CHOOSING A MORTGAGE

Like homes, home mortgages come in all shapes and sizes: short-term, long-term, fixed, adjustable, jumbo, balloon-these are all terms that will soon be familiar to you, if they're not already.

There's a mortgage out there that's right for you. To figure out which one, though, you'll want to take into consideration such factors as your risk tolerance, the length of time you plan on staying in your home, whether you're looking for a mortgage with low up-front costs and the size of the mortgage you need.

Fixed rate mortgages

As the name implies, the interest rate on a fixed rate mortgage remains the same throughout the life of the loan. Your monthly payment (consisting of principal and interest) generally remains the same, as well. The entire mortgage is repaid in equal monthly installments over the term (length) of the loan.

Length does make a difference

In the mortgage market, long-term loans are generally considered to be 30 or more years in length; short-term loans are those under 30 years in duration. While they may vary between 10 and 40 years (depending in part on the size of the loan), the usual terms for fixed rate mortgages are 15 and 30 years. Although the monthly payment for a 15-year mortgage will be higher than the monthly payment for a 30-year mortgage, it won't be twice as high, and the shorter term of the loan will save you a substantial amount in total interest charges.

> **Example(s):** If you borrow $100,000 at 8% for 30 years, your monthly principal and interest payment will be $733. Over the 30-year term, you'll pay a total of $164,155 in interest. If you borrowed the same amount at the same interest rate for 15 years, your monthly payment would be $955 (about 30% higher than the payment for the 30 year mortgage), and the total interest you'd pay over the 15-year term would be $72,017–a savings of $92,138.

Because the lender would lose money on a long-term fixed rate loan if interest rates were to rise, the lender may adjust the rate accordingly, in effect charging you a premium to offset this possibility. As a result, a 30-year mortgage may have a higher fixed interest rate than a 15-year loan, and both will carry higher interest rates than those initially charged on an adjustable rate mortgage (ARM).

The good news is, you're locked in; the bad news is, you're locked in

Locking in a fixed interest rate on your mortgage has its good and bad points. If interest rates rise, yours won't; as a result, your monthly mortgage payment will always remain the same. This can be reassuring to homeowners on tight budgets or with fixed incomes. For this reason, fixed rate mortgages often appeal to individuals with a low tolerance for the risk associated with fluctuating monthly payments.

But if interest rates go down, yours won't, and your (now high) mortgage payment will remain the same. While you might be able to refinance your home, paying off the higher-rate mortgage with one that carries a lower interest rate, this isn't always possible. In addition, the interest rate might need to drop significantly to offset the expenses associated with refinancing, and you'd need to remain in your home long enough to allow the monthly savings associated with the lower rate to recoup those expenses.

Adjustable rate mortgages (ARMs)

In general

With an ARM, also called a variable rate mortgage, your interest rate is adjusted periodically, rising or falling to keep pace with changes in market interest rate fluctuations. Since the term of your mortgage remains constant, the amount necessary to pay off your loan by the end of the term changes as your loan's interest rate changes. Thus, your monthly payment amount is recalculated with each rate adjustment.

> **Example(s):** You have a $100,000 ARM with an initial interest rate of 6.5% and a 30-year term. Your monthly mortgage payment (in whole dollars) is $632. The interest rate is adjusted annually. At the end of the first year, the interest rate increases to 8.5%. To reflect this increase and to repay the outstanding principal balance over the remaining 29 years in the term, your payment will increase to $766 per month. If at the end of the second year the interest rate increases to 10.5%, your payment will increase to $906 per month.

Depending on what's specified in the mortgage contract, an ARM can be adjusted semi-annually, quarterly, or even monthly, but most are adjusted annually. The adjustments are made on the basis of a formula specified in the mortgage contract. To adjust the rate, the lender uses an index that reflects general interest rate trends, such as the one-year Treasury securities index, and adds to it a margin reflecting the lender's profit (or markup) on the money loaned to you. Thus, if the index is 5.75% and the markup is 2.25%, the ARM interest rate would be 8 percent.

What's to keep the interest rate from going through the roof or, for that matter, from plunging through the floor? Most ARMs specify interest rate caps. The periodic adjustment cap may limit the amount of rate change, up or down, allowed at any single adjustment period. A lifetime cap may indicate that the interest rate may not go any higher or lower than a specified percentage over or under the initial interest rate.

> **Example(s):** Your ARM has an initial rate of 9% and is adjusted annually. The periodic adjustment cap is 1.75 percent per year, and the lifetime cap is 5%. This means that at your first adjustment, your interest rate can't exceed 10.75% or go below 7.25%. Over the life of your loan, your interest rate can't exceed 14% or fall below 4%.

