Contents

Introduction: Mortgage Basics

What is the largest purchase that you will make during your lifetime? It's your home, right? Wrong, it's your mortgage!

If you buy a $120,000 home financed with a $20,000 down payment and a $100,000 mortgage at 8 percent interest for 30 years, you will pay $165,849 in interest over the life of the loan. That's more than the purchase price of the home.

Most people do not consider obtaining a mortgage the same as choosing and buying a product. But a mortgage is a product like any other, and as with other products it pays to be a smart consumer. By shopping around and knowing what you are shopping for, you can save thousands of dollars, whether this is your first home or umpteenth. Saving 0.5 percent on the interest rate of a $100,000 mortgage lowers your payments by $450 a year and saves you $13,400 in interest over 30 years.

Making you a smart consumer is the whole point of this book. It tells you what you need to know when shopping for your mortgage.

Chapter 1 The Application Process

Getting a mortgage can be a long and sometimes frustrating ordeal. Applying for a mortgage is not quick nor simple. In fact, it is a lengthy complicated process (see Figure 1.1) that often involves many different people and companies such as:

- Borrower,
- REALTOR
- Mortgage broker,
- Lender (loan officer, loan processor, underwriter and/or loan committee),
- Credit bureau,
- Appraiser,
- Borrower's employer(s),
- Borrower's banks and creditors,
- FHA, VA or mortgage insurance company,
- Inspector,
- Surveyor,
- Title insurance company and
- Settlement attorney.

Each of these people and companies can play a part in the processing, approval and settlement of your loan.

The whole process, from the time of the loan application to the settlement (also known as the closing), can take from 30 to 90 days. Under normal conditions, you should plan on 45 days. During the peak homebuying season or periods of heavy refinancing activity, count on 60 to 90 days. When applying, ask your lenders, what its processing time has been averaging.

Problems arise when one or more people involved in this process make a time-consuming mistake or get backlogged with work and fail to get part completed on time. The borrowers themselves also can delay the process by not supplying the necessary information on time.

Although the paperwork starts with submitting of a loan application, two steps in the process precede the application: prequalification and shopping for a loan.

Chapter 2 Qualifying for a Mortgage Loan

Before making a mortgage loan, a lender spends from $500 to $800 putting together a package of documents for its underwriters and loan committee. Based on these documents and on a set of nationally accepted standards, the lender decides whether to approve the loan application.

As many as *one-third* of all mortgage loan applicants will fall in the gray area where loan approval decisions must be made. For example, first-time homebuyers will stretch their income to buy the largest home that they can afford. Before spending the $300 to $400 to apply for a mortgage, you should have a good idea whether you qualify for the loan amount that you want. If you get turned down, you may lose your application fee and, worse, you may lose the opportunity to buy the house you want.

Even if you are seeking only to refinance an existing mortgage, you could have trouble qualifying. Some of the nationally accepted qualification standards have changed in the past two years, and these changes may affect you. If your income has dropped since you got your last mortgage, you may have trouble refinancing, *even with the same lender*. If you have had any recent credit problems or if you have been delinquent on your current mortgage payments, this also may disqualify you.

If you have any doubts about your ability to qualify for the mortgage amount that you want, this chapter tells you what you can do to help you qualify yourself.

Chapter 3 Overcoming Qualification Problems

You are not alone if you have some problems qualifying for a mortgage. As many as 25 percent to 50 percent of all mortgage loan applications do not precisely fit the guidelines described in Chapter 2. For example, the following are common problems:

- *Monthly income and expenses*. Lenders have very specific requirements on the types of income included for qualification purposes and the kinds of expenses that are counted in calculating ratios. Your income may not meet the lender's requirements, or you may have debts that the lender considers too high.
- *Credit history*. People have illness in their families, get busy with travel or simply forget to mail payments for bills that are due, resulting in "late payments" on their credit report. At a minimum, you will almost certainly have to explain any "blemishes" (late payments) that appear on your credit report.
- *Property appraisal.* Sometimes houses simply cannot be appraised for the amount of the sales price.
- *Source of cash for down payment and settlement costs*. Your funds may come from sources that are unacceptable to traditional lenders.
- *Employment history.* People lose their jobs, start new jobs, get transferred, and experience all types of other changes relating to employment; these changes may adversely affect the lender's underwriting consideration.

The purpose of this chapter is to outline some of the problems that you might encounter when applying for a mortgage loan and to suggest some possible strategies to overcome them *before* you apply.

To illustrate how widespread problems from credit ratings alone, can be, consider the national statistics in Figure 3.1 regarding types of credit accounts that may be delinquent (30 days *or more* late) at the end of any given month:

These numbers represent percentages of total loans outstanding that are delinquent as of each month. Loans may be delinquent in one month but not the next, so the total number of loans that are delinquent at some time during the course of the term of the loan is likely much higher than these statistics indicated .

Also look at the following statistics on repossessions or foreclosures (by which the lender repossesses the secured property for nonpayment of the debt):

- Automobile loans --more than .08 percent per month or almost 1.0 percent per year;
- Mobile home loans --more than .11 percent per month or more than 1.3 percent per year;
- Marine financing (boat) loans-- more than .12 percent per month or more than 1.5% per year and
- Mortgages (first lien)-- more than .1 percent per month or about 1.25 percent per year.

These numbers represent percentages of total loans outstanding that result in repossession during the month. Vehicles may be repossessed more than once if the borrower makes up the delinquent payments, pays towing fees, etc., to bring the loan current. Mortgages in foreclosure do not necessarily indicate that the loan is "foreclosed." The process is full of legalities and takes several months (depending on the state in which the property is located) to complete. As with repossessed vehicles, loans may go into, and out of, foreclosure several times. Consequently, the number of mortgage loans that end up being actually "taken back" (property repossessed) by a lender is less than the numbers reported.

These numbers tell us that many people have less than perfect credit. In fact, almost everyone has some "blemish" on his or her credit report, whether because of an item lost in the mail, a forgotten payment, or any number of other possible reasons. This does not mean that mortgage loans are not available; *it simply means that you must be more resourceful in presenting your case to the lender.*

Overcoming High Housing/Debt Ratios (Not Enough Income To Qualify)

Chapter 4   Choosing the Right Type of Mortgage

In 1980, this chapter would have been very short. You could choose from only a few types of mortgages. Today, however, many are available . This chapter describes the mortgage products that are most popular and widely offered, and it gives the advantages and disadvantages of each type:

- Traditional 30-year, fixed-rate mortgages,
- 15-year, fast payoff mortgages,
- Graduated-payment mortgages,
- Growing equity mortgages,
- Adjustable-rate mortgages,
- Balloons, 3/1 and Two-Steps and
- FHA, VA and conventional loans.

Chapter 5 Shopping for a Mortgage

When shopping for a mortgage, your goal should be twofold: First, shop to make price comparisons (see Figure 5.1). A recent survey showed that in major metropolitan markets, mortgage interest rates vary by 0.375 percent to 0.50 percent for exactly the same product. That difference amounts to $350 a year on a $100,000 mortgage. The price difference also can show up in the points lenders charge. The same survey showed differences as large as 2.5 points for the same product at the same rate, as much as $2,500 on a $100,000 loan!

Second, look for a lender with a reputation for integrity and service. Although most lenders stand behind their commitments and provide good service, there have been instances when consumers did not get what they bargained for. Ask your REALTOR, your attorney or the Better Business Bureau about the reputation of a lender before submitting an application.

Chapter 6 Miscellaneous Mortgage Topics

Chapter 7 Investor Loans

Over the past ten years, individuals and real estate partnerships have purchased thousands of residential units -- single-family homes, townhouses and condominium units -- have been purchased by individuals and real estate partnerships as investments. Most of these purchases were financed with what the industry refers to as an *investor loan*. An investor loan is a mortgage on a one-unit to four-unit residential property that will be rented by the owner to others. If the owner plans to live in one unit and rent out the other units, it is called an *owner-occupied property*, otherwise it is called *nonowner-occupied*.

This chapter covers the requirements for getting a mortgage on a small (one-unit to four-unit) residential investment property. It does not cover the advisability of making such an investment, and it does not cover the financing of large commercial properties or larger apartment buildings.

In 1984, some of the nation's major mortgage lenders and mortgage insurers began having delinquency and default problems on investor loans. These problems climaxed in 1985 when Equity Programs Investment Corporation (EPIC), a purchaser of 20,000 residential investment properties, declared bankruptcy.

The entire mortgage industry and especially the $100-billion Fannie Mae responded to these problems by tightening their underwriting guidelines and charging an additional premium of 0.25% to .50% & interest rate for investor loans. The FHA has eliminated its investor loan programs entirely for nonowner-occupied properties. As a result, it is much more difficult to get an investor loan today than it was before the problems of the mid-1980s.

Chapter 8 Refinancing

What This Book Covers

The Mortgage Kit is strictly a consumer's guide and covers what consumers should know. It is not for people who work in the mortgage industry and need more in-depth knowledge of the topics discussed. Although it may be a useful overview of the mortgage process for REALTORS and those just entering the business. It does not cover the history of mortgage lending or the arcane mathematics that underlie mortgages. Time is valuable, so to the extent possible, the third edition of *The Mortgage Kit* is short and to the point.

Chapter 1 explains the application process. Getting a mortgage is complicated, often taking from one to three months. Knowing what information your lender needs can help you shorten that time and eliminate much of the frustration surrounding the process.

Chapter 2 tells you what a lender looks at before deciding whether or not to make a loan. It answers the questions "How large a loan can I get?" and "What can I do to help myself qualify for a mortgage?"

The brand new chapter 3 is written for (the almost half of all) mortgage applicants whose employment history, income, savings or property they are financing does not fit the national standards imposed by mortgage lenders. It describes in some detail how you can build your case to obtain a favorable consideration on your loan application.

Chapter 4 describes the various types of mortgages available today, including fixed and adjustable rates, level and graduated payments, FHA, VA and conventional loans. Different types of mortgages satisfy different consumer needs -- lower rates, easier qualifying, fast payoff, low down payment and low initial monthly payments. This chapter will help you pick the right type of mortgage for your needs.

Chapter 5 reveals how to save money by shopping. You should expect to save at least $1,000 by shopping, but you must know what to look for and what to look out for. This chapter also helps simplify and organize your shopping efforts.

Chapter 6 covers assumability, buydowns, mortgage insurance, prepayment penalties, second mortgages and tax deductions. This edition describes some of the new developments in mortgage insurance including the new monthly PMI (private mortgage insurance), which dramatically reduces the amount of cash required to close. A number of these topics are referenced in other chapters.

Chapter 7 is for anyone getting a mortgage on a small residential property bought as an investment rather than as a residence. It covers the additional qualification and documentation required for loans on investment properties (but not the advisability of making such an investment).

Chapter 8 is about refinancing. It helps you figure out whether you should refinance your existing mortgage, how much you would save and how much it would cost. It also offers some tips on how to reduce your refinancing costs.

The rest of the introduction is devoted to three topics that are basic to understanding mortgages: mortgage prices, loan-to-value ratios and monthly payments. Be sure that you understand these topics before going on to read the chapters that are of special interest to you.

What is Real Estate?

A mortgage is a method of financing real property, or real estate as it is commonly known. Consider for a moment what if means to own property. Real property, unlike other types of property such as automobiles, jewelry and clothing, is not portable. You can't pick it up and move it around. Ownership of land is defined by the location of that property. A lot survey defines the parcel of land that you buy in terms that relate to other fixed points of reference that are known and agreed on by all. This information is usually recorded in permanent records that are maintained by local governments.

- *Fee Simple property versus estates.* All states recognize fee simple ownership of real property. *Fee simple* means that the land and all improvements on the land (e.g. the house) transfer with the deed to the property. *Leasehold* means that the land is owned by a leaseholder who collects rent for the land. If you purchase a leasehold property, you obtain ownership of the improvements, but you incur an obligation to make leasehold payments, also known as ground rent, to the leaseholder. Residential leasehold properties are common in Hawaii and occur occasionally in Maryland.

- *Condominiums*. When you buy a condominium, you do not acquire land but three dimensional space defined as being within the exterior walls, ceiling and floors of the condominium unit. The condominium unit itself may be an apartment unit in a high-rise or low-rise building, but it can also be a townhouse or even a freestanding, detached single-family home. The land on which the condominium is located is owned by the condominium owners association which is governed and controlled by the condominium unit owners and is almost a minigovernment complete with bylaws and procedures, including the right to assess "taxes" in the form of association dues for maintenance and capital improvements to the common area. The definition of the condominium unit is described in the condominium documents that created the condominium. Condominiums are common in most states.

- *Cooperative units of co-ops.* When you buy a co-op, you do not acquire title to any real property. You actually buy "shares" in a cooperative that owns the real estate and all the improvements thereon. The cooperative, in return for your purchase of shares, grants you the right to occupy a specified living unit, structure or which can take any form as with condominiums. Cooperatives can be found in almost all states but are most common in large cities such as New York and Washington, D.C. Because cooperative ownership is substantially and legally different from other types of ownership, many lenders do not offer cooperative loans. The loan is not secured by real estate; it is secured by a lien against the shares of the cooperative.

Different types of ownership do not affect how you will qualify for a home loan, but they do affect the types of documents that you sign at settlement and may affect some of the costs associated with ownership. For example, leasehold payments for leasehold estates and condominium or homeowner's association fees are included in your total housing cost for qualification purposes.

What is a Mortgage?

The term mortgage is actually one of two different methods of financing real property: mortgages and deeds of trusts. For the most part, states are either deed of trust states or mortgage states. (See Appendix K for a list of what system each state uses.) Georgia uses a security deed, which is similar to a mortgage. A *mortgage* is a financial claim against your real estate. You *give* that to a lending institution along with a *bond* or a *note*, which is a personal promise to repay. In return, the lender gives you money--cash. You do not "get a mortgage;" you do the mortgaging--you are the *mortgager*. The lender *takes* your mortgage, *holds* your mortgage and is the *mortgagee*.

Loans secured by properties located in deed of trust states are secured by a document called a *deed of trust*. When you sign a deed of trust, you actually transfer ownership of the property to a trustee. The trustee holds the deed to the property in trust until such time as the loan is paid off. If a dispute arises between lender and borrower, the trustee must resolve the dispute according to state law. If the borrower stops making loan payments the trustee must hold a foreclosure sale to pay off the lender. The procedure for a foreclosure is clearly spelled out in the deed of trust and state law, and in most states, a court hearing is not required. In most mortgage states, however, the lender must go to court, argue the case before a judge and obtain judge's approval before a foreclosure sale can be held. Lenders prefer to have loans secured by deeds of trust because foreclosing on a deed of trust is cheaper and quicker than on a mortgage. As a borrower, you can consider mortgages and deeds of trust as generally interchangeable terms in this book.

Down Payment and Loan-to-Value Ratio

Lenders prefer a borrower who makes a large down payment and a mortgage with a low *loan-to-value* (LTV) ratio. Your loan-to-value ratio is simply your mortgage amount divided by the value of your property. (See Figure I.1) The *value* of your property is your purchase price or the appraised value, whichever is lower. Usually, they are the same.

Throughout this edition of *The Mortgage Kit*, there are many references LTV. The amount that you can borrow, your effective interest rate and the availability of certain types of mortgages depend on your LTV ratio. Mortgage insurance (see Chapter 6), which costs hundreds of dollars a year, is required if your LTV ratio is more than 80 percent. Investor loans (see Chapter 7) are difficult to find with an LTV ratio higher than 85 percent. Qualification ratios (*see* Chapter 2) are stricter for high LTV ratios. Very large loans are available only with LTV ratios of 80 percent or lower, which means that your down payment must be at least 20 percent of the property value.

For all of these reasons, it is important to know approximately what your LTV ratio will be. Chapter 5, "Shopping for a Mortgage," and the Mortgage Data Form in Appendix D will help you estimate your LTV ratio.

Calculating Your Monthly Payment

Your monthly mortgage payment includes not only principal repayments and interest on your loan, but also an additional amount known as escrow to cover real estate taxes, homeowner's insurance and mortgage insurance (if required). Your lender then pays your tax and insurance bills for you when they come due. Sometimes lenders will require that you pay enough to cover condominium/homeowners' association dues as well. This whole package of payments is known as *PITI* (principal, interest, taxes and insurance).

The sample PITI form in Figure I shows how to calculate your total monthly mortgage payment for a 30-year loan of $100,000 at 8 percent interest. (A blank form and detailed instructions are in Appendix A)

The principal repayment and interest make up the largest portion of your monthly payment. This is calculated by multiplying your loan amount by your loan's payment factor divided by 1,000. The payment factor depends on the interest rate and term of your loan. The payment factor for an 8-percent, 30-year loan is 7.3376. The instructions for the PITI Form in Appendix A include an abbreviated table of payment factors for 15-year and 30-year loans from 2.000 percent interest to 17.875 percent interest. Appendix I contains a complete table of payment factors for fully amortizing loans with terms of 1 year to 30 years, 35 years and 40 years and with interest rates from 2.000 percent to 19.875 percent.

The Price of a Mortgage

Question: Which is a better deal: (1) a 30-year fixed-rate mortgage at 8 percent interest plus three points or (2) one at 8.25 percent interest plus only one point?

ANSWER: It depends.

Comparing prices of different mortgages is complicated. In addition to the quoted interest rate, lenders charge a variety of additional up-front fees:

- Discount points,
- Origination fee,
- Appraisal and credit report fee,
- Inspection fee (for new homes),
- Underwriting/review fee and
- Document preparation fee....

Discount points, often referred to simply as *points*, are usually the largest fee that lenders charge. Each point equals 1 percent of your loan amount. If you borrow $100,000 but have to pay three points, you really get only $97,000. However, you have to repay $100,000, and you have to pay interest on $100,000.

Points change the interest rate that you pay. The real rate is called the *effective interest rate*. For a 30-year loan at 8 percent plus the three points repaid over its full 30-year term, the effective interest rate is 8.32 percent.

The *annual percentage rate* (APR) is the effective interest rate for loans that are repaid over their full term. After you apply for a loan, truth-in-lending laws require lenders to tell you a loan's APR within three business days. While this is better than not knowing what rate you are paying, there are two problems with this procedure:

1. Finding out the APR after you apply does not help you with comparison shopping.
2. The APR calculation assumes that you will keep your loan for its full 30-year (or 15-year) term. However, most people sell or refinance their home within 6 to 12 years.

The effective interest rate depends on how long you keep your loan. If the $100,000 loan were repaid after 6 years rather than 30 years, its effective interest rate would be 8.66 percent, not the 8.32 percent APR.

You need a computer or financial function calculator to determine effective interest rates precisely, but the following formula is a fairly accurate way of estimating it for comparison shopping:

Effective interest rate = Quoted rate + (Number of Points ÷ 6)

(If you *know* that you will be keeping your loan for more than 12 years, divide the points by 8 instead of 6. If you plan to stay for only 4 to 6 years, divide the points by 4. If you plan to stay for 1 to 3 years, divide the points by the number of years.)

Let's go back to the question posed at the beginning of this section: "Which is better, (1) a 30-year loan at 8 percent plus three points or (2) one at 8.25 percent plus one point?" Loan Number 2 is better.

Loan Number 1: Effective rate = 8.00% + (3 points ÷ 6) = 8.50%
Loan Number 2: Effective Rate = 8.25% + (1 point ÷ 6) = 8.42%

That small percentage difference does not seem like much, but for a $100,000 loan paid off after 12 years, you would save $1,000. If you paid off the loan after only six years, you would save $1,500.

Shopping and knowing how to shop saves money!

Sometimes lenders charge a one point (or half-point) *origination fee.* This has the same effect as discount points. You should add an origination fee to the discount points before you calculate your effective rate.

For purposes of comparison shopping, you usually do not have to add the other miscellaneous fees (credit report and appraisal, inspection, etc.) into your rate calculations. Although they increase your effective interest rate somewhat, they are less significant than points, and most lenders charge about the same amount of miscellaneous fees as their nearby competitors.

Prequalification

Before you apply for a mortgage (even before you start earnestly shopping for a home), you should have a fairly solid idea of how large a loan you will qualify for -- how much money you can borrow. National guidelines based on family income and debt obligations are used by most lenders to determine the maximum amount that they will lend. The first step in getting a mortgage is known as **prequalifying**, is determining how much a lender will lend to you. (See Figure 1.2.)

