Mortgage Loans 101:

How Mortgages Work and the Types of Loans Available

A REAL ESTATE EBOOK FROM The CE Shop
INNOVATING CAREER EDUCATION

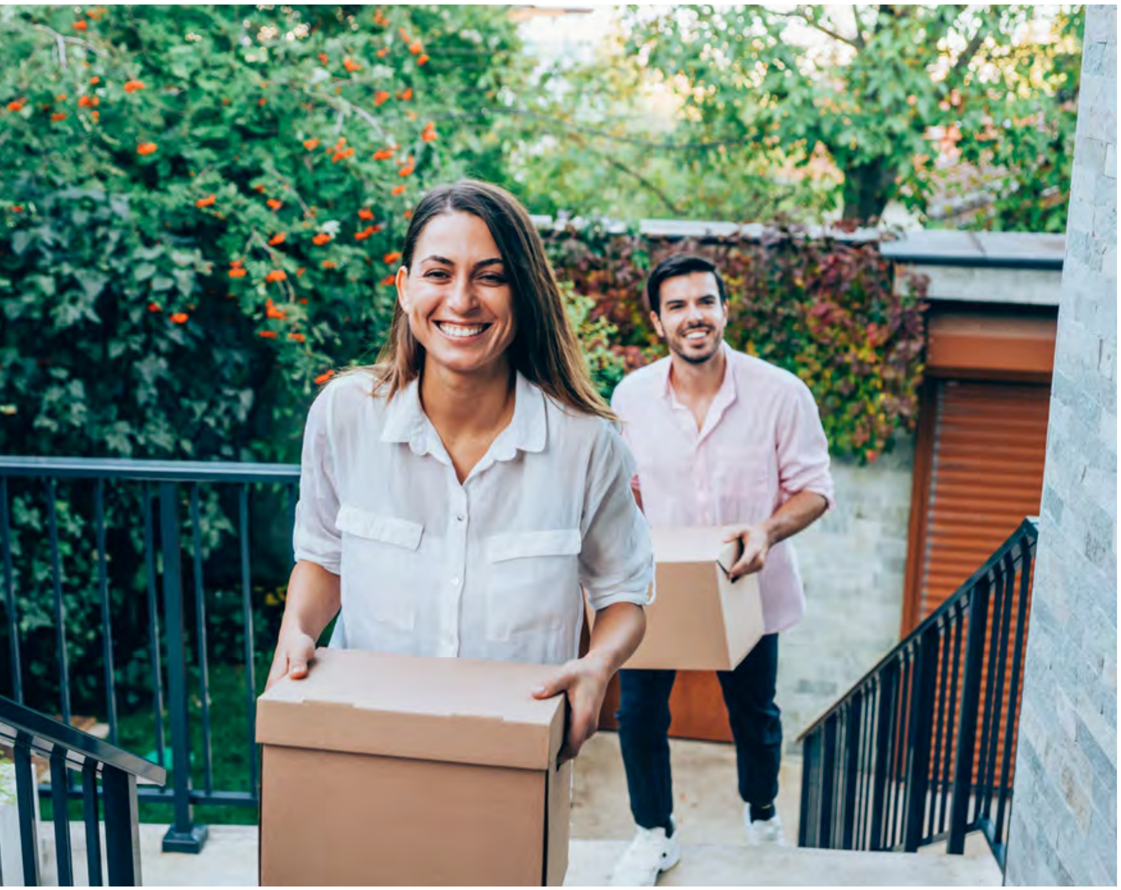
Mortgage Loans 101

As a residential real estate agent, it's your job to guide clients through the process of purchasing their new home. That often means learning to explain difficult concepts in a way that's easy to understand. After all, your clients should see you as a trusted resource and industry expert.

But don't forget that positioning yourself as a real estate expert means understanding the ins and outs of mortgages, too. Although your clients are almost always going to be working with a mortgage professional to secure financing for their home, you shouldn't be clueless about the process.

