Charting Your Course to Home Ownership

Navigating the Mortgage Process

Today's home mortgage market has a variety of choices. Many home buyers feel safest choosing a conventional, standard fixed-rate mortgage loan, but other types of loans can be more affordable or better suited to a buyer's personal situation. There are also special programs and loans to make home ownership possible for people who don't qualify for a conventional loan. Taking the time and effort to shop around and learn about available home finance options can save you thousands of dollars or make it possible to buy the home you want.

Understanding Mortgage Terms

The mortgage process has its own language. Don't let it frighten you away from finding the best suited mortgage loan for your particular needs. Here are some of the most important terms to understand.

For the typical mortgage loan, you must make a **down payment** to buy the property and borrow the rest of the purchase price. The other fees and expenses involved in getting and processing loans are called **closing costs**.

Lenders use **qualifying guidelines** to figure out the amount they will lend a buyer. A **qualifying ratio** of 28/36 means that: your monthly housing costs should total no more than 28% of your monthly gross (before tax) income, and your total long-term debt expenses (including housing and other debts) should total no more 36% of your monthly gross income. Simply stated, the larger the numbers in the ratio, the larger the loan you may qualify for.

Most loan decisions are made with an Automated Underwriting System (AUS), rather than a simple qualifying ratio. But it is a good idea to use the 28/36 ratio as a personal decision factor in what you can afford.

The minimum down payment needed is set by the **loan-to-value ratio (LTV).** For example, an 80% LTV means you can borrow no more than 80% of the appraised value of the property you want to buy. Higher LTV loans (to make a lower down payment) usually require you to buy mortgage insurance. **Mortgage insurance** protects the lender (not you) in case you don't pay the loan **(default).** The cost of mortgage insurance is usually added to the monthly mortgage payments and closing costs.

The **interest** (the fee for borrowing) you pay each month is based on the simple interest rate of the loan. The loan may also charge discount points, a form of interest paid up-front when the loan is made. Each point equals 1% of the loan amount. The annual percentage rate **(APR)** reflects the total cost of the loan, including simple interest, points and other fees.

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The monthly payments during the early years are mostly interest. In time, more of each payment is credited to paying down the debt (the **principal**). Gradually, as you pay off principal, you build up **equity** (ownership). This process of reducing debt through fixed payments of principal and interest (where the payment amount stays the same, but the part which applies to your debt gets larger over time) is called **amortization**.

In addition to principal and interest, monthly payments usually include an extra amount that is set aside by the lender (in escrow) to pay the borrower's property taxes and home owner's insurance. Lenders call this total amount **PITI** (principal, interest, taxes, and insurance).

The interest rate of a **fixed rate mortgage loan (FRM)** never changes, so the monthly payment (of principal and interest) stays the same for the full **term** (length) of the loan. The interest rate of an **adjustable rate mortgage loan (ARM)** can change (up or down) on the loan's adjustment dates. These changes are based on a financial **index** (such as the interest rate of one-year Treasury Securities). At adjustment times, the loan's interest rate is changed to a certain **margin** (added point spread) over the index rate. Typical margins vary from 1.25 to 2.5 percent points. It is wise to shop around for small margins.

In most **adjustable rate mortgages**, your initial interest rate (starting rate) is lower than for fixed rate mortgages because you are sharing the long-term risk (of higher interest rates) with the lender. Watch out for deeply discounted **initial "teaser" rates** (more than two percentage points less), which can rise sharply after the first year.

Today's ARMs generally offer some protection for the borrower by providing **interest rate caps**. A periodic or adjustment rate cap limits the amount the interest rate can increase at one time. A total or **lifetime cap** limits the total amount the interest rate can increase over the entire term of the loan.

In general, ARMs are more affordable in the beginning because they have lower interest rates than FRMs. The longer the time between rate adjustments, the higher the starting interest rate (but usually still lower than an FRM). All in all, the borrower pays more for interest rate stability. **The more stability, the higher the interest rate. The greater the risk to the borrower, the lower the starting interest rate.**

A summary of various loan programs and types of mortgage loans follows. Not all of these may be available to you. New types are continually being developed and offered. Still, this summary should be a handy reference to help you explore your options.

