

Home Sweet Home Loans

Choosing the right mortgage is a little like finding the ideal spouse or partner. Love at first sight, unfortunately, only happens with any regularity in the movies. Finding a mortgage that works for you involves research and analysis. One way to start is by estimating just how much you feel comfortable paying every month toward your mortgage debt. Your goal is to secure a loan that will result in this amount at the best possible interest rate.

You find this by tinkering with the many variables that a mortgage entails. How much down payment can you afford? If you increase the down payment, how does that decrease the monthly payment? Are you considering a fixed-rate or adjustable mortgage? Will the adjustable mortgage's different rates increase or decrease your monthly payment? Ten, 15-, or 30-year duration? Points or no points? Conventional or government insured? Bank-, mortgage company- or mortgage broker-provided? The options are legion. How you make these decisions can make all the difference.

Decisions, Decisions, Decisions

When it came to house ownership, Sam and Sally thought they were real pros. They'd bought their first home when they were first married with

the help of Sally's parents, who provided the down payment as a wedding gift. It was an adorable house, but now, 5 years later, with business clients to entertain and a toddler in tow, they felt they wanted to expand their space. So they enlisted the help of a real estate agent, carefully scanned the Sunday real estate sections of the local newspaper, cruised neighborhoods they liked looking for open house signs, and even briefly considered new construction. After nearly a year of looking, they finally found what they wanted and placed a competitive bid on the table. After a bit of back and forth, their offer was accepted and the contract signed.

Next up on their list was selling their current house, because they would need the money for a down payment on the new house. They also needed to get moving on applying for a mortgage. Sally volunteered to spearhead the house-selling effort, and Sam took on responsibility for finding financing.

Sam knew that between his and Sally's earnings, they could conservatively afford a monthly mortgage payment of about \$2,000. The new house was going to cost about \$400,000, and Sam was sure he and Sally would be able to provide 25 percent of that, or \$100,000, as a down payment. This money would come from the sale of their current house. Working backward and assuming a 7 percent interest rate over 30 years, this came to about \$300,000 for a loan amount. Perfect, right?

Not so fast. Sally questioned Sam's assumptions about the mortgage. She pointed out that their previous mortgage had had a 30-year fixed rate and they had "paid through the nose" for it, as she put it. That's because it happened that there was a spike in interest rates on the day they locked in their rate 5 years earlier. They had signed forms guaranteeing a rate that was higher than the rates were on the day they closed on the house and, as it turned out, higher than the averages rates for the next 5 years. They might have refinanced, but since they assumed this was a "starter home" and wouldn't live in it for too long, they decided it would be even more expensive to do this.

Still, they realized they would have been much better off taking an adjustable-rate mortgage back then, since rates progressively got lower and lower. Moreover, because they had stayed in that house only 5 years, they'd ended up paying a lot more for that mortgage in closing costs. Since closing costs, which include the fees to transfer the title and seal

the deal, are paid up front, they can make the short-term use of a long mortgage an expensive proposition.

Sam agreed to explore a little further their mortgage options. He knew that the two basic decisions were the type of mortgage—fixed-rate or variable/ adjustable—and the term of the mortgage, meaning how long it would take to pay it off in full. He had always assumed a fixed-rate mortgage was more desirable, since the criteria to qualify seemed harder to meet. He also preferred the idea of a fixed rate because he would always know what his payments would be every month, though experience had demonstrated that adjustable-rate mortgages not only have the potential to go up but also down, benefiting the homeowner. On the other hand, so far as he could tell, interest rates were now climbing again, which would make an adjustable rate mortgage only more expensive over time.