We're here to help! The following is a comprehensive overview of mortgage loans, from how they work to the various types of loans that your clients might be considering.

What Percentage of Homebuyers Take Out Loans?

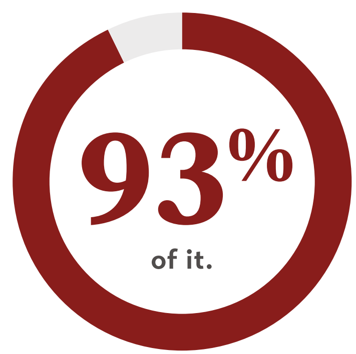


Source: The National Association of REALTORS® 2020 Profile of Homebuyers and Sellers

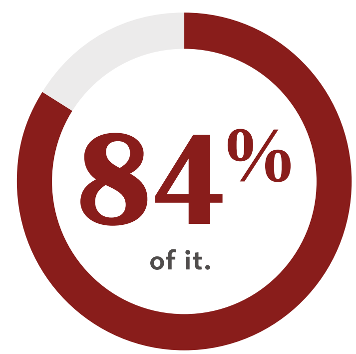
87% of recent homebuyers **took out a loan** to make the purchase.

Those who took out a loan to purchase their home typically **financed** **88%** of it.

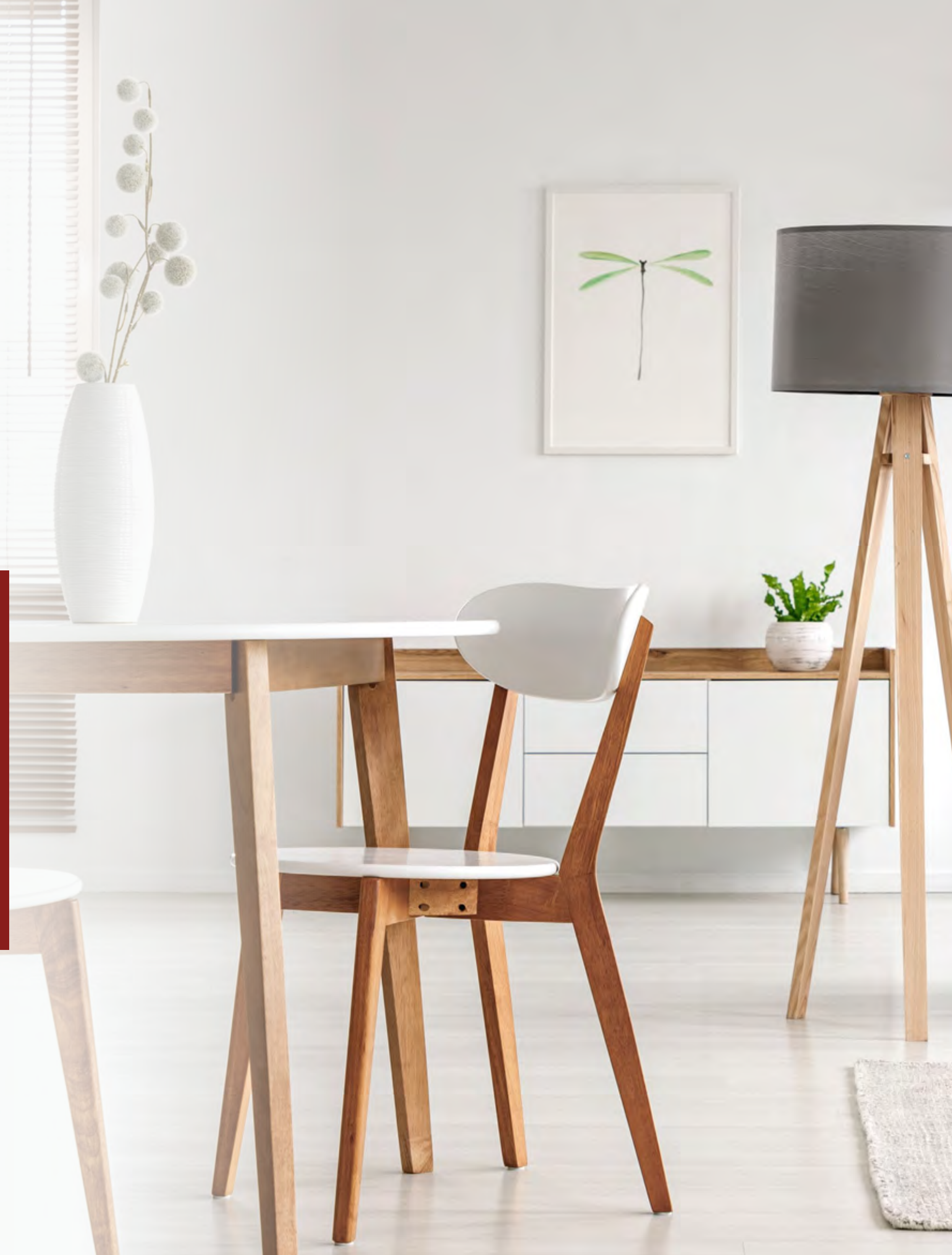
First-time buyers who financed their home typically financed



