgage lender or servicer must automatically terminate PMI when your mortgage balance drops to 78 percent of the home's purchase price or at the halfway point of your loan's amortization schedule. To compare, if you had a 30-year FHA loan and made a down payment of less than 10 percent, you'd be paying those insurance premiums for the full three decades (unless you sell the home or refinance into a conventional loan).
- **Flexible repayment timelines:** When you're browsing conventional loans, the most common loan terms you'll find are 15-year and 30-year payback periods. However, some lenders have conventional loan programs, known as flexible-term or flex-term loans, that allow you to choose from a wider range of time frames, typically eight years to 29 years.
- **More financing and property types:** While government-backed mortgage programs tend to come with the owner-occupied requirement (in other words, you have to live in the home), conventional loans are available for second homes and investment properties. Plus, the fact that jumbo loans fall into the conventional loan bucket means that highly-qualified candidates can manage to borrow high sums of money.

## Can you get Down Payment Assistance with a Conventional Loan?

Yes, you can get down payment assistance with a conventional mortgage. There are many different types of down payment assistance — consult with a lender or your local housing agency to see what might be available to you.

## What are the downsides of a Conventional Loan?

- **Rigid requirements:** One of the biggest downsides to a conventional loan is the requirement that the borrower has a credit score of at least 620. (Some lenders ask for even higher.) If your credit could use some work, a conventional loan won't be an option for you until you improve your score. Likewise, lenders tend to stick to that 43 percent DTI ratio limit with a conventional loan, which might shut you out of getting one. Some other loan types, in contrast, have more wiggle room with the DTI ratio.
- **Scrutiny of past hardship:** If you have a foreclosure on your record, you'll need to wait a longer period of time to apply for another conventional loan compared to other types of mortgages. For conventional loans, the timeline is seven years after the foreclosure; for government loans, it's two years or three years.
- **PMI:** Although PMI does get canceled eventually, the fact remains you'll still need to pay the premiums (and hence, a bigger monthly payment) if you put down less than 20 percent. Generally speaking, PMI on conventional loans tends to be more expensive than the MIP on FHA loans (though there's a lot of variance).

## How long do you pay mortgage insurance on a Conventional Loan?

You pay mortgage insurance on a conventional loan until you have at least 20 percent equity in your home. At this point, you can request to have mortgage insurance removed. Lenders are legally obligated to remove PMI when your equity reaches 22 percent of the home's value when the mortgage was written, or at the halfway point of your loan term.



# Let's Chat.

**I'm sure you have questions and thoughts about the real estate process.**

I'd love to talk with you about what you've read here and help you on the path to selling your house. My contact information is below, and I look forward to working with you.

**CORBIN CLAYPOOL**

BRANCH OWNER / PARTNER

9499 N Fort Washington Road  
Suite 103 Fresno, CA 93730



corbin@veromortgage.com



(559) 313-5819



NMLS 1227308



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