When making your way through the mortgage process, remember:

- Don't assume tomorrow's real estate market will behave like yesterday's.
- Don't count on rapid appreciation and inflation to make your home equity grow.
- The key is affordability – both now and later. Compare total loan and housing costs, including down payment requirements, monthly loan payments (now and at maximum levels), closing costs, moving expenses, utilities, maintenance and property taxes with expected income changes.
- Do your homework. Learn about home finance, the local real estate market and the home buying process before you begin.
- Shop around. Look into several sources of financing and types of mortgages.
- Subprime or non-prime loans exist to serve the needs of those with credit scores of 620 and below. Some prime lenders also offer subprime loans. **Subprime** (or nonprime) **loans** are more likely to have a prepayment penalty, high interest rates, higher fees and costs, and/or a balloon payment.
- Ask questions. Make sure you fully understand words, forms and what is happening.
- Watch out for sharks. Predatory lenders often lend money regardless of borrower's ability to repay. They may also pressure home owners to refinance their mortgage frequently.
- Don't assume you won't qualify for prime loans… check it out.
- A good defense is to keep your **credit history** clean, raise your **credit score**, shop around and compare.
- Negotiate. Better terms may be available than those first offered.
- Consider hiring a real estate attorney to help you understand the fine print.
- Study all available materials about mortgage costs. Institutional lenders are required to give you a statement of loan costs and terms before you sign.
- Don't assume anything. Don't be afraid to question anything that you are told.

LOAN PROGRAMS		
Loan Programs	**Description**	**Considerations**
Community Home Buyer's and other "Affordable Home Ownership" Programs	Programs targeting households with modest incomes and/or first-time home buyers. Various types of loans with flexible qualifying guidelines, low down payments and other forms of assistance. Widely available through private mortgage lenders, some may involve nonprofit organizations, state housing finance agencies, local government programs. Bond issues may make limited funds available for loans with below-market interest rates.	Designed to make home ownership possible. May allow nontraditional credit history, very flexible loan requirements. Usually requires home buyer education. Borrower may qualify for a loan size that is too large to manage comfortably, possibly resulting in default of loan. Bond-issue loans not always available; first come, first served.
Conventional	A mortgage that is not guaranteed nor insured by the federal government. Usually requires 20% down payment (80% LTV) unless private mortgage insurance is purchased to reduce it. Typical qualifying ratio is 28/36.	Typically requires more cash at closing than government program loans. Requires more income and less long-term debt to qualify. Loan processing time may be shorter. Larger loans possible. Widely available.
FHA (Federal Housing Administration)	FHA insures mortgage loans by approved lenders. May require only 3% to 5% down payment. Maximum loan limits based on local average housing costs. Higher (more affordable) qualifying ratios. Borrower pays mortgage insurance premium.	Easier to qualify for. Allows very low down payment and closing costs. Loan size may not exceed FHA limit for the area. Property must meet standards. May be assumable. Widely available. May provide some protections and alternatives to foreclosure for some delinquent borrowers.
Housing Finance Authority (HFA)	Typically offered by state agencies and often provide lower interest rates.	Total amount of funds are limited, therefore may not always be available. In most cases can not be combined with other bond issued programs.
U.S.D.A. Rural Development	Offers government guaranteed rural housing loans to moderate income buyers through private lenders and direct home ownership loans to low-income households in rural areas. No down payment, flexible qualifying guidelines, low interest rate, property standards.	Very attractive, affordable loan programs, but only for homes in defined rural areas and residents at or below income limits. Newly built homes must meet standards. Direct loans limited to very-low and low-income households available from local Rural Development offices. May require home buyer education.
Veterans Administration (VA)	Guaranteed by Veterans Administration, protects lenders against loss if payments are not made and is intended to encourage lenders to offer veterans more favorable terms.	Must have a Veteran's Certificate of Eligibility. No down payment is required in most cases. Loan maximum may be up to 100%. No PMI required. Limitations on buyers' closing costs. Variety of repayment plans.

