

How Can You Choose The Right Mortgage?

You may think today's home loan market is terribly confusing with dozens of mortgages to choose from. But if you know the basic facts about financing a house, it really isn't too bad. Let's start with the questions that are probably uppermost in your mind.

How Large a Mortgage Can I Get?

That depends upon your income and the cost of your new house. Lenders use certain guidelines to determine the mortgage amount that they will lend any one homebuyer. The two guidelines used are housing expenses and long term debt. Lenders generally say that housing expenses (including mortgage payments, insurance, taxes and special assessments) should not exceed 35 percent to 38 percent of the homeowner's gross monthly income. Lenders measure prospective homebuyers with "Residual Income," or the monthly income minus expenses. The remainder is then measured against geographical and family size data to qualify the borrower.

- Conventional Loans

Housing Expenses = 35% - 38% of gross monthly income

Housing Expenses + Long-Term Debt = 43% - 45% of gross monthly income

Long-term debt is defined as monthly expenses extending more than 10 months into the future. These expenses should not exceed 43 percent to 45 percent of the homeowner's gross monthly income. At Loanontime we will work out these figures for you when you sit down to discuss the mortgage you want, sometimes the DTI ratio can go up to 50% depending on programs and personal qualification.

What Types of Loans Are Available

Although you may see many different types advertised, they all belong to just two families: those mortgages that carry fixed interest rates, and those whose rates change during the course of the loan on a periodic schedule mutually agreed upon by you and your lender. This page does, however, discuss some new loans who are really "cousins" to each family of convertible mortgages.

Fixed Rate Mortgages

You are probably familiar with a fixed-rate mortgage, that's very common program for years! The major advantage of fixed rate mortgages is that they present predictable housing costs for the life of the loan. Some fixed-rate mortgages you will probably hear about are:

- 40-year fixed-rate mortgages
- 30-year fixed-rate mortgages
- 15-year fixed-rate mortgages

When people thought of a mortgage 10 to 50 years ago, they thought of a 30-year fixed-rate mortgage. This traditional favorite is not the only choice nowadays because volatile financial times created a whole new range of selections. However, the 30-year fixed-rate mortgage may still be the best mortgage for your circumstances. It offers the lowest monthly payments of fixed-rate loans, while providing for a never-changing monthly payment schedule. Some lenders offer 20, 25, and even 40-year term mortgages as well. But remember, the longer the term of the loan, the more total interest you will pay.

The 15-year fixed-rate mortgage allows homeowners to own their homes free and clear in half the

time and for less than half the total interest costs of the traditional 30-year loan. The loan's term is shortened by the 10 percent to 15 percent higher monthly payments. Some homebuyers prefer this mortgage because it allows them to own their home before their children start college. Others prefer it because they will own their home free and clear before retirement and probable declines in income.

The major disadvantages of the 15-year fixed-rate mortgage are the sometimes higher monthly payments. But if saving on total interest costs and cutting the time to free and clear ownership are important to you, the 15-year fixed-rate mortgage is a good option. Remember, however, that you trade lower total interest costs for fewer mortgage interest deductions on your federal income tax. Your ability to qualify for this type of loan is based on a 30-year term, and most lenders who offer this mortgage will allow the homebuyer to convert to a more traditional 30-year loan without penalty. Availability is limited on this mortgage, but it can be worth looking for.

Mortgages That Change

Another type of mortgage that is becoming popular is called a Lender Buydown, where the homebuyer gets an initially discounted rate and gradually increases to an agreed-upon fixed rate over a matter of three years. For example: When the market rate is 7 percent, the fixed rate for the mortgage is set at about 7.5 percent, but the homebuyer makes monthly payments based on a first year rate of 5.5 percent. The second year the rate goes up to 6.5 percent, and for the third year through the remaining life of the loan, the rate is calculated at 7.5 percent. A second type of lender buy-down, called a Compressed Buydown, works the same way, but with the interest rate changing every six months instead of on a yearly basis.

The Lender Buydown gives consumers the advantage of lower initial monthly payments for the first two or three years of the loan when extra money may be needed for furnishings and, secondly, the advantage of knowing that, although the interest rate does change during the first three years of the loan, the interest is fixed from the third or fourth year on.

Adjustable Rate Mortgages

Adjustable Rate Mortgages (ARMs) have become one of the most popular and effective tools for helping some prospective homebuyers achieve their dream of homeownership. Developed during a time of high interest rates that kept many people out of the housing market, the ARM offers lower initial rates by sharing the future risk of higher rates between borrower and lender.

ARMs can be an excellent choice of financing under certain conditions, such as rising income expectations, high interest rates, and short-term homeownership. But because payments and interest rates can increase either steadily or irregularly, homebuyers considering this kind of mortgage need to have the income to keep up with all possible rate and/or payment changes. Each ARM has four basic components:

- Initial interest rate, which is typically one to three percentage points lower than that of most fixed-rate mortgages. Lower interest rates also make ARMs somewhat easier to qualify for. The initial interest rate is tied to certain economic indicators that dictate in part what the monthly payments will be.
- Adjustment interval, at the time between changes in the interest rate and/or monthly payment will be.
- Index, against which lenders measure the difference between what they are making on their investment in the mortgage and what they could be making on other types of investments. The most popular index is based on the rate of return on a one-year Treasury bill (also called T-bill).
- Margin which is the additional amount the lender adds to the index to establish the adjusted interest rate on an ARM. The margin is usually 2.25 percent to 2.75 percent.

