Your *First Steps* toward Homeownership

Getting Started

Many people don't consider buying a home because they're afraid they can't afford it. But for most people, homeownership is within reach — especially with special programs for first-time home buyers. In fact, for many, homeownership is as affordable as renting.

Know Your Finances

There is no substitute for being prepared, and that means having a real budget. Be honest. Be realistic. Know how much is coming in every month — and how much is going out. It will not only help you but also help professionals like your lender do the best they can for you.

Choose a Lender Before You Shop for a Home

Mortgages are complicated financial transactions, but lenders are experienced in explaining the ins and outs of home loans to buyers. Here's what a lender will do for you, in addition to lending you money:

- Help you determine just how much house you can afford
- Identify the type of mortgage that meets your specific financial needs

If you choose your lender early in the process, you'll already have a working relationship when it comes time to apply for your mortgage. There's nothing worse than falling in love with a house you can't afford — unless it's bypassing a house you could have afforded.

That's why it is important for you to have a good idea how much house you can afford. Most people can't do that alone. If you work with a lender before you decide on a home, you'll know whether you qualify for a mortgage large enough to finance the home you want — and if you don't qualify, you'll know what steps to take to get you there in the near future.

Which Mortgage Is Right for You?

Many factors can and should influence your selection of a mortgage. As you read about the mortgages that are available and discuss them with your lender, keep the following five factors in mind:

- Your current financial situation and resources
- How you expect your finances to change in the future
- How long you intend to keep the home you're buying
- How comfortable you might be with the idea of your mortgage payment changing from time to time
- How rapidly you want to build equity

Common Mortgage Choices

Some loans may have higher rates but lower payments at the beginning; others carry lower rates but possibly higher payments. Some have steady payments, while others have payments that may go up or down. The key to understanding why loans behave this way is to understand "risk" and who is taking the most risk — you or the lender. Risk can refer to many things, but in mortgage lending it is the risk of interest rates going up or down and the risk of the loan not being paid back.

There are two basic categories of mortgages: fixed rate mortgages and adjustable rate mortgages (ARMs). Mortgages with payment adjustments — ARMS — usually result in lower payments at first, but you risk having significant payment increases if interest rates go up. Mortgages with predictable, fixed payments are less risky but could cost you more over the life of the mortgage, and you may need to pay the cost of refinancing to get a lower payment if interest rates fall.

Fixed Rate Mortgages

With this type of mortgage, the interest rate is fixed for the entire term of the loan. Your monthly payments for interest and principal never change, regardless of how interest rates change in the market. Only changes in property taxes and homeowners insurance — both of which are usually included in your monthly payment — may slightly increase or decrease your payment amount, but generally the mortgage payment is stable.

KEY ADVANTAGE: Predictability. The principal and interest part of your mortgage payment doesn't change, so budgeting and financial planning are easier.

KEY DISADVANTAGE: The beginning principal and interest payments are usually higher than those of most adjustable rate mortgages, and if rates fall you may have to refinance and pay refinancing costs to get a lower payment.

Government-Backed Fixed Rate Mortgages

Many mortgage lenders offer special mortgages backed by agencies of the U.S. government (and many state and local governments as well) that can make getting a first mortgage easier. While most are not open to everyone, they can provide significant benefits to those who qualify.

FEDERAL HOUSING ADMINISTRATION (FHA) MORTGAGES

These are government-insured loans, primarily for first-time homebuyers. These loans may offer a lower downpayment than a conventional mortgage and may allow downpayments to be borrowed from a relative. Each area of the country has a maximum loan amount that is set by the Department of Housing and Urban Development (HUD).

DEPARTMENT OF VETERANS AFFAIRS (VA) MORTGAGES

These government-insured loans are available to veterans of the armed services, those currently on active duty or in the reserves, and widows or widowers of veterans. Some VA loans do not require a downpayment. There are limits on the size of VA loans, but they are large enough to cover the purchase of moderately priced homes in most areas of the United States.

RURAL HOUSING AND COMMUNITY DEVELOPMENT SERVICE (RHCDS)

If you are a farmer or live in a rural area, ask your mortgage lender if you qualify for this program, which is sponsored by the U.S. Department of Agriculture.

