General Financing Questions

What is a mortgage?

Generally speaking, a mortgage is a loan obtained to purchase real estate. The "mortgage" itself is a lien (a legal claim) on the home or property that secures the promise to pay the debt. All mortgages have two features in common: principal and interest.

What is a loan to value (LTV)? How does it determine the size of my loan?

The loan to value ratio is the amount of money you borrow compared with the price or appraised value of the home you are purchasing. Each loan has a specific LTV limit. For example: With a 95% LTV loan on a home priced at $200,000, you could borrow up to $190,000 (95% of $200,000), and would have to pay $10,000 as a down payment. The LTV ratio reflects the amount of equity borrowers have in their homes. The higher the LTV the less cash homebuyers are required to payout of their own funds. So, to protect lenders against potential loss in case of default, higher LTV loans (80% or more) usually require mortgage insurance.

What types of loans are available and what are the advantages of each?

Fixed Rate Mortgages: Payments remain the same for the life of the loan

Types

- 15-year
- 30-year

Advantages

- Predictable
- Housing cost remains unaffected by interest rate changes and inflation.

Adjustable Rate Mortgages (ARMS): Payments increase or decrease on a regular schedule with changes in interest rates; increases subject to limits

Types

- Balloon Mortgage- Offers very low rates for an Initial period of time (usually 5, 7, or 10 years); when time has elapsed, the balance is due or refinanced (though not automatically)
- Intermediate ARM – Interest is fixed for a period of time and then adjusts like a typical ARM.
- ARMS linked to a specific index or margin

Advantages

- Generally offer lower initial interest rates
- Monthly payments can be lower
- May allow borrower to qualify for a larger loan amount

When do ARM's make sense?

An ARM may make sense if you are confident that your income will increase steadily over the years or if you anticipate a move in the near future and are not concerned about potential increases in interest rates.

What are the advantages of 15- and 30- year loan terms?

30-Year:

- In the first 23 years of the loan, more interest is paid off than principal, meaning larger tax deductions.
- As inflation and costs of living increase, mortgage payments become a smaller part of overall expenses.

15-year:

- Loan is usually made at a lower interest rate.
- Equity is built faster because early payments pay more principal.

Can I pay off my loan ahead of schedule?

Yes. By sending in extra money each month or making an extra payment at the end of the year, you can accelerate the process of paying off the loan. When you send extra money, be sure to indicate that the excess payment is to be applied to the principal. Most lenders allow loan prepayment, though you may have to pay a prepayment penalty to do so. Ask your lender for details.

Are there special mortgages for first-time homebuyers?

Yes. Lenders now offer several affordable mortgage options which can help first-time homebuyers overcome obstacles that made purchasing a home difficult in the past. Lenders may now be able to help borrowers who don't have a lot of money saved for the down payment and closing costs, have no or a poor credit history, have quite a bit of long-term debt, or have experienced income irregularities. Even loans with prepayment penalties can usually pay up to 20% of the loan balance per year without a penalty.

How large of a down payment do I need?

There are mortgage options now available that only require a down payment of 5% or less of the purchase price. But the larger the down payment, the less you have to borrow, and the more equity you'll have. Mortgages with less than a 20% down payment generally require a mortgage insurance policy to secure the loan. When considering the size of down payment, consider that they also need money for closing costs, moving expenses, and - possibly -repairs and decorating.

What is included in a monthly mortgage payment?

The monthly mortgage payment mainly pays off principal and interest. But most lenders also include local real estate taxes, homeowner's insurance, and mortgage insurance (if applicable).

What factors affect mortgage payments?

The amount of the down payment, the size of the mortgage loan, the interest rate, the length of the repayment term and payment schedule will all affect the size of your mortgage payment.

How does the interest rate factor into securing a mortgage loan?