Sam also looked more closely at the implications of obtaining a shorter-term mortgage than 30 years. It wasn't that he expected to sell the house earlier, but rather that he and Sally were interested in building equity faster. He made a chart of his options for his \$300,000 mortgage, assuming the same 7 percent rate, even though he was aware that sometimes rates are slightly more favorable for shorter terms:

BORROWING \$300,000 AT 7%

TERM (YRS)	MONTHLY PAYMENT	TOTAL INTEREST	PRINCIPAL BALANCE REMAINING AFTER 10 YEARS
10	\$3,483	\$117,990	\$0
15	\$2,696	\$185,367	\$136,823
30	\$1,995	\$418,527	\$257,437

Note: For illustrative purposes only

This was really helpful in understanding the differences between shorter- and longer-term mortgages. While Sam didn't think the family could afford the \$3,483 monthly payment on the 10-year mortgage, he realized that adding \$700 a month to their initial budgeted amount of

\$2,000 (the 15-year mortgage) substantially reduced the interest they would pay over the life of the loan and provided them with much more equity after 5 to 10 years than would the 30-year mortgage. If they went for the 30-year mortgage, they would be paying more in interest than the original price of the house!

Sam also looked into the issue of reducing the closing costs. He found out that most of these, which include loan origination, processing, and underwriting costs, as well as document preparation and tax-service fees, were unavoidable, as were the broker fees for selling the house. He did realize when he looked at rates that he should pay special attention to make sure that all fees were included by comparing annual percentage rates, or APRs, rather than the boldface advertised rates that might not include all the fees. This was the only way he'd be able to tell the true cost of his mortgage.

Sam was now prepared to revise his recommendation to Sally about the type of mortgage they should seek. Meanwhile, thanks to Sally's diligent effort at selling their present home, a small bidding war had taken place, and they accepted an offer that was greater than the selling price their real estate agent had helped them set. They decided to put the excess into their down payment, which would help lower the monthly payment and free up more of their cash flow for all those extra expenses associated with a new house, like remodeling and moving costs.

Commonsense Considerations

As Sam assumed, many consider a fixed-rate, 30-year mortgage to be standard. However, there is no one-size-fits-all mortgage in today's lending market. Choosing the right mortgage is as critical to your future finances as choosing the right house is to your lifestyle. You should seek advice from trusted advisers and thoroughly investigate the variety of products available before making up your mind. Here are some questions that go into the equation.

- **How much do you plan to spend in total on a home?**
- **How much do you plan to spend on the down payment?** In considering your down payment approach, you have to determine whether you care more about your monthly cost or your initial cost. Since the

amount of your down payment directly affects your loan amount (purchase price—down payment = loan amount), it also affects the monthly payments on your loan. So the smaller your down payment, the larger your loan amount and, therefore, your monthly payments. Making a larger down payment can also lower your interest rate. This makes your monthly payments even smaller.

- **How long will it be before you move or refinance?** If you are moving from a rental to a home you own, time is one of the most important factors to consider. Unless you live in an area where property prices are shooting upward, it generally does not make sense to buy a house if you can't commit to owning it for at least four years. That's because there are many fees, charges, and deposits required in buying and selling a home. These transaction fees can cost you 10 percent or more of the selling price of the home. With costs like that, it generally makes sense to stay put for a while and wait for the property's appreciation to cover your transaction expense. If you are not sure how long you will own a house, make a conservative guess. The average American moves every 10 to 13 years. Most people move for lifestyle changes, not financial reasons. You may get transferred, or read a compelling article about the joys of life in rural South Carolina. In these cases, the last thing you want is to stay because of money concerns, but for others it can make the difference between making a profit and taking a loss on housing.
- **What kind of mortgage payments do you want?** The three basic options are monthly fixed, payments that are initially fixed, then variable, or variable.
- **What type of property is it?** Single family, condominium or cooperative, or two-, three-, or four-family residence? This can affect both your rates and the types of mortgage you may be offered, and how much you can borrow.
- **How many points do you want?** Points can be either positive (discount points) or negative (rebate points). The more positive points you choose to pay up front, the lower your interest rate may be. For every point you pay, your rate will usually go down by about 0.25 percent. On the other hand, you can opt for a loan with a higher interest rate

in exchange for a rebate, which will give you a credit toward paying some of your nonrecurring closing costs, such as title insurance, appraisal, and origination fee. You can't get any cash back from rebate points.

