

A HOME FOR YOUR FAMILY 12

Choosing the Best Mortgage

Selecting a mortgage can be perplexing, frustrating, and time-consuming. Mortgage lenders offer a variety of loan packages under different names with different interest rates, up-front costs, and fine print terms, all of which can change frequently. You need a lot of information to get a mortgage that best fits your needs at a competitive price.

Sources of mortgages include: savings and loan associations, commercial banks, federal and related agencies, life insurance companies, some credit unions, and family members.

When you start to shop for a mortgage, you will find a number of factors may cause interest rates to vary, such as differences in lenders, the size of the mortgage, the amount of down payment, and general conditions in the money market.

A number of mortgage types are on the market today, including: fixed rate, adjustable rate, graduated payment, growing equity, balloon, or wraparound and others. In addition, you have other choices to make:

- Fixed versus adjustable payments.
- Fixed interest rate with payments that usually do not vary versus adjustable and variable-interest rates where payments do vary.
- Variations of fixed or adjustable payments.
- “Creative financing” alternatives.
- Form of payments.

Your challenge is to match a mortgage to your personal situation. You need to con-

sider current market conditions, the age of your family, your attitude toward risk, and how long you plan to stay in the house. It may take time, phone calls, and leg work, but when you are ready to sell the house or pay off the mortgage, your investment in time and effort will pay off.

FIXED RATE MORTGAGES

The traditional, fixed rate mortgage (FRM) is considered the granddaddy of all mortgages. Its advantage is that neither the interest rate nor the monthly payment (principal and interest) ever changes over the life of the loan. If money is borrowed at 10 percent and rates go up to 18 percent, the rate stays the same. You know at the outset exactly how much the loan will cost each month until it is paid off. This is good if you place a high value on predictability.

The price paid for this predictability usually comes in the form of a higher interest rate than on an initial adjustable rate mortgage (ARM). Lenders often charge as much as 2 to 3 percentage points more. They do this to offset the risk that sometime during the life of the loan overall interest rates will increase but they will not be able to adjust the fixed rate. This same risk applies to you in reverse. If overall interest rates go down, you will still be locked in at the higher rate. This higher initial interest rate means you need a higher income to qualify. If interest rates drop, you will not pay less unless you refinance and incur the up-front costs of getting a new mortgage.

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**North Carolina
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If your family's income is not high enough to qualify for a fixed rate, you might seek an ARM. However, 75 percent of borrowers choose to go with a fixed rate because they favor predictability and are averse to financial risk. The amount is set in advance and by prepaying they can substantially reduce the loan balance at any time. The rate can never increase.

Short-term mortgages of 10-, 15-, and 20-year maturity periods have become popular variations on fixed rate mortgages. They are often just like the 30-year loans but offer a lower interest rate because there is less long-term risk. You are rewarded by a dramatic reduction in overall interest charges. That means that you build equity faster and thus own the house sooner. However, higher monthly payments may make it more difficult for you to qualify.

An alternative to a shorter-term loan is to sign up for a **biweekly mortgage**. Biweekly mortgages are amortized as regular 30-year loans but the monthly payments are divided in half and you make a payment every other week. This amounts to 26 payments a year or 13 monthly payments in 12 months. It will shorten the length of time and reduce the interest charges for repaying the loan.

Three government-backed loan programs offer fixed rate mortgages.

Federal Housing Administration Insured Loans (FHA)

- FHA guarantees the lender that it will pay losses resulting from foreclosure.
- Interest rate is usually lower than conventional mortgages.
- Mortgage insurance is charged.
- Points may be charged.
- FHA accepts higher credit risks than conventional lenders.
- FHA appraises the house to be purchased and gives this information to the bank making the loan; loans take longer.
- Seller may increase price of house to make up for points they may have to pay.
- Low down payments.
- Long repayment period.
- Loans are assumable.

Veterans Administration Loans (VA)

- VA guarantees the loan.
- Only veterans or their survivors are eligible.
- No down payment is required.
- Lower interest rates.
- Repayment period is up to 30 years.

- No prepayment penalty is assessed to the borrower.
- No cost for mortgage insurance.

Farmers Home Administration Loans (FmHA)

- Administered by USDA for rural families
- Interest rate relatively low.
- Payment period is up to 40 years.
- No down payment.
- Amount of loan based on applicant's eligibility.
- Mortgage is insured.
- Must meet income guidelines.

ADJUSTABLE RATE MORTGAGES

If you plan to move or refinance in 3 to 4 years, you may want to forego a fixed rate mortgage and choose an adjustable rate mortgage (ARM). **Flexible** or **variable rate** loans are two other names for this popular mortgage choice. They have one characteristic in common—the interest rate can and probably will change periodically during the life of the loan, depending on interest rates in financial markets.