In addition to the four basic components, an ARM usually contains certain consumer safeguards such as interest rate caps, which limit the amount that the interest rate applied to the payments may move. This prevents the amount of interest the consumer pays from rising higher than perhaps the homeowner can afford. For instance, a typical ARM would have a two percentage point cap over the life of the loan. That means that a loan with an initial interest rate of 5.75 percent would be able to go no higher than 10.75%-11.75 percent over the life of the loan, and it would be able to move no more than two percentage points per year.

Another safeguard found on some ARMs are monthly payment caps that limit the amount homeowners need to increase their payments at adjustment time. Monthly payment caps can, however, sometimes prevent the monthly payments from increasing enough to keep up with the rise in the interest rate, causing negative amortization-resulting in higher or more payments for the homeowner later on.

Creative Financing or Seller-Assisted Mortgages

This type of financing became popular when interest rates went to very high levels in the early 1980s. Seller-assisted creative financing usually means the seller of the home helps with the financing by underwriting all or part of the loan.

The advantage of this type of arrangement is that the mortgage usually carries a lower interest rate with lower monthly payments. The disadvantage is that the previous homeowner, not an institution, may hold the deed of trust. If the loan terms call for certain payment schedules, the buyer may have to seek new financing. Many homebuyers in recent years have found "creative financing" deals to be fraught with problems and useful only as short-term alternatives to mortgages from traditional lenders.

One type of mortgage you are apt to run into with seller financing is the balloon payment mortgage. Balloons, as they are known, are usually offered as short-term fixed-rate loans. The balloon payment mortgage gets its name from the payment schedule, which involves smaller payments for a certain period of time and one large payment for the entire amount of the outstanding principal. They have terms of 3, 5, and sometimes 15 years, though payments are usually calculated as though it were a 30 year loan. Sometimes a balloon will be offered as a second mortgage where you also assume the homeowner's first mortgage. The major disadvantage with a balloon payment loan is that it may be difficult to save up the money to make the final large payment (often the entire amount of the principal) while paying interest on the loan. Some lenders guarantee refinancing, though the interest rate is usually adjusted when the principal comes due. If you cannot refinance, you may have to leave the property if you cannot meet the large payment. Balloons are an advantage if you plan on living in an appreciating house for a short period of time and want to pay less while you live there.

How Do We Evaluate Different Loans?

One important method is by bearing in mind that mortgage packages consist of more than interest rates. They consist of a quoted rate, plus discount points (pre-paid interest assessed by the lender at settlement, or the meeting when the property legally changes hands) and other fees, plus a full range of terms including adjustable versus fixed-rates, low down payment versus high down payment, the presence or absence of prepayment penalties, and many other features noted earlier in this brochure.

One way to evaluate rates, however, is by examining the Annual Percentage Rate (APR). The APR can help you compare different types of mortgages. It indicates the "effective rate of interest" paid per year. The figure includes discount points and other charges and spreads them out over the life of the loan. While the APR provides you with a common point for comparison, look at the whole product before deciding which mortgage to get. Pick the one with the rate, payment schedule and other terms that suit your situation best.

Terms You Should Know

Acceleration Clause

If you miss a monthly payment, an acceleration clause allows the lender to speed up the rate at which your loan comes due or even to demand immediate payment of the entire outstanding balance of the loan.

Assumability

Assuming a mortgage is simply taking the loan over from the holder (seller) and becoming liable for the repayment.

Buydown

The buydown mortgage is one where the seller and/or the home builder subsidizes the mortgage by lowering the interest rate during the first few years of the loan. While the lower initial payment and interest rate make this kind of loan easier to qualify, the payments may increase when the subsidy expires.

Closing Costs/Settlement Costs/Escrow

Closing costs are the costs associated with settlement, the meeting where the buyer and seller (or their agents) sit down to fill out the papers and make the exchanges that allow the property to legally change hands. Closing costs include appraisal fees, title search and insurance, survey, tax adjustments, deed recording fees, credit report and points, among others.

Due-on Sale Clause

A clause or provision in a mortgage or deed of trust that allows the lender to demand immediate payment of the balance of the mortgage at the time of sale.

Negative Amortization

This occurs when your monthly payments are not large enough to pay all the interest due on the loan. This unpaid interest is added to unpaid balance of the loan. The danger of negative amortization is that the homebuyer could end up owing more than the original amount of the loan.

Private Mortgage Insurance

In the event that you do not have a 20 percent down payment, lenders will allow a smaller down payment-as low as 5 percent in some cases. With the smaller down payment loans, however, borrowers are usually required to carry private mortgage insurance.

Private mortgage insurance will require additional premium payment of 0.5 percent to 1.0 percent of your mortgage amount plus an additional monthly fee depending on your loan's structure. On a \$75,000 house with a 10 percent down payment, this would mean an initial premium payment of \$338 to \$675 and an extra \$15 to \$20 a month.