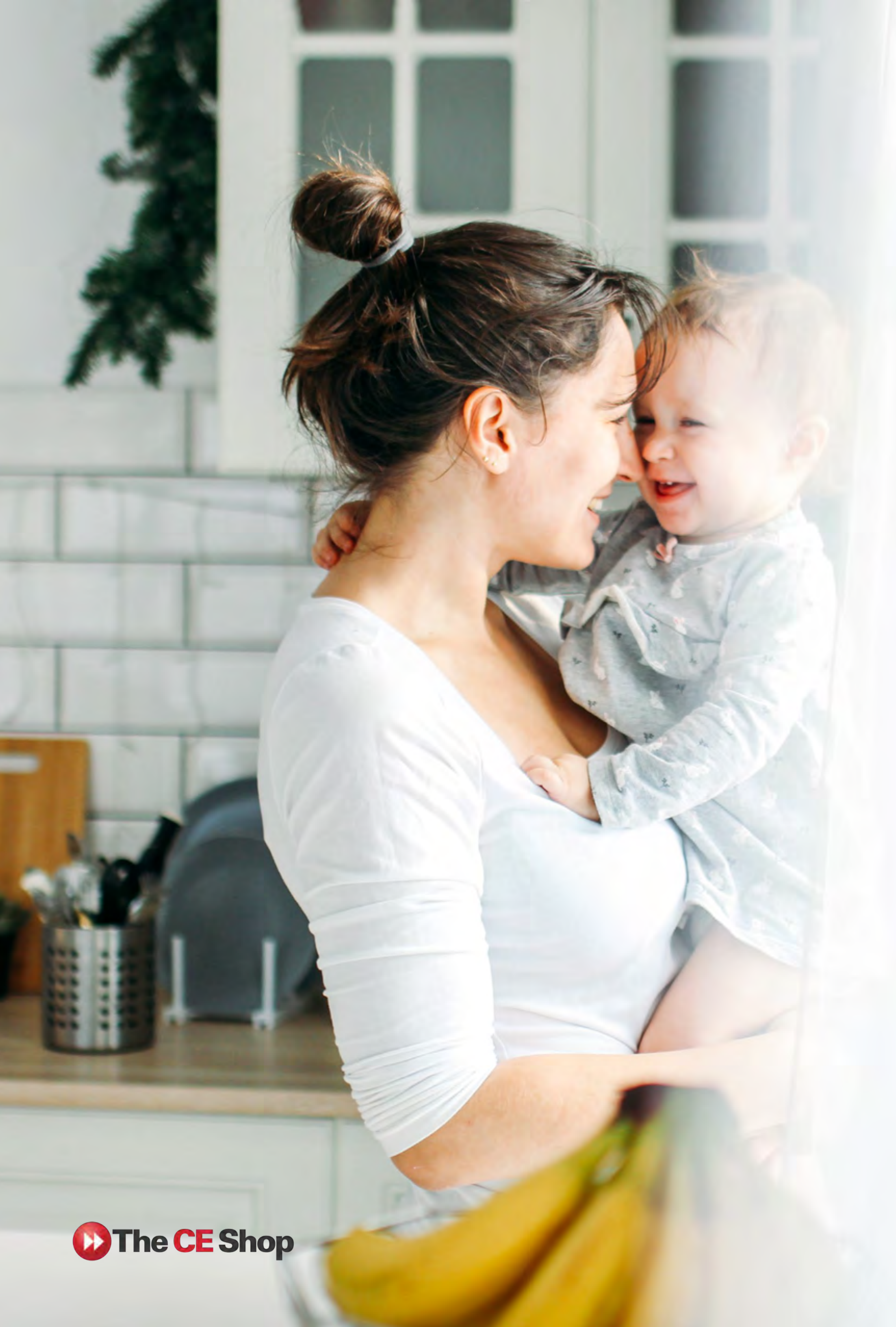
Repeat buyers who financed their home typically financed



