A Critical Guide To Home Loans:

Your Options And How They Affect Your Future

An Insider's Guide To Understanding Mortgage Loans

There was a time in the not-so-distant past when financing the purchase of a home was relatively uncomplicated. You went to your local savings and loan and signed up for a 30-year, fixed-rate mortgage loan.

Those days are gone, probably forever. Today, you have what seems like an endless array of choices—different rates, terms, down payments, fees, etc. (One lender told me there are literally more than 40,000 available loan options on computer database!) **So how do you pick the combination that makes the most sense for you?**

Having spent many years helping buyers understand the ins and outs of financing a home, I've developed this guide to assist you in evaluating which mortgage is best for you. **More than any other single factor, choosing the right mortgage will influence whether or not your investment is a good one.** Let's say you get a great price on a home, but you end up with a mortgage that has high fees and a high interest rate. **You could see the money you saved disappear in a very short time.**

Keep in mind that a great mortgage for one person may be terrible for you. **Each of us has different circumstances that determine whether a particular loan is a good deal or not—**whether you're

just starting out or nearing retirement, how secure your job is, how long you plan to be in the home, etc. You can be sure that the best loan for a first-time home buyer planning to move up in five years is quite different from the best loan for a couple who's staying for the next 20 years.

First things first—know what you can afford

You can save yourself a lot of time and trouble if you take a few minutes to figure out the loan amount you can afford. The general guidelines are:

•**No more than 28 percent of your gross monthly income should be spent on housing expenses** (principal, interest, insurance and taxes). This can vary upwards if you have a good credit history, liquid assets, or if you're already spending more than 28 percent on your housing expenses.

•**Your total debt (mortgage and consumer debt) shouldn't exceed 36 percent of gross monthly income.** Again, people with good credit and liquid assets can often creep above this line.

You can save yourself a lot of time and trouble if you take a few minutes to figure out the loan amount you can afford.

As you compare your income to your potential housing expenses, **keep in mind that your mortgage principal and interest are not your only costs.** You also need to allow for any association fees, property taxes, insurance payments, etc.

Having said this, I should point out that the rules are looser than ever today. The "28 over 36" rule is no longer the ironclad guideline. Both the federal government and mortgage lenders have gotten very creative in their efforts to attract first-time buyers to the market. **Today, there's a loan program out there to put all but the worst-risk people into homes.** But for your own safety and confidence down the road, your best bet is to adhere as closely as possible to the above guidelines.

Avoid unpleasant surprises

Talk to your Realtor® or loan officer about checking your credit history prior to applying for a mortgage. There's no reason to waste time and money in the application process if you have credit problems that will cause you to be rejected. Once you know about any potential problems, you can work on clearing them up before you apply.

Once you know about any potential problems, you can work on clearing them up before you apply.

Shopping for a mortgage lender

There are several potential lenders in today's marketplace. They include:

Mortgage Banks—A mortgage banker is a **direct lender.** He or she qualifies applicants, finds the best available loan and funds it. Because this is their main business, mortgage banks can offer very competitive rates—but are not necessarily the cheapest.

Mortgage Brokers—Brokers don't lend money; **they find lenders for a fee** in addition to the traditional application and processing costs. While a good broker might be able to find you the cheapest mortgage, make sure the fee doesn't offset any savings. Since most brokers' fees are paid by the lender in the form of a commission, their services cost you nothing—that is, no out-of-pocket costs. Something also to remember—a mortgage broker is the legal agent of his or her client and does not work for the lending institution. **So, a mortgage broker will have access to the widest spectrum of loan options—whereas a bank or savings and loan representative will draw from only "in-house" loan options.** Going by this information, a reputable mortgage broker would most likely be your cheapest source for home loans and refinancing.

Something also to remember—a mortgage broker is the legal agent of his or her client and does not work for the lending institution.

Savings and Loans—Once the primary source of home financing, savings and loans hold a much smaller piece of the market today. **But some experts recommend checking their offers before looking at a bank.**

Banks—Commercial banks have come on strong in recent years. **Some have made home loans a significant part of their business.**

Credit Unions—A good source often overlooked by borrowers. **Credit unions function like brokers because they generally don't lend their own money.**

Whichever route you ultimately take, **be sure to shop around.** What lenders charge might differ by as much as two or three percentage points. That's pretty significant when you look at the impact on a 30-year fixed-rate mortgage—depending on the size of the loan, the difference could be a few hundred dollars a month!