TYPES OF LOANS		
Types of Loans	**Description**	**Considerations**
Adjustable-Rate Mortgage (ARM)	The borrower's interest rate fluctuates according to an index of interest rates based on changes in credit costs in the economy. ARM rates are usually 1 to 3 percent below conventional mortgage rates. Rate changes usually occur on an annual basis, but may be as often as monthly. Most ARMs have interest-rate caps that limit the amount by which the interest rate can increase.	Monthly payment can increase or decrease. Borrowers should consider worst case scenario under their contract and calculate the resulting monthly payment. "Teaser rates" may be offered to entice borrowers; beware the higher monthly rates that will occur when interest rates rise. Payment caps limit the amount by which the payment can vary. An ARM with a payment cap but without an equivalent interest-rate cap can result in negative amortization.
Assumable Mortgage	A mortgage that can be transferred to a new buyer when the home is sold.	Possibly lower monthly payments. May need second mortgage (at higher rate) to make up difference between down payment and equity; combination of loans should be analyzed to make sure it is more economical option. May be prohibited if "due on sale" clause is in original mortgage. Not permitted on most new fixed rate mortgages.
Balloon Mortgage	A type of fixed-rate mortgage loan in which the principal and interest payments are amortized over a longer period (perhaps 30 years) than the actual term (usually 7 years) of the mortgage. At the end of the term (when the balloon payment comes due), the outstanding balance must be paid with a lump sum payment or refinanced for the remaining period.	The option to refinance is not automatic and is conditional upon factors such as payment of closing costs, lender fees, and special assessments, and payment history. Generally, requalifying is not required to refinance unless there is a significant change in rate. Interest rate may be lower than comparable fixed rate mortgage. May be good for borrowers planning to sell or refinance within 7 years—provides relatively low payment during that time.
Buy-down	Developer (or third party) provides interest subsidy, which lowers monthly payments during a specified period of the loan.	Offers a break from higher payments during early years. Enables buyer with lower current income to qualify. Buyer must be prepared for payments to rise at end of subsidy. Developer may increase selling price to compensate for subsidy.

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Construction Loans	Short term loans meant to exist only during construction of home. Construction loans aren't meant to be a method of long-term financing.	Dispersed during construction, they are interest only on funds drawn at that time. At building completion, a mortgage loan is then secured.
Fixed Rate Mortgage (FRM)	FRMs are fixed-rate, fixed term, fixed payment mortgage loans. They are considered the granddaddy of all mortgages.	Neither the interest rate nor the monthly payment (principal and interest) ever change over the life of a FRM. Good for borrowers who place a high value on predictability. Interest rate may be 2-3 percentage points higher than initial rate on an adjustable rate mortgage. Higher initial interest rate means borrower must have a higher income to qualify. If interest rates drop, payments will remain the same unless the loan is refinanced and the borrower incurs costs of getting a new mortgage.
Home Equity Line of Credit (HELOC)	Typically a secondary loan, a HELOC is a type of loan that allows a home owner to tap into the equity of their home to obtain cash for other uses. A HELOC may also be called an equity line or an equity loan.	Because home was used to secure extra monies with a non-mortgage loan makes it crucial to get this paid promptly. Fewer steps involved in seizing home, in event of non-payment on loan.
Graduated-Payment Mortgage	Smaller-than-normal payments are required in the early years, but payments gradually increase to larger-than-normal payments in later years. Interest rate is fixed.	Low payments early in the life of the mortgage may be insufficient to pay interest, resulting in negative amortization. Attractive to buyers who expect substantial future income increases. Borrowers will pay more interest over the life of the mortgage than with fixed monthly payments.
Growing Equity Mortgage (GEM)	Designed to reduce interest costs by paying off the mortgage loan early. Bi-weekly mortgages are one form of GEM. Extra payments increase the total amount paid annually. Bi-weekly payments allow a 30 year mortgage to be repaid in about 20 years. Has fixed interest rate, often a few points below market.	Forces borrower to make the agreed-upon extra payments. Note that almost all lenders permit payment of additional amounts toward principal at any time as a way to get the loan paid faster and reduce interest charges. Borrower's income must be able to keep pace with payments. Equity increases faster.