What Is a Mortgage Rate?



Before we start talking about the types of mortgage loans you'll see throughout your career, you need to understand what a **mortgage rate** is. Put simply, it's the **rate of interest charged by a mortgage lender on a home loan.**



Mortgage Payments and Interest Rates

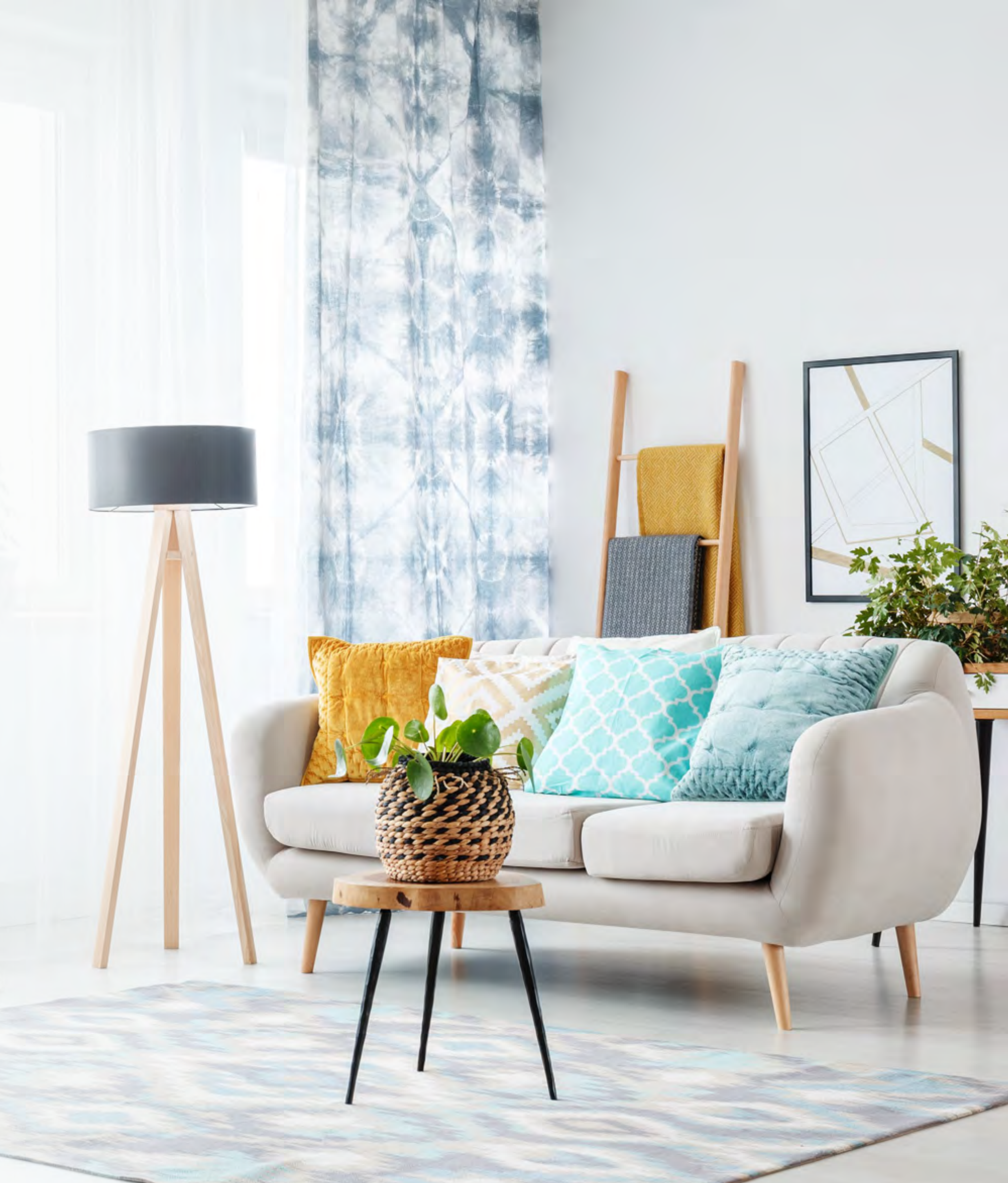
Once your client purchases a home, they will pay interest each month. Their monthly mortgage payments will typically include P&I, which stands for principal and interest, as well as property taxes and home insurance.