Chapter 2, "Qualifying for a Mortgage Loan," provides you with an in-depth understanding of how a lender decides whether to make a loan. The table in Figure 1.3 is not a substitute for reading Chapter 2, but it will give you a rough idea of how much you can borrow with a 10 percent down payment given the prevailing interest rate and your annual income.

For example, if your annual family income is $40,000 and prevailing mortgage interest rates are around 8 percent, you could get a $105,000 conventional first mortgage from most lenders (assuming a 10 percent down payment, good credit and manageable debts). Chapter 2 also describes other requirements and tells how you can qualify for a larger loan.

You can use several ways to prequalify yourself. In addition to using the table in Figure 1.3, you can use the Do-It-Yourself Prequalification Worksheet in Appendix C. You can also ask a loan officer of a local lender to prequalify you.

Shopping for a Loan

Shopping for a loan (see figure 1.4) is an important step in the process. Saving 0.25 percent on the interest rate of a $100,000 loan saves $5,000 over the 30-year term of the loan. Saving a half discount point on a $100,000 loan saves $500. Lenders' prices vary widely, so comparison shopping is valuable to you. Chapter 5, "Shopping for a Mortgage," explains.

Part of shopping is deciding what type of loan you want. Chapter 4, "Choosing the Right Type of Mortgage," describes the different types of mortgages most commonly available and their advantages and disadvantages.

A professional, qualified loan officer also can describe the benefits of different loan products. Be aware, however, that most loan officers are commissioned salespeople, and they try to sell the loans that they have to offer and are most familiar with. Find out for yourself what kind of loan you need so you can shop more effectively.

Applying for a Loan

After you select a loan type and complete your shopping for a lender, you must submit an application and sign numerous forms that allow your lender to contact your employers and banks (see Figure 1.5). Just as there are national guidelines for qualifying, there also are national standards for application forms and required information. Most lenders will request some or all of the following: (so you should gather the information ahead of time.)

General Information

- Social Security numbers for each applicant;
- Current address and prior addresses for the past two years and/or
- Name and address of current mortgage lender (if any).

Employment Information

- Names and addresses of current employers and prior employers for the past two years;
- W-2 forms or 1099s (sometimes required if you are paid by commission or if you work out of a trade union hiring hall) and/or
- Past two years' tax returns and current profit -and-loss statement (if self-employed).

Assets

Bank accounts (account numbers, bank name, address and approximate balance).
If your income from salaries is sufficient to qualify you, some lenders will let you exclude information on investments and other income. If not, you need to provide the following information:

- Stocks and bonds (copies of brokerage statements or stock certificates);
- CDs, money market funds, IRAs (account number, bank name, address and approximate balance);
- Family trusts, pensions and other annuities;
- Cash value of whole life insurance policies;
- Automobiles (copy of registration or title);
- Statement of personal property (furniture, etc.) and/or
- Other real estate (mortgage lender's name and address, loan number, monthly payment amount).

Debts

You must provide information on your debts, including the creditor's name and address, loan number, monthly payment and approximate balance required for each loan.

- Charge accounts and credit cards (provide a copy of last monthly statement);
- Car loans;
- Mortgage loans;
- Personal loans;
- Student loans and/or
- Other installment loans.

Miscellaneous

Other information that may have to be provided includes the following:

- Copy of signed sales contract (for home purchase) or copy of deed (for refinance);
- Condominium or co-op documents (if applicable and lender does not already have them);
- Alimony, child support and separation maintenance payments due (copy of divorce decree or separation agreement);

- VA Certificate of Eligibility, DD-214 or Statement of Service (VA loans only);
- Copy of real estate tax bill for the past year and/or
- Copies of utility bills (required by some lenders for FHA or VA loans).

The more complicated your financial situation, the more information you must supply. However, some lenders offer loans that require only minimal information from the borrower. If your down payment is 30 percent or more (LTV ratio of 70 percent or less), ask lenders if they offer these loans. It could cut your processing time and eliminate much of the hassle.

The application interview may take place in the lender's office, in the REALTOR's office, in your office or home or sometimes over the telephone. A loan officer probably will help you fill out the loan application. (A sample application is provided in Appendix B.) Bring all the required documents to the interview to help speed the application process. In addition, when you apply for a mortgage, you must pay a nonrefundable application fee of from $300 to $400. This covers the cost of an appraisal and a credit report.

Locking in the Rate

In many areas of the country, lenders will allow you to lock in the price (i.e., the rate and points) of your mortgage when you apply. Many lenders require payment of a commitment or lock-in fee, especially for refinance loans. Others will set the rate and points for your loan after you have been approved or shortly before the day of settlement. During times of heavy refinancing volume, some lenders may require that you lock in a rate at the time of settlement *and* pay a nonrefundable commitment fee.

The major benefit of shopping for a loan is to lock in the best rate available for the product that you select. If lenders in your area will not let you lock in a rate and points when you submit an application, shopping for a low-priced loan becomes more difficult. You must look for a lender with a reputation for low rates.

If you do lock in the price of your loan, get a written statement from the lender that clearly spells out the rate, points, other fees and conditions of the lock-in agreement. An oral promise is not enough to protect your interests.

Within three business days from when you file an application, lenders are required by truth-in-lending laws to mail you a disclosure of the annual percentage rate (APR) for your loan. You also will receive a booklet prepared by the U.S. Department of Housing and Urban Development called "*A Homebuyer's Guide to Settlement Costs*" and an estimate of your settlement costs.

Verification

Assembling a loan package with all of the required documents is the most time-consuming step in the application process. All the key statements that you have made on your loan application must be verified and documented (see Figure 1.6). After you have submitted an application, the lender's loan processor assigned to your case will:

- Order a credit report and appraisal;
- Mail letters to your employers asking them to verify your salary and commissions;
- Mail letters to your banks asking them to verify your account balances and
- Gather and prepare the other documents necessary to complete the loan package.

Some requested documents are returned quickly; others must be requested a second or even a third time. When you are asked to provide a document, do so as quickly as possible. Your failure to give lenders what they need promptly can give them cause to cancel your lock-in agreement or even deny you credit.

Alternative Documentation

Most lenders offer loan programs that shorten the time-consuming process of gathering written verifications from your employers, creditors and banks. Instead of requiring all the letters listed previously, they accept substitute documents that provide them with sufficient proof of your income and assets. In place of a written verification of your salary, they require copies of two or three of your most recent paycheck stubs and a verbal confirmation of your employment and income from your employer. In place of a verification of your bank deposits, they require copies of two or three of your most recent bank statements. Alternative documentation loans can save considerable time and effort.

The loan officer who takes your application and the loan processor who assembles the necessary documentation generally do not have the authority to approve your loan. They simply gather information for others who will make the yes-or-no decision.

Underwriting

The approval process is known as **underwriting**. In some instances, as many as three different entities must approve your loan the lender's underwriter, a mortgage insurance company (for loans with a LTV ratio greater than 80 percent) and the lender's investor (for large loans requiring preapproval).

The underwriting procedure can yield four possible outcomes:

1. Approval;
2. Approval with conditions (i.e., approval subject to the sale of the applicant's old home);
3. Application returned for additional documentation and resubmission or
4. Denial of credit.

When your loan is approved or approved with conditions, the lender will issue a commitment letter and begin preparations for *settlement* (also known as *closing*).
If the underwriter needs additional information before approving your loan, the entire package is returned to the loan processor. The processor will gather the additional documents and resubmit the package to underwriting.

If you are turned down and denied credit, the lender must issue a letter stating the reason for denial. If you were denied credit because of adverse information in a credit report, you have the right to inspect a summary of the report issued by the credit reporting agency, challenge inaccuracies and request that the credit agencies make corrections.

Usually, your loan application is approved (or disapproved) by someone who has never met or even talked with you; the decision is based on the documents in your file. To some people, this depersonalization of the credit approval process is offensive and even emotionally upsetting. Some lenders, especially smaller banks and savings-and-loan associations, offer more personalized service. If personalized service is very important to you, ask lenders about their approval process when shopping around for a loan.

Settlement (Closing)

Settlement is the procedure for funding the loan (See figure 1.8). Several additional documents must be gathered or prepared for settlement:

- Deed (for home purchase, not refinance),
- Notes and addenda,
- Deed of trust or mortgage (depending on your state) and riders,
- Mortgage insurance certificate,
- Title insurance policy (or binder),
- Survey (in most states),
- Homeowner's insurance policy,
- Miscellaneous affidavits and agreements,
- Certificate of occupancy (newly constructed homes),
- FHA/VA documents (for FHA/VA loans) and/or
- Uniform Settlement Statement (HUD-1).

Many costs are involved in closing a mortgage loan, and they vary greatly depending on the state, county and metropolitan area. Figure 1.9 shows an example of the range of possible settlement costs.

The lender charges the bulk of the settlement costs. Chapter 5, "Shopping for a Mortgage," tells you how to lower those costs. Title insurance, settlement attorneys and homeowner's insurance costs are three other items where you can save money by shopping around.

Mortgage Tip: Comparison shopping can help you save money on title insurance, settlement attorneys and homeowner's insurance.

The logistics of settlement -- location, method and disbursement of funds -- vary depending on state law and local custom. Your lender, attorney or REALTOR can explain how settlements are transacted in your area and can estimate your costs. Settlement of a refinance mortgage is generally less complicated and less expensive because no transfer of title is involved.

Newly Constructed Homes

If the home that you are buying is under construction when you apply for your mortgage, the settlement process will be somewhat more complicated than the process for an existing home. After your house has received its occupancy permit, your lender will inspect the house to make sure that it has been finished according to plans. The lender may require additional finish work or repairs before funding your mortgage.

Frequently, homebuyers want to move into a new home before it is completely finished. (They may have to vacate their apartment or old house.) Some lenders will not settle until the house is 100 percent complete. Often, they will hold back some of the mortgage until the house is completed. For example, a lender may fund only $90,000 of a $100,000 mortgage, pending completion of landscaping, a garage or a finished basement. When a lender holds back funds, a homebuyer often can hold back payment to the builder. Holdbacks protect both the lender and the homebuyer from builders who fail to complete all the work that they promised. These holdbacks are also known as *completion escrows*.

National Standards

The majority of lenders today process and underwrite loans according to generally accepted national standards. These standards are dictated by Wall Street investors and government agencies who invest in mortgages or insure them against default. These investors are known as the *secondary mortgage market*. Knowing their standards will help you choose a mortgage and a lender.

Within the context of these standards, a lender has some leeway to be lenient and flexible, or strict and even picayune. If, after reading through this chapter, you have concerns about qualifying for the loan amount that you want, shop for a lender that is flexible.

What does a lender look at before saying "yes" (or "no")? The lender looks at the following:

- Each applicant's monthly income and expenses;
- Each applicant's credit history;
- Property appraisal;
- Source of cash for down payment and settlement costs and
- Each applicant's employment history

What Are Your Monthly Income and Expenses

The first question that lenders must ask is "Can you afford the monthly payments on this new mortgage?" To find the answer, they examine your current income and expenses plus the cost of the new mortgage, and they apply mathematical formulas to see if you can afford the payments. Government loans (FHA/VA) and conventional loans use different formulas. Chapter 4, "Choosing the Right Type of Mortgage," explains the differences between government and conventional loans.

Conventional Loans

For conventional loans, lenders make two calculations that compare your income and mortgage expenses. These calculations determine your Housing Ratio and Debt Ratio. Your *housing ratio* (also known as *front ratio* or *top ratio*) is your total monthly mortgage payment (your payment of principal, interest, taxes and insurance or **PITI**) divided by your total monthly income (see Figure 2.1). Your *debt ratio* (also known as *total obligations ratio, back ratio* or *bottom ratio*) is the sum of your total monthly mortgage payment and other monthly debt payments divided by your total monthly income (see Figure 2.2). If your ratios are too high, the lender may decide to deny your application. If you can demonstrate your ability to carry greater debts, the lender may allow you to exceed national standards but usually not by very much. These ratios are very important. You can use the Do-It-Yourself Prequalification Worksheet enclosed in Appendix C to calculate your own ratios. Figure 2.3 is a sample worksheet.

Your monthly housing expenses include:

- Mortgage principal and interest payments,
- Monthly cost of homeowner's insurance and flood insurance (if required),
- Monthly mortgage insurance payment (if any),
- Annual real estate tax divided by 12 and
- Monthly condominium or homeowners' association dues. Your monthly housing expenses do not include utilities, the phone bills, etc.

For all applicants, whether or not married, your monthly income includes:

- Gross monthly salaries (pretax, not take-home pay),
- Commissions,
- Bonuses,
- Investment income (dividends, interest and rent),
- Pension or trust income and
- Alimony or child support (that you receive, not pay).

Monthly income does not include anticipated raises or unsubstantiated estimates of future commissions and bonuses. It also does not include investment income on bank accounts or other assets that will be used for your down payment. It does include the salaries and other income of both husband and wife for two-income families.

All claimed income must be verified. The lender will send a letter to your employers to confirm your earnings or for alternative documentation loans, the lender will call your employers. Lenders may reduce your estimates of future income from commissions if you do not have at least a two-year history of consistent earnings that support those estimates.

Investment, pension and trust income also must be verified. Lenders will ask for copies of stock certificates, brokerage account statements and pension or trust documents. If you own a rental property, some lenders will assume a 25 percent vacancy rate when calculating the property's cash flow unless you show them a long-term lease. In almost all cases, lenders will deduct some amount for maintenance and repairs to the rental property.

Your fixed monthly obligations include:

- Monthly housing expense (from housing ratio in Figure 2.1);
- Car payments;
- Student loan payments;
- Alimony or child support (that you and/or your coapplicant must pay);
- Credit card or charge account payments and
- Other loan payments (including loans for which you have cosigned or guaranteed, *even if you don't*

make the payments on those loans).

As with your income, your lender will require documentation on your debts. Installment loans (such as car loans) with ten or fewer monthly payments (six payments for FHA and VA requirements) remaining do not have to be included in your fixed monthly obligations, but you still must disclose them to your lender.

If you or your coapplicant are paying (or receiving) alimony or child support, you must provide a copy of your divorce decree. Even if you are not paying alimony or child support, many lenders require a copy of the divorce decree to prove that you are not obligated, especially if there are minor children involved.

The maximum allowable housing and debt ratios depend on your lender, the type of loan, the property and the loan amount. For purposes of prequalification, you should use a maximum housing ratio of 28 percent and a maximum debt ratio of 36 percent (28/36). These are the generally accepted standard ratios that most lenders use. Some lenders use ratios of 30/38, especially with very large loans, some adjustable-rate mortgages (ARMs) are available with ratios of 40/40, and higher ratios are available on various new affordable housing programs, but these vary by locality.

An underwriter, who is the lender's employee evaluating your credit application, is not tied completely to strict standards. Offsetting factors will be taken into account. If you can add further explanation to your income or expense situation that will make your numbers look better, by all means do so. However, document your claims in writing if possible.
In the sample Do-It-Yourself Prequalification Worksheet in Figure 2.3, Mr. and Mrs. Homebuyer's housing ratio is 25.9 percent, and their debt ratio is 39.1 percent. National standards for a 30-year, 87 percent LTV ratio loan are 28 percent for the housing ratio and 36 percent for the debt ratio. A strict lender could turn them down because their debt ratio is too high. A more lenient lender would accept these ratios if other aspects of their credit package were acceptable.

Self-Employment

You are considered self-employed if you own a 25 percent or greater interest in the business that employs you. If you fit this definition, you will have to supply the following additional documentation:

- Signed copies of your two most recent personal federal income tax returns with all applicable schedules;
- Signed copies of your two most recent federal *business* income tax returns, if your business is a corporation, S corporation or partnership;
- A business credit report, if your business is a corporation, S corporation or partnership;
- A year-to-date profit-and-loss statement for your business and/or
- A balance sheet for the previous two years, if your business is a sole proprietorship (audited, if possible, when not prepared by an accountant).

The stability of your income is very important to mortgage lenders. For salaried employees, lenders look at your job history for at least the past two years. For self-employed borrowers, they look at the profitability and cash flow of your business for the past two years in addition to your individual income. If you have started a business within the past two years, or if your business was unprofitable for one or both of the last two years, this presents a problem for most mortgage lenders.

Limited Documentation Loans

Some lenders *do not require any verification of income information* if your down payment is 30 percent or greater. Some charge a slightly higher interest rate for these special loans. If you are self-employed or your personal finances are complicated by unverifiable sources of income, and you can afford to make a large down payment, you should definitely look into these "low doc" or "easy doc" loans. This will help you avoid the hassle of verifying all of your finances. You will still be required to disclose your income, but the verification requirements will be minimal.

Note that these limited documentation loans are much less common than they were just a few years age. In addition, for audit purposes, lenders required signed authorization to obtain your tax records from the IRS.

Mortgage Tip: Some lenders do not require any verification of income information if your down payment is 30 percent or greater.

Government Loans

Federal Housing Administration (FHA)

The FHA calculates ratios using the same method that is used for conventional mortgages. The FHA's standards, however, are more lenient than those of conventional loans. Its maximum housing and debt ratios are 29/41.

Department of Veterans Affairs (VA)

Formerly called the Veterans Administration, The VA uses two methods of calculating a borrower's ability to afford a mortgage: a maximum 41 percent debt ration (and no housing ratio) and a calculation to determine residual income. Residual income is the amount of money you have left after paying your mortgage, your utilities, food and clothing and other necessities. Figure 2.4 shows an example of that calculation.

The VA has charts and formulas for utilities, maintenance and family support payments that vary depending on the area of the country in which you live, your family size and the type of home that you are buying.

In this example, the residual income of only $145 per month indicates a relatively tight budget for Mr. and Mrs. Homebuyer.

What Is Your Credit History

The second question that lenders must ask is "Have you repaid your past debts in a timely fashion?" To find this answer, the lender orders a mortgage credit report from a local credit bureau. A *credit bureau* collects information from retailers, banks, finance companies, mortgage lenders and a variety of public sources on all consumers who use any type of credit -- credit cards, car loans, mortgages, personal loans and charge accounts. The information collected is stored in nationwide computerized "credit repositories". Credit reports can be generated from credit repositories in minutes for a minimal cost. These reports, also know as "in file" reports, may not always contain the latest information on your credit standing. These computers track payment histories on more than 200 million accounts.

Mortgage Credit Reports

The credit bureau begins preparing of your mortgage credit report by searching the national computer files and its own files for information on you (and your spouse or coborrower, if applicable). In addition to searching their existing files, they obtain the latest information about your credit by making inquiries by telephone and letter specific to the information on your mortgage application.

The primary focus of your credit report is your credit history. For each of your bank and automobile loans, credit cards (whether you have used them recently), charge accounts, school loans, leases and business and mortgage loans, a line of descriptive information will appear on your credit report, such as:

- Creditor's name;
- Type of account (installment, credit card, charge account, automobile loan, etc.);
- Account number;
- Date opened;
- Maximum allowable balance, "high" credit balance, current balance and past due amount (if any);
- Required monthly payment and
- Payment history.

The payment history is of critical importance to your lender's underwriter. For each account listed, it shows how many times you were more than 30/60/90+ days late in making your required monthly payment. It also shows your usual payment patterns, whether you almost always pay on time or are usually late 30, 60 or 90 days. It also reports any repossessions, credit workouts and accounts fully paid.

In addition to reporting on your credit history, the mortgage credit report verifies some of the noncredit information that you disclose on your mortgage application as well:

- Employment history for at least the past two years (employers, job titles, income, if available);
- Residency information for at least the past two years (address, landlord and rental or mortgage payment history) and
- Public record information (lawsuits, legal judgments, marriage or divorce, tax liens, bankruptcy and foreclosures).

Failure to disclose credit problems or answer all of the related questions on your mortgage application fully is a sure way to be rejected.

Although the lender charges you for a credit report as part of your application fee, you will not have a chance to look at your credit report. As mentioned in Chapter 1, you do have right to inspect a summary of the credit report, challenge any inaccuracies and request that the credit agencies make corrections. You can buy a special "consumer version" of your report. If you are concerned about the information collected about you, it is worth the $25 or so that you must pay for it. You can also request a free copy of your credit report from TRW, one of the largest credit bureaus. You can obtain a free report as often as once a year by calling 214-390-9191. A taped message will instruct you how to obtain the report.