HOW POINTS AFFECT AN 8 PERCENT 30-YEAR TERM \$100,000 LOAN

POINTS	INTEREST RATE	YOU PAY/RECEIVE	MONTHLY PAYMENT
1.0	7.75%	You pay \$1,000 for the lower rate	\$716
0	8.00%	You pay nothing	\$734
-1.0	8.25%	You receive up to \$1,000 toward your closing costs	\$751

Note: For illustrative purposes only

- **How long would you like to lock in the interest rate?** The lock-in period is the amount of time you're guaranteed a loan's interest rate. Once you've locked in an interest rate on a loan, you'll be guaranteed that rate for a certain period of time, usually for 30, 45, or 60 days. Normally, the longer the lock period, the more points that you have to pay up front, since the lender is taking a greater risk to guarantee a rate for a long time. You'll need to complete your home purchase or refinance within the lock period. If you need extra time, you may have to pay up to 1 point (1 percent of the loan amount) or more, and there's no guarantee that you can keep your original interest rate after the expiration date.

Any number of items can affect the rate you are ultimately offered, including your credit profile, the type of mortgage you are seeking, and the house itself. You may want to plan ahead and get your finances in order before sitting down to apply. You may even think you are ready—but you're not. Take, for example, the following case.

Getting in Shape

Doug, a rising advertising executive who had enjoyed bachelorhood for several years, decided as he approached his 30s that it was nearing time to settle down. He felt he had spent enough money on rent, and the time was right to buy a house. He didn't have much saved up, but figured he could always throw some money from his next few paychecks into his savings account for a down payment. Once he made up his mind about things, Doug liked to act immediately. He was looking forward to moving into his new house by the end of the year, about three months away. He was already planning the housewarming party.

Doug's sister-in-law, Betsy, was a licensed real estate broker who offered to help him hunt for his new home. She raised her eyebrows when Doug told her his time line but didn't try to dissuade him. However, she did recommend that Doug set up a meeting with a mortgage broker or bank officer just to see what financing possibilities were available.

Doug figured he would be a highly desirable candidate for a mortgage because he had worked steadily at a number of jobs with increasing responsibility and had a wallet full of credit cards. His annual salary was more than adequate to support a couple, let alone a single guy, once he added in the substantial bonus he received in February of each year as part of his pay package.

Doug called to set up a meeting with a mortgage specialist at the bank where he had his checking and savings accounts. He figured he was a slam dunk to qualify for at least six figures at their best-advertised interest rate. Geoff, the loan officer who took his call, asked whether he'd come in to sign a form allowing the bank to order a full credit report on Doug. Doug signed the form and, the next week, returned to the bank for his appointment. Expecting the meeting to take all of five minutes, he had arranged to meet Betsy afterward to immediately start looking at some properties in his price range.

Geoff asked Doug to sit down and opened a file folder, scanning the contents of a paper on top. Geoff first complimented Doug on his prompt payment of his rent every month. He said that this was something that the bank specifically looked for in evaluating mortgage applicants. "I

have a few questions I hope you don't mind answering," he told Doug. Doug shrugged and said, "Sure, no problem."

Geoff's first area of concern was Doug's work history and salary. Though Doug had thought his income was more than adequate to support a mortgage payment, he quickly learned otherwise. His career path, which had resulted in changing jobs four times in the previous 6 years, had placed him squarely in a high-risk category, and his bonuses, while hefty, weren't counted as part of his income, since they were tied to the profitability of his firm. Doug explained that in his industry, it is common to change jobs often, especially when an account is lost or moves to another firm. He also wanted Geoff to know that his bonuses over the previous 5 years had steadily increased and that he thought there was little chance of a decrease.

Next the subject of Doug's credit came up. It turned out that Doug's applying for—and receiving—numerous credit cards was a red flag to the bank. And although he kept low balances, the total amount of potential credit available to Doug signaled that he might be in a cash-flow crunch. He assured Geoff that he didn't need all those credit cards and would be happy to close out the balances on all but one or two if that would help assure the bank that he wouldn't overextend himself.