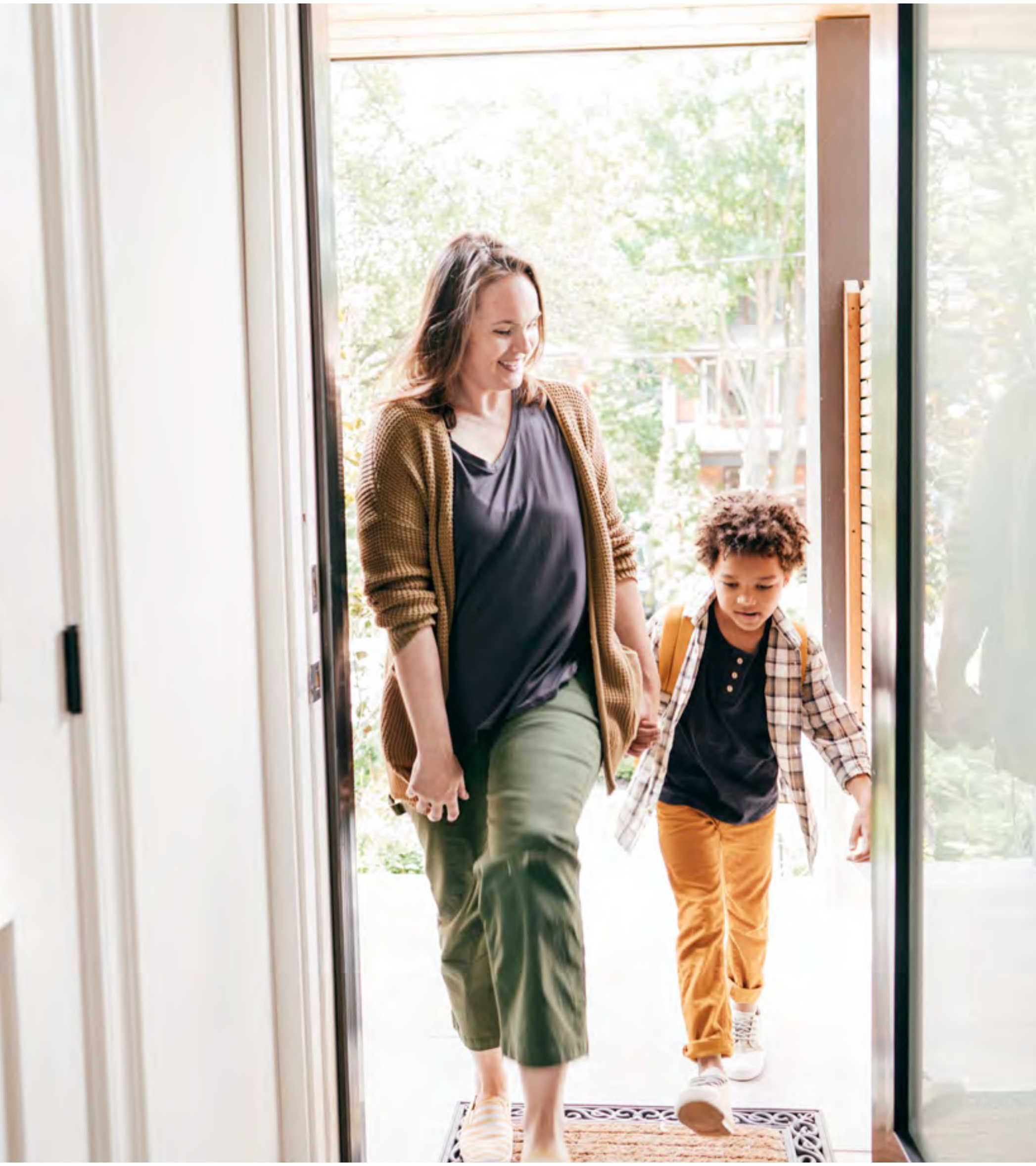
Your client's Mortgage Loan Officer will help determine which loan is best for them and help them secure the best (that is, the lowest) rate. A variety of factors might influence the interest rate that the homebuyer is offered, such as their credit score or the state of the U.S. economy. The type of loan they're securing can also affect the rate.

