



Home-Buying Process

Mortgage Options

Home-Buying Process: Mortgage Options

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Unless you can pay cash for a house, you will need to obtain financing. The principal ways to finance a house are a real estate contract or a mortgage. The main difference between these agreements lies in who holds the legal title to the property.

If you finance your house through a real estate contract, the seller remains the legal owner of the house until the full price of the purchase with interest is paid. If you default during the period specified on the contract, the seller can evict you and you forfeit all payments on the principal you have made. An advantage of a real estate contract is the owner may not be as concerned about your credit rating as a financial institution; however the contract may have a higher interest rate than a traditional mortgage.

When you obtain a mortgage to buy a house, the house itself becomes the security for the loan. When the mortgage is paid off, you retain full ownership of the house. Mortgage loans are repaid in monthly installments over a set period. Most mortgage loans are 15 or 30-year loans. Each payment is applied first to the interest due, then to the principal. The principal is the face amount of the loan. For example, if you obtain a loan for \$130,000 at 7 percent interest, the principal would be the \$130,000. If you fail to make payments on the loan, the lender has a legal right to take possession of the house.

When financing your house with a mortgage loan there are many loan choices available. The most common types are fixed-rate mortgage

loans, adjustable-rate mortgage loans and balloon mortgage loans. The mortgage loan you choose depends on your financial situation.

The following is a list of common loan products to consider when looking for a mortgage loan. Keep in mind that many financial institutions have their own variations of these products. Use the Mortgage Shopping Work Sheet to compare mortgage options from lender to lender.

Fixed-Rate Mortgage

The fixed-rate mortgage is the most common type of loan. In a fixed-rate loan, the interest rate stays the same for the term of the loan. Payments are predictable and are not affected by interest rate changes, although taxes and insurance rates can fluctuate.

Most fixed-rate loans are 15-year or 30-year terms. A 30-year mortgage is more common because the payment is lower. A 30-year mortgage allows you to borrow money with a lower monthly payment but will generally have a higher interest rate than a 15-year mortgage. During the life of the loan, you pay much more interest with a 30-year mortgage than with a 15-year mortgage.

The chart below shows the difference in interest paid on an \$80,000 loan with 15-year and 30-year terms.

	15-Year Term	30-Year Term
Loan Amount	\$80,000	\$80,000
Interest Rate	6.5%	6.5%
Payment	\$696	\$505
Total Cost of Loan	\$125,280	\$181,800

Although you can expect to pay more interest throughout the life of the 30-year term, there are things you can do to minimize the total interest paid. A simple step is to make more than the minimum monthly payment, if prepayment is allowed. Some people feel more comfortable taking the 30-year mortgage and making payments as if it were a 15-year term. By doing this they are on track to pay off their mortgage loan in 15 years. However if something happens and they cannot make the higher payment, they can make the 30-year term payment until they get back on track.

Another option is to pay an additional payment each year. If making this extra payment at once is a challenge, consider dividing up the principal and interest portion of the payment into 12 equal amounts. This can shorten a 30-year mortgage by several years and reduce the amount of interest paid.

Adjustable-Rate Mortgage

With an adjustable-rate mortgage (often called ARM) the interest rate can increase or decrease during the term of the loan. The loan might have a low rate at the beginning of the term, which increases over time. However, be aware that the rate and your payment can increase significantly throughout the term of your loan. For example, a 3/1 ARM loan would have a fixed rate for the first three years and be adjusted once a year thereafter.

The interest rate on an adjustable-rate mortgage loan is reset on the loan's anniversary date. Your monthly payment increases and decreases with a change in

the loan interest rate. Because loan payments change periodically, adjustable-rate mortgages are not for every homeowner. Adjustable-rate mortgage loans usually have a periodic and lifetime cap that limit how high the interest rate can change in one period and over the lifetime of the loan, respectively. For more information on ARMs ask your loan officer.

Balloon Mortgage

A balloon mortgage offers the buyer the option to pay small monthly payments for the first several years (five, seven or 10 years). At the end of that time period, the borrower must pay off the outstanding balance with a lump-sum payment or refinance the loan. The usual strategy is to refinance before the balloon note becomes due.

These are some of the common loan products available to consumers. A person who plans to stay in a house for only a few years may consider an adjustable-rate mortgage (ARM), which allows the borrower to finance more house for his or her money. A person living on a fixed income may choose a 15 to 30-year fixed-rate loan where the payment does not vary.

Consult your loan officer and explain your future plans and goals. The loan officer will have the information necessary to help you choose the best mortgage loan.