Caution: Some ARMs cap the payment amount that you are required to make, but not the interest adjustment. With these loans, it's important to note that payment caps can result in negative amortization during periods of rising interest rates. If your monthly payment would be less than the interest accrued that month, the unpaid interest would be added to your principal, and your outstanding balance would actually increase, even though you continued to make your required monthly payments.

The initial interest rates (referred to as teaser rates) on ARMs are generally lower than the rates on fixed rate mortgages. If you can tolerate uncertainty in your mortgage interest rate and fluctuations in your monthly mortgage payment amount, believe that interest rates will stay low or go lower in the future, or plan to live in your home for only a short period of time, then you may want to consider an ARM.

Hybrid ARMs

Hybrid ARMs are mortgage loans that offer a fixed interest rate for a certain time period (3, 5, 7 or 10 years) and then convert to a 1-year ARM.

Example(s): Your mortgage offers a fixed rate of 7% for 5 years. At that point, the mortgage converts to a 1-year ARM with a periodic adjustment cap of 1% and a lifetime cap of 4%. For the first 5 years, you pay 7% interest. In the sixth year, when the mortgage converts to a 1-year ARM and your first annual rate adjustment is made, your interest rate can't go above 8% or below 6%. Over the life of the loan, the interest rate can't go over 11% or below 3%.

The initial fixed interest rate on a hybrid ARM is often considerably lower than the rate on either a 15-year or 30-year fixed rate mortgage. The longer the initial fixed-rate term, however, the higher the interest rate for that term will be. Generally speaking, even the lowest of these fixed rates is higher than the initial (teaser) rate of a conventional 1-year ARM.

Hybrid ARMs are ideal for individuals who plan to stay in their homes for a short period of time (3 to 10 years), since they can take advantage of the low initial fixed interest rate without worrying about how the loan will change when it converts to an ARM. If you think your plans may change or you are planning on staying put for a while, look for a hybrid ARM with a conversion option. This option will allow you to convert your loan to a fixed rate loan before it turns into an ARM.

Government mortgage programs

Generally, government mortgage programs offer mortgages insured and/or guaranteed by agencies of the federal government. These programs are often attractive to buyers (particularly first-time homebuyers) because they:

- Offer fixed interest rates that are lower than those offered by conventional loans
- Require little or no down payment
- Use more liberal qualifying guidelines than conventional loans
- Allow the buyer to work with a third party to pay part or all of the mortgage closing costs or allow the buyer to finance the closing costs as part of the mortgage balance
- Carry no prepayment penalties

FHA loans

Federal Housing Administration (FHA) mortgages are similar to conventional fixed rate mortgages, except that they are insured by the federal government. The borrower pays mortgage insurance premiums (MIPs). The initial premium is based in part on the term of the loan and the size of the down payment, and can equal as much as 2.25% of the amount borrowed. This initial premium can be financed into the loan. Depending on the same factors, the annual MIP varies from .25 to.5% of the amount financed; it is collected as a part of the monthly mortgage payments.

In part because of the security this insurance offers, lenders sometimes set their FHA mortgage rates below the current interest rates on conventional mortgages. And depending on the amount you borrow, an FHA loan may allow a down payment of as little as 3.5% of the purchase price of your home.

> **Example(s):** FHA mortgage amounts are limited, and the maximum loan amount varies among geographic regions.

> **Caution:** If you're buying a newly constructed home (less than 12 months old) and are applying for an FHA mortgage, you may need to convince the builder to sign a warranty as part of your loan package. If the home isn't new, FHA loans require that the home be in good repair.

> **Tip:** The Housing and Economic Recovery Act of 2008 includes the HOPE for Hom owners Act of 2008, which created a temporary program within the FHA to back FHA insured mortgages to distressed borrowers. These mortgages refinance distressed loans at a significant discount.

VA loans

If you are a veteran, you may qualify for a Department of Veterans Affairs (VA) mortgage, which is similar to a conventional fixed rate mortgage. The VA guarantees to the lender that a certain portion of the mortgage will be repaid by the federal government if the borrower defaults on the loan. Based on the size of the loan, the VA guarantees:

- 50% of a loan up to $45,000
- Up to $22,500 for loans over $45,000 and not more than $56,250
- 40% of loans over $56,250 and not more than $144,000
- 25% of loans over $144,000, up to a maximum of 25% of the FHA conforming loan limit for a single unit dwelling (currently, $104,250)

Generally, a lender will offer a VA loan equal to four times the VA guaranty amount to a qualified borrower–with no down payment required. As a result, a qualified veteran with an available guaranty of $104,250 could receive a mortgage of up to $417,000, or up to $625,500 in the most expensive parts of the country.. Some lenders may allow servicemembers and veterans to borrow more than this amount if they're able to make an additional cash down payment.

In part because of the security this guaranty offers, lenders usually set their rates on VA mortgages lower than those for conventional mortgages.