Most lenders are strict on credit problems. Some do not make mortgage loans to people who have had a previous foreclosure or bankruptcy. Others require two or more years with a clean credit record, following such a major credit problem. If you have had credit problems, disclose them to the loan officer and ask about the lender's policies prior to application.

Many lenders will require you to submit a written explanation of any detrimental comments that appear on your credit report. For example, "Explain why you were a month late on two MasterCard payments the past year", or "Why did you miss a mortgage payment two years ago?" Although these requests may seem a little picky and may be somewhat irritating, a simple explanation such as "I was on vacation" or "I misplaced the bill" usually will be enough for minor credit discrepancies like these examples.

Moderate tardiness on paying bills usually will not disqualify you for a mortgage. But when combined with tight qualifying ratios and a small down payment, chronic credit problems may cause lenders to turn down your application.

Property Appraisal

The third question that a lender must ask is "How much is the property worth?" An appraisal is necessary to ensure that a lender does not lend more on a property than its value. Most lenders hire an outside appraiser who:

- Inspects the property,
- Compares it to nearby comparable properties sold recently,
- Determines its value based on the sale prices of those comparable properties and
- Submits a report to the lender.

Unlike your credit report, you are entitled to receive a copy of the appraisal report if you paid for and if your request a copy in writing. Most lenders now provide a disclosure notifying you that you are entitled to a copy.   Some lenders routinely provide a copy of the appraisal to the applicant when the report becomes available. If you want a copy of the appraisal, be sure to make arrangements with the lender at the time that you are submitting your application.

National standards govern the content, format and valuation methodology of residential appraisals. Whether you are applying for a government-insured loan (see Chapter 3) or a conventional loan, your appraisal format will be based on requirements developed jointly by the Federal Housing Administration (FHA), the Department of Veterans Affairs (VA), Federal National Mortgage Association (Fannie Mae) Federal Home Loan Mortgage Corporation (Freddie Mac). The FHA and VA do continue to require certain additional information for their appraisals in the form of addenda included with the appraisal report. Some small local lenders may have their own special requirements, but most lenders follow the national requirements.

The national standards govern not only the format for appraisals;   they also specify the appraiser's qualifications and credentials. In addition, most states now have enacted (or are in the process of enacting) appraiser licensing requirements for appraisers evaluating properties located within those states. Most lenders deal only with appraisers whose work they know and trust. Appraisers are required to have a certain amount of training and experience before their valuations are acceptable to mortgage lenders and investors.

Valuation Methods

Appraisers use three different methods to value residential properties: the *market value approach, replacement cost approach,* and, for investment properties, the *Income Approach*. Using these three different methods, an appraiser will frequently come up with slightly different values for the property. Using judgment and experience, the appraiser reconciles the difference and assigns a final appraised value.

The *market value approach* is the most important valuation method in appraisal because a property is worth only what a buyer is willing to pay and a seller is willing to accept. The market value is based on the actual sales prices of nearby similar homes that sold recently. These are known as *comparable sales*.

Appraisal reports are very detailed. (See Appendix G the Fannie Mae/Freddie Mac forms)   For the property being appraised (the subject property in appraisal terminology), they include:

- *General information*. Legal description, title restrictions (if any), real estate taxes and zoning information
- *Site description*. Lot size and shape, availability of public utilities, improvements such as sidewalks, curbs and gutters and streetlights
- *Neighborhood analysis*.   Includes population density (urban, suburban, rural), development growth and other changes, price stability (rising, falling or stable), availability of public amenities (schools, shopping, transportation, recreation, police and fire protection, employment) and nearby land use (single-family homes, apartments, commercial).

- *Home description*. Size, design, construction materials, number and type of rooms, appliances, adequacy of heating/cooling/plumbing and overall quality of workmanship.
- *Other factors affecting value*. Garage or carport, swimming pool and other improvements.

In addition, the appraiser must report on obvious construction problems such as leaking roofs, termite damage, dry rot, and exterior and interior damage that affect the salability of the property. If construction problems do exist, most lenders require that they be repaired prior to the sale or before the entire loan amount is fully disbursed. This is intended to protect the lender, but it also protects the buyer from problems that might not otherwise be recognized.

To value the property, the appraiser reviews the details of recent comparable home sales near the subject property. Those properties most similar to the subject property are used for comparison, detail by detail: size, date of sale, location, site, design, quality of construction, age, condition, heating and cooling and other relevant improvements.

The appraiser adjusts the price of each comparable sale (up or down) depending how it compares (better or worse) with the subject property. He or she then reconciles the different prices to determine the market value of the property.

As an additional check on the value of the property, the appraiser also estimates the replacement cost for the property. Replacement cost is determined by valuing a vacant lot and determining the cost to build a house of similar size and construction. Finally, he or she reduces this cost by an age factor to reflect deterioration and depreciation.

It is very common for the appraised value on a property to be exactly the same as the amount of your sales contract. This is not a coincidence, nor does it indicate malfeasance on the appraiser's part.. Your sales contract is the most comparable sales transaction there is. It represents what a buyer is willing to offer for the subject property and what the seller is willing to accept. Only when the comparable sales differ greatly from your sales contract will the appraised value be very different.

In the mid-1980s, appraisals caused problems for consumers in two ways. First, many appraisers were unable to keep up with the heavy work load that lower interest rates caused. Some had backlogs as long as two months, delaying loan approvals. Second, in some areas of the country where home prices were rising rapidly, appraised values were lower than asking prices. In the early 1990s, low appraisal values often caused problems for homeowners who wished to refinance. This often occurred when the homeowner had used maximum financing (e.g., 95 percent LTV) to acquire the property and the value of the property had not appreciated enough to refinance (most lenders will not refinance a home for more than 90 percent LTV). It also occurred in situations where the value of the property dropped since the time the property was acquired, or was last refinanced. If you are purchasing a home and the appraised value comes in lower than the purchase price, you may have to increase your down payment to qualify for the mortgage. Ask your REALTOR for advice on local appraisal conditions.

Source of Cash for Down Payment and Settlement Costs

The fourth question that lenders must ask is "Do you have enough money to close the sale and where are you getting it?" (This does not usually apply to refinancing.) Lenders require verification of deposits, gift letters and other written evidence of funds available for settlement. These are necessary because of past frauds in which sellers or real estate agents loaned money to buyers "under the table" to facilitate a higher selling price or to circumvent lenders' qualification standards. Some lenders even require homebuyers to show where they got the money for the deposit shown in the sales contract, particularly if the cash available is marginal, or very close to the total amount needed for settlement or if there have been large deposits to your accounts within the last few months.

Employment History

The two largest causes of mortgage foreclosure are divorce and unemployment. A lender cannot anticipate divorce, but employment history is reviewed. The final question that a lender must ask is "Will your future income be stable enough to meet monthly mortgage payments?"

The ideal employment history from a lender's perspective is several years of employment with a well-known, prosperous company, or a few job changes with increases in salary and responsibility. A lender may require a borrower with a spotty employment history to give an oral or written explanation. Usually, employment history will affect a lender's decision only when there are other problems with the application, such as a bad credit report or tight qualification ratios. Conversely, an excellent employment history -- stability, promotions and raises -- often can overcome tight qualification ratios.

What if There is a Skeleton in the Closet

One-third to a one-half of all mortgage loan applications do not precisely fit the guidelines described in this chapter. Nevertheless, more than 90 percent of mortgage loan applications are approved. An application can be turned down for a variety of reasons:

- Not enough income to support the loan payments, or too much outstanding debt already,
- Past credit problems,
- An undesirable property or low appraisal value,
- Insufficient cash to close or
- A poor or limited employment history.

Although some things are outside of your control, the best advice is "Before applying, do everything that you can to make sure that your application will be approved."

Mortgage Tip: Before applying for a loan, do everything that you can to make sure that your application will be approved.

If after reading this chapter, you are confident that your income, assets, credit history, and employment history fall well within national qualification guidelines, go on to Chapter 4. If not, or if you have a "skeleton in the closet," Chapter 3 provides useful techniques to help you overcome qualification problems. Think of these as "skeleton keys." Few qualification problems cannot be solved if they are addressed early enough in the application process.

🏠 Overcoming High Housing/Debt Ratios (Not Enough Income To Qualify)

Your ability to repay your mortgage is demonstrated by your Housing and Debt Ratios, each of which is defined by the lender. (see Chapter 2.) If your ratios are too high, your application can be turned down. This section will give you several solutions to the problem of high ratios.

Solution #1: Restructure Your Financing

If after prequalifying, you realize that your Housing Ratio and Debt Ratio are higher than the acceptable national standards, choose a loan type that will lower your ratios. The following chart shows how Mr. and Mrs. Homebuyer (whose ratios were calculated in the sample Do-It-Yourself Prequalification Worksheet in Figure 2.3) could have lowered their ratios by choosing a different type of mortgage and lowering the starting payment rate. (Fixed payment and adjustable-rate mortgage loans are discussed in Chapter 4.) Mortgage Tip: Lower your ratios by choosing a different loan type.

Buy Down the Interest Rate.

If you have the available cash, consider paying additional points (or having the seller pay additional points) to reduce the interest rate.

Obtain a Temporary Buydown.

If you have the available cash, you can create your own buydown subsidy. The lender qualifies you on the "bought-down" rate, thus bringing your ratios within the guidelines. You can also have the seller fund your buydown, or you can obtain a "lender-funded" buydown. The lender funds the buydown by charging you a higher note interest rate to recoup the up-front expense of funding the temporary buydown, much as the lender might fund "zero- point" loans (See Chapter 6). This is attractive if you happen to be short of funds to close *and* have higher debt ratios.

Increase Your Down Payment.

If you have enough available cash, increase your down payment to reduce the loan amount and bring your ratios into compliance with the guidelines (see the following chart). Increasing your down payment also has other benefits. Lenders prefer large down payments. Mortgages with a 5 percent down payment are ten times more likely to go into foreclosure than loans with a 20 percent down payment. With a down payment of 20 percent, most lenders allow higher housing and debt ratios. Finally, a larger down payment can save you the cost of mortgage insurance, and your monthly mortgage payment will be lower.

Choose a Loan Type with More Lenient Qualification Ratios.

FHA, VA and nonconforming conventional loans may be easier to acquire because of their more lenient qualification ratios.

Solution #2: Document Additional Income

Provide your lender with information about additional income that may have been overlooked or disallowed.

Self-Employment Income:

Lenders generally will not accept self-employment income unless it has been stable and continuous for at least two years or more. This means that you have at least two years of tax returns to document the income. Exception: If you can demonstrate that you were successful in a similar business or activity prior to becoming self employed (e.g. you were a salesperson and started your own marketing firm) the lender may consider a shorter term of self-employment. Even then, the lender probably will use an average of the two years' income unless the income for the most recent year is less than the previous year. In this case, the lender probably will use the lower of the two figures. If so, provide three or more years' tax returns (and an up-to-date profit-and-loss statement) to document that your self-employment income is cyclical and is not in permanent decline. If you can successfully argue this, the lender may be persuaded to use an average of your self-employment income over three or more years. If you are marginally qualified on the average of your self-employed income, you may persuade the lender to use your most recent year's income if you can demonstrate a consistent and significant upward trend (i.e., three years or more of increased earnings of at least 15 percent per year). Perhaps you can make another argument to support your case, for example, you just obtained a multiyear noncancelable contract and can document it from a large and stable customer over and above your ongoing business.

Commission income

Generally, commission income is treated in about the same way as self-employment income. Provide documentation that your income is stable or increasing via your tax returns. If you are marginally qualified on the average of your commission income, you may persuade the lender to use your most recent year's income if you can demonstrate a consistent and significant upward trend (i.e., three years or more of increased earnings of at least 15 percent per year). Also, if you have a contract(s) in the present year that will significantly increase your income, you may receive favorable treatment. For example, Bob a life insurance salesperson, generates commission in two ways; from sales of new policies during the current year and from residuals, or renewals of policies sold in previous years. If Bob continues to sell the same volume of policies each year, his income will continue to increase by the amount of the renewals of existing policies each year. In this case, a salesperson with a proven track record might qualify for a loan based on his most recent years' earnings rather than on an average of two or more years, *because of the probability of continued increasing income.*

Overtime Income

Income from overtime may be considered if you can document a full two-year history of consistent earnings for overtime income. Even if you cannot document two-full years, it can be a strong compensating factor if you can demonstrate a year or more. You might persuade the lender to consider the overtime income if this income resulted from a year or more of overtime work and you can document that you will be required to continue working overtime in the foreseeable future.

Part-Time Income

This type of income may be considered if you can document a full two-year history of consistent earnings for part-time income. Even if you cannot document two full years, it can be a strong compensating factor if you can demonstrate a year or more.

Seasonal Income

This income may be considered if you can document a full two-year history of consistent earnings. Even if you cannot document two full years, it can be a strong compensating factor if you can demonstrate a year or more. If the income is from a regular source, such as a department store during the holiday season, or doing landscape work during the spring and summer, it is helpful to provide a letter from the employer indicating that you will be rehired for the next season.

Household Members' Income

Income earned by other members of the household will not be considered unless that individual is a party to the mortgage note. But, you may be able to use the income of that person, for example an adult child living at home, as a compensating factor.

Tax-Free Income

This income can be "grossed up" to account for the tax-free status of that income. If you receive significant income from nontaxable municipal bonds, VA benefits (other than education), child-support payments, certain types of retirement and disability income or even food stamps, the earnings from these types of income can be increased by an amount equivalent to taxable earnings.

Child-Support or Alimony Payments

These payments may be considered stable monthly income if there is a history of receiving these payments on a timely basis (and you can document it) and there is a likelihood that such payments will continue for at least three more years. If these payments are scheduled to end in less than three years but will last for a year or more, then this should be counted as a compensating factor.

Solution #3: Document Compensating Factors

Income is defined by mortgage lenders as *stable monthly income*, that is, income that can be documented for two previous years and can reasonably be expected to continue without interruption. Income that does not meet these strict guidelines, such as the income mentioned in Solution #2 may not be usable in calculating ratios, but it can be used as compensating factors allowing your lender to accept your application.

- *Probability of increased earnings*. This is a strong compensating factor if you happen to be a recent graduate and in a profession such as a lawyer, dentist or physician, etc. You can present earnings data of other professionals in your field to argue for favorable consideration.
- *Have spotless credit*. If you have exemplary credit and you carry a heavy debt load, you can argue that you manage your financial affairs in a competent manner and that you will continue to do so when you own your own home. This argument is particularly strong if your overall monthly expenses will be about the same once you are in the house (i.e. your present housing expense is approximately the same as the proposed housing expense).
- *Highlight the tax advantages of home ownership*. Even if your overall housing expense increases with the new mortgage, argue that this increase is offset by the deductibility of mortgage interest for federal (and most states) income taxes. This is especially true for borrowers in high tax. When you factor income-tax savings, your overall housing expenses may be lower than what you are now paying if you are renting a house!

Solution #4: Get a Cosigner

Some lenders will relax their income qualification ratios if your rich uncle agrees to cosign (guarantee) your loan. For example, without a cosigner, a lender may require that your monthly payment be less than 28 percent of your monthly income. With a wealthy cosigner, the lender may allow the monthly payment to be as much as 35 percent of your income and your debts 43 percent of your income. However, as a cosigner, your "rich uncle" will be required to go through all the processing and income verification hassles required for loan approval. You may not want to put your cosigner through that process. In addition, all the cosigner's debts will be included in the ratios, so be sure that the additional debt will be more than offset by the additional income before you bring the cosigner into the transaction.

Solution #5: Restructure Your Other Debt Obligations

If your housing ratio is low enough but your debt ratio is too high, lower your monthly debt payments. Your debt ratio equals your total monthly debt payments divided by your stable monthly income as defined by the lender. Consider the relationship between income and debt: For each dollar of your monthly debt payments, you must generate three dollars of income to stay within mortgage lenders' guidelines. Clearly, it is far more efficient (and usually easier) to reduce your debt than it is to increase your income.

- *Plan ahead; pay off your debts.* Before shopping for a home, make a sustained effort to reduce your overall debt burden. Prepay those items with the highest payment (relative to the balance due) first. This has the greatest impact on your debt ratios. While the lender is concerned with your overall debt burden, the total balance is not nearly so important as the monthly payment burden.
- *Consolidate or recast your debts.* Consolidate your debts well ahead of the time that you apply for your mortgage loan so that you can establish a payment history for the new debt, and your old debts will show "paid" on your credit report. Keep in mind that your goal is to reduce your monthly payment in order to reduce your ratios, so opt for longer term, lower payments. If you don't reduce your overall monthly payment, you have not accomplished your goal. Exercise care when you consolidate revolving debt, such as credit cards and store credit accounts that have no fixed payment amount. You can consolidate your debts once or twice without creating problems. If you consolidate more than this, during a reasonable time span, you create a pattern of "running up" revolving debts followed by consolidations, resulting in an ever-increasing balance of outstanding debt. *Be prepared to explain the source of funds for paying off the debts as payoff dates are listed on the credit report*.

Overcoming a Bad Credit History

Disclose past credit problems to the loan officer before applying. One of the worst approaches to overcoming past credit problems is trying to hide them. Describe the steps that you have taken to solve those problems. The loan officer will know how strict his or her underwriters are with respect to credit problems. If your credit history would disqualify you with this lender, the loan officer should know and will give you advice.

Seek a Hard-Money Lender

If your past credit problems are severe enough (bankruptcy, foreclosures or unresolved lawsuits) to disqualify you with most traditional lenders, you may want to seek a "hard-money" lender. **Hard-money** lenders do not use the national standards, and they find loans for people with credit problems. Their rates are quite a bit higher than traditional lenders, but they can lend money to people who have been turned down elsewhere. Beware of a lender that charges a large up-front fee (more than the $300 to $400 appraisal and credit report fee). As with all lenders, be sure to check the reputation of hard-money lenders. Check with your REALTOR and call the Better Business Bureau.

Wait Until You Reestablish a Good Credit Record?

Depending on the nature of your past credit problems, it may be best to put off the purchase of a home until after you have reestablished a good credit record. The National Foundation for Consumer Credit (900-388-CCCS) is a nonprofit organization that can direct you to one of 617 local agencies. They can put you in touch with a local agency that will help analyze your finances and give you good advice about whether you're ready to buy a house. Generally, two years of clean credit is enough for conventional lenders. In reestablishing your credit, consider that although late payments should always be avoided, *some late payments are worse than others. Never, ever miss a mortgage or rent payment.* Be particularly sensitive to installment payments such as car payments, bank loans, student loans and any government obligation (delinquent government obligations are important for FHA and VA loans). If you must be late on something, let the credit card or other revolving debt (except home equity loans) be the first to go.

Correct Mistakes Early

Occasionally, a dispute with a store over an incorrect billing or returned or damaged merchandise will show up as a detrimental comment on your credit report, even after the dispute has been resolved. If you have had such a dispute, tell your loan officer about it and ask him or her to have the loan processor who is assembling the documents for your loan call you when your credit report is received. Provide the loan officer with documentation of the dispute. This includes dates and times of telephone calls and who you spoke with as well as copies of letters you have written regarding the dispute. If the dispute is on the report, you can get it corrected right away.

If you are turned down by a lender, even if a mistake on your credit report was the cause, your rate lock-in commitment (see Chapter 5, "Shopping for a Mortgage") may expire before the mistake is resolved. *Correct mistakes on your credit report as soon as possible.*

Overcoming a Low Appraisal

The appraised value of the property (see Chapter 2 "Qualifying for a Mortgage Loan") is the one item over which you have the least control. However, you can affect some things, or use to your advantage to compensate for weakness in another area.

Appraised Value is Less Than the Purchase Price

Lenders use the *lesser* of the sales price or appraised value to determine the LTV ratio. If you are attempting to get maximum financing, or are just trying to avoid buying mortgage insurance, a low appraisal can be disastrous. If you are making a substantial enough down payment on the property so you will be unaffected by the appraised value, then it may not matter what the appraised value is, as long as you feel that the price fairly reflects the value that you perceive.

If you believe that the value is more accurately reflected in the sales price, you can appeal for a reappraisal of the property's value. To support the appeal, have your REALTOR provide comparable sales data from his or her database of sales for comparable properties sold in the area within the previous six months.

