SHOPPING FOR A MORTGAGE

The Traditional Fixed-Rate Mortgage

Key characteristics: Level payments, fixed interest rate, fixed term. This mortgage is the one which most of us know, and it is still the loan most used. You make a down payment, and then agree to pay the remaining balance of the loan in equal payments over a long period, such as 20 to 30 years. Though monthly payments are level, the relative amounts of principal and interest vary. In the early years, you pay almost all interest. In the later years, most of your money goes to principal. As you pay off more of the principal and the home also increases in value, you build “equity” or ownership in your home.

Graduated Payment Mortgage

Key characteristics: Designed primarily for first-time home buyers. Your payments begin low, increase for a few years, and then level off at a higher amount. The interest rate is fixed. With this mortgage, young buyers who are good credit risks and have a promising income can often qualify with slightly less income than ordinarily required for the amount being borrowed. That’s because the payments start at a level which you can afford, then rise – as you count on your income to do the same in future years. Typically, the payments start below those of a traditional mortgage for the same amount, rise in the first years (up to a maximum of ten years), then level off at an amount above that of a traditional mortgage. The risk, of course, is on your income keeping up with the rise in payments. But there’s no guesswork. The graduated payment mortgage will cost more over the term than a traditional one because payments in the early years don’t cover all the interest owed each month. That interest is tacked onto the balance of the loan in the most commonly used form of this mortgage. In fact, the balance on the loan actually increases during the early years. (Rather than paying off, or amortizing the loan, you are making it larger – a practice that’s called “negative amortization” in the lending business.)

Variations on Graduated Payment Mortgage

Key characteristics: By various means, monthly payments are made easier to handle in the early years, and then increase later; the interest rate is fixed. In one variation, called the pledged account loan, some of you down payment is used to supplement early payments. Though the amount owed each month remains level, what you’re required to produce out of pocket does not. Initially, part of your down payment is put into a savings account that pays you interest. Each month money is drawn out and combined with out of pocket money to make up the total payment. The amount withdrawn decreases over the years. Once the savings account dries up (typically after five years), you must come up with the entire payment out of pocket. As you can see, the money that goes into the savings account does not really work as a down payment. In fact, the total cost of the mortgage is increased by the amount that’s put into the pledged savings account. However, there’s no negative amortization with the pledged account mortgage. Monthly payments do cover all the interest.

Adjustable Rate Mortgages

Key Characteristics: Interest rates and possibly the term vary. It is potentially good if you buy when interest rates are high and you think they are going to decline. Options vary according to the lending institution. Because of that, adjustable rate mortgages (ARMs) do not all work alike. (Similar mortgages have been available under the name “variable”.)

An ARM is a mortgage which has changeable interest rates in order to reflect current market rates. Periodically, the rates are moved up or down according to an index that's beyond the control of the lender. For instance, the index might be a monitor of the average cost of mortgage money across the country or Treasury Bill rates. In order to attract consumers, some lenders offer the mortgage initially at a rate below the prevailing one on fixed rate mortgages. When interest rates are high, the ARM could be good for you because you won't be locked in over a 30 year mortgage at high rates, if, of course, rates don't drastically shoot upward. There's a good chance they'll come back down. Of course, when mortgage rates are low, you're better off with another type of mortgage.

Graduated Payment Adjustable Mortgage

Key characteristics: A cross between an adjustable rate mortgage and a graduated payment mortgage. Essentially, it's designed so that payments begin lower than those of a traditional mortgage, then increase for the first few years until they level off at a figure higher than that of a traditional mortgage. As with the adjustable rate mortgage just discussed, interest rates charged on the loan can be changed upward or downward as the index being used for the loan indicates. Lenders predict that the increases which might occur could be less drastic than those with a simple adjustable rate mortgage because of the graduated approach. The danger of negative amortization – and thus extremely slow equity building – is great. Negative amortization occurs when monthly payments don't cover the interest charged and therefore the extra money is tacked onto the principal. In essence, you're increasing your debt rather than lowering it. Ask about any limit on the total increase of the loan that's possible should you be interested in this kind of loan.

Balloon Payment

This type of loan starts off as though it were a conventional 25 of 30-year mortgage with a fixed interest rate and monthly installment. At the end of a specific period (i.e. 3, 5, 10 years), however, the entire amount of the loan must be paid off, although you may be given the option of refinancing the loan at the prevailing interest rate.

Renegotiable Rate

With this type of loan, sometimes called "rollover", the lender determines a new interest rate at either 3, 4, 5 or 9 year periods. You have the option to accept or reject the new rate. If you accept, your monthly payments are adjusted. If you reject, the full unpaid balance of your mortgage becomes due. Interest rates can rise within limits and downward adjustments reflecting market conditions are mandatory.

Reverse Annuity Mortgage

Key characteristics: Designed primarily for older people who have paid off (or almost paid off) their mortgages and live on fixed incomes. Equity built up in the home is turned into regular payments to the owners. Increasingly, older people on fixed incomes are being forced to sell their homes in order to get more money to live on. This mortgage – just the opposite of other mortgages – allows these owners to turn their equity into cash while still living in the house. The owner can borrow up to a percentage (typically no more than 80 percent) of the house's current value. This money is paid to the borrower on a regular basis, usually monthly. Just the opposite of a typical mortgage, the borrower is receiving income and surrendering equity rather than making payments and building equity. Reverse annuity mortgages can work in different ways. In one approach, the lender pays an annuity (just a regular monthly payment for the term of the loan) to the home owner. During this time of payment, the debt to the borrowers in continuously rising. Interest is computed on and added to the principal each month.