Bond-backed mortgages

A bond-backed mortgage is a mortgage loan issued by a city, state or county government. The government entity sells bonds to investors and uses the proceeds from the bond sales to fund the mortgage loans. The interest rates on these mortgages are often lower than rates

available from conventional lenders. Mortgage terms and standards of eligibility are set by the individual government entity and will vary among different communities.

Other types of mortgages

Balloon mortgages

A balloon mortgage is a short-term mortgage with a large principal payment due at the end of the loan's term. With this type of mortgage, you make fixed monthly payments for a certain period of time (3, 5, 7 or 10 years, with 5- and 7-year terms being the most prevalent). However, these monthly payments are based on the same repayment schedule (called an amortization schedule) as those for a 30-year fixed mortgage. For this reason, the fixed payments during this period are relatively low. At the end of this period the loan matures, and the remaining principal balance is due as one large final payment (called the balloon payment).

> **Example(s):** Your $150,000 balloon mortgage has an interest rate of 6.5% for 5 years, after which time the remaining principal comes due. Based on a 30-year amortization schedule, your monthly mortgage payment against principal and interest will be $948. At the end of the 5-year term, you'll owe a remaining principal balance of $140,422. This is your balloon payment.

The short term and relatively low monthly payments make balloon mortgages attractive, particularly for buyers who do not intend to remain in the property beyond the term. However, this type of mortgage is best suited for individuals who are certain they'll be able to make the large payment due at the loan's maturity. If you want the option of converting the balloon payment to a different type of mortgage (perhaps you'll decide to stay in the house), look for a balloon mortgage with a reset feature. The reset feature allows you to convert the balloon payment to, for example, a fixed rate mortgage at the currently prevailing rate for the remainder of the original amortization schedule.

> **Example(s):** Your balloon mortgage described above has a reset feature that allows you to convert the remaining principal balance to a fixed rate mortgage with a 25 year term (the remaining term of the original amortization schedule). When the balloon payment of $140,422 comes due, the prevailing rate is 7.5%. Exercising the reset option, your new fixed payment becomes $1,048 per month.

Graduated payment mortgages

A graduated payment mortgage (GPM) begins with low monthly payments that gradually rise (usually over a 5- to 10-year period) and then level off for the remainder of the loan term. The interest rate on a GPM remains fixed throughout the life of the loan (usually 30 years).

> **Example(s):** You borrow money at 8% for 30 years. Each year for 5 years, your payments will increase by 7.5%. Thus, if your payment is $500 per month in the initial (0) year, it would be (in whole dollars) $538 per month after year 1, $579 per month after year 2, $621 per month after year 3, $668 per month after year 4, and $718 per month after year 5 and thereafter.

The greater the annual increase rate and the longer the period of increases, the lower the initial monthly payments on a GPM will be.

> **Caution:** Because monthly payments on a GPM can start out quite low, negative amortization can occur in the early years of these loans. If the monthly interest charge according to the amortization schedule is greater than the monthly payment amount, the overage is added to the principal, and your loan balance will consequently increase until such time as your monthly payment amounts grow large enough to reverse this process.

A GPM is best suited for a homeowner who enjoys predictable annual income increases (and so can afford the increasing payments) and who (in order to reverse the effects of negative amortization) will own the home for longer than the short term of the periodic increases in the monthly payments.

Growing equity mortgages

A growing equity mortgage (GEM), also referred to as a rapid-payoff mortgage, is actually a formalized method of prepaying your mortgage. The interest rate for a GEM is generally lower than that for a conventional fixed rate mortgage, and remains fixed throughout the life of the loan. However, the monthly payments generally begin at approximately the same level as those of a 30-year fixed rate mortgage. The payments gradually rise, usually over a period of 5 to 10 years, and then level off for the remainder of the loan term. The increases may be based on a predetermined schedule or on changes in an economic index specified in the mortgage contract.

> **Example(s):** For 10 years, the changes in your monthly GEM payment will be made annually, and your monthly payment will increase by 75% of the rate of increase in a U.S. Department of Commerce index that measures per-capita income growth. Thus, if the index increases by 6.8%, your payment would increase by 75% of that, or by 5.1%. If your monthly mortgage payment is $500 at the time of the adjustment, it will increase to $525.50 ($500 x 1.051).

When your payment increases, the additional funds are applied each month directly to your loan's principal balance. This will accelerate the timetable for your mortgage payoff and reduce the total amount of interest you'll pay over the (shorter) life of the loan. As a result, while a GEM doesn't offer any long-term tax deduction advantages, it allows you to build equity in your home more rapidly.

Shared appreciation mortgages

A shared appreciation mortgage offers you a low fixed interest rate in exchange for your agreement to share with a lender a sizable share (usually 30 to 50%) of the appreciation in your home's value, either upon its sale or at a specified date. As part of the contract, the lender may also agree to make a portion of your monthly payments.