1. Consider the prices of the properties that are geographically closest to yours (much of a home's features can be changed, but relocating the house generally is not feasible).
2. Consider houses that have similar lot sizes and square footage, the same number of bedrooms, similar floor plans and amenities (such as remodeled kitchens, appliances, swimming pools, decks, balconies, landscaping, particularly striking views, etc.).
3. Consider the trend of prices; can you demonstrate that prices of similar homes have been increasing? If so, provide information, including newspaper clippings, information from the REALTORs' database and (although weighted much less heavily) asking prices for homes currently on the market. Consider the sales cycle; are comparable homes being "snapped up" as soon as they come on the market, or does it take months to sell?

If you make a convincing argument, the appraiser may relent and give you a higher value. Be aware, however, that you are questioning the judgment of a professional, so be sure to have convincing information in hand before beginning this discussion. You might be allowed by your lender to *get a second appraisal*, but it too might come in low.

If you believe that the first appraisal is correct, that perhaps the value is less than the sales price, you might *negotiate with the seller to obtain a lower sales price*.

If the *appraised value is greater than the purchase price*, it does not affect the lender's valuation of the property for determining LTV ratio because the sales price then becomes the determining factor. If your loan application is weak in another area, however, it would be helpful to highlight the compensating factor that the property is of a greater value. Every positive feature that you can document about the transaction increases your chances getting the mortgage.

Finding Sources of Cash for Down Payment and Closing Costs

Liquid assets, or *cash to close*, may come from a number of sources. Rules concerning sources of cash to close vary depending on the type of loan and the loan to value. FHA and VA are more flexible concerning sources of cash to close. The major agencies, Fannie Mae and Freddie Mac, are very strict about the minimum contribution from the "borrower's own funds"; at lower LTV ratios, they permit larger amounts from sources other than "borrower's own funds". If you are short of cash to close (you should make this determination long before you ever sign a sales contract), you may be able to improve your position by doing one or more of the following:

- *Increase the sales price.* Consider that everything in the purchase transaction is negotiable. The amount of money that is *net* to the seller, (how much money the seller gets after all expenses are paid) is the major concern for the seller. You can structure the transaction to meet the mortgage lender's guidelines, increase the loan amount and reduce your cash out of pocket. Here's how: Offer the seller a higher sales price, and have the seller pay your closing costs. Most mortgage lenders permit sellers to pay discount points, origination fees, buydown fees and closing costs (except prepaid items, such as odd days' interest, insurance and taxes) up to 3 percent of the "value" (the lesser of the appraised value or sales price) for loans more than 90 percent LTV and up to 6 percent of "value" for loans with an LTV of 90 percent or less. The seller gets the same net proceeds from the transaction and you don't spend all your cash at the settlement table. (See Figure 3.3.) The downside is that the house may not appraise for the higher price; if it does, you will have a somewhat larger mortgage with somewhat larger monthly payments. If you are marginally qualified on the ratios, this could be detrimental.
- *Request* monthly *private mortgage insurance (for conventional insured loans).* Many private mortgage insurance companies have recently introduced monthly mortgage insurance. Using monthly mortgage insurance can reduce your closing costs dramatically. Under the old plan, the first year's premium is required to be paid at settlement. Depending upon the LTV ratio and the type of loan, this could result in a premium of .5 percent to 1 percent of the loan amount, or $300 to $600 for a $100,000 mortgage loan. With monthly mortgage insurance, you simply pay the first month's premium at settlement (approximately $35 dollars in this example). This can result in a savings of approximately 90 percent of your mortgage insurance costs at the settlement table ($265 in this example). Although the monthly mortgage insurance premium is somewhat higher than annual mortgage insurance, it is well worth the cost if it makes the difference in whether you can own your own home.
- *Get a gift.* If you have a family member (or church, municipality or nonprofit organization) who is willing to help with closing costs, that person can "give" you the money. A family member generally is defined as a close relative and the amount that can be given is limited to amounts over the minimum 5 percent (of the sales price) contribution from "your own funds" unless the LTV ratio is 80 percent or less. The "donor" must sign a letter that specifies the amount and date of the gift; and indicate the donor's name, address, telephone number and relationship to the borrower and include a statement that *no repayment is expected*. A gift can be part of the minimum 5 percent down payment if the relative has lived with you for the previous 12 months and intends to continue to live with you in the new house. The mortgage lender will verify that the donor has the funds available to "give" and that the funds have been transferred into your possession. Under *no circumstances* can you be given a "gift" by a party to the transaction such as the REALTOR, seller, builder, etc.
- *Get a loan.* If you have assets that you do not wish to liquidate, you can borrow against those assets to meet your cash requirements. The key is that the borrowing must be "secured." Unsecured loans are not permitted. Consider that repayment of the borrowed funds will be counted in your ratios and the debt will be included in your total debt.
- *Have the lender pay some or all of your settlement costs.* Many lenders now have programs known as "zero-point" or "zero-cost" loans. Zero-point loans pay all origination fees and discount points by charging a somewhat higher interest rate on the loan. Zero-cost loans pay origination and discount points as well as your closing costs (except prepaid costs). Again, this is accomplished by charging a higher interest rate so that the lender recoups costs over time. There are limitations to this if the lender is affiliated with a party to the transaction (for example, the seller is a builder and the builder

owns the mortgage company or the mortgage company is owned by the REALTOR, or REALTOR's company).

- *Have your employer pay part of your closing costs.* If your employer has a program by which it pays closing costs as an employee benefit, you may use these funds as part of your closing costs.
- *Sign up for a "Community Homebuyer Program."* Both Fannie Mae and Freddie Mac (and many states) are encouraging lenders all over the country to participate in these programs. Special underwriting standards apply to these programs for first-time homebuyers. This permits you to contribute as little as 3 percent of your own cash, and in some cases you can borrow or get a grant for the entire down payment.
- *Investigate Community Reinvestment Act (CRA) opportunities.* Many banks now are focusing intense efforts to comply with Community Reinvestment Act (CRA) requirements. They are focusing their lending efforts in targeted neighborhoods in an effort to comply with the law. This often means that the mortgage lenders may have special programs in effect with relaxed underwriting standards to increase lending in targeted neighborhoods. Check with your local lenders to see whether this might apply to you.
- *Rent with the option to purchase.* If you have a signed agreement with the seller, you have rented the property for at least 12 months (and can document it with canceled checks or other means), you can apply the portion of the rent that is above the *market rent* (as determined by an appraiser) toward the down payment. Be aware that if the appraiser determines that the rent is below market, it will have the opposite effect and be treated as a "sales concession," which is deducted from the price of the house.
- *Only veterans can apply.* You can get a VA guaranteed loan with 100 percent financing (90 percent financing for cash out refinances), or you can apply for an FHA-insured loan (through its Veterans' purchase program) with as little as $200 out-of-pocket cash.

Resolving Employment History Problems

Salaried employment for the two full years preceding the mortgage application is almost automatically considered unless the company (or industry) in which you work has special difficulties. Several common employment history problems include the following.

- *Employed for less than two full years*. If you were employed for less than two years and you were previously in school or the military, then provide a copy of your diploma or military discharge papers.
- *Gaps or interruptions in employment*. Employment gaps or interruptions that extend beyond one month should be addressed in writing. Describe gaps in employment honestly but as favorably as possible.
- *Frequent job changes*. If you change jobs frequently to advance within the same line of work and you are successful in that work, then you should receive favorable consideration. Document your success in changing jobs or careers in a letter to the loan officer. If you do not demonstrate advancement (i.e., increased pay) when you change jobs or move from one line of work to another, however, the lender may view this as a negative *unless* you can demonstrate that the changes in jobs were due to industry or economic changes over which you had no control. In fact, you can turn this into a plus by arguing that you were able to maintain your level of income despite widespread economic or industry changes.

Fixed Rate Mortgages

Fixed-rate mortgages include not only the traditional 30-year loan that most people are familiar with, but also 15-year loans, graduated payment mortgages and growing equity mortgages. With all of these mortgages, your interest rate remains the same throughout the life of the loan.

Traditional 30-Year Mortgage

Its rate does not change, its payment does not change and in 30 years, it is all paid off. It is the most popular mortgage, and when interest rates are less than 10 percent, most borrowers should get the traditional 30-year mortgage.

With a $100,000 30-year mortgage at 8 percent, you would pay $733.77 principal and interest (P&I) per month. A portion of the P&I payment is the interest on your loan. The remainder of the payment reduces the loan's outstanding principal balance, slowly repaying the entire loan. Loans that are repaid gradually over their life are called *amortizing loans*. The loan amortization chart in Figure 4.1 for a $100,000 loan at 10 percent shows the remaining principal balance over the life of the loan.

You repay very little in the early years. At the end of ten years, your remaining loan balance is still $88,000; at the end of 20 years, $61,000; at the end of 30 years, it is paid off. Appendix J contains amortization tables for loans with terms from 5 to 40 years and interest rates of 2 percent to 17.75 percent.

Advantages

The main advantage of the traditional fixed-rate mortgage is certainty that your rate, monthly principal and interest payments will not go up. Your payment stays the same for 30 years.

Disadvantages

If overall interest rates go down as they did in the early 1990s, your rate on a traditional mortgage will not go down with them. To take advantage of lower interest-rate levels, you would have to refinance, and that may cost thousands of dollars. Many people who bought homes in the early 1980s with fixed-rate loans at 14 percent and 15 percent refinanced in early 1985 to new fixed-rate loans at 12 percent. Then they faced the prospect of paying even more to get the 10-percent loans being offered in 1986. More recently, in the early 1990s, lenders introduced *zero-point* and *no-cost refinance loans* that enabled many borrowers to refinance repeatedly without adding to their loan balances, or being faced with extraordinary out-of-pocket costs. (See Chapter 8, "Refinancing" for a fuller discussion.) A fixed-rate loan is a two-edged sword. It is good when rates go up, but bad when rates go down.

15-Year, Fast-Payoff Mortgage

The 15-year mortgage generally becomes popular when mortgage interest rates are lower, as consumers tend to refinance their 30-year fixed-rate mortgages with 15-year mortgages. It is just like a traditional 30-year loan except that its monthly payment is higher and it pays off in 15 years. (See Figure 4.2)

Advantages

Because lenders get their money back sooner than with a traditional mortgage, they charge a slightly lower rate for 15-year loans. The difference varies from lender to lender, but if 30-year loans are offered at 8 percent, then you could expect 15-year loans to be at 7.75 percent.

Also, because you pay off the loan faster, you borrow less money for less time, and over the life of the loan, you pay less total interest -- more than 50 percent less (see Figure 4.3).

Like a 30-year fixed-rate loan, you have the security of knowing that your monthly principal and interest payment will not go up.

A 15-year mortgage is probably best suited for people who are planning to retire in 15 years and would like to "burn their mortgage" at their retirement party.

Disadvantages

Your monthly payment is much higher.

In the example in Figure 4.4, the monthly payment is 28 percent higher than that of a comparable 30-year loan. Because the monthly payment is higher, you must have a higher annual income to qualify for it.

In the example in Figure 4.5 (assuming the lender uses a 28-percent housing ratio), you would need to earn about 28 percent more to qualify for a 15-year loan. (See Chapter 2, "Qualifying for a Mortgage Loan," for a full description of housing and debt ratios.)

Although 15-year loans have been highly touted, many believe that 30-year loans are still better deals. With most mortgages today, you can make extra payments whenever you like to reduce your loan balance. Depending on the size and frequency of your extra payments, you will pay off your loan in much less than 30 years. For example, if you make 13 payments a year instead of 12, you will pay off a 30-year mortgage in about 20 years. With a 30-year loan, you have the flexibility of making the extra payments when you want to make them.

A 15-year mortgage can be thought of as a "forced savings plan." You are putting money into your mortgage that you might otherwise invest in stocks, bonds or other real estate. Depending on your investment alternatives, you may have better ways to invest your money than paying off your mortgage.

Graduated-Payment Mortgage

A graduated-payment mortgage (GPM) is designed to be more affordable in the early years than the traditional mortgage. Its monthly payments start low and increase by a fixed percentage every year for five years.

The example in Figure 4.6 is a $100,000 graduated-payment mortgage at 8.75 percent. The starting monthly payment is $593.45 compared with $733.77 for a traditional mortgage. Its payment increases by 7.5 percent every year until it reaches $851.97 in the sixth year. From there on, it stays the same until paid off in 30 years.

The graduated-payment mortgage's amortization chart (see Figure 4,7) looks similar to the traditional loan's amortization chart, but it is different. For the first five years, the remaining loan balance goes up slightly instead of down like the traditional loan. This is called *negative amortization*. Negative amortization (see Figure 4.8) occurs when your monthly payment is too small to cover the interest due your lender, so the amount you pay goes up to cover the interest.

The outstanding principal balance of this graduated-payment mortgage reaches a maximum $104,050 at the end of the fifth year before starting back down again. Negative amortization is not inherently bad. It is simply a way for you to borrow more money so that you can buy the home that you want.

Advantages

The main advantage of the graduated-payment mortgage is affordability. Because of its low starting payments, you can qualify for a larger loan with less income.

In the example in Figure 4.9, you could qualify for a $100,000 loan with 20 percent less income.

This mortgage form is ideally suited for young homebuyers whose income will rise to meet the GPM's monthly payments through raises and promotions.

Disadvantages

First, lenders charge a slightly higher interest rate for GPMs. The rate for a graduated-payment mortgage is typically 0.75 percent to 1 percent higher than for a traditional mortgage.

Second, lenders usually require at least a 10-percent down payment with a GPM, compared with a minimum of 5 percent with a traditional mortgage.

Third, negative amortization, although not usually a problem, can be under certain economic conditions. If home values go down in your area, a GPM's loan balance may become larger than the home's reduced value. This also can happen with a 5-percent down payment loan. The real problem is not negative amortization, but the local economy.

Growing Equity Mortgage (GEM)

A *growing equity mortgage* (GEM), also known as an *early-ownership mortgage*, is a graduated-payment mortgage whose payments continue to increase until the loan is paid off. They do not level off after the fifth year like those of a GPM (see Figure 4.10).

There are a wide variety of GEMs. Usually, the first year's monthly payments are the same as a those of traditional 30-year loan. They increase each year by a fixed percentage.

In this Figure 4.10 (a $100,000 GEM at 7.75 percent), the first year's payments are $716.41. They go up 4 percent each year to $1,240.54 in the 15th year when the loan is paid off.

Advantages

Like a 15-year mortgage, a GEM is paid off quickly, and its interest rate is typically 0.25 percent to 0.50 percent less than that of a traditional mortgage. Also, as with a 15-year loan, you would pay less total interest over the life of the loan.

Unlike a 15-year mortgage, it is no harder to qualify for a GEM than it is to qualify for a traditional loan because of a GEM's lower starting monthly payment.

On balance, a GEM would be well suited to someone whose income is rising and who is planning to retire in about 15 years.

Disadvantages

With a GEM, the payments keep going up whether or not your income goes up with them. In the previous example, the payments increase by more than 70 percent over 15 years. For many people, family income keeps pace with the rising payments. For others, rising payments squeeze the household budget.

Adjustable-Rate Mortgages

Adjustable-rate mortgages (ARMs) became popular in the early 1980s when interest rates were much higher. When lenders were offering fixed-rate mortgages at 15 percent to 16 percent, more than 60 percent of homebuyers chose ARMs with interest rates starting at 12 percent to 13 percent. In 1986 and 1987, when rates were below 10 percent, most lenders reported that fewer than 15 percent of homebuyers were financing their homes with ARMs.

ARMs are good to consider when:

- You believe that rates are going to fall to levels much lower than they are today;
- You plan to keep your home for only two or three years, and an ARM looks less expensive in the short term.

If you have an ARM right now and are wondering whether to refinance to a fixed-rate mortgage, this section as well as Chapter 8 can help you decide what to do.

The obvious difference between an adjustable-rate mortgage and a traditional fixed-rate mortgage is that with an ARM, the interest rate goes up and down. It changes according to a set formula every year or so for the life of the loan. Usually, your monthly payment goes up and down with the interest rate.

Basic and Optional Features

An ARM, much like a automobile, has some basic features and a number of options. This section covers the four basic features common to all ARMs and the four most common optional features.

Basic Features

- Index,
- Margin,
- Adjustment interval,
- Initial interest rate.

Optional Features

- Life interest rate cap,
- Periodic interest rate cap,
- Monthly payment cap and
- Convertibility to fixed-rate.

Basic Features

Index

An ARM's interest rate goes up and down according to a nationally published index (see Figure 4.13). Your lender has no control over the index and cannot arbitrarily adjust your rate. Your rate is determined by the index.

Different ARMs follow different indexes. The One-Year Treasury Bond Index is the most common ARM index. Other indexes are:

- Six-Month Treasury Bill Index,
- Three-Year Treasury Bond Index,
- Five-Year Treasury Bond Index,
- 11th District Cost of Funds Index (COFI),
- National Cost of Funds Index,
- Federal Home Loan Bank Board (FHLBB) Contract Rate Index and
- (LIBOR) Index (London Interbank Offering Rate) Index.

The two Cost of Funds indexes are better for consumers than the Treasury Bond and FHLBB indexes because they do not go up so quickly when overall interest rates rise. For example, in September of 1981 when the One-Year Treasury Security Index hit a high of 17.15 percent, the 11th District Cost of Funds Index (COFI) was only 12.325 percent. During the 1980s, the COFI was never higher than 12.70 percent. The current values of the most commonly used mortgage indexes frequently are reported in the business or real estate section of your newspaper.

Margin

Your ARM's interest rate is the sum of the index value plus the margin. Your lender sets the ARM's margin before settlement of your loan. Once set, the margin does not change for the life of the loan. In the hypothetical example in Figure 4.14, the margin is 2.75 percent. At the end of year 5, the index is 7.75 percent. So the rate for Year 6 becomes 10.5 percent (7.75 percent plus 2.75 percent).

Adjustment Interval

The interest rate of an ARM changes at fixed intervals. This is called the *adjustment interval*. Different

ARMs have different adjustment intervals. The interest rate of most ARMs adjusts once a year, but others adjust every month, every six months, every three years or every five years. An ARM whose rate changes once a year is called a "one-year ARM"; the example in Figure 4.15 is a one-year ARM.

Sometimes the first adjustment interval is longer or shorter than following intervals. For instance, an ARM's interest rate might not change for the first three years, but then change once a year thereafter. Or the initial rate might change after ten months rather than a year, to accommodate the lender's accounting systems.

Initial Interest Rate

The final feature common to all adjustable rate mortgages is the *initial interest rate.* This is the rate that you pay until the end of the first adjustment interval. The initial interest rate also determines the size of your starting monthly payment, which the lender usually uses to qualify you for the loan. Note that for loans with exceptionally low initial interest rates, the lender *may* qualify you at a higher rate, usually the fully indexed rate, or the second year maximum rate. The initial interest rate Figure 4.16 is 5 percent.

Often the initial interest rate is lower than the sum of the current index value plus margin. When it is several percentage points lower, it is called a *teaser rate*. If your ARM starts with a teaser rate, your interest rate and monthly payment will increase at the end of the first adjustment interval unless your ARM's index goes down enough to offset the discounted teaser rate.

Optional Features

Most ARMs have consumer protection options that limit the amount that your interest rate and monthly payment can increase. They are called *caps*. The first type of cap that you want on an ARM is the *life interest rate cap*. It sets the maximum and minimum interest rates that you can be charged for the life of the loan.

Life Interest Rate Cap

In the example in Figure 4,17, the life interest rate cap is 10 percent. In year 6, the index value plus margin equals 10.5 percent, but the life cap limits the rate increase to 10 percent. Even if the index went to 16 percent, as the One-Year Treasury Bond Index did in 1982, the interest rate of this ARM would still be limited to 10 percent.

Sometimes the life cap is quoted in percentage points over the initial interest rate. For example a "5 percent life interest rate cap" means 5 percent over the initial rate, which in Figure 4.17 is 8 percent.

Periodic Interest Rate Cap

The second type of cap is the *periodic interest rate cap*. It limits the amount an ARM's interest rate can change from one adjustment interval to the next. In the example in Figure 4.18, the periodic interest rate cap is 2 percent. This means that the ARM's interest rate cannot go up or down more than 2 percent from one year to the next, even if the index goes up or down more than 2 percent. In the example in Figure 4.13, the index went up 2.5 percent from year 4 to year 5. Without a periodic interest rate cap, the ARM's rate would have gone from 7 percent in year 4 to 9.5 percent in year 5. But, with a 2 percent periodic rate cap, it goes to 9 percent.