The mortgage can have a term of a set number of years or can be due after a certain event, such as the sale of the house or death of the owner. The balance can be paid at the end of the term by financing (the house's appreciation will help some), by selling the home or, in case of death, by the estate. In another version, no debt is repaid during the term of the loan by the use of a deferred life annuity policy purchased from a life insurance company.

GLOSSARY OF FINANCING TERMS

AMORTIZED LOAN
A loan which is paid off in equal installments during its term.

ASSUMABLE MORTGAGE
The purchaser takes ownership of real estate encumbered by an existing mortgage and assumes responsibility as the guarantor for the unpaid balance of the mortgage.

BALLOON PAYMENT
The final payment of a mortgage loan when it is larger than the regular payment; it usually extinguishes the debt.

CAPITAL GAINS TAX
The taxable profit derived from the sale of a capital asset. The capital gain is the difference between the sale price and the basis of the property, after making appropriate adjustments for closing costs, fix up expenses, capital improvements, allowable depreciation, etc.

CLOSING COSTS
The expenses incurred in the closing of a real estate or mortgage transaction. Purchaser's expenses normally include cost of title examination, premiums for title policies, survey, attorney fees and recording charges. In addition, the purchaser may have to place in escrow a sum of money to cover accrued real estate taxes and insurance.

CONVENTIONAL MORTGAGE
A loan neither insured by the FHA nor guaranteed by the VA.

CERTIFICATE OF REASONABLE VALUE (CRV)
A document (appraisal) issued by the VA establishing its opinion of maximum value.

EQUITY
The difference between the market value of property and the homeowner's indebtedness (mortgage).

ESCROW PAYMENT
That portion of a mortgagor's monthly payment held in trust by the lender to pay for taxes, hazard insurance, mortgage insurance, lease payments and other items as they become due. Known as impounds in some states.

EXCHANGE
The trading of equity in a piece of property for the equity in another.

FREDDIE MAC
Nickname for Federal Home Loan Association (FHLMC), a tax-paying corporation created by Congress to support the secondary mortgages insured by FHA or guaranteed by VA, as well as conventional home mortgages.

FIRM COMMITMENT
A lender's agreement to make a loan to a specific borrower on a specific property. A FHA or PMI agreement to insure a loan on a specific property with a designated purchaser.

INVESTOR
The holder of a mortgage or the permanent lender for whom the mortgage banker services the loan. A person or institution that invests in mortgages.

LEASE PURCHASE AGREEMENT
The buyer makes a deposit for the future purchase of a property with the right to lease the property in the interim.

LOAN COMMITMENT
A written promise by a lender to make a loan under certain terms and conditions. These include interest rate, length of the loan, lender fees, annual percentage rate, mortgage and hazard insurance, and other special requirements.

LOAN TO VALUE RATIO
The ratio of the mortgage loan principal (amount borrowed) to the property's appraisal value (selling price). On a $100,000 home with a mortgage loan principal of $80,000, the loan to value ratio is 80%.

LAND CONTRACT
Pledge of real property to secure a debt by a written instrument given by the mortgagor. Should be recorded in the County Recorder's Office.

MORTGAGE INSURANCE PREMIUM (PIP)
The consideration paid by a mortgagor for mortgage insurance either to FHA or a PMI company.

MORTGAGEE
The lender of money or the receiver of the mortgage document.

NOTE
A written promise to pay a certain amount of money.

ORIGINATION FEE
A fee or charge for work involved in the evaluation, preparation and submission of a proposed mortgage loan.

POINT
One percent of a loan amount.

PREPAYMENT PENALTY
A fee to the mortgagee for paying the mortgage before it becomes due. Also known as a prepayment fee or reinvestment fee.

PREPAYMENT PRIVILEGE
The right given a purchaser to pay all or part of a debt prior to its maturity. The mortgagee cannot be compelled to accept any payment other than those originally agreed to.

PRIVATELY INSURED MORTGAGE
A conventional mortgage loan on which a private mortgage insurance company protects the lender against loss.

PRIVATE MORTGAGE INSURANCE (PMI)
Insurance written by a private company protecting the mortgage lender against loss occasioned by a mortgage default.

RENT WITH OPTION
A contract which gives one the right to lease property at a certain sum with the option to purchase at a future date.

SECOND MORTGAGE
Junior Mortgage or Junior Lien; an additional loan imposed on property with a first mortgage, generally at a higher interest rate and shorter terms than a first mortgage.

STRAIGHT LOAN
A loan with periodic payments of interest only; the principal due in one lump sum upon maturity.

TITLE
Often used interchangeably with the word “ownership”. It indicates the accumulation of all rights in property; the owner’s and others.

TITLE INSURANCE
An insurance policy which protects the insured (purchaser or lender) against loss arising from defects in the property title.