What a Realtor® can do for you

If you're using a Realtor® to help you find a home, ask to be put in touch with a lender he or she works with on a regular basis. In most cases your Realtor® is not a loan officer, but it is his or her job to help people buy and sell homes. **A good real estate professional has long-standing relationships with home mortgage professionals and can point you in the right direction to answer any questions you may have.** He or she can also share insights into what they've seen work—or not work—for others in situations similar to yours.

Which loan is right for you?

Adjustable. Fixed. Balloon. It's easy to get lost in mortgage verbiage. Here's a rundown of the most common loans.

Adjustable-Rate Mortgages—Your interest rate (and monthly payment) **rises and falls with the index to which it's tied.** Because they start out two to three percentage points below fixed-rate mortgages, **they're particularly popular when fixed rates are high.** To protect you against interest rate hikes, the best loans put a cap on annual rate increases of two percentage points a year, with a lifetime increase of no more than five percentage points above where you began.

The most popular ARM indexes are those linked to three-month, six-month and one-year Treasury Bills, the 11th District Cost of Funds (COFI), the prime rate and the London Interbank Offer Rate (LIBOR).

As a rule, ARMS make more sense if you don't plan on staying in your home longer than five years at most. Which index is good for you depends on two things: the economic forecast and your personal comfort level.

A prudent approach is to always plan financially for the "worst case" scenario: Assume that your loan will always rise the maximum amount.

Libor and T-Bill indexes, for example, react more immediately to changes in the economy—a good thing when interest rates go down, not so good when they rise. Whatever happens, you'll see it pretty quickly in your monthly payment.

More conservative buyers prefer indexes linked to the prime rate or the COFI because they're more stable and move up (and down) more slowly than other indexes. That's good when rates are low and rising, less so when they're high and dropping.

Is an ARM a good choice for you? Well, if you need a lower monthly payment to afford the home you want and you're planning to stay there less than three to five years, then yes. **But make sure you can handle the higher payments that might come down the road.** A prudent approach is to always plan financially for the "worst case" scenario: Assume that your loan will always rise the maximum amount. If you wouldn't be able to afford it, then consider another loan. You know your own personal "comfort level." Use it to make your decision.

Let's say you're buying your first home. You have a modest income today but a bright future. Even so, you need to keep your payments low. A long-term ARM makes sense even though your interest rate could rise over time. If you move in the next two or three years, you won't be around for any significant rate hikes. If you choose to stay longer, a rise in income will help you keep pace. Or you can always refinance to a fixed-rate mortgage.

Fixed-Rate Mortgages—People usually opt for a fixed-rate loan for the security it offers. **You know exactly what you'll be paying each month for the life of the loan.** If interest rates fall, you can

refinance at a lower rate. Lenders are offering more loan programs based on fixed rates, such as lower down payments—that is, five percent down or less. Adjustable rate loans generally require a larger down payment. **The most common fixed-rate loans are for terms of 15 or 30 years.** If you can afford the shorter term, it's a good way to build equity fast and save tens of thousands of dollars over the life of the loan. (However, I can show you how it will be a more savvy move to go with a 30 year fixed and pay an extra payment each month above and beyond your established mortgage payment. Just be sure to indicate your extra payment is for principal paydown only, not interest. This way you could even pay off your mortgage sooner than 15 years and save tens of thousands of dollars. You also have the "safety net" of paying your lower established mortgage payment should things get tight one month.)

Fixed-rate mortgages make the most sense when interest rates are low and if you're planning to stay put for the next seven or more years.

Fixed-rate mortgages make the most sense when interest rates are low and if you're planning to stay put for the next seven or more years. They offer safety to people on fixed incomes who might not be able to afford a rising housing bill. If you need to lock in your level and can afford the monthly payments, consider a fixed-rate loan.

Let's say you make a good salary working for a large company. You're comfortable and job security is pretty good, but there's not much chance of further advancement. **In other words, you don't anticipate moving anywhere else in the foreseeable future, and you want to avoid the possibility of higher house payments down the road.**

Graduated-payment mortgages are more of a risk. Your early payments are so low that they don't cover the interest due, which results in negative amortization.