An adjustable-rate mortgage like the one Figure 4.18 is called a "one-year ARM with two and five caps."

Monthly Payment Cap

The third type of cap is the *monthly payment cap*. It limits the amount that your monthly payment can increase from one adjustment interval to the next. Figure 4.18 shows the effect of a 7.5 percent monthly payment cap. Without the cap, the monthly payment would have gone up $128 from $537 to $665. With the cap, it went up only $40 to $577 (see Figure 4.19). ARMs with payment caps may, like GPMs, incur negative amortization, but if the ARM also has a life interest rate cap, the negative amortization will be minimal.

ARMs usually have a monthly payment cap or a periodic interest rate cap, but not both. Either of these caps provides you with good protection against extreme increases in your monthly payment. The monthly payment cap provides slightly better protection than the periodic interest rate cap, but through negative amortization, you pay for the better protection with more interest charges.

Some of the ARMs offered in the early 1980s and some of the adjustable-rate second mortgages offered today have no caps! If a lender offers you an ARM with no caps, beware. If you plan to pay it off in a year or two, it probably will be no problem for you. But if you are looking for a long-term loan, get a fixed-rate mortgage or an ARM with caps.

Mortgage Tip: Beware of ARMs with no caps! If you are looking for a long-term loan, get a fixed-rate mortgage or an ARM with caps.

Convertibility to Fixed Rate

The fourth optional feature, which can be a great benefit to consumers, is *convertibility* to fixed rate (see Figure 4.20). ARMs with this feature can be converted at the borrower's option to a fixed-rate mortgage without refinancing.

The terms of convertibility vary substantially from lender to lender. Some ARMs with this feature are convertible at any time. others only during the first five years and others only at the end of five years. The fixed-rate loan to which you can correct may not be a "market" rate at that time. Most lenders add a margin to the existing fixed rates for purposes of conversion, making a converted fixed rate somewhat higher than market rates. Terms of conversion are specified in the lenders disclosures and in the ARM rate.

Lenders often charge a one-point fee for the convertibility feature, either at the inception of the loan, at the time of conversion or both. A good conversion feature is worth the additional fee. Most people who choose an ARM when rates are high prefer a fixed-rate mortgage. With a convertible ARM, they can wait until rates fall and convert to the fixed-rate loan that they really wanted in the first place.

Advantages and Disadvantages

Advantages

With adjustable-rate mortgages, your mortgage interest rate goes up and down. If rates are high and likely to fall, this is an advantage. If rates are low and likely to rise, this is a disadvantage. ARMs have some other attractive attributes, but interest-rate forecasts should be the major factor in deciding whether or not to get an ARM.

If you think rates are going down, consider an ARM. If you think rates are going up, get a fixed-rate mortgage. If interest rates stabilize or fall, an ARM will be less expensive than fixed-rate mortgages over the long term.

The initial interest rate of ARMs is typically 2 percent to 3 percent lower than traditional fixed-rate mortgages. ARMs are generally more affordable in the first two years, and you do not need so much income to qualify for an ARM as for a traditional fixed-rate loan.

Most ARMs are assumable (see Chapter 6, "Miscellaneous Mortgage Topics," for an explanation of assumability). This could make it easier to sell your home if interest rates increase to the high levels prevalent during the early 1980s.

Disadvantages

With an ARM, your mortgage interest rate and monthly payment can and probably will go up sometime during the life of your loan. In the hypothetical example, the ARM's initial 5 percent rate in year 1 rose to 10 percent in year 6. That kind of increase in rate would cause a 65 percent increase in your monthly payment even with all of the protective caps. Few household budgets can absorb that kind of mortgage payment increase without feeling a pinch.

In 1993, the One-Year Treasury Security Index (the most common ARM index) ranged from 7.5 percent to 8.5 percent. Over the ten years from 1981 to 1990, it has ranged from a low of 5.5 percent to a high of 17.2 percent. Overall interest-rate levels may go lower than they are today, but based on the past ten years, rates have a lot more room to go up than down. Predicting interest rates is difficult for even the most skilled economists. It is even more difficult if you are betting your mortgage payment on your predictions.

Important! Before you decide to get an ARM, be sure to get answers to the following three questions:

1. If interest rates (and the ARM's Index) stay at the same level as today, what will my monthly payment be after one year? Two years? Three years?
2. If interest rates (and the ARM's Index) rise precipitously, what will be the maximum monthly payment that I might possibly have to pay? Can I afford it?
3. Will there be negative amortization that increases my loan?

You need to answer question 1 because those are the payments you will most likely be making. Usually, these payments will be disclosed on your preliminary and final Truth-in-Lending disclosures provided to you by your lender.

You need to know the answer to question 2 because this is the worst-case scenario. If you keep your home for 30 years, rates will rise dramatically at least once or twice during that period. To calculate the maximum payment in a worst-case scenario, calculate the *maximum interest rate* (initial interest rate + life interest rate cap) and multiply your loan amount by the mortgage payment factor (found in Appendix I) for the maximum rate to determine the maximum payment.

You should feel comfortable that you can afford the expected payment increases (question 1) as well as the worst-case payment increases (question 2).

Special Mortgage Packages

In the late 1980s, three new residential mortgage variants were introduced (or reintroduced) on a national scale: "balloon loans," the Freddie Mac "Reset," the Fannie Mae "Two-Step" ARM and 3/1 ARM (also the 5/1, 7/1 and 10/1 ARMs). All of these loans have one feature in common: *For the first few years, their rates and payments are fixed*. After the initial period of three, five, seven or ten years, their rates and payments change, but in a different way for each type of loan.

Advantages

Each of these loan types starts at a lower rate and monthly payment than a 30-year fixed-rate loan. The interest rate for a seven-year balloon will typically be 0.5 percent lower than a comparable 30-year fixed-rate loan. This makes it easier for you to qualify, and it makes the loan payment more affordable in the critical first few years of the loan. When compared with a normal ARM, these loans provide a longer initial period of stable rates and monthly payments.

Disadvantages

After the initial period of fixed rate and payments, the new rates and payments are uncertain. Some of the loans have caps to protect consumers from "payment shock." The balloon loans and some of the others, have no protection.

Balloon Loans

A *balloon loan* is just like a traditional 30-year fixed-rate loan, *with one major exception!* At the end of five, seven or ten years (depending on the "balloon term"), the loan becomes due and payable. A balloon loan amortizes just like a traditional fixed-rate loan. A $100,000 7.5-percent, seven-year balloon loan with 30-year amortization requires 83 principal and interest payments of $699.21 and a final payment of $91,958.51.

When it matures, you must pay it off in cash or refinance. Some balloon loans, *but not all,* require your lender to refinance the loan when it matures at the then current interest rates, assuming that you qualify for the new loan. You will have to pay closing costs again, and you may be required to provide all of the income, employment and debt information that you supplied when you first applied for your loan. If you choose a balloon loan, be sure that you read and fully understand the conditions of your right to refinance.

Under what circumstances should you choose a balloon loan over a 30-year fixed-rate loan? The answer is *when you know for certain that you will be selling your home or refinancing before your balloon loan matures.* Even if you are sure that you will be selling or refinancing before your loan matures, try to find a balloon that requires your lender to refinance your loan just in case your plans change.

Two-Steps and Resets

Fannie Mae the Two-Step loan while Freddie Mac developed the reset . Both loans are really a type of adjustable-rate mortgage, but the rate adjusts only once in its 30-year term. For the first seven years (five years for the Freddie Mac "Reset"), the *initial period,* the rate is fixed at the note rate that is quoted to you. At the end of the initial period, the rate is adjusted like every other ARM by adding a specified margin to an index. The new rate and monthly principal and interest payment then remain the same for the remaining 23 years or 25 years. At the end of the 30 years, the loan is fully amortized. These loans are sometimes referred to as a "7/23" or "5/25."

The Two-Step and the Reset have the advantage of a lower initial rate like a balloon, but they do not require you to refinance at the end of the initial period as you would with a balloon loan. This makes the Two-Step and the Reset more desirable than a comparable balloon.

The Two-Step and Reset loans are appropriate for someone who wants a fixed-rate loan but is willing to trade a little bit of future uncertainty to get a lower and more affordable initial monthly payment.

3/1 ARMs

A *3/1 ARM* is a one-year ARM with an initial adjustment interval of three years. For the first three years, the rate and monthly payment are fixed. At the end of three years and annually thereafter, the rate and payment are adjusted as they are for a one-year ARM. There are also 5/1, 7/1 and 10/1 ARMs with initial adjustment periods of five, seven and ten years, respectively.

When interest rates for fixed-rate loans are too high for you to qualify for your desired loan amount, and you want a loan that will provide a level payment for at least the first few years, the 3/1, 5/1 or 7/1 ARMs could be right for you. Their initial rates will be lower than a fixed-rate loan for easier qualifying, and their payments will remain the same for a few years, giving you a fixed amount for which you can budget.

As with other ARMs, make sure that you have answered the questions "What will my payments be if rates stay where they are today?" and "What is the maximum monthly payment amount?"

FHA, VA and Conventional Mortgages

To support home ownership for veterans and low- to moderate-income families, the federal government's Department of Veterans Affairs (VA) and Federal Housing Administration (FHA) have mortgage loan programs. About 20 percent of residential mortgages carry a government guaranty or insurance. In the mortgage industry, they are called *government loans.* The other 80 percent described in the following sections are called *conventional loans.*

Government Loans

Advantages

FHA loans and VA loans have several advantages to the consumer over conventional loans:

- Lower interest rates (often 0.5 percent lower),
- Easier qualifying requirements (more lenient qualification formulas than conventional loans),
- Lower down-payment requirements (FHA: 2 percent to 3 percent; VA: no money down to $184,000) and
- Assumable loans.

Both FHA and VA loan programs include 30-year and 15-year fixed-rate, level-payment loans, one-year ARM loans with 1/5 caps and graduated-payment mortgages.

Disadvantages

FHA and VA loans carry some restrictions and disadvantages:

FHA

- The maximum loan amount for an FHA insured single-family loan ranges from the high $60,000 to $151,275 ($227,550 in Alaska and Hawaii). The maximum FHA loan limit depends on a combination of the average cost of housing in your geographic area *and* the maximum conforming loan amount that could be purchased by Freddie Mac as of September 30, 1992.
- Figure 4.21 shows current FHA mortgage insurance premiums (MIP) schedules. These MIP fees are much higher than comparable premiums for conventional loans. They are so much higher that they completely offset the advantage of lower interest rates available on FHA loans. However, they do not offset the more relaxed underwriting standards offered by FHA, including the much smaller down payment required for an FHA-insured loan.
- They are not available for nonowner-occupied investment properties or vacation homes except for certain refinances of existing FHA-insured loans.

VA

- In the mid=1990s, the maximum loan amount for a VA-guaranteed loan was $184,000.
- To get a VA loan, you must be a qualifying veteran, the unmarried widow of a veteran, a Public Health Service Officer or an active-duty serviceman (with 181-day service). Check with the VA with questions on eligibility.
- Presently, the VA Funding Fee is as much as 3% of the loan amount, depending on your down payment, whether you are a veteran of active duty military service or a reservist with at least six years of service and whether this is a first-time use of the VA guaranteed loan program. Following are the VA loan guaranty fee structures for loans closed through September 30, 1998:

Loan Type		**Active Duty or Veteran**	**or**	**National Guard/ Reservist**
Purchase/construction	0% down	2.000%		2.750%
	5% down	1.500%		2.250%
	10% down	1.250%		2.000%
Regular refinance (cash out)		2.000%		2.750%
Rate reduction refinance		0.500%		0.500%
Second or subsequent use		3.000%		3.000%

(other than rate reduction refinance or purchase/construction with at least 5% down)

- VA loans are not available for investment properties or vacation homes.

Because of their lower rates and assumability, VA loans are better deals for consumers than conventional loans. (However, if you are making a down payment of 20 percent or more, the VA guarantee fees, which are charged regardless of loan-to-value ratio, may make a VA loan more expensive than a conventional loan. If you are making a down payment of less than 20 percent, a VA loan probably will be less expensive.)

Mortgage companies make more than 85 percent of the nation's FHA and VA loans. So if you decide to get a government loan, concentrate your shopping effort on mortgage companies.

Conventional Loans

The federal government also affects the market for *conventional mortgages*. Two federally chartered government agencies, Fannie Mae and Freddie Mac, buy mortgages from lenders. These two agencies supply more than 20 percent of the nation's mortgage money and directly affect mortgage rates for conventional loans.

Congress has set some restrictions on the mortgages that Fannie Mae and Freddie Mac can buy. The most critical restriction is the maximum loan amount. For 1994, it is as follows:

Number	**Maximum Loan Amount:**	
of Units	**Continental U.S.**	**Alaska and Hawaii**
1	$203,150.00	$304,725.00
2	$259,850.00	$389,775.00
3	$314,100.00	$471,150.00
4	$390,400.00	$585,600.00

Conventional loans that Fannie Mae and Freddie Mac are allowed to purchase are called *conforming loans*. Conventional loans that are too large for these government agencies are called *nonconforming loans* or *jumbo loans*. Jumbo loans have higher interest rates than conforming loans, typically 0.5 percent to 1 percent higher. Jumbo loans also have higher down-payment requirements, especially for loans larger than $300,000.

Other Mortgage Programs

In addition to the traditional 30-and 15-year fixed-rate mortgages, adjustable rate mortgages, balloon mortgages, etc., other less common mortgage programs are available. These include reverse annuity (sometimes known as reverse equity) mortgages, mortgages insured by the Farmers Home Administration (FmHA) and biweekly mortgages.

Reverse Annuity Mortgages

The Federal Housing Administration insures reverse annuity mortgages. The program is developed for elderly individuals (62 and over) who own their home but need additional income for day-to-day living expenses. Under this program, borrowers do not receive the entire principal balance at settlement but receive periodic payments of principal during the term of the loan up to a maximum insurable amount as defined by the FHA. The amount may increase by 1/12th of the expected annual appreciation (of the property) each month. Interest on the principal advanced and FHA's annual mortgage insurance are added to the outstanding balance on a monthly basis. When the total outstanding principal balance reaches the maximum insurable by FHA, payments of principal balance reaches the maximum insurable by FHA, payments of principal cease. If the value of the home is not sufficient to pay off the outstanding loan amount when the borrower dies, FHA will not attempt to collect the balance from heirs to the estate. If the value of the home is greater than the loan balance, the remainder of the proceeds is available to the estate. However, in some cases, there is an equity sharing arrangement: The lender shares in a percentage of the appreciation of the property if the value is greater than the loan balance. The program has not proven to be very popular among borrowers, and lenders who are authorized to lend under this program are limited. See your local lender for details.

Biweekly Mortgages

Payments are due on a biweekly basis (every two weeks) rather than once a month. The payment is calculated by dividing the monthly payment by two. Since the payment is collected every two weeks, you make an extra month's payment every year, thus substantially speeding up the amortization of your loan. In addition, with a true biweekly mortgage, the loan is amortized on a biweekly basis, so the impact of the payment each year. Most biweekly mortgages require that the biweekly payment be deducted directly from your checking account by the lender. If you had insufficient funds in the account under certain circumstances, the loan would revert to a normally amortizing mortgage.

Be aware, however, that some third parties will offer to convert your existing traditional mortgage to a biweekly mortgage by collecting the payments on a biweekly basis and forwarding them to your mortgage lender. This offer is not such a good deal. Although an extra monthly payment is made each year, the loan does not actually amortize on a biweekly basis and the third party charges for the service, which may cost most than the savings in interest over the term of the loan. You would probably be better off by making an extra mortgage payment on your own each year in this scenario.

Farmers Home Administration Mortgages (FmHA)

Because traditional mortgage programs have rather strict guidelines for the land-to-value ratio (the value of the land as a percentage of the total value), usually approximately 25 percent to 30 percent, and because mortgage loans are often less available in rural areas, the Farmers Home Administration produced an insurance program. FmHA-insured loans are similar to FHA insured loans except as follows:

- They are limited to rural areas (outside urban area as defined by the U.S. Census Bureau.)
- Loans are insurable by FmHA up to 100 percent of the loan amount.
- Maximum loan amount is $67,000, except "high cost" areas as defined by FmHA.
- FmHA insurance fee is nonrefundable 1 percent of the loan amount.
- Loans must be underwritten and approved by FmHA prior to settlement.
- FmHA sets an "allotment" each year on the dollar volume of loans it will insure.

Choosing the Right Type of Mortgage for You

For most people, a conventional 30-year traditional mortgage is the right choice. It is by far the most popular. It also makes a good benchmark for making comparisons with other types of loans. The type of loan that you choose depends on your needs. The chart in Figure 4.22 summarizes the characteristics that you might be looking for in a mortgage and matches loan types to those characteristics.

Not all loans are readily available for all loan amounts and all loan-to-value ratios. Figure 4.23 summarizes the limitations for various types of loans.

The Mortgage Data Form described in Figure 5.3 in Chapter 5, "Shopping for a Mortgage," will help you determine how large a mortgage you need and your loan-to-value ratio. Chapter 2, "Qualifying for a Mortgage Loan," will help you determine how large a loan you qualify for and if you need a loan type that makes qualifying easier. In addition to using all of this information, you can consult a loan officer of a mortgage company, bank or savings-and-loan association for help in choosing the right type of loan.

Determine Your Needs

Before you start telephoning lenders, you should have a firm idea of the product that you are going to inquire about. Rates and the availability of mortgages depend on the following factors:

- Loan amount,
- Loan type,
- Occupancy (to be used as a primary residence, second home or investor property?),
- Loan-to-value ratio and
- Purpose of loan (for a home purchase or refinance?)

Mortgage Data Form

The first step in shopping for a mortgage is documenting precisely what you need so that you can answer some of the basic questions lenders will ask you.

A sample Mortgage Data Form in Figure 5.3 includes most of the information that you should have at your fingertips for your initial contact with lenders. Appendix D has a blank form for you to fill out.

In the example in Figure 5.3, Mr. and Mrs. Homebuyer need a $107,500 mortgage to purchase a home for $125,000. The home will be their primary residence, and the LTV ratio will be about 86 percent. (They already have prequalified for this loan amount at prevailing interest rates.)

Select the Mortgage Product

The topics in Chapter 2 "Qualifying for a Mortgage Loan," Chapter 4 "Choosing the Right Type of Mortgage," Chapter 7, "Investor Loans" and Chapter 8 "Refinancing," all affect the type of mortgage that you select. Read through them and make your selection before calling lenders (see Figure 5.4). Make sure that your loan amount and the loan-to-value (LTV) ratio fall within the limits of the loan that you select. (See Figure 4.23, "Restrictions on Different Types of Mortgages.")

Mortgage Insurance

If your loan-to-value ratio is greater than 80 percent and you are shopping for a conventional loan, you usually will be required to pay a mortgage insurance premium (MIP) each month as part of your monthly payment (see Chapter 6). Monthly mortgage insurance premiums vary from 0.25 percent to 0.50 percent of the original loan amount depending on LTV ratio, loan type and loan amount. These premiums increase your effective interest rate by the rate of the premium.

Some lenders self-insure by charging a slightly higher mortgage rate instead of requiring mortgage insurance. To compare their rates to lenders who require mortgage insurance, you must add the mortgage insurance premium rate to the rate to get the effective rate. If none of the lenders that you canvass self-insures or your LTV is 80 percent or below, you can ignore the cost of mortgage insurance.

Temporary Buydown

If you plan to use a temporary buydown to help in qualifying, you must ask about the cost when you do your rate shopping (see Chapter 6). Different lenders charge different amounts for the same buydown plans, just as they charge different rates for the same loans.

Canvass Lenders

It is difficult, if not impossible, to find the "best deal" in town. Many lenders change their posted rates daily. No lender has the best rates all the time, and a lender with the lowest rates in one type of mortgage may have high rates in another type. Despite the difficulties involved with shopping for a loan, there is no better way for you to save money than telephoning lenders and comparing rates (see Figure 5.5).

Whom To Call

Some large metropolitan areas, may have be many as 150 mortgage lenders; smaller markets, as few as a dozen. In most areas, calling every lender in the telephone book would be impractical, but calling 15 to 20 lenders should result in significant savings.

If only a dozen lenders are in your area, call them all. If there are 150, how do you choose the 15 or 20 to canvass?