Then Geoff brought up two issues that caught Doug by surprise. The first was an open balance on a cell phone bill dating back more than 5 years. It was just \$45, and Doug had completely forgotten about it. He had disputed the bill at the time but then never again heard from the wireless company and assumed they'd taken it off their books. Apparently, they hadn't. Geoff explained that many times, it's not worth the effort for a creditor to refer small amounts to collection agencies, but the balance can remain open on the consumer's credit record for 7 years. It was Doug's responsibility to clear this up, preferably before he formally applied for his mortgage loan, or the debt might adversely affect the outcome of his application. Doug thought that the wireless company had been bought out a while earlier, so he wasn't even sure if he could clear it up, but he said he'd try it. Geoff made a note of that.

Geoff had saved the biggest bombshell for last. He asked Doug about his "other mortgage," the one that was currently in default for payments that were more than 30 days late. Doug laughed and said he had no

other mortgage—and if he did have one, he certainly wouldn't be late in paying it. He asked to see the documentation that asserted this claim, and Geoff showed it to him. Puzzled, Doug saw that his credit report indeed showed an outstanding mortgage of \$135,000, underwritten by a bank across the country. Was someone using his name perhaps? Geoff said this was entirely possible, though not necessarily in a criminal sense; it might be that the records of someone who actually had the same name were inadvertently mixed up with Doug's report. He recommended contacting the credit bureau and requesting an investigation.

Geoff explained to Doug that while he probably could secure a mortgage in spite of these factors, it wasn't likely he would be offered a preferred interest rate until his credit report had been cleaned up. He also suggested that the human resources department at Doug's company write a letter, to be submitted with the loan application, explaining the nature of the advertising industry and how its executives are typically compensated, so that more weight would be given to Doug's annual bonus. And he strongly recommended that over the next few months, Doug put aside as much money as he could to make a down payment that would lower the amount he'd need to borrow.

Doug left the bank knowing far more about what's important in getting a mortgage than he had realized on entering. When he met up with Betsy, he told her his timetable had changed and it might be longer than three months before he would move. Betsy just smiled.

Commonsense Considerations

As Doug learned, you need to get your finances in top shape before applying for a mortgage. Here is a program that you can follow to help get your profile in order before you apply.

- **Order a credit file disclosure.** These are generated by three consumer credit reporting agencies: Equifax, Experian, or TransUnion. You can easily order your credit report online through www.annualcreditreport.com (you're entitled to one free report annually at no charge, or you may opt to pay for more frequent reports or bells and whistles such as a calculation or analysis of your credit score). You can also order one through the toll-free number 1-877-322-8228. Scruti-

nize your report(s) closely for errors and “red flags.”

- **Always pay your bills within 30 days of the due date.** Payments more than 30 days late are one of the measures creditors use to determine a borrower’s credit unworthiness. Make yourself a payment schedule and post it in a prominent place, annotate your kitchen or personal calendar, or arrange for recurring bills to be paid automatically out of your bank account.
- **Pay off or negotiate current collection accounts to close them out.** Outstanding debts continue to be reported to the credit bureaus for 7 years from the date of nonpayment.
- **Work to reduce your debt-to-income ratio.** This is the total of all your debt payments every month divided by your monthly gross income (your income before subtracting taxes and any other deductions). Typically, lenders like to see a maximum debt ratio of no more than 40 percent of your gross monthly income. If your debt ratio exceeds the maximum, consider consolidating debts into a single lower payment.
- **Decrease your loan-to-value ratio.** If you borrow the full appraised value of the home, your loan-to-value ratio is 100 percent. You can decrease your loan-to-value ratio by offering a down payment. The higher the down payment, the lower your loan-to-value ratio will be. An additional incentive is that if you can offer a down payment of at least 20 percent of the purchase price of the home, you may be able to avoid private mortgage insurance, which is insurance from a private insurer that helps protect the mortgage lender against your mortgage default.
- **Call a moratorium on applying for additional credit.** Every time you fill out a credit application, it shows up on your credit report as an “inquiry.” Numerous inquiries can indicate you are having a cash-flow problem and need access to open lines of credit. This can negatively affect your credit score.
- **Organize your documents.** Locate, sort, and file all your bank statements, pay stubs, W-2 forms, monthly credit statements, and tax returns. If any are missing, order duplicates.
- **Build savings.** You will need funds for your down payment and closing costs, as well as cash reserves in a bank account for two to three

months before you apply for your loan. And don't forget those moving costs.

