Types of Mortgages

Millions of Americans tuned in to one of the most popular sitcoms for a decade, "Friends." Living in a cramped West Village New York City apartment on top of one other makes viewers wonder, why don't they purchase places of their own?

What sort of loan would each of these characters qualify for or suit their personality? Let's take a fun, entertaining deep dive into the types of mortgages available.

The Rachel Green or the conventional loan is like the girl next door. The closest you can get to a standardized mortgage. The conventional loan is the most popular and common type of mortgage offered by lenders that are not backed or guaranteed by the federal government, unlike FHA, VA, or USDA loans. These loans are sold on the secondary mortgage market by Fannie Mae and Freddie Mac to free up money so more people can take out loans to buy houses.

Conventional loans are often the best option for borrowers with stable job histories, a minimum credit score of 620, a 3% down payment, a debt-to-income ratio of less than 43%, and you are borrowing up to a maximum of $548,250.

If you choose to put less than 20% down or cannot afford to, you will be asked to pay for private mortgage insurance. This insurance for lender protection if you default on your payments and the home goes into foreclosure. Putting less than 20% down deems you a higher-risk borrower. Private mortgage insurance adds 0.5% to 1% on top of your mortgage payment.

The good news is, just like our "Runaway Bride" who couldn't commit, she finally does when she has a child. It's no different for the banks. Once you have met that 20% equity threshold, the bank is now ready to eliminate this PMI penalty fee and commit to you.

Conventional loans are used for a primary residence, second home, or investment property.

In obscene markets like the "Friends" West Village apartment, the maximum threshold amount of $548,250 can be slightly higher but not enough to afford a 1-bedroom apartment. (Sigh)

Thus, most loans originated in the Manhattan marketplace are non-conforming jumbo loans.

Ju**mbo Joey** finally hit it big after years as a struggling actor and was able to buy a place. Jumbo loans require a minimum of 20% down. With his colossal windfall, he could pay down all his debts, bring his credit scores up to 700-720, bring his debt-to-income ratio to well below the hard cap of 45%, and borrow an amount well above the Fannie Mae and Freddie Mac conforming guidelines of $548,250.

These loans require the borrower to show the lender that they have enough cash on hand to cover at least a year in mortgage payments and are taken out by affluent buyers purchasing a high-end home in expensive areas.

Reliable Ross is like the 30-year fixed-rate mortgage. These are loans well suited to those who plan to be in the home for 15, 20, or 30 years. Just like his profession as a paleontologist, it takes patience to build equity, just like it is to dig up a bunch of bones! Slow and steady wins the race with this type of mortgage product.

The predictability and stability of this loan are reflected by the unchanging interest rate and payment amount for the life of the loan.

Just like Ross's romantic feelings for Rachel, which began in high school, not everyone may have the patience to see this one through. As a borrower, you want to decide how fast of this slow and steady pace you would like to pay down your loan and if you have the cash flow to pay it down more quickly.

A 30-year loan is typically the most popular because it offers the lowest monthly payment. The home will cost more over the life of the loan since the interest and principal are paid down at a much slower rate. If you take a shorter fixed-rate, you will have higher payments, but the home won't cost you as much because you will be paying bigger chunks of principal and interest.

One benefit of this type of loan is that you can afford more of a house. Qualifications for this type of loan are based on your ability to make monthly payments. The longer the life of the loan, the more home you can afford.

If you choose to avail of this type of mortgage, the first question you want to ask yourself is, “How long do I plan to stay in this home?” If your answer is 5-7 years, then an adjustable-rate mortgage will be a better option.

Motivated Monica is much like an ARM or adjustable-rate mortgage. Chefs and food service workers like her character are known for the complexity of their scope of work, their adaptability, and flexibility. An adjustable-rate mortgage is no different.

As the name connotes, the interest rates tied to these mortgages rise and fall with the marketplace rates. These rates are linked to the LIBOR index, which is a cost of funds interest rate. Interest rates have been at historic lows for decades.

The one saving grace is, rates haven't been volatile like during the Savings & Loan Crisis, which did a 6+ point hike from June 1979 to March 1980.

Adjustable-rate mortgages are great vehicles to get into a home. It offers lower interest rates for a specified amount of time because you assume the risk of interest fluctuations. The rates can decrease, enabling you to pay more into your principal. Remember, there is also always the option to re-finance to something more stable when you are already in a home.

The right ARM product could help you qualify for financing and make it easier to buy when the market is hotter than Monica’s kitchen.

Peculiar Phoebe is the highly specialized FHA, VA, or USDA loans. They are government-backed with precise eligibility requirements. These loans are not available to everyone and just as quirky as the character she represents.

FHA loans are loans offered by the Federal Housing Administration and insured by the Housing and Urban Development (HUD). This type of loan allows low to moderate-income earners to purchase a property. The applicants have less than stellar credit scores and cannot qualify for a conventional loan. The purchaser can put anywhere from 3.5% to 10% down. This loan's disadvantage is that you will are forced to pay a mortgage insurance premium (MIP) plus additional insurance of 1.75% on the FHA loan.

VA Loans are government loans backed by the U.S. Department of Veterans Affairs. These loans allow for a 0 down or 1% down. To qualify, you will need to meet one of these requirements:

- served 90 days of active wartime duty,
- been with the National Guard for 6 years,
- served 181 days active peacetime duty or
- be a surviving member of personnel who died in the line of duty.

USDA loans, also known as USDA Rural Development Guaranteed Housing Loan Program, and backed by the United States Department of Agriculture. These are 0% down loans that are better served to the rural low-income communities and must be in a qualified rural area, have a steady job, a 640 minimum credit score, a maximum of 41% debt to income ratio, and comes with an income cap to qualify.

VA and USDA loans can offer below-market rates with the right credit score and a low debt to income ratio.

We are all "Friends" here and we hope that we clearly explained the various home loans available to you. But don't forget, choosing the right mortgage company is just as essential and can also make or break your overall experience.