A fixed-rate, long-term mortgage makes sense in this situation. Although you're probably paying one to two percentage points more than an adjustable loan, you also have the security of a fixed payment each month. And if interest rates drop three or more points, you can refinance at the lower rate.

Graduated-Payment Mortgages—This one is more of a risk. **Your early payments are so low that they don't cover the interest due, which results in negative amortization—which means you owe more each month, not less.** Your monthly payments gradually increase to cover principal and interest, and you end up paying more than you would have for a regular loan. Some GPMs are fixed, others are adjustable.

Given the fact that lenders have literally rewritten the rules to get more people into homes today, I can't think of a good reason to consider a GPM.

Intermediate Fixed Mortgages—These are a family of 20- or 30-year loans that are fixed for a set amount of time, such as 5 to 7 years, then they readjust once for the remainder of the loan. This readjustment is based on a predetermined index. Some may refer to these as "balloon" mortgages, but this term is falling out of favor because of negative connotations associated with balloon mortgages of the past—which were fixed for 5 to 7 years, at which time the entire balance of the loan became due.

Today, they are more commonly known as intermediate fixed loans or extended balloon mortgages. Some of these loans are not for the fainthearted. You enjoy low fixed payments from one to seven years, and then the loan readjusts—**as long as certain conditions are met,** such as interest rates haven't risen more than five percentage points, you haven't made any late payments in the previous 12 months, etc. If conditions aren't met, there are no guarantees, so beware. It's best to consult your Realtor® or loan officer if you have questions regarding these loans.

If you're a first-time home buyer who plans to trade up before the loan comes due, you might ask your Realtor® about a balloon mortgage.

If you're a first-time home buyer who plans to trade up before the loan comes due, you might want to consider a balloon mortgage in order to have lower monthly payments. **But be sure to get all stipulations in writing and review them carefully.** (There's a new family of intermediate loans becoming available that are similar to these other balloon mortgages, but when they become due after 5 to 7 years, they adjust and become *variable* rate loans. They also do not carry the rigid stipulations that balloon loans carry, making them a little easier to live with if you don't move before the loan is due.)

There are various other loan types—including roll-overs, wraparounds, zero-interest-rate mortgages and buy-downs—but the ones I've listed here are most common. **If you decide to opt for something more exotic, discuss it with your Realtor® and loan officer carefully to make sure you know what you're getting yourself into.** If you get in over your head and can't meet your obligations, you could end up losing your home and doing serious damage to your credit.

When it's a good time to refinance

Whatever you decide is the best option for you today may change as economic conditions or your personal circumstances change in the future. **So how do you know it's time to refinance?**

Whether or not you should refinance usually depends on three things: **what you think interest rates will do in the near future, how much monthly savings you'll enjoy, and how long you expect to be in your home.**

Refinancing is not something you consider lightly because it can be expensive. The total cost of your loan can rise as much as five percent when you add in the up-front points, fees and costs.

A good rule of thumb is to *start* looking into refinancing when interest rates drop 1 to 1½ points below what you're currently paying. The reason is that some lenders offer loans that cost little or nothing at all. As soon as interest rates drop below your rate, start talking to your agent or loan broker.

Next, figure out what you'll have to pay up front. Then calculate your monthly savings. With these two numbers, you can figure out how long it will take you to cover the cost of the new loan. For **example, if**

refinancing costs you $5,000 up front and saves you $200 a month in mortgage payments, it will take 25 months to cover your costs. If you're not planning to move for several years, refinancing makes a lot of sense. But if you're going to look for a new home in two years, you wouldn't really be around long enough to reap the benefits. In fact, you'd lose money in this situation.

A good rule of thumb is to start looking into refinancing when interest rates drop even one point below what you're currently paying because there are some loans that cost little or nothing at all.

If you refinance today and rates drop even further in the next few months, you'll miss out on additional savings. **If you refinance to save $10 or $20 off your mortgage payment, then you'll have to stay in your home forever to see it pay off.**

WARNING: The math is easy for fixed-rate loans, not so easy when you're talking about ARMS. If you don't feel comfortable running the numbers yourself, ask your lender or Realtor® for help.

Questions to ask while shopping for your loan

Before you can effectively compare mortgages, there are a number of questions you'll need to ask the loan officer. Some are obvious, others are not. Be sure to ask them all.