Mortgage Insurance

Depending on the type of loan your client is considering, they might have to pay **private mortgage insurance** (PMI), which is separate from homeowner's insurance. PMI is a form of insurance that's usually required for conventional loans if a buyer is purchasing a home with a down payment of less than 20%. It's insurance that protects the lender if the buyer fails to pay. (It does not, however, protect the buyer.)

PMI is typically paid through a monthly premium, which increases the amount the homebuyer is paying per month for their home.





Plummeting Mortgage Rates

In 2020 and 2021, mortgage rates dropped to record-low levels as the federal government worked to revive the economy in the wake of COVID-19. In mid-2021, NAR predicted that the year's average 30-year fixed mortgage rate would be 3%.

Average 30-Year Fixed Mortgage Rates by Year

2020	3.11%
2019	3.94%
2018	4.54%
2017	3.99%
2016	3.65%

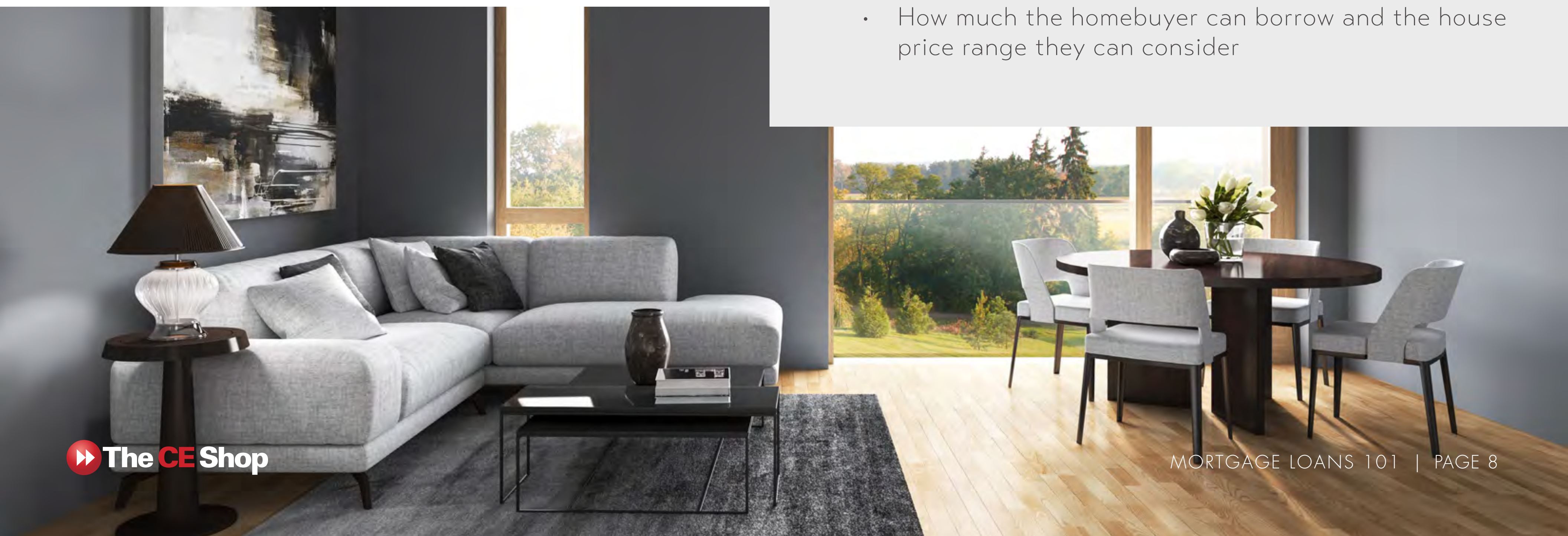
Source: Freddie Mac

Conventional Loans vs. Government-Backed Loans

Most homebuyers apply for a **conventional loan**, which is backed by a private lender, not by the federal government. But some **government-backed loans** — such as FHA loans, which are insured by the Federal Housing Administration — are popular among first-time homebuyers because they don't require a large down payment or a high credit score.

The Consumer Financial Protection Bureau says that choosing between conventional loans and government-backed loans can affect:

- How much a homebuyer will need for a down payment
- The total cost of the loan, including interest and mortgage insurance
