Understanding Your Mortgage

by Steven Merkel,CFP®, ChFC (Contact Author | Biography)

One of the biggest financial decisions people will make in their lifetime is the choice to buy a home. Why would anyone want to make such a large financial commitment when renting is cheaper, flexible to where you want to live, and short term in obligation? (See *To Rent or Buy: The Financial Issues - Part 1* and *There's More To It Than Money - Part 2*.*)* The reasons are quite straightforward: homeownership allows you to build equity and allows you a deduction for mortgage interest paid, which makes it the single biggest tax break available to most taxpayers, not to mention all the intangible benefits that ownership has to offer. When you are buying a home your monthly payouts will increase and you'll need to set a few dollars aside for those unexpected expenses, but owning your home can be one of your most rewarding decisions if you play your cards correctly from the start.

Step One: Clearing Up Existing Debt

Proper preparation before you buy your home is half the battle. The first item on your list is to obtain a copy of your credit report. What you'll want to do here is clean it up; if you have open credit cards that you never use, close them out. Then you'll want to look for any mistakes or discrepancies with your creditors' reporting and have them corrected as well. Saving as much money as possible for your down payment is important, but not worth overlooking your high-interest rate debt. Any credit-card rates that have an interest rate greater than two times the prime rate are way too high. For example, if the current prime rate is 6%, you should try to pay off all your credit cards with an interest rate of 12% or greater, or look for another lender with a better rate in which to transfer your debt.

Step Two: Shopping for Lenders

Once you've cleaned up your act, you're ready to start shopping around for a lender. Check out www.lendingtree.com or www.bankrate.com to find multiple lenders in your area. Then the fun begins; let three or four of the lenders compete for your business. Do not give each lender approval to access your credit report! Obtain a preliminary copy of the "good faith estimate" (HUD-1 form) and analyze every charge on it. Then, once you've selected the lender you're going to use, allow them to check your credit.

Lenders have lots of imagination and flexibility when it comes to the fees that are charged to the borrower. Fees such as "loan origination", "processing fees" and "underwriting fees" can be negotiated down usually at least 50% or even waived by the lender if they want your business bad enough. "Points" are a real drag too. When you pay points, you pay interest (1 point = 1%) in a lump sum upfront to get a lower rate on your fixed-rate mortgage, which basically increases the amount of your down payment. Points are unnecessary additional charges by the lender. Refuse to pay these fees or take your business elsewhere.

In some cases it may be worth the fee to hire a real-estate attorney to clean up the bogus costs or get yourself a knowledgeable real-estate agent who can lead you through which costs are customary and those that are flexible or potentially eliminated. For example, "title costs" in the State of Florida are the responsibility of the buyer (unless the seller agrees to pick up the costs), so you need to know that these costs should appear on your good faith estimate. If your lender is an out-of-state lender, then they may have different fees (which usually exceed $1,000) and may show up as a surprise cost on your HUD-1 settlement statement prior to closing.

Why Lenders Love PMI

Lenders are like hungry wolves circling their prey when it comes to first-time homebuyers. Most lenders charge private mortgage insurance (PMI), if you fail to make an initial down payment of 20% or more on your home. This insurance protects the lender, not you, in case of default on your loan. Generally a lender will consider a loan financed at more than 80% of the home's value a greater default risk and require the PMI payment. Just how much is this payment for PMI? If you're applying for a $200,000 loan with 10% down payment, you can expect to pay at least $100 per month for the PMI payment. It's not unusual to see PMI payments in the range of $150 to $200 a month.

For those of you already in a mortgage with a PMI payment, when you reach a certain equity percentage in your home (usually 20%) you can cancel the PMI. Over 30 years, a $150 monthly PMI payment can add up to over $54,000! Since the lenders will not remind you that you can cancel the additional payment, many homeowners never take the time to cancel the PMI payment themselves and the lenders are more than happy enough to keep receiving your money.

Step Three: Coming Up with the Down Payment

What can you do if you can't afford the 20% down payment on your home loan? Let's say you're looking at a $200,000 home and you have $10,000 for the down payment. Clearly, most lenders will require a PMI payment if you do not put at least $40,000 down on the home (lending/loan fees have been excluded from our loan calculation). For most first-time homebuyers a $40,000 down payment is out of the question. So, here's where you'll need to get a little creative and try to “piggy-back” your loans so two lenders take part in the loan. This would work like an 80-15-5 type plan: you'll finance 80% on a primary mortgage, finance 15% on a second mortgage or home-equity loan, and 5% as your down payment. By using the home-equity loan plus your down payment, you can leverage that amount against the purchase price of your home and cover the 20% down requirement and thus avoid PMI. The home-equity or second loan will most likely have a variable rate or a rate higher than your primary mortgage, so you'll need to keep an eye on this loan and try to pay it off first. The interest from the home-equity loan is also deductible interest on U.S. federal taxes (home-equity debt is subject to a $100,000 ceiling for deductibility).

Types of Loans

Fixed-Rate Loans The most common mortgage loan is the 30-year fixed-rate loan because the interest rate does not change over the life of the loan. Most homeowners prefer this type of loan since they know that their monthly mortgage payment will remain steady over the years. A 15-year fixed loan is becoming more popular because it reduces your time horizon on the loan, allowing you to decrease dramatically the amount of interest you'll pay over the life of the loan. Generally these loans will carry a higher rate of interest since the lender is giving up their opportunity to make more money in an economy where the interest rate is rising.

Adjustable-Rate Loans The median length of stay in a home is only 8.2 years (1998 U.S. Census data), so if you plan on staying in the new home for a short period of time, you may want to consider alternative financing to the traditional fixed-rate loan. Adjustable-rate loans offer a lower interest rate for a set period of time. The interest rate on these loans can be adjusted annually or you can see them listed as "3-1", "5-1", "7-1" or many other variations. For example, under a "7-1" adjustable rate loan, the loan will stay fixed for the first seven years and then reset each year thereafter. This means that the loan will stay fixed for the first seven years.

Then in the eighth year, the rate is adjusted based on current market conditions, which is usually based on the one-year Treasury index.

Initially, the interest rates on adjustable-rate mortgages can be anywhere from one to three percentage points below the conventional fixed mortgage, and then typically adjusted annually after the fixed term expires. If you only plan to stay in the home for seven years, then this may be the perfect loan for you. You'll need to watch out if interest rates start to rise; you may find yourself paying more than the traditional 30-year fixed.

For more on these two main categories of mortgages see *Mortgages: Fixed-Rate versus Adjustable-Rate*.

Conclusion

Remember, it's definitely worth the extra effort to review your HUD-1 settlement statement prior to the closing date of your new home; the figures listed there should match those that were provided to you on the good faith estimate. If the figures are inflated or you see new charges, contact the lender and ask them to explain or correct the mistakes. After all, purchasing a home is a valuable long-term commitment, so make sure that you fully understand all the terms of your loan and don't overlook any hidden charges that you'll later regret.

To learn more about the home costs, see *Mortgages: How Much Can You Afford?*, *Home-Equity Loans: The Costs* and *The Home-Equity Loan: What It Is And How It Works*.

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