A lower interest rate allows you to borrow more money than a high rate with the some monthly payment. Lender must disclose the Annual Percentage Rate (APR) of a loan. The APR shows the cost of a mortgage loan by expressing it in terms of a yearly interest rate. It is generally higher than the interest rate because it also includes the cost of points and other fees included in the loan.

Use Financing to Your Advantage; Don't be Afraid

Assume a loan amount of $200,000
Assume today's rate is 7.00% at 0 points

$1,297.20 at 6.75% & $200,000 loan
$1,330.60 at 7.00% & $200,000 loan
$1,364.35 at 7.25% & $200,000 loan
$1,398.43 at 7.50% & $200,000 loan

If the interest rate is reduced by .25%, 1 point is added into the closing costs. At 6.75% the payment is $33 per month less than it would be at 7.00%. It will take approximately 5 years to make this back, however, if the borrower feels this is important, do it!

If the interest rate is increased by .25%, the benefit is 1 point to be used to help pay closing costs. 1% of $200,000 = $2,000 for closing costs. The payment is increased by $33.75. At that rate it would take 5 years before you spent more than $2,000.

If the interest rate is increased by .50%, the benefit is 2 points to be used to help pay closing costs. 2% of $200,000 = $4,000 for closing costs. The payment is increased by $67.82. At that rate it would take 5 years before you spent more than $4,000.

The point is if you want a lower payment, take it. You will save money over the long term. If you need cash to close, use it. It takes a long time before you have invested more than you would have spent. If a lower payment is desired, consider a 40-year mortgage, a 5/1 ARM or a 5/1 ARM with interest only for the first 5 years.

No Doc Loan: If today's rate is 7.0% for a fully documented, conforming loan and you do not indicate employment, income or assets, you will pay approximately 9.0%. At $200,000 the difference is approximately $278.64 per month. The reason that you would do this has to do with the borrower not wanting to justify income, assets or other reasons.

If a home appreciates 5% per year the $222,222 (if the loan was 90% of value) the value of the home after 5 years would be $283,618 or $61,618 in gained equity. The borrower would have paid 60 payments at $278.64 more or 278.64 x 60 payments would be $16,718. If the borrower needed this loan to get the home, they would have gained $63,000 in equity for the $16,700 difference or a 375% return over the 5 years. This assumes that the other costs were about the same.

Waiting: Now let's assume you decide to wait 1 year to buy and during that year the home has appreciated 5% and rates have increased to 8%. If you purchase the same house at the appreciated value and put the same 10% down, the down payment would increase by $1,100, the equity would be $2,500 less and the payment would be $210.10 more per month or $10,000 over the 4 years. (The first loan would be in place for 5 years and the delayed loan 4 years) The borrower just lost $13,600 for waiting 1 year.

What happens if interest rates decrease and I have a fixed rate loan?

If interest rates drop significantly, you may want to investigate refinancing. Most experts agree that if you plan to be in your house for at least 18 months and you can get a rate 2% less than your current one, refinancing is smart. Refinancing however, may involve paying many of the same fees paid at the original closing, plus origination and application fees.

Discount points:

Discount points allow you to lower your interest rate. They are essentially prepaid interest, with each point equaling 1% of the total loan amount. Generally, for each point paid on a 30-year mortgage, the interest rate is reduced by 1/4 (or.25) of a percentage point. When shopping for loans ask lenders for an interest rate with 0 points and then see how much the rate decreases with each point paid. Discount points are smart if you plan to stay in a home for some time since they can lower the monthly loan payment. Points are tax deductible when you purchase a home and you may be able to negotiate for the seller to pay for some of them.

Escrow account:

Established by the lender, an escrow account is a place to set aside a portion of the monthly mortgage payment to cover annual charges for homeowner's insurance, mortgage insurance (if applicable), and property taxes. Escrow accounts are a good idea because they assure money will always be available for these payments. If you use an escrow account to pay property tax or homeowner's insurance, make sure you are not penalized for late payments since it is the lender's responsibility to make those payments.