- How much the homebuyer can borrow and the house price range they can consider



Types of Government-Backed Loans

Government-backed loans are often subject to strict eligibility requirements, and there are limits to what kinds of properties they can be used to purchase. Some government-backed loans also require a form of mortgage insurance.

Government-backed loan types include:

- Department of Veterans Affairs (VA) loans
  are available only to veterans, servicemembers, or surviving spouses. These loans don't require a down payment.
- U.S. Department of Agriculture (USDA) loans
  are available for low- to middle-income homebuyers in certain rural areas. These loans also don't require a down payment.
- Federal Housing Administration (FHA) loans
  aren't restricted to a specific population like VA and USDA loans are. These loans allow for a much lower down payment than conventional loans — a minimum of 3.5% — and are available to people with low credit scores.

Loan Terms and Interest Rate Types

The most popular type of conventional loan is a 30-year fixed-rate mortgage. Using this as an example, there are two important variables at play:

THE LOAN TERM & **THE INTEREST RATE TYPE**

The loan term refers to how long the homebuyer has to repay the loan. So, in this example, the homebuyer would have 30 years to pay their mortgage. 15-year loan terms are also fairly common.

"In general, the longer your loan term, the more interest you will pay," the Consumer Financial Protection Bureau says. "Loans with shorter terms usually have lower interest costs but higher monthly payments than loans with longer terms."