In some metropolitan areas, there are "Mortgage Rate Reporting Services" that poll lenders for their rates and publish a weekly report, some Boards of REALTORs maintain a list of mortgage rates on their Multiple Listing Service computers, and many newspapers publish a list of mortgage rates in their real estate section. Ask your REALTOR or check with the local newspaper to find out if there is a rate reporting service in your area. You can also select a mortgage broker, explained later in this chapter.

Because interest rates change frequently, the weekly listings often are out-of-date by the time they are published. However, some lenders' rates are consistently lower than average and other lenders whose rates are consistently higher. The value of the rate reporting services is to help you select the 20 lenders to canvass.

If there is no rate reporting service in your area, you will have to rely on your REALTOR, your attorney, your friends and the yellow pages. Mortgage companies make more than half of the nation's mortgage loans. Commercial banks now make more than 25 percent, and savings-and-loan associations less than 20 percent (see Figure 5.6). This is an almost complete reversal from the situation of only a few years ago, when more than half of all mortgage loans were originated by savings-and-loan associations and commercial banks were only "bit" players. Figure 5.6

If you are refinancing or have a mortgage on a home that you are selling, call your current mortgage lender first. Some lenders will give special deals to existing borrowers. Second, call the banks where you have checking and savings accounts. They may not be active in the mortgage market, but if not, they can be another source of advice on who the most competitive lenders are.

Mortgage companies make 85 percent of the FHA and VA insured loans. If you are shopping for an FHA or VA loan, limit your search to mortgage companies. If you are shopping for a conventional loan, call several savings-and-loan associations, several mortgage companies and a few banks. If you are self employed or own a business, your commercial bank may give you a subsidized mortgage rate as an incentive to keep your commercial accounts.

Shopping Lists

Appendices E and F, have two shopping lists for you to use while calling lenders for their rates: One list is for fixed-rate loans and one is for adjustable rate mortgages. Figure 5.7 shows you a blank fixed-rate shopping list.

Try to make all your telephone calls to lenders within one or two days. If you spread the calls out over a week's time, the rates will have changed by the time you have finished canvassing all of lenders on your list. Also, plan to submit an application immediately after you have canvassed the lenders. Again, if you wait a week, the rates may have changed.

Some lenders may give you two or three quotes for the same loan but with different combinations of rate and points. Write them all down and decide which is best later.

If you are refinancing, be sure to ask the lender for a loan with just one or two points so that your payback period will be short. Most lenders will be able to quote several combinations of rate and points.

If you are buying a home and do not have much cash for the down payment and closing costs, you should also ask for a loan with low points. This will reduce your closing costs and the cash required to buy the home.

Locking In a Rate

In most markets, lenders will allow you to lock in the quoted rate and points that are available when you submit your application. Usually, lock-in commitments are good for a period of 45 to 60 days. Even if interest rates increase while your loan is being processed and approved, the lender will close your loan at the lower rate that you locked in earlier. If rates have fallen, most lenders still will expect you to close the loan at the lock-in rate.

Problems arise when lenders are unable to process and close a loan within the lock-in commitment period. In April and May of 1986, for example, lenders were flooded with loan applications from homebuyers and homeowners seeking to take advantage of low interest rates. Many lenders, appraisers, title companies and settlement attorneys had a 90-to 120-day backlog. Lenders were unable to close loans within 60 days. Many homebuyers lock-in commitments expired and they were forced to close their loans at higher rates. During periods of exceptionally high loan volume, some lenders may temporarily stop offering lock-in commitments.

Question: If you cannot lock in the low interest rate that you find by canvassing lenders, what value is there in shopping around?

Answer: Lenders with below-average rates today are more likely to have lower rates in three months than lenders with higher rates today. If lenders in your area are not offering lock-in commitments, the value of shopping will be diminished but not lost. Just as discount stores have lower prices than full-service department stores, some lenders have lower-than-average mortgage rates on an ongoing basis.

Question: Are lock-in commitments free?

Answer: In most markets, lenders will not charge a nonrefundable fee for locking in your rate if you are purchasing a home, but in some markets they will. It is not uncommon for lenders to charge a lock-in fee for refinance loans. Some lenders will charge one-half to one full point more for a loan with a 60-day lock-in commitment. Others will factor the cost of commitments into the interest rate and number of points that they charge.

Some lenders offer a 120-day lock-in commitment for a non-refundable up-front fee. This might be attractive to you if you cannot settle for three or four months, but would like to lock in a low interest rate.

Even when a lock-in commitment is available and the lender will be able to close your loan within the lock-in period, you may not want to lock in a rate. If you feel strongly that interest rates are falling, you may want to wait until closing to set your rate. If so, do not lock in a rate.

Mortgage Brokers

In some areas of the country, mortgage brokers will take your application and find a lender for you. They provide a very useful service. They know which lenders have the most competitive rates and which lenders have the most relaxed underwriting standards. Generally, they can do a better job of shopping than a consumer who does not have the time to do it thoroughly.

However, many lenders do not accept application packages from mortgage brokers, and others will tack on an additional fee to their ordinary rates to pay the broker's commission. Some brokers will add their own fee on top of that.

Bottom Line on Mortgage Brokers

If a mortgage broker with a good reputation can get you a loan at a lower price than you can find yourself, use him or her.

Compare Your Choices

Question: After you have made your telephone calls and filled out the shopping list, how do you select one loan and lender from among the many choices?

Answer: By process of elimination.

The price that you pay for a loan is a combination of rate, points and fees. Price comparisons are tricky, and unfortunately there is no way to make good comparisons without resorting to some arithmetic. Comparing the prices to choose a lender is a four-step process:

- Sort your list of loans by rate and points.
- Eliminate the obviously high-priced loans.
- Calculate effective rate for remaining loans.
- Choose a low rate loan from a reputable lender.

When you have completed your telephone calls, you will have a list of 15 to 25 loans. To make the example in Figure 5.9 simpler, we have listed just eight of them.

Figure 5.9 shows the loans in the same order as they came from the shopping list. Note that the rates are expressed as decimals rather than fractions. This makes the arithmetic easier. Use the following conversion table if lenders quote rates in fractions:

8 % = 8.000 %
8 1/4 = 8.250
8 1/2 = 8.500
8 3/4 = 8.750
8 1/8 = 8.125
8 3/8 = 8.375
8 5/8 = 8.625
8 7/8 = 8.875

1. After you have finished canvassing the lenders, sort your list of quotes by rate and then points (Figure 5.10). You usually will find that the mortgages with the lowest rates will have the most points.
2. The next step is to eliminate the loans whose rates and points are obviously higher than other loans on the list (see Figure 5.11). This will cut down the amount of arithmetic required.

Eliminate loans that have the same rate as another loan on your list and more points. In the example that follows, American Home Mortgage Company's loan at 8 percent plus five points is higher priced than ABC Mortgage Company's loan at 8 percent plus 4.75 points, and First National Bank's loan is one point higher than Hometown S&L.

Also eliminate loans that have a higher rate than another loan on your list and the same number or more points. First Federal S&L's loan at 8.5 percent plus two points is higher priced than Hometown S&L's loan at 8.375 percent plus two points so it, too, can be eliminated. First Home Savings Bank's loan at 8.25 percent plus 4.25 points is higher priced than ABC Mortgage Company's loan at 8.125 percent plus four points because both its rate and points are higher.

Making the Arithmetic Easier

3. The third step is to convert the rate and points for the remaining loans into their effective rate. Calculating the effective rate precisely requires a computer or financial calculator, but you do not need to be that precise to compare loans. The following formula works well for people who plan to keep their loan for 7 to 12 years:

Interest rate + (Points ÷ 6) = Effective rate

For example, the effective rate for ABC Mortgage Company's 8 percent plus 4.75- point loan is: 8.0 percent + (4.750 points ÷ 6) = 8.792 percent. (Note: This formula does not work with adjustable-rate mortgages.)

If you plan to keep your home for more than 12 years, divide the points by 8 instead of 6. If you plan to stay for four to six years, divide the points by four. If you plan to stay one to three years, divide the points by the number of years.

4. The final step is choosing a low rate from a reputable lender. In the previous example, Hometown S&L has the lowest effective rate at 8.708 percent (see Figure 5.12). In the case of a tie, you can use fees as a tiebreaker, but in any event check a lender's reputation before submitting your application, and make sure that the lender can process and close your loan during the rate lock-in period.

Comparing ARMs

Comparing adjustable-rate mortgages is much more difficult than comparing fixed-rate loans. ARMs have so many different features that it is impossible to develop a simple formula for deciding which loan is best.

For ARMs, the interest rate is determined by the index, margin, points, fees, starting rate and periodic and life interest rate caps. Without knowing what future interest rate levels will be, you have no sure way to know what the loan rate will be.

However, you should consider these critical elements:

- The maximum rate (life rate cap),
- The index and margin and
- The points and initial rate.
- The possibility of negative amortization

The maximum rate is especially important because it will determine the maximum monthly payment that you would have to make if high interest rates return. The monthly payment for a $100,000 mortgage is $878 at 10 percent versus $1,029 at 12 percent. The critical question with an ARM is "How much monthly payment can you afford?"

With ARMs, your interest rate is adjusted yearly (or periodically depending on the adjustment interval). The new rate is determined by adding the margin to the new index value. If two ARMs have the same index (most use the One-Year Treasury Security Index), then the loan with the lower margin is the lower rate loan. Some ARMs use the Bank Board's Cost-of-Funds Index. Because it rises more slowly when interest rates go up, it is better for consumers than the Treasury Security Index.

With ARMs, points and initial rate are often traded one-for-one. For example, a lender might offer a choice of the same ARM with an initial rate of 9 percent plus two points or 8 percent plus three points. This is similar to a temporary buydown (see Chapter 6, "Miscellaneous Mortgage Topics"), but there is a difference. If the periodic and life interest rate caps are keyed to the initial rate (i.e., two and five caps), the maximum second-year payment and the life rate cap will be 1 percent lower for the loan at 8 percent plus three points than for the loan at 9 percent plus two points.

Before choosing an ARM over a fixed-rate mortgage, compare the current index value plus margin (i.e., 3.54 percent One-Year Treasury Index + 2.75 percent margin = 6.21 percent) to the current fixed-rate (i.e., 8.25 percent). The difference (2.04 percent) is the interest rate savings that you would get by choosing an ARM if interest rates were to remain the same. You should weigh this savings against the risk that the ARM's rate could increase to its maximum (i.e., 10 percent) if rates rise to high levels again. If you select an ARM loan that includes the possibility of negative amortization, you should consider the effect of interest being added to your original loan amount.

Submit Your Application

After you have made your choice, move quickly to submit your application (see Figure 5.13). Rates can change daily! If you are canvassing lenders on Wednesday and Thursday, plan to submit your application on Friday. When you call to set up an appointment for the application interview, reconfirm the rate, points and fees that you were quoted, and try to get an oral commitment to hold that price.

Review Chapter 1, "The Application Process," so that you bring all of the necessary documentation with you to the interview. All borrowers (i.e., both husband and wife) must sign the loan application, and some lenders require all borrowers to attend the interview.

Final Note on Shopping

After you have applied for the loan, your lender probably will ask you for some additional documents or information. Make a log of when you received those requests, and respond quickly (keep track of when you responded). If your lock-in period expires and your lender tries to renege, you will have documentation to show that you complied with all requests.

Assumability

During the early 1980s when interest rates were very high, many homebuyers shopped for homes with an *assumable mortgage*. A loan is assumable if the lender will allow a new borrower to replace the old borrower (see Figure 6.1). Rather than finance the home purchase with a brand-new loan at 15 percent or 16 percent interest, for example, a buyer would make a larger down payment and take over the responsibility of making the payments on the seller's old 9-percent or 10-percent loan.

Having a low rate, assumable mortgage during periods of high interest rates gives a seller a definite advantage in selling a home. By assuming a loan, the buyer pays less interest and lower monthly payments. Closing costs are lower, and often the buyer can avoid going through the qualification process.

Assumability is an attractive feature to have on your mortgage, but it is not important unless (1) interest rates rise and (2) you are forced to sell your home when rates are much higher. If you are choosing between two mortgages that are identical in price and all other respects, except that one is assumable and the other is not, choose the assumable loan.

Generally, FHA loans, VA loans and ARMs are assumable, and conventional fixed-rate loans are not assumable. (You can assume a VA loan even if you are not a veteran.)

Loans that are not assumable have a due-on-sale clause in the mortgage note. A *due-on-sale clause* states that the loan is due and payable if the property is sold. If a mortgage is assumable, it will have a clause describing the conditions of assumption --assumption fee (typically one point), buyer qualification and processing requirements. If you are assuming a loan or getting a new mortgage that is assumable, read the conditions of assumption.

Assuming a Loan Versus Getting a New Loan

If you are buying a home that has an assumable mortgage, here are some questions to ask:

- Will the lender charge an assumption fee? How much?
- What is the outstanding balance of the old loan? Is it large enough? How much cash will I need?
- If it is not large enough, will the seller be willing to take back a second mortgage?
- What are the rates and costs of a second mortgage? From the seller? From a lender?
- Would the combined monthly payments and interest of the old mortgage plus a new second mortgage be more or less than those of a new first mortgage?

There is no simple formula or rule of thumb to help decide whether or not to assume an old loan. However, the following example shows how an assumption can be much better than a new loan.

***Example*:** Mr. and Mrs. Homebuyer are purchasing a $125,000 home, and they have $30,000 in cash to cover the down payment ($25,000) and closing costs (about $2,000, plus points). They have the option of assuming an existing loan with a balance of $73,000 or getting a new first mortgage.

Option 1: Assume Old Loan

Old first mortgage:

- $85,000 original balance, $73,000 remaining balance
- Seven-percent first mortgage with one-point assumption fee
- 20 years remaining on 30-year term
- Monthly principal and interest payment: $565.61

New second mortgage:

- $25,000 at 10-percent fixed rate plus one point
- 15-year term
- Monthly principal and interest payment: $268.65

Option 2: Get New Loan

New first mortgage:

- $100,000 at eight-percent fixed rate plus three points
- 30-year term
- Monthly principal and interest payment: $733.76

By assuming the existing loan, Mr. and Mrs. Homebuyer would save $2,000 in points. The assumption fee is one point ($730), and the second mortgage lender charges one point ($250) for a total of $980, versus $3,000 in points for a new first mortgage. The monthly payments for assuming the old loan are $100 per month higher. But because the interest rate on the old mortgage is only 7 percent, the interest charges are $80 per month lower. More of the payments are going toward principal and less toward interest. By paying just 15% or $100 per month more in their monthly payments, Mr. and Mrs. Homebuyer would pay off their mortgages faster and save more than $80,000. (See Figure 6.3.)

Option 1: $565.61 x 240 months + $268.65 x 180 months = $184,079
Option 2: $733.76 x 360 months = $264,153

In this example, assuming the old loan would be far better than getting a new mortgage.

Buydowns

A *buydown* is a method of lowering the interest rate of a mortgage by paying additional points. There are two types of buydowns: permanent and temporary. A *permanent buydown* lowers the interest rate for the life of the loan, and a *temporary buydown* lowers the interest rate for the first few years.

A permanent buydown is most often used as a sales incentive by the seller of a home. The seller (especially a homebuilder) will advertise "below market rate" financing as a special inducement to would-be buyers. Usually, the cost of the lower rates are factored into the asking price of the house. (Large builders also have other ways of offering low rates. They often can negotiate lower rates with lenders because of the large volume of loans.)

In negotiating to buy a home, you may write a clause into the sales contract that requires the seller to pay up to a certain number of points for your mortgage. This is common with FHA and VA loans. The seller is, in effect, buying down your interest rate.

The cost of a buydown varies depending on the type of loan and the lender. To lower the interest rate of a 30-year loan by 1 percent for the life of the loan, you usually will be charged from six to eight points.

Temporary buydowns lower the interest rate (and monthly payment) for the first few years of a loan. Temporary buydowns are used like a graduated payment mortgage to help a borrower qualify for a higher loan amount than his or her income would allow with a level payment mortgage. Unlike GPMs, there is no negative amortization with a temporary buydown. The additional points pay for the lower initial interest rates.

The "3-2-1" buydown is the most common type of temporary buydown. A 9 percent loan with a 3-2-1 buydown would have a 6 percent rate for the first year, 7 percent for the second year, 8 percent for the third year and 9 percent for years 4 through 30.

The example in Figure 6.4 is a $100,000 3-2-1 buydown. Monthly payments start at $599.55 and rise to $804.63 by the fourth year. Using a 3-2-1 buydown, a homebuyer can qualify for an approximately 25 to 30 percent larger loan. However, the cost of a 3-2-1 buydown is usually five and a half to six additional points, a big increase in closing costs.

Another popular temporary buydown is the 2-1 buydown. It reduces your interest rate 2 percent in the first year and 1 percent in the second year. It does not cut your initial payment as much as the 3-2-1 buydown, but it costs only about half as much (about three points).

A buydown is an expensive way to reduce your initial payments, but you can use two methods to offset the up-front costs of a buydown. First, negotiate to have the seller pay for some or all of the buydown costs. It is very common for homebuilders to pay buydown costs for buyers. Second, your lender may allow a "buyup" in the loan's base interest rate to offset the cost of the temporary buydown. For example, if the market rate for a 30-year fixed-rate loan is 8 percent plus two points, you might expect to pay five points for an 8 percent rate with a 2-1 buydown. Some lenders will offer an 8.5 percent rate with a 2-1 buydown for two points. The first year rate would be 6.5 percent, the second-year rate would be 7.5 percent, and the remaining payments would be at a rate of 8.5 percent.

Late Payment Charges

If you fail to make your monthly mortgage payment by the 15th of the month, lenders add a late charge to your payment. A typical late charge is 5 percent of your monthly payment of principal and interests, i.e., $36.69 for being late on the $733.77 monthly payment for a $100,000, 8 percent loan. The late charge for FHA-insured and VA -guaranteed loans is no more than 4 percent of the payment of PITI.

In shopping for and comparing loans, the late charge is not something that you should be concerned with. But the late charges will be disclosed in the truth-in-lending statement that you receive after submitting your application. Review the late-charge clause for the loan that you have selected and calculate the cost of being late with your payment.

Many banks and savings-and-loan associations will allow you to set up an automatic monthly withdrawal from a savings or checking account to pay recurring bills such as mortgage payments. By setting up such a withdrawal, you can avoid the hassle of late charges entirely.

Mortgage Insurance

If your down payment is less than 20 percent (loan-to-value ratio greater than 80 percent), you must buy mortgage insurance. *Mortgage insurance* insures the lender, not the borrower, against default and foreclosure. If a borrower defaults on his or her payments and the property is foreclosed, the mortgage insurance company must repay the lender all or a portion of its losses.

[Note: Do not confuse mortgage insurance with mortgage life insurance. *Mortgage life insurance* is an optional life insurance policy that you can buy from your lender or your insurance agent. It pays off your mortgage in the event of your death.]

Although mortgage insurance primarily benefits the lender, it does allow homebuyers to purchase their home with a low down payment. The borrower pays the mortgage insurance premium (MIP).

There are three types of mortgage insurance, or loan guaranty: FHA mortgage insurance, VA loan guaranty and Private Mortgage Insurance. FHA loans are insured by the Federal Housing Administration, and VA loans are guaranteed by the Department of Veterans Affairs. Both are agencies of the federal government. Conventional loans are insured by private mortgage insurance companies.

The terms, conditions and premium charges for mortgage insurance have changed several times since the early 1980s, particularly for private mortgage insurance. For up-to-date details on specifics such as maximum loan amount, LTV ratio, mortgage types and premiums, you must talk to a lender.

Financing Mortgage Insurance

For conventional loans, there are two ways to pay for private mortgage insurance (PMI): (1) by adding a small premium amount to each monthly payment (renewable plan, or annual plan) or (2) by paying a larger, one-time, or single, premium at settlement. The *single premium plans* fall into two categories: *refundable premiums* and *nonrefundable premiums*. Refundable premiums cost more up-front, but you get a refund of the unused premium if you pay off the loan early. If you are planning to keep your mortgage for only a few years, the pay-by-month plan is probably the best deal. If you are planning to keep your mortgage for several years, look into a one-time premium. Most lenders will let you add the cost of mortgage insurance to your loan amount so the up-front premium does not increase your closing costs: however, your monthly payment will increase to reflect the larger loans.