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Interest-Only Mortgage	Borrower pays monthly payments on the interest on the mortgage for a fixed term. No monthly payment is made on the principal during this term, so the balance or debt remains the same. At the end of the term, usually 5 to 7 years, borrower can refinance, pay the balance in a lump sum, or begin paying off the principal with an increase in monthly payment.	Lower monthly payments may be attractive. Payments may increase significantly after the interest-only period. May be risky if you cannot afford higher payments in the future. Higher monthly payments may be avoided by refinancing—but no one knows what interest rates will be like in 3, 5 or 10 years. May incur prepayment penalties. Negative amortization may occur if housing prices stay the same or fall.
Land Contract	Seller retains original mortgage. No transfer of title until loan is fully paid. Equal monthly payments based on below-market interest rate with unpaid principal due at loan end.	Lower rate and payments, but may offer no equity until loan is fully paid. Buyer has few protections if conflict arises during loan.
Land Trust Mortgage	Loan to buy housing on leased land, typically owned by nonprofit organization seeking to create affordable housing opportunities.	Makes affordable housing possible. Not widely available. Home owner does not own land.
Lease-Purchase or Rent with Option to Buy	Renter may pay "option fee" for right to purchase property at specified time and agreed-upon price. Rent may or may not be applied to sales price. If provided by nonprofit organization, rent amount is sent to cover mortgage payments and an extra amount for savings for future down payment.	Enables renter to buy time to obtain down payment and decide whether to purchase. Locks in price during inflationary times. Failure to take options means loss of option fee and rental payments.
Piggy Back Loan **(also called two-tiered home loan)**	Designed to avoid paying private mortgage insurance (PMI) on loans with less than a 20% down payment.	Borrower secures two home loans — a primary mortgage for 80 percent of the purchase price, and a higher-rate secondary mortgage (the piggyback loan) for the rest of the borrowed amount. In some cases the combined monthly payment is less than one mortgage and PMI.
Reverse Annuity Mortgage (Home Equity Conversion)	Borrower owns mortgage-free property and needs income. Lender makes monthly payments to borrower, using property as collateral.	Can provide home owners with needed cash. At end of term, borrower must either have money available to repay, sell property or refinance. Usually most suitable to elderly with large equity but limited income.

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Rollover (Renegotiable Rate) Mortgages	Consists of a series of short-term loans for 2-5 year periods. Total amortization is spread over 25-30 years. The loan is renewed at the end of each time period at the prevailing market interest rate.	Monthly payments are fixed for 2-5 years and there is an agreement to refinance with the original lender.
Seller Financing	Seller agrees to accept all or a portion of the purchase price in installments, rather than as a lump sum. May be short-term arrangement with amortization over longer period with balloon payment due at designated time.	Buyer usually obtains title at closing. Safer than a land contract or contract for deed as title transfer occurs before all terms of contract are satisfied.
Seller Take-Back	Seller provides all or part of financing. Often done in combination with an assumed mortgage.	Some eager sellers may offer a below-market interest rate; no origination fees or points. May have a balloon payment requiring full payment in a few years or refinancing at market rates, which could increase debt.
Shared Appreciation Mortgage	Below-market interest rate and lower monthly payments in exchange for a share of profits when property is sold or on a specified date.	If home appreciates greatly, total cost of loan jumps. If home fails to appreciate, projected increase in value may still be due, requiring financing at possibly higher rates.
Wraparound	Seller keeps original low rate mortgage. Buyer makes payments to seller, who forwards a portion to the lender holding original mortgage. Offers lower effective interest rate on total transaction.	Lender may call in old mortgage and require higher rate. If buyer defaults, seller must take legal action to collect debt.

Adapted from: Reichel, C. (1998). Your Path to Home Ownership. Baton Rouge, La.; LSU AgCenter.

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