KINDS OF FINANCING—Fixed? Adjustable? What about government-backed programs? Any special deals you should be aware of? **Make sure you've got a complete picture of the product menu.**

INTEREST RATES—Rates differ not only between different types of loans. **The same loan at three different lenders could have three different rates!**

TERMS—There are options beyond 15- and 30-year terms. **Find out how different terms affect interest rates and how they impact the final cost of your home.** This is especially important if you plan to be in the home for a long time.

DOWN PAYMENT—What's the minimum required for different loans? **Today's down payment can range from as high as the old standard 20 percent to nothing at all in certain targeted programs.**

LOAN LIMITS—Many lenders set limits based on a loan-to-value ratio. For example, with an 80 percent loan-to-value ratio (LTV) you can only borrow $80,000 on a $100,000 home.

LOAN QUALIFICATION—Different lenders may qualify you using different formulas. **Make sure you understand how you're being evaluated.**

POINTS—Think of these as prepaid interest charged by the lender. **One point equals 1 percent of the face amount of your loan.** In some cases points are paid up front; in others, they're bundled into the loan.

The latter saves you money up front but costs you more over the life of the loan. No-point loans also save you money up front, but lenders usually charge one-quarter to one-half point more than in the case of loans with points. **Be sure to look at what your total costs will be over the life of the loan.**

Think of these as prepaid interest charged by the lender. One point equals 1 percent of the face amount of your loan.

PREPAYMENT PENALTY—If you decide to pay off your mortgage before the term is up, or refinance when interest rates go down, you may have to pay a prepayment penalty.

SPECIAL DEALS—Some lenders reduce interest rates for customers who avail themselves of other services offered. For example, **your bank might take a quarter of a percentage point off if you agree to automatic prepayment from your checking account.**

TIME TO APPROVAL—Find out how long it will be before you'll have a decision on whether or not your loan application has been approved by the lender. A week or two is pretty normal.

LOAN COMMITMENT PERIOD—Make sure you know how long your lender's commitment is good for. **The last thing you need is to decide on a loan amount at a certain rate, find the right home and discover your interest rate went up in the meantime.**

Many lenders now offer lock-in programs. This means that the lender will guarantee in writing your loan at a certain rate for a certain period of time. Common lock-ins are for 10-, 12-, 21-, 30-, 45- and 60-day periods. The longer the lock-in, the more time you have to shop and iron out hitches in the loan process. But a lender might charge you more in points for longer periods. Then again, a short lock-in period can be next to useless given the amount of time the loan process can take. **The lesson here is to be very clear of what a lock-in offers—and doesn't offer.**

The longer the lock-in, the more time you have to shop and iron out hitches in the loan process. But a lender might charge you more in points for longer periods.

Once you have this and other information on various loan programs from different sources, you can make an informed decision as to where to shop for the best mortgage.

Don't get stung by unexpected fees

One of the most common errors I've seen borrowers make is in not considering the various fees they will end up paying in figuring out the final cost of a home. **Let's take a look at what you can expect.**

LOAN APPLICATION FEE—This is what the lender charges you for applying. It isn't refundable, even if you're refused.

APPRAISAL FEE—This flat fee is usually charged by the prospective lender to pay an independent appraiser

to inspect the home and estimate its fair market value. This fee is also nonrefundable whether or not your loan goes through.

Loan Origination Fee—This charge, which covers the lender's administration costs, can either be a flat amount or a percentage of the loan amount. It's paid in cash at closing.

Tips for the best deals

Now that you know a little more about mortgages and where they come from, **I'll share with you my tips for getting the best deal and saving yourself a lot of headaches in the process.**

Prequalify Before You Shop for a Home—Smart buyers make sure to know exactly how much they can afford to borrow before beginning to look at homes. **You can bet that the seller's agent will ask if you've been prequalified; if you haven't, they may decide you're not a serious buyer.** Having a deal in your pocket is always good ammunition in negotiations. (However, I generally have my buyers "preapprove" before they start looking at homes. This is a much more savvy way—you have it in writing, providing you even more leverage when making offers and during negotiations.)

Lock in a Rate (or not)—In the time it takes you to find a home and close your mortgage, the interest rate on your loan could fluctuate upward. **If it looks like rates are heading up, lock it in. If rates appear to be falling, let it float.** If your lender agrees to a lock, make sure you get it in writing. (Get the advice of your Realtor® or your mortgage broker. Their knowledge and experience can really help you in this decision.)