Financing the one-time mortgage insurance premium has one additional benefit. Mortgage insurance premiums are not a valid income-tax deduction, but if you finance the one-time premium, the interest that you pay on the slightly larger loan amount is deductible. In addition, you can see in Figure 6.6 that the total monthly payment of is somewhat less when premiums are financed rather than paid monthly. The disadvantage is that financed mortgage insurance cannot be canceled unless you pay off the mortgage.

With the FHA mortgage insurance premium (MIP) and the VA funding fee, you do not have the same flexibility that you do with conventional loans. As with conventional mortgage insurance, you may choose to pay the VA funding fee or up-front portion of MIP in cash or finance it. Note that with FHA-insured loans you still must pay monthly MIP in addition to the up-front premium.

Discontinuing Mortgage Insurance Premiums

If you have a conventional loan with private (renewable) mortgage insurance, your lender may allow you to discontinue the PMI premiums when your LTV ratio declines to 70 percent or 80 percent. (Fannie Mae and Freddie Mac require that for loans sold to them, lenders allow you to cancel your mortgage insurance when your loan amortizes to less than 80% LTV.) This can happen in two ways. First, several years of monthly payments will reduce your loan balance and your LTV ratio. Second, if the value of your home goes up, your LTV ratio goes down. (Lenders will usually require you to pay for a new appraisal to document the higher value.)

***Example*:** Mr. and Mrs. Homebuyer purchase a $110,000 home with a $10,000 down payment and a $100,000 mortgage. Their LTV ratio is 91 percent, and they must get mortgage insurance. Their annual premium would be $440 per year. In a few years, the value of their home has gone up to $140,000, and they have reduced their mortgage balance through monthly payments to $97,000. Their new LTV ratio would be 69 percent. Their lender will allow them to discontinue the PMI premiums but charges them $250 for a new appraisal. The $250 reappraisal would save them $440 a year.

Prepayment Penalty

Some lenders charge a fee if you pay off your mortgage early. It is called a *prepayment penalty*. If your loan has a prepayment penalty clause, your lender will disclose it in the truth-in-lending statement that you receive shortly after submitting your application. A typical prepayment penalty clause charges borrowers a three-point fee on the remaining principal balance if they repay their mortgage within the first three years of the loan.

In the 1970s, prepayment penalties were more common than they are today. If you are planning to move, refinance or pay off your new loan within three years, however, ask your lender whether or not you will be charged a prepayment penalty before submitting an application. Because of the huge refinancing volume during the early 1990s, there is much talk among lenders about reinstituting prepayment penalties.

Second Mortgages

A *second mortgage,* just as its name suggests, is a second loan secured by the same property as a first mortgage. There are two reasons why you might want a second mortgage:

1. First, if you are buying a home, a second mortgage can help supplement your cash for your down payment and closing costs, especially if you are assuming a low rate but small first mortgage (see section on "Assumability") (See Figure 6.7.)
2. Second, if you are refinancing to "take cash out" of your property, a second mortgage or home equity loan often is cheaper than replacing your first mortgage (see Chapter 8, "Refinancing").

Figure 6.7 How a Second Mortgage Can Help You Supplement an Assumed First Mortgage

Higher Rates, Shorter Terms

To lenders, second mortgages are riskier than first mortgages. In the event of default and foreclosure, the second mortgage lender gets paid off only after the first mortgage lender is paid in full. Because of this additional risk, lenders usually charge a higher rate for second mortgages than for first mortgages.

Most first mortgages have terms of 15, 25 or 30 years. Second mortgages typically have terms ranging from 5 to 15 years.

Combined Loan-to-Value (CLTV) Ratio

If you have a $125,000 home and a $100,000 first mortgage, the loan-to-value ratio for that mortgage is 80 percent ($100,000 ÷ $125,000). If you also have a $10,000 second mortgage in addition to your first mortgage, your combined LTV ratio is 88 percent ([$10,000 + $100,000] ÷ $125,000). Your *combined LTV* (CLTV) ratio is the sum of all your mortgages divided by the value of your home.

When making a second mortgage loan, lenders will restrict your CLTV ratio. Depending on loan type, occupancy and purpose, the maximum CLTV will range from 70 to 90 percent. The rate for this type of second mortgage is typically 2 percent to 3 percent higher than the rate for a 15-year first mortgage. If your CLTV ratio is more than 80 percent, you should expect the rate for your second mortgage to be 3 percent to 6 percent higher than a 15-year first mortgage.

Balloon Versus Fully Amortizing Second Mortgages

With a traditional first mortgage, a portion of each payment that you make reduces your loan balance, and by the time you reach your last monthly payment, you have fully paid off your loan. This is called a *fully amortizing* loan. Some second mortgages are also fully amortizing.

Others, however, come due with a large portion of their principal balance still unpaid. These loans are called *balloon* loans and the final principal payment is called a *balloon payment*.

Example:

- $25,000 second mortgage at 10-percent interest
- 7-year term with 30-year amortization schedule
- $219.40 monthly principal and interest payment
- $23,881 balloon payment due at the end of seven years

In the previous example, you would have paid off only 4 percent of your $25,000 loan by the time it comes due in seven years. The advantage of a balloon loan is a lower monthly payment. The monthly payment of a fully amortizing $25,000 seven-year loan at 10 percent would be $415.03 versus $219.40 for the balloon loan.

Purchase-Money Mortgages

When the seller of a property makes a mortgage loan to the buyer, it is called a *purchase-money mortgage*. Usually, the seller "takes back" a second mortgage to facilitate the sale when a buyer cannot meet the amount required for the down payment and closing costs. Purchase-money mortgages often are made in conjunction with an assumed first mortgage. Typically, a seller will loan you money at a better rate than a traditional lender.

Tax Deductions

One of the enduring benefits of home ownership is the federal tax deduction for interest and real estate taxes. On a home with a $100,000 mortgage, the deductions will total about $8,000 per year, and depending on your tax bracket, they will reduce your federal taxes by $1,200 to $2,900. This amount will decrease as you pay down the loan or, if you have an ARM loan, may go up in the event your interest rate increases.

Figure 6.8 Tax Deductible Interest and Points, First Year, 8 Percent Mortgage

The Tax Reform Acts of 1990 and 1993 have changed the rules governing the deductibility of interest, and the regulations are particularly complicated when you purchase a home or refinance your mortgage. The Internal Revenue Service's Publication 545, *Interest Expense*, describes when and if interest, fees, points and other charges relating to your mortgage are deductible. The rules for home purchase are different from refinancing, and the rules for FHA/VA loans are different from conventional loans. Consult with an accountant, tax attorney or an IRS adviser for the proper way to file your taxes, especially for the year that you get a new mortgage.

(See Figure 6.8.)

Fannie Mae Guidelines

Not all lenders follow Fannie Mae's underwriting guidelines for investor loans, but understanding Fannie Mae's guidelines will give you a good idea of the kinds of issues that all lenders consider before making an investor loan. If you have not already read Chapter 2 on qualifying for a loan, go back and read it before continuing with this chapter. The chapter will help you better understand the following examples.

Supporting Income and Expense Projections

Fannie Mae's operating income statement that you (or the appraiser) must fill out is long and detailed, but both the appraiser and the underwriter will review each income and expense item on it before your loan is approved. If an appraiser or underwriter makes adjustments to your projections, most likely he or she will lower the rental income or increase projected expenses. These adjustments will reduce the debt service coverage ratio and net cash flow projections. They may disqualify the loan.

Whenever possible, support your income projections with documentation. Submit copies of leases to support rent projections and utility bills for expenses. Submit prior years' operating statements ("Schedule E" from prior year's tax returns) if they are available. Well-documented projections will have fewer adjustments.

Prequalification for Investment Properties

When applying for a mortgage on your primary residence, you must "qualify." You must have enough income to cover your housing expenses and other debt obligations according to industry standards.

When applying for a mortgage on a small residential investment property, you still must qualify according to the same standards; in addition, you must submit a detailed pro forma Operating Income Statement, Fannie Mae Form 216, on the investment property that you are buying. Also, your appraiser must submit comparable rent information using Fannie Mae Form 1007 for single-unit investment properties or Fannie Mae Form 1025 for two- to four-unit properties. (See Appendix G for Fannie Mae's instructions on completing these forms.)

Qualifying for an owner-occupied investor loan is different from qualifying for a nonowner-occupied investor loan. The two examples that follow illustrate the difference. In both examples, John Q. Investor is buying a four-unit property for $250,000. His income is $5,000 per month (before buying the property), and his only other debt obligation is a $300 monthly car payment.

Details of Purchase

Price	$250,000.00
Down payment	50,000.00
Mortgage amount	200,000.00
Loan-to-value ratio	80%
Mortgage rate	8.5%
Monthly payment (PITI)	$1,952.41

Each unit will rent for $500 per month, with a vacancy rate of 6 percent and a monthly operating expense of $100. (Some lenders assume a 25-percent vacancy rate for underwriting purposes. This makes it much harder to qualify.)

Summary Operating Income Statement
(Three Rental Units)

Monthly rental income	$1,500.00
Vacancy allowance at 6%	-90.00
Effective gross income	$1,410.00
Monthly operating expense	-300.00
Operating Income	**$1,110.00**

When qualifying as an owner-occupant, you use the entire mortgage payment to determine your housing expense ratio, even though you are living only in one of the units. The operating income (before PITI) is added to your income.

Owner-Occupied Qualification Example

Monthly income (before purchase)	$5,000.00
Operating income from rental units	+1,110.00
Gross monthly income	$6,110.00
Monthly housing expense (PITI)	$1,952.41
Monthly car payment	+300.00
Fixed monthly obligations	$2,252.41

HOUSING RATIO: 32.0% DEBT RATIO: 36.9%

Because industry standards call for ratios of "28/36" or lower, Mr. Investor *would not qualify for the loan in* *the first example,* if held to these Fannie Mae standards.

Example 2 Mr. Investor buys the property and rents out all four units for investment income.

Details of Purchase

Price	$250,000.00
Down payment	75,000.00
Mortgage amount	175,000.00
Loan-to-value ratio	70%
Mortgage rate	8.5%
Monthly payment (PITI)	$1,753.93

As in the first example, each unit will rent for $500 per month with a vacancy rate of 6 percent and a monthly operating expense of $100. When the purchaser of an investment property will not be occupying one of the units, an additional calculation if required. The monthly payment is deducted from the operating income to determine net cash flow.

Summary Operating Income Statement
(Four rental units)

Monthly rental income	$2,000.00
Vacancy allowance at 6%	-120.00
Effective gross income	$1,880.00
Monthly operating expense	-400.00
Operating Income	$1,480.00
Mortgage payment (PITI)	-1,753.93
Net cash flow	**$-273.93**

When qualifying as a nonowner-occupant, you use your existing residence to determine your housing ratio, not the investment property. For this example, assume that Mr. Investor has the same $5,000 per month income as in the first example. The mortgage on his residence is $125,000, and his mortgage payment (PITI) is $1,281.55. If the projected net cash flow from the investment property is positive, it is added to your income for qualifying. If negative, it is added to your debt obligations. In this example, the net cash flow is a negative $273.93 per month, so it is added to his debt payments.

Nonowner-Occupied Qualification Example

Gross monthly income	$5,000.00
Monthly housing expense (PITI)	$1,281.55
Monthly car payment	300.00
Net cash flow from real estate investment	- 273.93
Fixed monthly obligations	$1,855.48

HOUSING RATIO: 25.7% DEBT RATIO: 37.2%

Because industry standards call for ratios of "28/36" or lower, Mr. Investor *might not qualify for the loan in the second example* because his debt ratio is too high, if held to these Fannie Mae standards.

Fannie Mae Restrictions for Investor Loans

In addition to tightening up its qualification requirements, Fannie Mae has increased the amount of down payment that you must make to purchase an investment property.

- **Owner-occupied properties**. Minimum 10 percent down payment for two-unit properties (90 percent LTV), and 20 percent for three- to four-unit properties (80 percent LTV).
- **Nonowner-occupied properties**. Minimum 30 percent down payment (70 percent LTV).

Mortgage Tip: Whenever possible, support your income projections with documentation. Submit copies of leases to support rent projections and utility bills for expenses. Submit prior years' operating statements ("Schedule E" from prior year's tax returns) if they are available. Well-documented projections will have fewer adjustments.

Note: The previous examples used Fannie Mae's minimum down payments. Other lenders are willing to make investor loans with smaller down payment requirements.

- **No "cash out" refinance loans**. If you are refinancing an investment property, Fannie Mae will not allow you to borrow any more than is necessary to pay off your old mortgage and cover the settlement costs of your new mortgage. You may not refinance to pull money out of a property that has appreciated in value.
- **No ARM loans**.
- **No temporary buydowns**.

These restrictions, plus a maximum loan-to-value ratio of 70 percent and a "no cash out" provision for refinances, substantially reduce investors' flexibility. Two major advantages of investing in real estate are leverage and tax shelter. The 70-percent maximum LTV ratio reduces leverage, and the "no cash out" restriction for refinancing makes it difficult for an investor to liquidate an investment without selling the property and incurring capital gains tax and sales costs.

- **Maximum of five mortgaged units**. Some investors buy as many properties as their incomes allow. Fannie Mae now limits a borrower to *five mortgaged properties*. Properties may include any combination of single-family, second homes or one-to-four unit properties that are *financed*. Under this restriction, you could have no more than four investment properties plus your residence that are *financed through any lender*.

FHA Guidelines

The FHA no longer insures mortgages on nonowner-occupied properties. It still will insure mortgages on owner-occupied two- to four-unit properties. The maximum mortgage amounts, which change from time to time are as follows:

2 units	$194,100
3 units	$234,600
4 units	$291,600

In areas of the country with lower housing costs, the maximum FHA mortgage amounts will be lower than these amounts.

Assuming an FHA Loan as an Investor

FHA loans are assumable. (See Chapter 6, "Miscellaneous Mortgage Topics," for an explanation of assumability.) As an investor, you may find a property that you would like to buy that has an existing FHA mortgage. Whether you may assume the loan as a nonowner-occupant depends on when the loan was made initially:

- FHA loans closed on or after February 15, 1989, may not be assumed by a nonowner-occupant investor.
- FHA loans closed from February 5, 1988, through February 14, 1989, may be assumed by a nonowner-occupant investor, but the loan must be paid down to 75 percent of the original acquisition cost or appraised value (new appraisal required).
- FHA loans closed prior to February 1, 1986, may be freely assumed. No credit check or income qualification is required unless the original borrower wants to be released from liability.

Assuming an older FHA loan is one of the best ways to acquire an investment property because of the high LTV (hence leverage) and generally lower interest rates. When looking for investment properties, ask your real estate agent to look for properties with older FHA loans in place.

Why Refinance?

A refinance mortgage is a financing of a property in which property ownership is not transferred. A refinance mortgage pays off existing mortgages, if any, may pay some or all closing costs and may even return equity (cash out) to the owner of the property. There are many reasons why you might want to refinance your home mortgage, but all of those reasons fall into three general categories:

1. Saving money by paying lower interest rates,
2. Borrowing more money or
3. Restructuring (changing from one type of mortgage to another)

You may want to do all three. This chapter covers the important issues for all three of these categories, and it will direct you to other chapters that you should read before beginning the process of refinancing your home.

Saving Money

Mortgage interest rates have gone up and down more sharply over the past 12 years than they had previously since World War II.

Today, however, rates are much lower than they were in the mid-1980s (see Figure 8.1). If you bought or mortgaged your home with a fixed-rate mortgage between 1980 and 1992, you probably can lower your monthly mortgage payment and *save thousands of dollars in interest by refinancing your old mortgage.*

Refinancing to save money is like making an investment. The cost of refinancing is the amount of your investment, and the interest you save is the return on your investment. However, during the boom refinancing years of 1992 and 1993, "zero- point" and "no-cost" refinance loans came into vogue. These "creative" refinance programs eliminate cost as a consideration in refinancing. Lenders can offer these programs by charging a somewhat higher interest rate than they would if you were paying points and closing costs. Lenders recover their costs by selling your loan into the secondary market at a premium. In other words, investors looking to get a higher return on their investment, will pay more for a higher interest rate loan than for a lower interest rate loan. Although there is no hard and fast rule, the relationship between interest and discount points is generally about 6 to 8 discount points for each percent of interest rate. For example, a lender might fund up to $3,000 of closing costs on a $100,000 loan for a borrower in exchange for an additional _ths percent interest rate over the current market rate.

Before investing your time and money to refinance your home mortgage, you should answer three questions:

1. How much money will I save?
2. How much will it cost me to refinance?
3. Are the savings large enough to justify the costs?

Calculating Your Savings

Figure 8.2 illustrates that by lowering your interest rate by as little as 2 percent on a $100,000 mortgage, you can lower your monthly mortgage payment by more than $140. The lower monthly payment is a direct result of paying less interest.

The table in Figure 8.3 shows the difference in the monthly payments on a $100,000 loan for different combinations of interest rates. For example, if you lower the rate on a $100,000 loan from 9 percent to 6 percent, you lower the monthly payment by $218.56.

In both Figures 8.2 and 8.3, the loan amount is $100,000. If your mortgage is $50,000 (or $75,000 or $175,000), you can adjust the examples to more closely fit your situation by multiplying the monthly payment and interest rate savings shown in the examples by .50 (or .75 or 1.75) as appropriate. (A Do-It-Yourself Refinance Worksheet, in Appendix H will help you estimate your savings and decide whether to refinance. Three worksheet examples follow in this section.)

Refinancing lowers the "principal and interest" portion of your monthly payment. (See the "Introduction" for an explanation of the elements of your monthly mortgage payment.) Occasionally, there will be some other small changes because of adjustments to your homeowner's insurance premium and your mortgage insurance premium. However, these changes will rarely be large enough to affect your refinancing decision.

Figure 8.3 Example of Potential After Refinancing

Cost of Refinancing

Refinancing your mortgage may cost anywhere from 2 percent to 6.5 percent of your loan amount. On a $100,000 loan, this would be from $2,000 to $6,500. Remember the settlement costs that you paid when you first bought your home? When you refinance, you have to pay most of these costs again. The cost of refinancing your mortgage depends on several factors:

- The lender and loan that you choose,
- The cost of settlement services in your area and
- The recording fees charged by your local government.

The largest cost items in refinancing are the points and other fees charged by your lender. Those fees generally range from 1 percent to 4.5 percent of your mortgage amount. All other costs combined range from only 1 percent to 2 percent of the total mortgage amount.

Some mortgages have a prepayment penalty clause that requires the borrower to pay a fee for repaying the mortgage before a specified period of years. (See Chapter 6, "Miscellaneous Mortgage Topics.") If your *old mortgage* has a prepayment penalty clause and you refinance it before the specified period is over, consider that fee an additional cost of refinancing. A typical prepayment penalty clause might charge from 1 percent to 3 percent of your loan amount if you repay your loan in less than three years. Read your current mortgage note to see if it has a prepayment penalty clause. If it does, you may want to wait until the prepayment penalty period is over before refinancing.

Few people are willing or able to reach into their pocket for $2,000 to $6,500 to save $150 a month, even if they know it is the smart thing to do. Usually, it is not necessary to pay out of pocket more than a few hundred dollars to refinance. You simply increase your mortgage amount to cover the cost of refinancing, or if your lender offers it, obtain a "zero-point" or "no-cost" refinance. Your cash outlay should be minimal.

Important Exception

Many lenders will not refinance a loan for more than 90 percent of appraised value. (The LTV ratio for the new loan must be 90 percent or less.) If your existing loan has a 90 percent or greater LTV ratio, you may have to pay some or all of the refinancing costs in cash. If this situation applies to you, try the following:

- When you are shopping for lenders, explain your situation to them and ask if they have products that will solve the problem.
- Shop for an FHA or VA loan if possible (both allow LTV ratios greater than 90 percent).
- Consider a "zero-point" or "no-cost" loan to minimize out of pocket expenses.
- If homes in your neighborhood have increased in value and your old loan is more than two years old, your lender will recalculate the LTV ratio for the new loan based on the new, higher appraised value.

Deciding Whether or Not To Refinance

The industry rule of thumb -- "refinance when you can lower your interest rate by 2 percent or more" -- no longer is correct. It may make sense for you to refinance even if you lower your rate by only .50 of one percent. (See Figure 8.5.)

On the other hand, if you plan to move in a year or two, you might be better off not refinancing. It makes sense to refinance if you can recover your costs and make a decent return on your investment before you plan to sell your home or pay off your mortgage.

