Charting Your Course to Home Ownership

Twenty Questions to Ask Before Choosing a Mortgage

To choose the best mortgage for yourself, you must know about the different types of mortgages. But, that's not all you need to know. You must also find the available options and evaluate each thoroughly. All mortgages of the same type are not exactly alike.

The Mortgage Search

Failing to comparison shop for your loan could be a costly mistake. Shop for interest rates. For example, the difference between a 6% and 7% interest rate on a $100,000 fixed rate mortgage costs $65.75 more per month and $23,670 over 30 years.

Another costly item is origination points. Each point equals to 1% of the loan, which will be charged at closing. Each additional point on a $100,000 loan will result in an additional $1,000. The larger the loan, the more such differences cost up front, but paying points can reduce your ongoing interest rate.

Mortgage Sources

Traditional home mortgage lenders – banks, credit unions, mortgage companies, online financial or mortgage companies and Rural Housing Service offices are the most common sources of mortgage loans. In addition, some financial companies and large corporations offer home loans. Special home ownership programs and loans may be available through local nonprofit organizations or government agencies.

Search Methods

Here are some ideas of how you might locate your mortgage options and narrow the list to a few you can analyze thoroughly:

- Some newspapers publish a weekly mortgage rate report in the real estate section. If all local lenders do not choose to participate, the list will not be complete. Still, it could help you follow rate trends, weed out some choices and give you a basis for comparison.
- It may be helpful to check any mortgage advertisements in newspapers and direct mail promotions. Ads should be interpreted carefully and not become the sole basis for your decision. They don't usually contain enough information to make fair comparisons.

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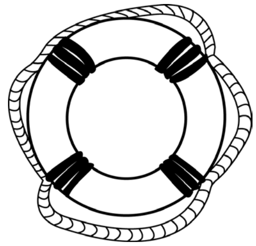


Life Saver
Conduct all mortgage inquiries within a 30 day period to count as only one inquiry on your credit score. Inquiries made over a longer period of time may impact your credit score.

- Local realtors are often an excellent source of current information about mortgage rates and terms. Most agencies survey all the major lenders in town every week or two as a service for their clients. Here again, the information they gather is probably not enough to make a final decision.
- Go online. Internet searches are a newer way to comparison shop for a mortgage loan. To find a reputable internet search engine, ask friends, family and co-workers for recommendations. A respected real estate agent is also a good source. Searching mortgage Web sites will likely reveal offers that appear to beat those of conventional "brick and mortar" lenders. However, this may not always be the case, as all offers also depend on your credit score. Next compare online offers of local lenders to provide an overview of rates in your area. By using information found through online comparisons, you may be able to negotiate a favorable rate locally or make an informed decision regarding on-line offers.

Remember, by spending a little time filling out forms, you can quickly come up with multiple offers to see if they offer more attractive deals.

Red Flag: When searching online, be watchful of sharing too much personal information.

Avoid mortgage search firms or realtors that charge a fee for helping you find a mortgage. Expect to pay commission to a realtor for representing you in buying or selling a house. You will also pay an origination fee to the lender for processing a loan application.

Red Flag: It is generally not a good idea to secure a loan from a lender that solicits you.

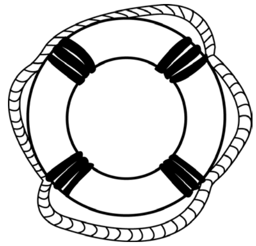
Mortgage Affordability

The maximum amount of your income that may be spent on your house note is set by the lender or the mortgage instrument. This is calculated to see how large a loan you may qualify for. **Keep in mind that qualifying for a certain loan amount does not always mean you can afford it. It is important to develop a household budget to see what monthly housing expenses you can really afford.**

It may be helpful to estimate monthly payments and affordability before you comparison shop. This is usually determined by two income ratios. For example, if the qualifying income ratios are 28/36, that means:

- your total monthly housing expense (principal, interest, taxes, insurance) cannot exceed 28% of your stable monthly income. This is called a **front-end ratio.**
- your total monthly debt payments (including this mortgage) cannot exceed 36% of your stable monthly income. This is called a **back-end ratio**.

For example, ratios would be calculated as follows for a family with a $48,000 annual pre-tax income, and $500 in monthly debt payments (car note and credit cards).