The interest rate type in this example is a fixed-rate mortgage whereby the lender charges a set rate of interest for the entire life of the loan. Adjustable-rate mortgages, on the other hand, offer an initial interest rate that's below the market rate for a comparable fixed-rate loan — but the rate increases over time.

Conforming Loans vs. Non-Conforming Loans

Most mortgage loans are **conforming**, which means that they fit Fannie Mae and Freddie Mac's guidelines for purchase.

Fannie Mae and Freddie Mac are government-sponsored enterprises, and the mortgage loans that they purchase have to conform to certain standards set by the Federal Housing Finance Agency, including the amount that can be borrowed. In most parts of the United States, the 2021 maximum conforming loan limit for one-unit properties is $548,250, up from $510,400 in 2020.

Loans that don't fit Fannie Mae and Freddie Mac's guidelines for purchase are called **non-conforming loans**.

Examples of Non-Conforming Loans:

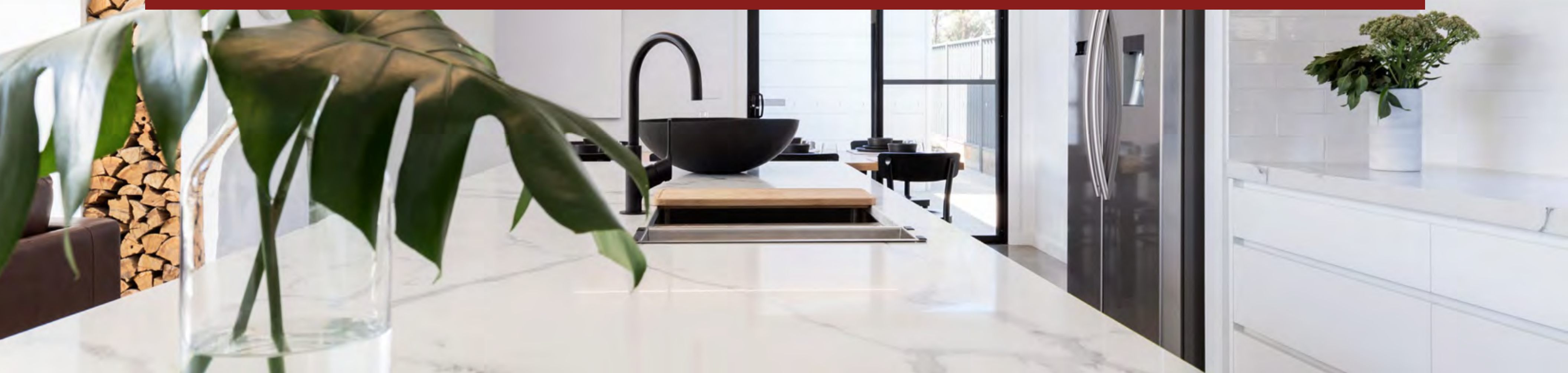
- Government-backed loans (VA loans, FHA loans, and USDA loans)
- Jumbo loans (loans that exceed the dollar amount allowed by the FHFA)

Conforming Loans vs. Non-Conforming Loans

Why does it matter if a loan is conforming or non-conforming, you ask?

Conforming loans present less risk to lenders. Also, conforming loans can (and likely will) be sold.

"Most lenders sell your loan to mortgage investors instead of keeping your loan when you get a mortgage," Rocket Mortgage says.
"This usually happens within a few months of closing on your loan and allows the mortgage lender to maintain a steady cash flow to offer more mortgages. Lenders have the option to sell your conforming loan to Fannie Mae or Freddie Mac."



Share Your Knowledge

Do you feel equipped to talk about mortgage loans like a pro? We sure hope so.

As you work with your next homebuyer, make sure to share your mortgage knowledge. While you can't replace a mortgage professional, having an understanding of different loan options will help you better serve your clients during an otherwise stressful time. After all, the homebuying process can feel daunting, but now you have even more tools at your disposal to put your clients at ease. Good luck!

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