OTHER FEDERAL, STATE AND LOCAL PROGRAMS

Other loan programs managed by state or local housing administrations, other agencies or private organizations may be available in your area. Similar to FHA and VA loans, these programs can offer lower downpayments and less stringent qualification guidelines. Call the office of your state governor or county or city administrator or chief executive officer for specific information in your area.

Types of Fixed Rate Mortgages

30-Year Fixed Rate Mortgage

This conventional loan offers the lowest monthly payments in the fixed rate category.

WHY THIS LOAN: People who plan to remain in the home for many years and want to keep housing expenses the same as long as they have the loan are likely to choose this loan.

15-Year Fixed Rate Mortgage

Because this loan has a shorter life — 15 years vs. 30 years — the borrower pays less than half the total interest of a 30-year mortgage. However, because you repay the loan in half the time, the monthly payments are higher than those of a 30-year mortgage.

WHY THIS LOAN: For people who can afford the higher monthly payments, the 15-year fixed rate loan allows them to own their home before their children start college or before reaching retirement.

Making Bi-weekly Payments

With most 30- or 15-year fixed rate mortgages, borrowers can decide to make half the payment every two weeks instead of one payment each month. By doing this, you make the equivalent of 13 months of payments every year — without any increase in the total payment. Because these payments are applied to the loan every 14 days, the principal (loan balance) decreases faster, saving interest costs. A 30-year loan can be shortened to 18 or 22 years, providing a substantial decrease in the total interest you pay.

If you decide to do this, you should do it all the time. Also, you must let your servicer (the company that collects your payments) know; otherwise the half payment may be applied as an extra principal payment — which also pays down your principal faster, but your full payment may still be expected on the due date.

Adjustable Rate Mortgages

Usually, adjustable rate mortgages (ARMs) offer a lower interest rate than a fixed rate loan at the start of the loan term, making the payments lower in the beginning and making qualifying easier. But the rate is “adjustable,” meaning it can go up or down based on a specific interest rate index (such as the U.S. Treasury Bill rate) plus an additional amount, called a margin. The dates these adjustments will occur are written in the loan documents, and they can result in significant payment increases. Rate caps at each adjustment date and over the life of the mortgage may offer some protection against sharp increases.

With an ARM, you and your lender share the risk of changes in interest rates. As a result, an ARM may offer an initial interest rate that can be as much as 2 to 3 percent lower than a similar fixed rate mortgage but can later increase substantially, covering the lender's original risk.

Developed when interest rates were high, ARMs may still be a good choice for people who expect their income to increase, who don't expect to be in their home for a long time and expect its value to increase, or who plan to refinance before the adjustment date occurs. However, because the interest rate can increase, you must have the resources to keep up with possible changes in your mortgage payment in case you can't move or refinance.

KEY ADVANTAGES: Most ARMs have lower initial interest and principal payments compared to fixed rate mortgages. If the rates have dropped when the loan adjusts, payments may be lower without refinancing.

KEY DISADVANTAGES: If rates increase, principal and interest payments increase.

A Little More about ARMs

There are four basic "ingredients" in all ARMs, and different mortgages combine them in different ways. While your lender can tell you more about the ARMs available in your area, here are some helpful definitions.

INITIAL INTEREST RATE: It typically will be 2 percent to 3 percent lower than a similar fixed rate mortgage.

INDEX: This is the economic "guide" or indicator used to determine changes to your ARM's interest rate. Your loan is "tied" to this index. As that number rises and falls, so does your interest rate. An example of an index commonly used for ARMs is the profit on a one-year Treasury bill (T-Bill); ask your lender for more detailed information.

MARGIN: This refers to percentage points the lender adds to the index to establish the actual interest rate of your ARM. This helps lower the risk for the lender. The margin stays fixed.

ADJUSTMENT INTERVAL: This is the time between changes in your ARM's interest rate. If your ARM has an adjustment interval of three years, your rate — and your monthly payment — will change every three years, based on the current "index" plus your margin. Typical ARM adjustments periods are one year, three years or five years.