If you have recently experienced difficulty meeting your financial obligations, it just may not be the right time for you to buy a home. If you can hold out until your credit situation stabilizes, you may save yourself thousands of dollars—and diminish the risk of shouldering a high-interest loan that, in turn, might put you in further credit distress.

However, if you cannot wait, and you know your credit is less than perfect, your mortgage options may not necessarily be limited to sub-prime lenders who charge higher interest rates and fees. It all depends on a constellation of factors, some of which are within your power to affect and others that are not. Separating these two categories and focusing on improving what you can control, will benefit your chances of getting the best rate possible, which, in turn, will benefit your wallet in the long run.

Grabbing the Brass Ring

After spending several years rebuilding her credit and many months pounding the pavement with the weekend real estate section of her local newspaper in hand, Lynda found a house that was perfect in every way. Because the owners were divorcing, they wanted to dispose of it as quickly as possible at a price well below market value. It was a once-in-a-lifetime opportunity for Lynda. Her real estate agent recommended a mortgage company that she knew from experience was willing to offer loans to applicants with a not-quite-perfect credit record.

Lynda's many years of steady employment strengthened her bargaining position. But unwilling to leave anything to chance, Lynda composed a detailed letter of explanation regarding her credit crunch. She explained that while in college she had been in an auto accident and found herself with insufficient insurance to cover significant medical costs. Eventually, though, she had been able to pay off the balances on those bills. Now she was able to provide proof of her commitment to her restored creditworthiness by contributing regularly to a savings account.

Lynda also had rent and utility receipts to verify a steady payment history and was able to demonstrate regular installment payments on her credit cards. Based on her credit score, the interest on the loan she was seeking was still higher than the rate available to individuals without her past problems. However, she was advised to consider refinancing in several years, after her credit score had had time to improve some more. This way, she wouldn't have to pass up the opportunity to buy this "perfect house."

Processing and approval of Lynda's loan application took somewhat longer than it would have if she'd had a better credit record. While it was nerve-wracking, in the end Lynda was granted an insured mortgage loan and became a proud first-time homeowner. This had been far out of the range of possibility several years earlier, when her financial situation was bleak. The passage of time, along with Lynda's concerted effort to improve her credit score, ultimately made all the difference.

Commonsense Considerations

When Lynda went to apply for her mortgage, she anticipated questions and took the extra step in providing a letter of explanation. When you are ready to complete an application, here is what you should know before you sharpen your pencils:

- Obtain two applications. Fill out one as a draft, and, if you make no mistakes, you can send it in. Otherwise, make all your corrections and then copy the accurate information to the clean form. Write as neatly as possible and try to avoid using correction fluid.
- Fill out the application completely and precisely. A lender cannot judge an application based on incomplete information and will return it to you with a request to provide the missing information, therefore prolonging the process.
- Provide complete documentation. You will typically need a month of pay stubs, 3 months of bank account statements, 2 years of W-2 forms, and 1 year of rent or mortgage history. You will also need proof for any source of income you are claiming on the application.
- Be prompt in supplying additionally requested information. Don't put yourself in a position to be turned down because too much time has

elapsed between a request and delivery of additional information. If it's appropriate for a third party to provide or verify information, such as an employer or landlord, ask them to do so on your behalf.

- Be prepared to explain any credit problems or late payments in detail. "I forgot" won't cut it.
- Make copies of everything you submit and hand-deliver the documents or send them by certified mail. Keep your copies handy until your mortgage loan is approved and closed, then file them carefully in a place where you can readily locate them if necessary. It will save you time if you apply for additional financing or for refinancing at a later date.
- See also Chapter 4, "Mortgage Matters," for further information.