The smart buyer makes sure to know exactly how much he or she can afford to borrow before beginning to look at homes.

Apply for an FHA- or Veterans Administration-Backed Mortgage—The Federal Housing Administration and the Veterans Administration don't actually make loans, but they do guarantee loans offered through traditional lenders. **With an FHA loan, you can put down as little as 3 percent, depending on the value of the property. VA loans often require no down at all,** but they carry eligibility requirements based on service in the armed forces.

Negotiate the Points—If you're considering a large mortgage, your lender may be willing to lower the points charged to get your business. You lose nothing by negotiating. **If you're planning to stay in your home for less than five years, lower your points paid by accepting a higher interest rate. If you're sticking around longer, consider more points against a lower mortgage rate.** You pay higher costs up front but can save money in the long run. Just remember there are three components to your mortgage loan: the interest rate, the points and the lender's charges.

Watch Out for Prepayment Penalties—Make sure you won't be penalized for paying off your mortgage ahead of schedule if you choose to do so. **(When making an additional payment above your**

regular mortgage payment, always be sure to specify that the additional amount is toward principal!)

Make sure you won't be penalized for paying off your mortgage ahead of schedule if you choose to do so.

WATCH OUT FOR MORTGAGE PROTECTION INSURANCE—Some lenders may offer you mortgage protection insurance which will make your payments in case you die, become disabled or lose your job. Check around; **you often may find the same kinds of protection through your regular insurance agent at a lower cost.**

PRIVATE MORTGAGE INSURANCE (PMI)—Private mortgage insurance is required by the lender on loans with down payments of 10 percent or less. The cost can run from one-third of a percent to 1 percent monthly. Once your equity reaches 20 to 25 percent, you may be able to cancel your insurance. **While some look at this required insurance as a nuisance, without it, there wouldn't be loan options with only 3% down or 5% down—all loans would probably require the more restrictive 20% down.**

Accelerating your monthly payments won't save much if you're in your home for only a few years, but for longer-term situations it makes a lot of sense.

CONSIDER THE BENEFITS OF AN EARLY PAYDOWN—There are several benefits to accelerating the payments on your mortgage. **Every extra dollar you put into your mortgage can save you up to three dollars down the line in interest savings.** You'll build equity in your home more quickly, which puts you in a better position to trade up in a shorter time period. also forces you to save money you might otherwise spend rather than invest. **But make sure you verify with your lender that there won't be prepayment penalty.**

Accelerating your monthly payments won't save much if you're in your home for only a few years, but for longer-term situations it makes a lot of sense.

(If you refinance your home, you may consider this option: Continue to pay your old mortgage rate instead of your new one—stipulating, of course, that the extra money is to pay off principal. By doing this, you will pay off your loan sooner and save tens of thousands of dollars.)

The affordable lending boom

In the past few years, lenders have come to realize that they can safely make loans to people who previously didn't believe they could qualify for a home mortgage.

A recent national study by the Consumer Bankers Association showed that **96 percent of the 130 institutions surveyed have cut their down payment requirement—the single biggest obstacle to home ownership for many Americans.** Where once a 20 percent down payment was the standard, today 5-, 3- and even zero-percent downs have become commonplace. Loans up to 90, 95 and even 97 percent of the purchase price are quite common today.

Lenders have also adopted much more lenient standards in terms of debt-to-income ratios. The standard 28 percent has moved up to 33 percent, and even as high as 38 percent in some programs. In addition, lenders are more flexible in their assessments of creditworthiness, employment histories and other factors that used to result in rejection for many. The point is simple—**there's never been an easier time to qualify for a mortgage.**

There's enough information out there on mortgage loans to fill several books. But I hope this provides you with a good general overview of what to look for and what to expect as you shop for the best home loan.

Real estate financing is a complicated subject. This special report is for general informational purposes only. As with any complex legal and/or financial matters, always consult with a qualified professional before making any decisions or proceeding with your home loan or refinancing.

Please feel free to call me if you would like further explanation on any of these topics, or if you have any questions at all regarding real estate. I simply see my mission as striving to be as helpful as possible to area home buyers and sellers.

©2006 Hobbs/Herder Advertising. No Reproduction Without Permission.

Notes