An ARM may contain limits that reduce the risk of extremely higher payments. One type of limit is a periodic cap that restricts the amount the interest rate can go up at each adjustment. ARMs also usually carry a lifetime cap that limits how much the rate can go up over the life of the mortgage.

BI-WEEKLY PAYMENTS: As with fixed rate loans, many ARM loans may be paid this way; check with the servicing company that collects your payments.

A Note on Other Mortgage Options

Lenders have developed what can be called "hybrid" mortgages to assist people in reaching their goal of homeownership. These loans can include combinations of features of fixed and adjustable mortgages. You should check with your lender to determine the options that are available to you at the time of your home purchase.

What's Wrapped into Your Monthly Mortgage Payment

PRINCIPAL AND INTEREST. *Principal* is the amount of money you borrowed. It begins, generally, as the sale price of the home you purchased minus the downpayment you made. With every payment you make, this figure will decrease. In the case of a 30-year fixed rate mortgage, only a small amount of your payment the first few years goes toward reducing the amount of principal. *Interest* is what you pay to borrow the money — it is "the cost" of using money that is not your own. At the beginning of your loan period most of your payment goes toward interest, but over time the amount applied to interest goes down and the amount applied to principal goes up.

WHAT ARE THE PARTS OF YOUR MORTGAGE PAYMENT THAT ARE NOT PRINCIPAL AND INTEREST? In most cases a portion of your monthly mortgage payment is paid into an escrow account, which is where money is held to pay taxes, homeowners insurance and mortgage insurance (if required). This is the element of the monthly payment that can fluctuate even in a fixed rate mortgage. Lenders sometimes require escrow accounts, but sometimes they do not.

Some people would rather pay their taxes and insurance themselves, putting money aside every month to do it and gaining interest for themselves on those funds. In some cases the interest rate on your loan may be slightly higher if you choose not to have an escrow account.

Currently, most states permit lenders to collect two months of estimated annual real estate taxes and insurance payments at the closing. Afterward, your monthly payment will include 1/12 of the annual total for taxes, insurance and other anticipated charges (your lender may collect an additional amount to ensure that a two-month cushion is maintained in the account). Your tax and insurance bills are paid by the lender or servicing company that handles your payments. Together, all the parts of a mortgage payment are commonly called PITI (Principal-Interest-Taxes-Insurance).

Comparing Mortgages

The total cost of a mortgage involves more than just the interest payments you make. There are also origination fees, discount points and other miscellaneous costs. What's more, there can be other terms and conditions that may affect the ultimate cost of your mortgage. When you compare different mortgages, be sure that you take into account all the factors that can influence your final costs.

Discount Points

A point is equal to 1 percent of the total amount of a mortgage; one point on a $100,000 mortgage is $1,000 (1 percent of $100,000). Generally, you will pay all points at closing. Most lenders offer mortgages with combinations of points and interest rates. Generally, the lower the interest rate, the more points you will pay at settlement. (Interest rates affect your monthly mortgage payment, while the points affect the amount of cash you must have at the settlement.) For example, if a loan with the current market interest rate has two points, a loan with an interest rate that's one-half percent higher than the market rate may have no points. Your choice among the various interest rate/points options will depend on how much cash you have available for the closing and settlement.

Final Interest Rate

As you discuss different mortgages with your lender, there are other conditions and terms you should keep in mind. One of the most important is how and when the actual interest rate you will pay is determined. Most lenders will quote a rate and fee at the time you apply for a loan, and then guarantee — or lock — the quote for a specified time. While this protects you from paying more for your mortgage if interest rates rise, it also means you will pay the quoted rate even if interest rates fall.

Lock periods usually run from 10 to 60 days. Longer periods are sometimes available for an additional fee. You may want your lock period to be long enough to get you through closing and settlement. Some lenders give you the option of letting the interest rate for your mortgage float, so the rate can change between the time you apply and the time you close, but the rate is usually set after some specified period before the actual closing.

Anyone interested in buying a home can find detailed information on this topic and many more at MBA's Home Loan Learning Center, www.homeloanlearningcenter.com.

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MORTGAGE BANKERS ASSOCIATION

1919 M STREET NW, 5th FLOOR
WASHINGTON, DC 20036

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