The time necessary to recover your costs is called the *payback period.* Determining the length of the payback period is the critical calculation that you must make before deciding whether to refinance. The Do-It-Yourself Refinance Worksheet helps you to estimate your payback period.

Should you refinance? To answer this question, you must know:

- Your current mortgage rate and amount,
- The mortgage rate for a new loan,
- Your approximate refinancing costs and
- About how long you plan to stay in your home.

In the example in Figure 8.6, the old mortgage rate is 10 percent, and the new mortgage rate is 8 percent. The estimated refinancing costs are about $2,300, and the annual interest savings are about $1,700. So it takes only a year and four months to recover the costs of refinancing. (The savings over 30 years would grow to $36,000.) Unless you had plans to move in less than two years, would make good sense refinancing in this situation.
Figure 8.7 Sample Do-It Yourself Refinance Worksheet B

Figure 8.7 is the same as Figure 8.6 except that the old mortgage rate is 9 percent instead of 10 percent. The difference between the rates is just 1 percent, but you would still recover your refinancing costs in just three years.

For most people, it would make sense to refinance with a three-year payback period. This example illustrates a weakness in the industry's "2-percent rule of thumb."

In Figure 8.8, the lender is charging no points for the new loan instead of one point, *and* the lender is picking up all the costs. The costs of refinancing are $2,220, but the lender is picking up all the costs. In this example, the savings are less, $621 compared to $809 in Figure 8.7, but the payback is *immediate*.

Business people and financiers often use payback periods to rate investments -- the shorter the payback period, the better the investment.

This is also true with refinancing. A shorter payback period is better. Even if you have to pay a slightly higher interest rate, choose a loan with few points over one with many points. You will be shortening your payback period.

In Figure 8.9, loans A, B and C from Figures 8.6-8.8 are all approximately the same cost. (A loan priced at 9 percent plus one point costs about the same as 8.75 percent plus two and a half points or 8.5 percent plus four points. See "Introduction.") If you were purchasing a home, these three loans would be essentially equivalent, but if you were refinancing an old 10 percent loan, loan A would be far superior to loans B and C. Its payback period would be only three years compared with four and a half years for loan B, and six years for loan C.

Loan D is a lower cost loan than loan A, but for this refinancing transaction, its payback period is a year longer. If you were planning to move within five or six years, loan A still would be better even though its rate is a half a percent higher than loan D. Only after seven years, would the lower overall price of loan D begin to provide better savings for you than loan A.

When you are shopping for a loan to refinance your current mortgage, ask lenders for a loan with no more than two points. The fewer points, the better.

Borrowing More Money

If you bought your home in the early 1980s, it probably is worth more today than you paid for it. At the same time, you have been paying off your old mortgage.

The *equity* that you have in your home is the value of the home less the outstanding mortgage balance. In the example in Figure 8.10, you would have had $10,000 equity (your down payment) in 1981. Today, your equity would have grown to $63,600.

How To Borrow Against Your Home Equity

You can borrow more money using your equity as collateral in one of two ways:

1. Replace your old mortgage with a larger new one or
2. Get a second mortgage, leaving your first mortgage in place.

There is no formula or rule of thumb to tell you which method is best. The choice must be based on what you plan to do with the extra money, how much you need and how quickly you plan to pay it off. You are borrowing more money, not saving money. Your new monthly payments probably will be higher, and your interest rates also may be higher.

If you need a lot of money over a long period, you could refinance your first mortgage, replacing it with a larger one, or you could get a long-term, fixed-rate second mortgage. Either choice serves the same purpose. To choose one method over the other, compare the refinancing costs and interest rates of each. (See Figure 8.11.)

Choosing an Equity Loan

Carrying through with the example of the home purchased in 1981, assume that you have a $61,400 mortgage balance on a home that now is worth $125,000. Suppose that you want to borrow $35,000 to add some new rooms to your home. Your choice is between a new 30-year fixed-rate mortgage at 8.5 percent plus three points and $1,000 in settlement costs or a 15-year fixed-rate second mortgage at 10 percent plus one point and $500 in settlement costs. (See Figure 8.12.)

Option 1: Get New First Mortgage

- Loan Amount: $100,400
- Monthly Payment: $771.99
- Refinancing Costs: $3,500.00
- Interest Rate: 8.5%

Option 2: Get Second Mortgage; Retain Old First Mortgage

- Loan Amount: \$35,850 (2nd) + \$61,400 (1st) = \$97,250
- Monthly Payments: \$385.25 + \$513.64 = \$898.89
- Refinancing Costs: \$850.00
- Interest Rate (Blended): (\$35,850 x 10% + \$61,400 x 7%) ÷ \$97,250 = 8.1%

If you evaluate these two options, you can see that in this example, the second mortgage is a better choice than a new first mortgage. The monthly payments would be slightly higher (\$898.99 versus \$771.99), but the overall interest rate would be lower, the total loan amount would be lower and the two mortgages would be paid off in 20 years versus 30 years for the new first mortgage.

If you need a large amount of money, but only for a few years, a second mortgage is cheaper than a new first mortgage. This is because of the high cost of refinancing a first mortgage.

For the same reason, a second mortgage is better usually for borrowing a small amount for a long time. If you need a small amount of money for a short time, consider an unsecured personal loan. It may be less expensive than a second mortgage.

Line-of-Credit Loans

If you need additional funds, but not all at once (e.g., for college tuition payments over four years), inquire at your bank or savings-and-loan association about a line of credit secured by the equity in your home. A line of credit allows you to borrow what you need, as you need it, up to an agreed amount. You are charged interest on the outstanding balance.

Restrictions on Cash-Out Refinancing Transactions

When you refinance a first mortgage, increasing the loan amount to borrow more money, it is called a *cash-out transaction*. Maximum allowed loan-to-value (LTV) ratios are lower for cash-out refinancing transactions than mortgages for home purchase or refinancing transactions in which the loan is increased only enough to cover refinancing costs.

First Mortgages	**Maximum Loan-to-Value Ratio**
Conventional mortgages (Fannie Mae, Freddie Mac):	75%
FHA mortgages:	85%
VA mortgages:	90%

Second Mortgages

Fannie Mae standards:	70%	combined LTV ratio
Most savings and loan associations:	80%	combined LTV ratio
Finance companies:	greater than 80%	(varies widely)

Restructuring

The final reason to refinance a mortgage is to restructure the financing that you have now.

Many homebuyers in the early 1980s financed their purchases by assuming an existing mortgage with the seller taking back a short-term second mortgage. With these second mortgages now coming due and interest rates down from their higher levels, many people are replacing their old loans with new ones.

As in the case of the previous example, it may be best to replace the old second mortgage with a new second mortgage with a lower interest rate, or replace both loans with a new, larger first mortgage that has a lower interest rate than the combined existing mortgages. The choice is a price comparison decision.

Many others who bought in the early 1980s financed their purchases with adjustable-rate mortgages (ARMS). With rates much lower, you could refinance to lock in the certainty of a low fixed rate and fixed payment.

Refinancing to replace an ARM with a fixed-rate mortgage is a difficult decision. If current rates on ARMs are lower than fixed-rate mortgages, refinancing to a fixed-rate loan will not only cost a few thousand dollars but also increase your interest rate and monthly payment.

Some ARMs have few or no consumer protection features such as rate caps and payment caps. If you have a "bad" ARM or you are simply uncomfortable with an ARM and if rates are down, then now is the time to refinance.

Some ARMs have a convertibility feature that allows you to convert your ARM to a fixed-rate mortgage by paying a small fee (typically a point). This is a lot cheaper than refinancing. Check your mortgage note to see if it has a convertibility feature and what the rate on the new mortgage would be.

Getting Started on Your Mortgage

Throughout this book, we have attempted to describe in simple terms what can be complicated and stressful process. There is often a feeling of not being in control during the process as well as the suspense of waiting to get an "answer" on your loan application. Just remember that, when you are buying a house and getting a mortgage to finance your purchase, *everyone is one your side*. The REALTOR doesn't get paid if the home purchase is not consummated. The loan officer usually gets paid on commission, so he doesn't get paid unless your loan is approved and closed. The mortgage company makes money, not by turning loans down or by arbitrarily making you jump through "hoops," but by originating loans that can either be sold at a profit or by collecting interest on the loan over the years. So consider that, although some of the requirements may seem unintelligible, there are valid reasons for lenders requesting the types of information that they do. We hope that this book is helpful to you in that process and that some of the terminology will be more familiar to you after reading this book.

Introduction

Mortgage Basics

Chapter 1

The Application Process

Chapter 2

Qualifying for a Mortgage Loan

Chapter 3

Overcoming High Housing/Debt Ratios (Not Enough Income To Qualify)

Chapter 4

Choosing the Right Type of Mortgage

Chapter 5

Shopping for a Mortgage

Chapter 6

Miscellaneous Mortgage Topics

Chapter 7

Investor Loans

Chapter 8

Refinancing

Glossary

A

abstract of title (abstract)
acceleration clause
acknowledgment
acre
adjustable-rate mortgage (ARM)
adjusted bias
adjusted sales price
agent
agreement of sale (purchase agreement, sales agreement, contract to purchase)
alienation clause (due-on-sale, nonassumption)
amortization
appraisal
appreciation
"as is."
assessed valuation
assignment
assumable mortgage
automatic renewal clause

B

balloon loan
balloon payment
bill of sale
binder
broker
building code
buydown
buyers' market

C

cap
capital gain
caveat emptor
ceiling
certificate of occupancy
chattel
client
closing (settlement, escrow, passing papers)
closing costs
closing statement
cloud (on title)
commission
commitment (letter)
common elements
comparable
comparative market analysis
conditional commitment
conditional offer
condominium
consideration
contract
contract for deed (land contract)

conventional mortgage
curtesy
customer

D
days of market (DOM)
deed
deed of trust
deed of restriction (restrictive covenant)
default
deferred maintenance
deficiency judgment
delivery
depreciation
direct endorsement
discount point
documentary tax stamp
dower
down payment

E
earnest money
easement
encroachment
encumbrance
equity
escrow

F
fee simple (absolute)
FHA
FHA mortgage
fiduciary
first mortgage
fixture
foreclosure
front foot

G
grantee
grantor

H I
index

J
joint tenancy
junior mortgage

K L
lien
lis pendens
listing agreement (listing)
loan servicing

M

abstract of title (abstract)

History of a parcel of real estate, compiled from public records, listing transfers of ownership and claims against the property.

acceleration clause

Provision in a mortgage document stating that if a payment is missed or any other provision violated, the whole debt becomes immediately due and payable.

acknowledgment

Formal declaration before a public official that one has signed a document

acre

land measure equal to 43,560 square feet

adjustable-rate mortgage (ARM)

Loan whose interest rate is changed periodically to keep pace with current levels.

adjusted bias

Original cost of property plus any later improvements and minus a figure with depreciation claimed.

adjusted sales price

Sale price minus commissions, legal fees and other costs of selling

agent

Person authorized to act on behalf of another in dealing with third parties

agreement of sale (purchase agreement, sales agreement, contract to purchase)

Written contract detailing terms under which buyer agrees to buy and seller agrees to sell

alienation clause (due-on-sale, nonassumption)

Provision in a mortgage document stating that the loan must be paid full if ownership is transferred, sometimes contingent upon other occurrences

amortization

Gradual payment of a debt through regular installments that cover both interest and principal

appraisal

Estimate of value of real estate, presumably by an expert

appreciation

Increase in value or worth of property

"as is."

Present condition of property being transferred, with no guaranty or warranty provided by the seller

assessed valuation

Value placed on property as a basis for levying property taxes; not identical with appraised or market value

assignment

Transfer of a contract from one party to another

assumable mortgage

Loan that may be passed to the next owner of the property

automatic renewal clause

Provision that allows a listing contract to be renewed indefinitely unless canceled by the property owner

balloon loan

Mortgage in which the remaining balance becomes fully due and payable at a predetermined time

balloon payment

Final payment on a balloon loan

bill of sale

Written document transferring personal property

binder

Preliminary agreement of sale, usually accompanied by earnest money (term also used with property insurance)

broker

Person licensed by the state to represent another for a fee in real estate transactions

building code

Regulations of local government stipulating requirements and standards for building and construction

buydown

The payment of additional points to a mortgage lender in return for a lower interest rate on the loan

buyers' market

Situation in which the supply of homes for sale exceeds the demand

cap

Limit (typically about 2 percent) by which an adjustable mortgage rate might be increased at any one time

capital gain

Taxable profit on the sale of an appreciated asset

caveat emptor

Let the buyer beware

ceiling

Also known as a lifetime cap, limit beyond which an adjustable mortgage rate may never be raised

certificate of occupancy

Document issued by a local governmental agency stating that the property meets the standards for occupancy

chattel

Personal property

client

The broker's principal, to whom fiduciary duties are owed

closing (settlement, escrow, passing papers)

Conclusion of a real estate sale, at which time title is transferred and necessary funds change hands

closing costs

One-time charges paid by the buyer and the seller on the day the property changes hands

closing statement

Statement prepared for the buyer and the seller listing debits and credits, completed by the person in charge of the closing

cloud (on title)

Outstanding claim or encumbrance that challenges the owner's clear title

commission

Fee paid (usually by a seller) for a broker's services in securing a buyer for property; commonly a percentage of sales price

commitment (letter)

Written promise to grant a mortgage loan

common elements

Parts of a condominium or Planned Unit Development (PUD) in which each owner holds an interest (swimming pool, etc.)

comparable

Recently sold similar property, used to estimate the market value

comparative market analysis

Method of valuing homes using the study of comparables, property failed to sell and other property currently on the market

conditional commitment

Lender's promise to make a loan subject to the fulfillment of specified conditions

conditional offer

Purchase offer in which the buyer proposes to purchase only after certain occurrences (sale of another home, securing of financing, etc.)

condominium

Type of ownership involving individual ownership of dwelling units and common ownership of shared areas

consideration

Anything of value given to induce another to enter into a contract

contract

Legally enforceable agreement to do (or not to do) a particular thing

contract for deed (land contract)

Method of selling by which the buyer receives possession but the seller retains title

conventional mortgage

Loan arranged between lender and borrower with no governmental guarantee or insurance

curtesy

In some states, rights a widower obtains to a portion of his deceased wife's real property

customer

Typically, the buyer, as opposed to the principal (seller)

days of market (DOM)

Number of days between the time a house is put on the market and the date of a firm sale contract

deed

Formal written document transferring title to real estate; a new deed is used for each transfer

deed of trust

Document by which title to property is held by a neutral third party until a debt is paid; used instead of a mortgage in some states

deed of restriction (restrictive covenant)

Provision placed in a deed to control the use and occupancy of the property by future owners

default

Failure to make mortgage payment or other violation of terms stated in the note

deferred maintenance

Needed repairs that have been put off

deficiency judgment

Personal claim against the debtor, when foreclosed property does not yield enough at sale to pay off loans against it

delivery

Legal transfer of a deed to the new property owner, the moment at which transfer of title occurs

depreciation

Decrease in value of property because of deterioration or obsolescence; sometimes, an artificial bookkeeping concept valuable as a tax shelter

direct endorsement

Complete processing of an FHA mortgage application by an authorized local lender; the authority granted to a lender by the FHA to process and approve mortgage loans without prior approval from the FHA

discount point

See Point

documentary tax stamp

Charge levied by state or local governments when real estate is transferred or mortgaged

dower

In some states, the rights of a widow to a portion of her deceased husband's property

down payment

Cash to be paid by the buyer at closing

earnest money

Buyer's "good faith" deposit accompanying purchase offer

easement

A permanent right to use another's property (telephone line, common driveway, footpath, etc.)

encroachment

Unauthorized intrusion of a building or improvement onto another's land

encumbrance

Claim against another's real estate (unpaid tax, mortgage, easement, etc.)

equity

The money realized when property is sold and all the claims against it are paid; commonly , sales price minus present mortgage and closing costs

escrow

Funds given to a third party to be held pending some occurrence; may refer to earnest money, funds collected by a lender for the payment of taxes and insurance charges, funds withheld at closing to ensure uncompleted repairs or in some states the entire process of closing

fee simple (absolute)

Highest possible degree of ownership of land

FHA

Federal Housing Administration (HUD), which insures mortgages to protect the lending institution in case of default

FHA mortgage

Loan made by a local lending institution and insured by the FHA, with the borrower paying the premium

fiduciary

A person in a position of trust or responsibility with specific duties to act in the best interest of the client

first mortgage

Mortgage holding priority over the claims of subsequent lenders against the same property

fixture

Personal property that has become part of the real estate

foreclosure

Legal procedure for enforcing payment of a debt by seizing and selling the mortgaged property

front foot

Measurement of land along a street or waterfront--each front foot is one foot wide and extends to the depth of the lot

grantee

The buyer, who receives a deed

grantor

The seller, who gives a deed

index

Benchmark measure of current interest levels, used to calculate periodic changes in rates charged on adjustable rate mortgages

joint tenancy

Ownership by two or more persons, each with an undivided ownership--if one dies, the property goes automatically to the survivor

junior mortgage

A mortgage subordinate to another

lien

A claim against property for the payment of a debt; mechanic's lien, mortgage, unpaid taxes, judgments

lis pendens

Notice that litigation is pending on property

listing agreement (listing)

Written employment agreement between a property owner and a real estate broker, authorizing the broker to find a buyer

loan servicing

Handling paperwork of collecting loan payments, checking property tax and insurance coverage, handling delinquencies

maintenance fees

Payments made by the unit owner of a condominium to the homeowners' association for expenses incurred in the upkeep of the common areas

margin

Percentage (typically about 2.5 percent) added to the Index to calculate the mortgage-rate adjustment

marketable title

Title free of liens, clouds and defects; a title that will be freely accepted by a buyer

mechanic's lien

Claim placed against a property by unpaid workers or suppliers

meeting of the minds

Agreement by a buyer and the seller on the provisions of a contract

mortgage

A lien or claim against real property given as security for a loan; the homeowner "gives" the mortgage; the lender "takes" it

mortgagee

The lender

mortgagor

The borrower

multiple-listing service (MLS)

Arrangement by which brokers work together on the sale of each other's listed homes, with shared commissions

negative amortization

Arrangement under which the shortfall in a mortgage payment is added to the amount borrowed; gradual raising of a debt

PITI

Abbreviation for principal, interest, taxes and insurance, often lumped together in a monthly mortgage payment

plat

A map or chart of a lot, subdivision or community, showing boundary lines, buildings and easements

PMI

Private mortgage insurance; insurance issued by a private company, which insulates the lender against loss in the event that the borrower defaults on the mortgage

point (discount point)

One percent of a new mortgage being placed, paid in a one-time lump sum to the lender

prepayment

Payment of a mortgage loan before its due date

prepayment penalty

Charge levied by the lender for paying off a mortgage before its maturity date

principal

The party (typically the seller) who hires and pays an agent; also, the outstanding balance of the mortgage; part of the loan proceeds

procuring cause

Actions by a broker that bring about the desired results

prorations

Expenses such as taxes, that are divided to the date of settlement between the buyer and the seller at closing

purchase-money mortgage

Mortgage for the purchase of real property

real property

Land and the improvements on it

realtist

Member of the National Association of Real Estate Brokers

realtor

Registered name for a member of the National Association of Realtors

redlining

The practice of refusing to provide loans or insurance in a certain neighborhood

RESPA

Real Estate Settlement Procedures Act, requiring advance disclosure to the borrower of information pertinent to the loan

restrictive covenant

See deed restriction

sellers' market

Situation in which the demand for homes exceeds the supply offered for sale

settlement

See closing

survey

Map made by a licensed surveyor who measures the land and charts its boundaries, improvements and relationship to the property surrounding it.

time is of the essence

Legal phrase in a contract, requiring punctual performance of all obligations.

title

Rights of ownership, control and possession of property

title insurance

Policy protecting the insured against loss or damage because of defects in the title: The "owner's policy" protects the buyer, the "mortgage policy" protects the lender; paid with a one-time premium

title search

Check of the public records, usually at the local courthouse, to make sure that no adverse claims affect the value of the title

VA

Department of Veterans Affairs, which guarantees a veteran's mortgage so that a lender is willing to make the loan with little or no down payment

vendee

The buyer

vendor

The seller

warranty deed

Most valuable type of deed, in which the grantor makes formal assurance of title

zoning

Laws of local government establishing building codes and regulations on usage of property