Mortgage 101: The Basics of Funding Your Home Purchase

Most first-time homebuyers use a mortgage to finance their home purchase. In fact, only 30 percent of U.S. home purchases in 2021 were paid entirely with cash.[1] But understanding how mortgages work and what type will work best for you can be challenging.

What's a Mortgage?

Put simply, a mortgage is a type of loan used to finance your home purchase.

When you obtain a mortgage loan from a lender, they cover the cost of the home upfront to make up the difference between the sale price and your down payment. You must then pay the lender back in small increments over the loan's term—usually 15 or 30 years.

Your monthly mortgage payment doesn't just go toward the loan's principal—you're paying for other expenses as well.

The Anatomy of a Conventional Mortgage Payment

Principal	Interest	Property Taxes	Homeowners Insurance	Private Mortgage Insurance (PMI)
The core amount that the lender lets you borrow	A percentage of the principal that the lender charges for borrowing	A percentage of your home's value collected by your local government, usually to fund various community services	An amount toward your yearly homeowners insurance premium, which covers potential damages to your home	An amount toward your yearly PMI premium, which covers the lender in case you default*

**PMI is only be included if your down payment is less than 20% of the home's value and will drop off once you've paid that 20%.*

Can Your Mortgage Payment Change?

How consistent your payment remains over the loan's term is primarily determined by the mortgage rate you choose.

If you get a fixed-rate mortgage, then the loan term and interest rate will remain consistent unless you refinance. This means that you may only see payment fluctuations due to changes in property tax rates, homeowners insurance rates, and PMI.

If you get an adjustable-rate mortgage, you may see more substantial fluctuations after the first few years of your loan's term, as the interest rate changes with the markets (typically every six months to a year).[2]

You should carefully review the loan terms to see how far up the interest rate can go, since this can substantially change the cost of your mortgage over time.

Types of Mortgages

Aside from fixed-rate and adjustable-rate mortgages, there are different types of mortgage loans that buyers can choose from based on their needs and qualifications as a borrower.

This list isn't comprehensive, so speak with your advisor about which loans are available for your unique situation.

Conventional Loan	Jumbo Loan	FHA Loan	VA Loan
Conventional loans follow standards put in place by Fannie Mae and Freddie Mac, the federally backed mortgage companies that set underwriting guidelines for home loans. Conventional loans are lower cost but have a higher barrier of entry than some other kinds of loans.	Because jumbo loans exceed FHFA borrowing limits, they're a great option for buyers searching for a home in a high-price market. Since these loans are high risk for the lender, they have more stringent qualifications than other types of loans.	FHA loans are insured by the U.S. Federal Housing Administration. They're designed to help buyers who don't qualify for a conventional or jumbo loan, so their requirements are more lenient.	VA loans are backed by the U.S. Department of Veterans Affairs and are intended for members of the military, veterans, and their surviving spouses that meet the minimum active service requirement detailed on the VA website.[6]
Requirements to qualify:[3]	Requirements to qualify:[3]	Requirements to qualify:[5]	Requirements to qualify:[3]
Down Payment: Minimum 3% down	Down Payment: 5–20% down, depending on the lender	Down Payment: Minimum 3.5% down	Down Payment: No minimum
PMI: Applied if down payment is less than 20%	PMI: Applied if down payment is less than 20%	PMI: None, but buyers must pay an Upfront Mortgage Insurance Premium (MIP) at closing and an Annual MIP for either 11 years or throughout the loan's lifetime	PMI: None, but must pay a funding fee at closing, or roll into the loan
Credit Score: 620 minimum	Credit Score: 680 minimum, with some lenders requiring 720 or more	Credit Score: 580 minimum for maximum financing, but can be 500 to access loans that finance 90% of the home's value	Credit Score: No minimum
DTI Ratio: 50% or lower	DTI Ratio: Varies, but generally 40% or lower	DTI Ratio: 43% or lower	DTI Ratio: 41% or lower, but may be waived if other aspects of borrowing history are strong
Conventional loans follow borrowing limits set by the Federal Housing Finance Agency (FHFA) standards.[3] You can find the most recent limits on the Federal Housing Finance Agency website.	Jumbo loan borrowing limits vary by lender.[4]	The borrowing limits for FHA loans follow FHFA standards.[5]	The borrowing limits for VA loans follow FHFA standards.[6]

When Choosing a Mortgage, Your Financial Health Matters

No matter which mortgage type sounds best at first glance, you must evaluate your full financial picture before looking at houses or pursuing financing.

That means understanding your income, credit score, debt levels, and—most importantly—how a home will further your overall financial goals.

Navigating the home financing process can be a challenge.

A financial professional can help.

Sources

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3. Fontinelle, Amy. "Mortgage Qualifications: How to Qualify for a Mortgage." Credible. October 12, 2021. **www.credible.com/blog**.

4. "Conventional Loans." Consumer Financial Protection Bureau. **www.consumerfinance.gov**.

5. "Federal Housing Administration FAQ." U.S. Department of Housing and Urban Development. October 1, 2020. **www.hud.gov/answers**.

6. "VA Home Loan Limits." U.S. Department of Veteran Affairs. February 9, 2022. **www.va.gov.**