If the lender knows you are on a fixed income and he or she cannot qualify you for a traditional fixed-rate mortgage, he or she may be able to qualify you

for a loan where the payment starts low and after a certain amount of time you are required to refinance the complete balance or the interest rate increases (such as a balloon mortgage or an ARM). In these situations, research can eliminate the potential of locking into the wrong loan product.

Some people have had to give up their houses because they did not understand their selected loan product. They got the payment they wanted, but did not realize what would happen after a few years.

All loan products have the potential for being good loans, but when a customer agrees to a loan product that does not meet his or her current and/or future needs, this could lead to failure.

Creative Mortgages

There are a number of creative or unconventional mortgage options that may make homeownership more affordable or allow a borrower to buy a more expensive home. One of the most popular of these mortgage options is the interest-only mortgage. With this option, a borrower pays only the interest charges (plus taxes and insurance) each month for a term of 5, 10 or even 15 years. Since the monthly payments do not go towards the principal, a borrower still owes the entire amount of the mortgage.

On a 30-year, \$100,000 mortgage with a 15-year, interest-only term, a borrower will still owe the \$100,000 principal and will have to pay down the debt for the remaining 15 years with a large monthly payment to the principal and interest charges. If the mortgage has a floating interest rate, the interest payments could increase during the term making it even more expensive.

If interest rates rise and home prices fall, a borrower could end up owing more than the home is worth. Interest-only loans are suited for borrowers who can handle the risk as part of a comprehensive investment plan. If this type of mortgage is the only

way a borrower can afford the home he or she wants, it is probably not a good idea.

Another creative mortgage option is the piggyback mortgage— sometimes called a combination or combo mortgage. If a borrower does not have enough money for the down payment, lending institutions can combine a first mortgage on the house with a home equity second mortgage that covers the down payment. For a conventional mortgage, this is a way to bypass the added expense of private mortgage insurance (PMI) while making a down payment as low as 5 percent of the purchase price. A borrower could purchase a larger home with a smaller first mortgage, avoiding the higher interest rate of a larger first mortgage loan. The home equity loan (second mortgage) has a shorter term than a traditional first mortgage loan, allowing the borrower to pay it off faster. This mortgage might be useful for first-time homebuyers with limited savings. It could be more suitable to buyers with high-yield investments who would rather use a home equity loan for the down payment instead of liquidating some assets. Borrowers need to be financially disciplined to make the payments. They could easily become overwhelmed with debt if the loan has an adjustable interest rate that increases or a serious financial emergency occurs.

Special Loan Programs

You may qualify for a special loan program or government-insured loan. Special loan programs include products from Fannie Mae, Freddie Mac and Ginnie Mae. Residents of New Mexico also are able to use the New Mexico Finance Authority. These organizations make homeownership more attainable for low and middle income households.

Fannie Mae and Freddie Mac are government sponsored, private corporations created by the U.S. Congress to support the secondary mortgage market by investing in home loans. For more information call Fannie Mae at 1-800-7Fannie (1-800-732-6643) or Freddie Mac at 1-800-Freddie (1-800-373-3343).

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The Government National Mortgage Association (Ginnie Mae) is a government corporation. Unlike the other mortgage investors it does not buy or sell loans, but guarantees investors timely principal and interest payment on mortgage-backed securities. Government-insured loan products under the Ginnie Mae umbrella include:

- **Federal Housing Administration (FHA)** - The Federal Housing Administration provides mortgage insurance on loans made by FHA-approved lenders throughout the United States and its territories. FHA insures mortgages on single family and multifamily homes including manufactured homes. It is the largest insurer of mortgages in the world, insuring nearly 33 million properties since its inception in 1934.
- **Veterans Administration (VA)** - VA loans are made by private lenders, such as banks, savings & loans or mortgage companies to eligible veterans for the purchase of a home which is for their own personal occupancy. The guaranty means the lender is protected against loss if the borrower or a later owner fails to repay the loan. The guaranty replaces the protection the lender normally receives by requiring a down payment and allows the borrower to obtain favorable financing terms.
- **US Department of Agriculture (USDA) Rural Development**— Formerly known as the Rural Housing Administration, USDA Rural Development provides a number of homeownership opportunities to rural Americans, as well as programs for home renovation and repair. It also makes financing available to elderly, disabled or low income rural residents of multiunit housing to ensure residents are able to make rent payments.
- **Department of Housing and Urban Development's Office of Public and Indian Housing (PIH)** - The Office of Public and Indian Housing (PIH) ensures safe, decent and affordable housing, creates opportunities for residents' self-sufficiency and economic independence

and assures the fiscal integrity of all program participants.

The New Mexico Mortgage Finance Authority (MFA), although not a state agency, was created under state mandate to provide affordable housing in the state. The MFA has the authority to issue tax-exempt mortgage revenue bonds. Proceeds from bond sales are used to fund below-market interest rate loan programs for single-family homebuyers and for developers of affordable multifamily dwellings. For more information on the programs offered by MFA call (505) 843-6880 or (800) 444-6880 (toll free in New Mexico).

