



## Selecting the Right Mortgage for You

A mortgage is a loan you take out to buy a home. This loan covers the "principal" (purchase price of the house minus your down payment) plus the "interest," which is the fee a lender charges you to borrow the money.

There are various types of mortgages, including Fixed-rate, Adjustable-rate, Balloon, VA, FHA, and FmHA. It is important to select the one that is right for you.

### **Fixed-rate mortgages.**

With a fixed-rate mortgage, your interest rate stays the same, or "fixed," throughout the term of the loan. Therefore, your mortgage payment stays predictably the same, making it easier to plan your spending each month. However, lenders typically charge a higher interest rate to make up for the lost income that could be gained from a rate increase. Charging a higher interest rate lowers the total amount you can borrow. And though you're protected from rising interest rates, you're also stuck with a certain rate even if the going rates fall.

The most common fixed-rate mortgages are 15-year and 30-year, which refer to the time you have to pay off the loans. The interest rate on a 15-year mortgage is usually lower than a 30-year mortgage, meaning you'll pay less over the life of the loan. But your monthly payments will be higher since you have half the time to pay off the mortgage.

### **Adjustable-rate mortgages.**

Adjustable-rate mortgages are also called ARMs or adjustables. These mortgages typically start off with a lower "teaser" interest rate that stays fixed for a specified time, and then "adjusts" periodically depending on changes in the market interest rate. The risk to you is that the interest rate—tied to a money market index such as the one-year U.S. Treasury bill or certificates of deposit—will fluctuate, and so will your payment. Your lender can tell you the highest possible monthly payment you would owe if the interest rate hit its max, or cap. You must be sure you can afford it!

A good reason for considering an ARM is if you don't plan to stay in your home for very long; another is if you're sure your income will increase enough to cover the maximum payment possible. And, of course, if interest rates go *down*, so will your payments. With these loans, the lender is taking less risk since he or she gets to charge you more interest when the rates go up. As a result, you can typically borrow a larger amount, making it possible to buy a home you wouldn't otherwise be able to afford.

An example of an ARM is the 10/1 ARM. This loan has a fixed interest rate (and monthly payment) for the first 10 years, with an *annual* (that's what the "1" in "10/1" refers to) adjustment to the interest rate for the next 20 years of a 30-year loan. The lower the first number, (for example 7/1 ARM, 3/1 ARM or even 6-month ARM), the lower your initial interest rate. How often rates are adjusted is established at the time you apply for your loan.

### **Balloon Loans**

Balloon loans have a lower interest rate than a fixed-rate mortgage. The interest rate stays stable for a specified time—such as five, seven or ten years. But when that time is up, you still have to pay off the entire balance of the loan. Borrowers consider balloon loans when they don't qualify for a traditional mortgage, or during periods of high interest rates. The idea is to refinance when the loan balance is due.

### **VA, FHA and FmHA mortgages**

If you have less than 20% of the purchase price to apply to a down payment, you can ask your lender about loans guaranteed by the government organizations below. These mortgages offer competitive interest rates, with little to no money down, such as:

- Veteran's Administration (VA) mortgage: Qualifying veterans can get VA loans with no money down for houses valued at up to \$203,000.
- Federal Housing Administration (FHA) mortgage: Designed for people with modest income, these mortgages usually require a down payment of around 3% to 5% of the purchase price and offer competitive interest rates.
- Farmers Home Administration (FmHA) mortgage: These no-money-down loans are for individuals with limited income who prefer to live in rural communities. Interest can be as low as 1%.

## Get answers!

Here are some important questions to ask your lender to help determine which loan is right for you:

- **Penalties.** Can you pay off the loan early without prepayment penalties?
- **Insurance and taxes.** What are the provisions for homeowners insurance and property taxes? With some loans, lenders insist you pay these expenses directly to them on a prorated basis, while they hold the money in a separate escrow account. The insurance and tax bills come straight to the lender, who then pays them with your money.
- **Loan limitations.** Are there limitations on your right to borrow additional money from another source to facilitate your closing?
- **Interest rates/mortgage balance.** Will your mortgage balance increase if interest rates go up? This is called "negative amortization," and it's as bad as it sounds! It has to do with adjustable-rate mortgages that place limits on the increase in your monthly payment without capping the interest rate. The result is that if interest rates go way up, your payments don't cover all the interest on your loan, and so your mortgage balance increases. Your balance is supposed to amortize—or gradually decrease over time. With negative amortization, the reverse is true!
- **Assumable mortgage.** Is the mortgage assumable? When you sell your home, can the buyer take over what's left of your loan balance? Most assumable mortgages are adjustable-rate rather than fixed-rate mortgages.
- **Second mortgage/home equity loan.** Can you borrow additional money against the home with a second mortgage or a home equity loan at a later date?
- **Selling limitations.** Are there limitations on selling the property without paying off the loan?
- **Total cost.** What is the total cost of the loan, including service charges, appraisal fees, survey costs, escrow fees, etc.?
- **What is a "point"?**  
Lenders make money on the interest they charge. "Points," (also known as "loan origination fees"), are up-front interest to compensate the lender for processing your mortgage. Each point equals 1% of the loan. For example, if you borrow \$200,000, one point would equal \$2000. Points are also referred to as "discount points" because usually the more points you pay, the lower the interest rate is, saving you money in the long haul. "Zero-point" loans exist, but the trade-off is you'll pay a higher interest rate, making for higher monthly payments over the life of the loan. Points, like interest rates, are negotiable; try to make them fit your situation.

## Do your homework!

Since knowledge about the various options will affect your monthly mortgage payments for the next 30 years, it is important that you do your homework! Then consult your real estate attorney or another trusted source to discuss your options until you feel you can make the best choice for your situation.