Life Saver
Contact at least five financial institutions for basic mortgage information and rates. For complete comparison, contact different types of lenders such as mortgage companies, banks, credit unions and online sources. Remember to ask each lender the same questions. Take notes so you can look over them later.

Front-End Ratio

Gross Monthly Income (pre-tax)	$4,000
X Housing Debt Qualifying Ratio	X .28
= Allowable Monthly House Payment (Principal, Interest, Taxes, & Insurance)	= $1120

Back-End Ratio

Gross Monthly Income (pre-tax)	$4,000
X Housing Debt Qualifying Ratio	X .36
= Maximum total Debt Allowed	= $1, 440
- Total Monthly Debt Payments	- $500 (car note and credit cards)
= Total allowable monthly house payment	= $940

Some lenders may offer special affordable loans or community home buyer programs with higher qualifying ratios (making the loan easier to qualify for) for first time or low- and moderate- income home buyers. Be sure to ask about these and whether or not you are eligible for them if such loans fit your needs and your budget.

It is also helpful to see how interest rates affect the monthly payment amount. You can check online or buy an inexpensive paperback book of amortization tables to look up monthly principal and interest payment amounts at various interest rates. If you can't find such a book, an estimate may be calculated from the following payment table:

Mortgage Payment Table
(Monthly payment for each $1,000 borrowed)

Interest rate	15 yrs.	20 yrs.	30 yrs.
4.5%	$7.65	$6.33	$5.07
5.0%	$7.91	$6.60	$5.37
5.5%	$8.17	$6.88	$5.68
6.0%	$8.44	$7.16	$6.00
6.5%	$8.71	$7.49	$6.32
7.0%	$8.99	$7.75	$6.65
7.5%	$9.27	$8.06	$6.99
8.0%	$9.56	$8.37	$7.34
8.5%	$9.85	$8.68	$7.69
9.0%	$10.15	$9.00	$8.05
9.5%	$10.45	$9.33	$8.41
10.0%	$10.75	$9.66	$8.78
10.5%	$11.06	$9.99	$9.15
11.0%	$11.37	$10.33	$9.53
11.5%	$11.69	$10.67	$9.91
12.0%	$12.01	$11.02	$10.29

Mortgage Analysis Tool

Once you finish your loan search, narrow your list to the two or three most appealing mortgages for a more thorough analysis. Call those lenders again for more details. Answers to the following list of questions are your tools for making a comparative mortgage analysis – the only way to make sure the loan is the best choice for you.

Questions for ALL Types of Mortgages:

❑ **1.** ***What qualifying ratios and guidelines apply to this type of loan?***

> *Red Flag: Be cautious. Getting the largest possible loan may be more than you can comfortably afford, even if you qualify for it.*

❑ 2. ***Are there any restrictions and special requirements for this type of loan?*** If you are eligible for a loan with flexible qualifying guidelines, you may be able to borrow more (to get a higher-priced home) than with a conventional loan. Several types of loans have ratios of 29/41; others use a housing expense ratio of 33%.

Most types of nonconventional or specialized loans are available only to borrowers who meet certain criteria. Some have income limits, loan size limits, location restrictions, special property standards or other criteria. For any loan, ask about all qualifying guidelines (in addition to the qualifying ratio) such as cash reserve (how much cash you must have remaining after closing) and employment stability requirements.

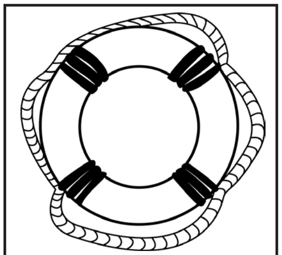
❑ 3. **What are the simple interest rate and discount points?** Discount points are a form of interest which is paid up front at closing. Each point equals 1% of the loan amount. Most lenders offer a choice of interest rates and discount points. The interest rate will be reduced for each point charged (roughly ¼% interest for 1 point, though the ratio varies).

As a general rule, the longer you plan to stay in your home, the greater the advantage of paying more points to get a lower interest rate. There may also be a tax advantage since points are tax deductible in the year paid. On the other hand, if you think you won't own that home very long, it's best to choose a loan with no points.