> **Example(s):** You want to buy a home with a sale price of $200,000. Normally, your lender charges 9% on conventional mortgages. If you put $40,000 down, your monthly mortgage payments on $160,000 for 30 years at 9% would be (in whole dollars) $1,287–more than you can afford at the time.
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> The property values in the neighborhood are appreciating, and both you and the lender feel that the home will be worth at least $250,000 in 5 years. The lender then offers to give you a 7% fixed rate mortgage for a 30-year term. Further, the lender agrees to make half the monthly mortgage payments for 5 years, if you'll agree to repay the lender those costs and 50% of the appreciated value of the property at that time (or upon the sale of the property, should that occur first).
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> At 7% for 30 years, the monthly mortgage payments would be $1,064. The lender will pay half this, or $532 per month, for 5 years (60 payments). At that point, your property is worth $250,000, and you pay the lender $31,920 in costs ($532 per month x 60 months) plus half the appreciated value ($25,000) for a total of $56,920. You then elect to stay in your home and repay the remaining mortgage balance at 7% over the 25 years left of the original 30-year term. Over the previous 5 years, you've gotten regular salary increases, and you can now afford the monthly mortgage payments of $1,064.

On a $160,000 loan at 7% for 30 years, the total interest you pay is $223,214. Had you taken the same loan at 9%, your total interest payments over the full 30 year term would have been $303,462. Your savings equal ($303,462–$223,214) - $25,000, or $55,218.

Caution: Given that you are not paying all of the mortgage interest on a shared appreciation mortgage in a regularly scheduled manner, you should check with a tax advisor to determine its deductibility.

A shared appreciation mortgage may limit or preclude your ability to borrow against the equity in your home. In addition, at the time you must meet your obligation to the lender, you may need to sell your home if you don't have an alternative means to meet that obligation. Moreover, if the value of your home has not increased as expected, the lender may require you to pay additional interest.

Jumbo loans

A jumbo loan (also known as a nonconforming loan) is any mortgage over $417,000, or over $625,500 in the most expensive parts of the country, for a single-family home or condominium. This figure is set by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac), and is adjusted annually. Jumbo loans are called nonconforming loans because these organizations will not underwrite them, making them more risky to lenders. As a result, lenders often set their jumbo loan interest rates higher than conventional mortgage rates.

This can make a significant difference over time. If you're just over the underwriting limit for conforming loans and are having to consider a jumbo loan, you might want to either look for a cheaper house or consider increasing your down payment in order to qualify for a conforming loan with a lower interest rate. Over the life of your mortgage, this could create significant savings.

For ideas that may help you increase your down payment, see our separate topic discussion, Alternative Ways to Fund Your Down Payment.

Mortgages from nontraditional lenders

Seller-financed mortgages

With a seller-financed mortgage, also called a take-back or purchase-money mortgage, the seller of the home actually acts as the lender. You buy the home under an installment sale arrangement, which means that you take possession of the house and pay for it in periodic installments under the terms of a mortgage contract. You and the seller negotiate the terms of the contract, and you make your mortgage payments directly to the seller, rather than to a bank or mortgage company.

Tip: Under such an arrangement, your property taxes and homeowners insurance are not included in your mortgage payment, as they often are with many traditional mortgages.

Wraparound mortgages

A wraparound mortgage is a type of mortgage in which the seller of the home you're purchasing also acts as your lender. You'll generally make your monthly payment on a wraparound mortgage directly to the seller. Each month, the seller uses a portion of your payment to make the payment on his or her original mortgage. The seller also finances an additional amount that covers the remaining purchase price of the home minus any down payment you tendered. These two parts–the seller's original mortgage and the additional balance the seller financed for you–combine to create the wraparound mortgage.

The interest rate on a wraparound mortgage is somewhat higher than the rate on the seller's original mortgage, but it is often lower than interest rates available from conventional lenders. This can create a situation favorable to both you and the seller.

> **Example:** You're buying a home for $250,000, and have $25,000 for a down payment. The current rate for a 30-year fixed rate mortgage is 7.5%. For a $225,000 loan, this would mean a monthly mortgage payment of $1,835. The seller offers to finance the $225,000 for 30 years at 7%. This would make your payment $1,496 per month. At a savings of $339 per month ($1,835–$1,496), you'll save $122,040 in total interest ($339 x 360 months) over the life of the loan.
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> When the seller receives your monthly mortgage payment of $1,496, a portion of it goes to the seller's own mortgage payment. The seller's mortgage is for $150,000 at 6.5% for 30 years; the monthly payment is $948. As a result, each month the seller pockets $548 ($1,496–$948). Over the life of your mortgage with the seller, the seller takes in $197,280 ($548 per month x 360 months), clearing a profit of $122,280 on the $75,000 ($225,000-$150,000) he or she directly financed for you.

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