Although these organizations do not grant loans directly to consumers, they do work with local financial institutions to offer more affordable and flexible loan programs. Some of these loan programs help individuals with limited credit or high debt-to-income ratios purchase a house with small or no down payments. There also are special loan programs for employees of educational institutions and law enforcement agencies.

To qualify, individuals may have to meet certain income requirements. To find out if you qualify contact your local loan officer. Because many of the programs are unique, the lenders that offer these programs must be properly trained. Not all lenders are authorized to offer all types of loans. Once you obtain the name of a local lender, consult the loan officer and have him or her recommend the best loan program for you.

Mortgage Shopping Worksheet

	Lender 1		Lender 2	
	Mortgage 1	Mortgage 2	Mortgage 1	Mortgage 2
<i>Name of Lender</i>				
<i>Name of Contact</i>				
<i>Date of Contact</i>				
<i>Mortgage Amount</i>				
A. Basic Information about the loan				
• Type of Loan: Fixed rate, variable rate, conventional, FHA, other?				
• Minimum down payment requirement				
• Loan term (length of loan)				
• Contract interest rate				
• Annual Percentage Rate (APR)				
• Points (may be called discount points)				
• Monthly PMI payments (mortgage insurance)				
• How long must you keep PMI?				
• Estimated monthly escrow for taxes and insurance				
• Estimated monthly payment (Principal, Interest, Taxes, Insurance, PMI)				
B. FEES – different banks have different names for similar fees. Listed below are some of the typical fees you may see on loan docs				
• Application or loan processing fee				
• Origination or underwriting fee				
• Lender fee or funding fee				
• Appraisal fee				
• Attorney fees				
• Document preparation and recording fees				
• Broker fees (may be quoted as points, origination fees, or interest rate add-on)				
• Credit report fee				
• Other fees				
C. Other Costs at Closing/Settlement				
• Title Search/Title Insurance For Lender For You				
• Estimated prepaid amounts for interest, taxes, hazard insurance, payments for escrow				
• State and local taxes, stamp taxes, transfer taxes				
• Flood determination				
• Prepaid PMI				
• Surveys and home inspections				
D. Total Fees and other closing/settlement cost estimates				

Name of Lender	Lender 1		Lender 2	
	Mortgage 1	Mortgage 2	Mortgage 1	Mortgage 2
E. Other Questions and Considerations about the loan				
• Can any of the fees or costs be waived?				
Prepayment Penalties				
• Is there a prepayment penalty?				
• If so, how much is it?				
• How long does the penalty period last? (3 yrs? 5yrs?)				
• Are extra principal payments allowed?				
Lock-ins				
• Is the lock-in agreement in writing?				
• Is there a fee to lock-in?				
• When does the lock-in occur – at application, approval or another time?				
• How long will the lock-in last?				
• When the rate drops before closing, can you lock-in at a lower rate?				
If the loan is an adjustable rate mortgage:				
• What is the initial rate?				
• What is the maximum the rate could be next year?				
• What are the rate and payment caps each year and over the life of the loan?				
• What is the frequency of rate change and any changes to the monthly payment?				
• What is the index the lender will use?				
• What margin will the lender add to the index?				
Credit Life Insurance				
• Does the monthly amount quoted to you include a charge for credit life insurance?				
• If so, does the lender require credit life insurance as a condition of the loan?				
• How much does the credit life insurance cost?				
• How much lower would your monthly payment be without the credit life insurance?				
• If the lender does not require credit life insurance, and you still want to buy it, what rates can you get from other insurance providers?				

This resource is one in a series on the Home-Buying Process which include:

Financial Readiness

What Creditors Look For
Finding Mortgage Money
Types of Financial Institutions
Mortgage Options
Down Payment and Closing Costs
Pre-Qualification or Pre-Approval

Factors to Consider in Housing Selection

Personal Needs and Wants
Location
Type and Style of House
Type of Construction
Interior and Exterior Space
Special Needs
Building as an Option

Locating a House

Finding the House
Using Real Estate Professionals
Buying Direct From Owner

The Sales Contract

Components
Acceptance

Home Inspections

Reasons for Home Inspections
Locating an Inspector
What Inspections Include
Limits of Liability

The Mortgage Process

Loan Application Process
Approval or Rejection
The Mortgage Payment

Purchasing Homeowners Insurance

Before You Start Looking for a Home
Stability of the Insurance Company
Costs and Coverage
Customer Service

Warranties

The Closing

Preparation for Closing
Final Walk Through
Closing Day Procedures

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