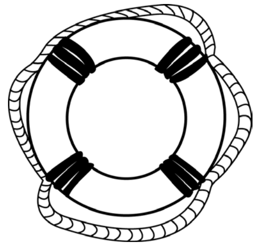
> *Red Flag: Beware of sub-prime loans that target buyers with lower than average credit scores. Higher APRs, that can add up to thousands of extra dollars, will be charged.*

❑ 4. ***What is the annual percentage rate (APR)?*** The APR takes into account all the costs of financing – including the interest, origination fee, discount points, mortgage insurance, etc. – and amortizes them over the full term of the loan. This gives you an easy way to compare loan costs, if you keep that loan for its full term. If you don't intend to stay in the home that long, the APR becomes biased and is not the best basis for choosing the lowest cost loan.

❑ 5. ***Will you lock in the interest rate?*** The loan approval process usually takes from three to eight weeks, but can be longer if applications have backed up. If not locked in, the mortgage interest rate could change (upward or downward) before closing date.



Life Saver
Your APR will be higher than the interest rate of the mortgage. It includes all the costs of financing — including the interest, origination fee, discount points, mortgage insurance, etc.



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When the ratio of your loan size to the current appraised value of your home drops below 80% you can save money by dropping your PMI.

Some lenders will lock in rates at no charge for 45-60 days; others may charge a fee to do so. Some allow you to lock in at any time during loan processing by telephone. This is helpful when market rates might fall.

❑ 6. ***What is the required down payment?*** Lenders will consider a number of factors in determining the down payment.

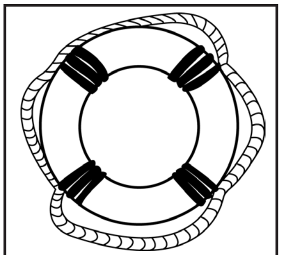
❑ 7. ***What would mortgage insurance cost?*** The down payment is determined by the loan-to-value ratio (LTV). For example, an 80% LTV translates a down payment of 20% of the home's appraised value. Private Mortgage Insurance (PMI) is required for any home with an LTV of less than 20%. It is purchased to protect the lender in case of default. Buying mortgage insurance and some special loan programs could reduce your down payments significantly.

PMI may require you to pay from two months to a first-year premium up front. After that, you typically pay monthly premiums until your loan balance (what you still owe) is reduced to 80% of your home's value.

For Federal Housing Administration (FHA) loans, you are charged a fixed insurance premium which will stay for the life of the loan and is called Mortgage Insurance Premium. Some special loan programs may have no premiums for eligible borrowers.

❑ 8. ***What is your loan application fee, and is it refundable?*** Most lenders charge a fee to cover the costs of an appraisal and credit report. The fee may not be refundable if the loan is not approved or if you decide against taking the loan.

❑ 9. ***What are the closing costs?*** Closing costs can total 2% to 8% of the loan amount (not including the down payment). Before you apply for a loan, most lenders can give you a good faith estimate—a form showing an estimate of closing costs for your potential loan. This estimate may include the origination fees (for making the loan), title charges and items which must be prepaid at closing. There may be other costs that are not listed on the form, however. Some fees may be negotiable or optional, and some of the fees may be paid by either the seller or buyer. So, ask the lender about all possible closing costs, in addition to what's on the standard form, developed by HUD. Lenders must also prepare and distribute with booklet a good faith estimate of settlement costs.



Life Saver
Lenders are required to provide all loan applicants a special information booklet, A Homebuyers Guide to Settlement Costs.

❑ 10. ***Are there any prepayment penalties?*** Penalties for paying off your mortgage early may be charged by your lender. Look for the terms "Prepayment Penalty" or "Early Termination Clause" in the mortgage documents. Knowing if your mortgage lender may charge this penalty is important if you may someday sell your home or if you might want to make extra payments to save interest. Be aware of differences in the penalties or clauses. "Hard" means the penalty will be charged no matter the circumstances under which the loan is prepaid, usually within the first five years. "Soft" means that if you sell the home to an unrelated or uninterested party, the prepayment penalty is waived.

Loans with prepayment penalties or early termination clauses may have lower finance costs. However, such a loan may be a good choice if you do not intend to prepay it or sell the home within the penalty period.

