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Current mortgage rates are still low making the path to homeownership closer than you think. Yet, there are many different types of mortgages to choose from. Conventional loans are the most common, but just what is a conventional loan and more importantly, is it the right home financing solution for you?

Conventional loans, which are home loans not backed by the federal government, account for over 71% of all U.S. mortgages. There are pros and cons to them like higher down payments and more stringent credit history requirements but no private mortgage insurance for qualified borrowers.

PMI is a type of mortgage insurance that gives lenders peace of mind knowing that their investment is protected should you default on the loan. It's more often associated with government-backed mortgages, but sometimes conventional mortgages require it, particularly if you have less than 20% for the down payment. The problem is that PMI can be costly and will not fall off of your mortgage until the balance has been paid down to 80% of the home value. However, if you have a good credit history, minimal debt, sufficient income, and you can afford a larger down payment, then a conventional mortgage might be a better choice than other types of mortgages.

What is a conventional loan?

Conventional loans are issued by prime lenders like banks, credit unions, and other financial institutions. They are not backed by the federal government like FHA, VA, and USDA loans. So, the criteria for eligibility are more stringent. They require a higher credit score than other loans. Although the credit score requirement varies by lender, you should have a credit score of at least 670 to qualify. This is the score that Equifax, one of the top credit reporting agencies, reports that most lenders find acceptable and can garner lower interest rates. That doesn’t mean that you might not qualify for a conventional home loan with a lower score, but, generally speaking, the lower your score, the higher the interest rate you might be obligated to pay.

A larger down payment is also essential for conventional loans. Usually, that translates to putting down 10% to 20% of the total home value. However, in some cases, a 5% down payment will suffice. Remember, though, any down payment of less than 20% will likely require that private mortgage insurance be added to the overall loan package. So, if you can afford to wait, it might be better to save for a larger down payment.

Finally, interest rates are higher for conventional loans, but how much higher depends on your overall financial and credit history, and the size and term of your loan. Rates vary from one lender to another. So, always shop around before deciding on which loan and lender to choose.

How conventional mortgages work

Conventional mortgages come with a variety of terms. The most common include 15- and 30-year fixed-rate terms where the annual percentage rate that you start with is locked in for the duration of the term. Alternatively, lenders also offer adjustable-rate mortgages with terms that vary by lender, but some of the most common ARMs include 5/1, 7/1, and 10/1 terms. The rates for ARMs remain fixed for the first several years of the term and adjust according to the market each year after. So, a 5/1 ARM would carry a fixed-rate for the first five years and an adjustable-rate each year after.

Down payments have a little variance. Most lenders require at least 10% to 20% down. However, depending on the lender and your financial and credit situation, some lenders will accept a 5% down payment. Remember, though, any down payment of less than 20% will likely require you to pay a PMI. If you can afford to wait, it might be better to save for a larger down payment and avoid the PMI entirely.

Types of conventional loans

There are two main types of conventional home loans — conforming and non-conforming. Each is determined primarily by the loan size, but more on that later. Both conforming and non-conforming home loans are similar to the variety of terms that are available to borrowers. The most common terms for conventional loans are 15- and 30-year fixed-rate terms, which means that your annual percentage rate remains the same throughout the entire term of your loan. However, there are other common terms available that are not as fixed.

Adjustable-rate mortgages, or ARMs, generally include 5/1, 7/1, and 10/1 terms, but sometimes lenders offer other flexible ARM terms as well. ARMs have rates that remain fixed for the first several years — the first five years in a 5/1 ARM, and then adjust according to the market each year after. ARMs are available for both conforming and non-conforming loans, but as with fixed-rate mortgages, APRs available vary according to the lender as well as your overall financial picture. However, as previously mentioned, terms aren't the only things that differentiate conforming and non-conforming loans.

Conforming vs non-conforming home loans

Conforming loans differ from non-conforming loans by the standards set by Fannie Mae and Freddie Mac with home value caps placed on the loans. The current maximum conforming loan for most areas across the country was raised to $484,350. However, there are a few areas where, due to much higher costs of the average home, the cap was raised to $726,525.

Non-conforming loans, however, are commonly referred to as "jumbo" loans by most lenders. They are primarily for homes that exceed the cap of conforming loan limits and cannot be purchased by Fannie Mae or Freddie Mac. Since non-conforming loans exceed the caps of their conforming loan counterparts, they carry greater risk to the lender. So, they often come with a higher APR than conforming loans. Additionally, lenders may have additional criteria that borrowers must meet like a higher credit score or etc.

When a conventional home loan makes sense

Determining when a conventional loan makes sense for you depends on your situation. Conventional mortgages are not backed by the federal government like FHA, VA, and USDA loans. However, that's because criteria for eligibility are stricter which reduces the risk to lenders. If you qualify for a conventional loan, it is possible to secure it with a 5% down payment, but most lenders ideally want to see 10% to 20% down. Also, bear in mind that any down payment of less than 20% will likely require the addition of PMI.

If you have low income, are a veteran, or plan to live in a rural area, then a government-backed loan like FHA, VA, or USDA might be a good option. These loans often require a minimum credit score of 580 and a smaller, minimum down payment or potentially no down payment at all. Some borrowers might even qualify for down payment assistance on these loans.

The bottom line

If you're ready to start your path to homeownership, then begin by evaluating your current financial situation. An online calculator can help you determine how much mortgage you can afford. Also, take a good look at your credit report. You can request a free credit report from all three credit reporting agencies once per year. Know your average credit score and what's on your credit report. If you find any discrepancies, dispute them with the reporting agency. Removing errors can bump your credit score up a notch and may help you qualify for better mortgage rates.

Knowledge is powerful. So, learn what you can about the different types of mortgages available, but also compare mortgage rates among top lenders. The APR with one lender often differs from another and shopping around can help you find the best rate.