❑ 11. ***Is the loan assumable?*** An assumable loan can be passed on to the buyer of your home if you sell, provided it does not have a "due-on-sale" clause. It may or may not guarantee the same interest rate. Either way, the closing costs on an assumed loan are less than for a new loan. So that characteristic of a loan may help you sell your home. Assumable mortgages can make a property more desirable if interest rates have risen, because the new buyer's payments are at the original rate.

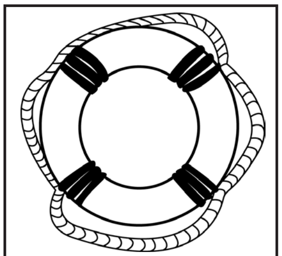
❑ 12. ***Is there a late payment charge?*** Most lenders charge a late payment fee, but they vary in how much and when the fee is charged.

Questions for Adjustable Rate Mortgages (ARMs):

❑ 13. ***Is the initial interest rate lower than that of a fixed rate loan?*** Some loans have very low initial interest rates ("teaser rates") to attract borrowers, and then rise.

❑ 14. ***If so, when and how will it change?*** Usually after one, three or five years the interest rate is raised to its normal level according to the loan agreement's formula.

Unless you intend to have the mortgage for only a short time, it is better to make comparisons based on the formula interest rate rather than the initial rate. But if you plan to sell soon, the lower costs from that initial discounted interest rate could save you a lot of money.



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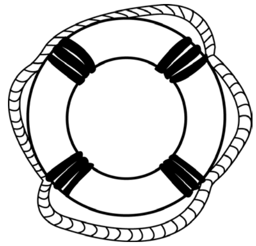
It's a good idea to figure out (or ask the lender to give you) what would happen to the monthly payment amount of an ARM if: (a) rates rose to the upper limits of the caps (the worst case scenario) and (b) if rates dropped by 1% or 2%. This will give you a clear picture of the risk (and whether or not it will be affordable) if rates rise and the realistic opportunity for savings if rates fall.

❑ 15. ***How often can the interest rate and payment amount change?*** In general, the shorter the rate adjustment period, the lower the interest rate and vice versa. Frequent adjustments are better when rates are falling, but offer less protection when rates rise. Here again, the length of time you plan to own the home should affect your choice. For example, if you plan to buy a starter home and sell it soon to move up to a more expensive home, you might choose a 3-, 2- or even a 1-year ARM. The lower interest rate would save you money if you sell the home before the rates rise beyond the current rate of a fixed rate loan.

❑ 16. ***What adjustments index is used?*** Lenders and investors in adjustable rate mortgages utilize a variety of indexes including the performance or yield of 1 month, 1 year, 3 years and even 10 years of U.S. Treasury securities. Popular indexes include Prime Rate, Certificate of Deposit Index or Treasury Bills.

❑ 17. ***What is the margin?*** The interest rate of an ARM follows a published market index rate. A common one is the one-year U.S. Treasury Securities index. In general, indexes tied to long-term indicators (such as three-year securities) change less than those tied to short-term indicators (such as three-month Treasury bills). Long-term is better when rates are rising; short-term is better when rates are falling.

The margin, or point spread above the index, determines what your mortgage interest rate will be at each adjustment date. The smaller the margin, the closer your interest rate is to the index rate and the less you pay. Keep in mind that the same margin over two different indexes may produce two different interest rates.



Life Saver
When applying for a loan: if you are unsure of anything, STOP. Check it out, making sure you understand everything and that what is written on the application is what you were told. It is a legal contract and you are bound by it.

❏ **18.** ***Are there periodic and overall rate caps?*** Rate caps limit how much the interest rate can rise or fall at the adjustment dates and over the life of the loan. In general, the lower the rate caps, the smaller the risk to you – but the higher the starting interest rate. Most ARMs have 5% to 7% overall rate caps and 1% to 2% periodic rate caps.

❏ **19.** ***Is it convertible to a fixed rate mortgage?*** Some lenders offer ARMs which can be converted to a fixed rate mortgage (FRM) during a certain time period. Convertible ARMs usually have an interest rate which is lower than FRMs but higher than nonconvertible ARMs.

❏ **20.** ***Is negative amortization possible?*** If interest rates rise, payment caps (limit on the amount your monthly payments can change when the interest rate changes) can cause your debt to grow rather than shrink. Loans which allow your debt to grow (known as negative amortization) may put you as higher risk. Loans with payment caps can be structured with rate caps to avoid negative amortization.

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

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