With an ARM, you pay a lower interest rate at the beginning of the loan term. This means you can qualify with a substantially lower income than for a comparable fixed rate loan and your initial monthly payments are lower. The interest rate, however, can go up over the life of the loan, and you must consider whether your future income will be enough to meet the greatest possible increase in payments.

If ARM interest rates increase enough, the monthly payment may be more than that paid for a fixed rate mortgage. However, if interest rates decline, so do monthly payments.

To avoid constant and drastic fluctuations, most ARMs have **caps** or **limits** on how much the interest rate or payments can change, both per adjustment period (every time the rate changes) and over the life of the loan. Adjustments are made periodically as specified in the loan contract. The most common adjustment periods are every 6 months, 1, 3, and 5 years. If you have an ARM with a one-year adjustment period, the interest rate can change only once a year on a specified date. Also, lenders may allow you to convert your ARM into a fixed rate mortgage under certain terms and conditions.

Some ARMs allow "negative amortization," which cancels out most of the protection offered by caps. This occurs if the monthly payment is capped, but the interest rate rises so the payments may not cover the full interest amount the lender is owed. The difference is added to the

loan balance. That means that after you make your capped monthly payment, the mortgage debt will increase, not decrease.

Lenders use standard **indexes** plus a **margin** to determine the rate to charge on ARMs. Some frequently used indexes are:

- Rate on 1-, 3-, and 5-year Treasury securities (or how much the Treasury is willing to pay on money it borrows),
- Federal Home Loan Bank Board's national or regional average mortgage rate charged by major lenders on the purchase of previously occupied homes (or how much people are paying on new mortgages nationwide), and
- Average cost of funds for savings and loans insured by the FDIC (or how much lending institutions are paying on the money they borrow).

Some of these indexes reflect what the market will bear across the country; others reflect local trends. The index selected should be one that can be verified easily. Its past performance may give an indication of how stable it is. Some indexes change monthly. You need to learn how much advance notice you will get before the new payment or rate goes into effect. The lender should be willing to tell you how the rate is determined. Ask your lender: Does the rate change monthly? Are there limits on the number of times and/or the amount the rate can fluctuate?

The margin is an additional amount that the lender adds on to the index rate (usually 1-3 points) and it is constant for the life of the loan.

ARMs may be your only choice initially if you do not have income to qualify for a fixed rate mortgage. Look for ARMs which can be converted to a fixed rate interest at a later date. Remember, ARMs can be very complicated. It is very important that you have a clear understanding of the pros and cons of fixed rate and adjustable rate mortgages. Despite the lower initial interest rate of an ARM, the traditional, fixed rate mortgages may be the better choice for you based on your income, credit history, and lifestyle.

ALTERNATIVE MORTGAGES (FIXED AND ADJUSTABLE RATE)

There are a number of types of alternative mortgages offering both fixed and adjustable rates. The major ones are:

Graduated Payment Mortgage (GPM). This was one of the first alternatives to the fixed rate mortgage. It usually offers a fixed interest rate with low monthly payments in

the early years. Payments rise at a set rate over a set period of time (usually 5 to 10 years) and then remain constant for the duration of the loan. Payments usually increase once a year. During the early years of the loan the borrower will pay less than the interest rate requires, but will make up for it in later years when the payment is higher.

This type mortgage may be a good alternative for first-time home buyers because it allows them to take advantage of their future earning power. They can gamble that by the time their payments rise they will have better paying jobs.

However, the disadvantages of the graduated payment mortgage are that salaries may not rise as expected, unemployment may be experienced, and the interest costs of a home purchased with a GPM may be considerably higher than with a fixed rate mortgage. Also, equity does not build very quickly and the borrower will need a larger down payment.

Pledged Account Mortgage. This offers an effective lower first-year interest rate because a large initial payment is made to the lender when the loan is originated. The payment may be made by the buyer, builder, or any other interested party. This subsidizes the interest payments over the first years of the loan because the payment is put in an account where it earns interest.

This plan can lower the interest rate substantially. For example, if it shaved 5 percentage points off the first year's 10 percent interest rate to bring it down to 5 percent, one percent would be added every year until the payments matched the 10 percent rate. On a \$50,000 loan, the first year's payments would amount to \$305 monthly, rather than \$438, for a savings of \$133 per month (with the difference coming from the pledged account). During the next 5 years the interest rate would increase one percentage point per year (depending on the terms of the loan) and the borrower would continue to draw down his/her pledged account. By the end of the fifth year, the balance in the account would be zero, and the loan would become a standard fixed or adjustable rate mortgage depending on the contract.

Balloon Mortgage. This mortgage is not for the faint of heart. The amount of the mortgage usually is amortized for a 30-year period, but the borrower makes payments for only 3-5 years. After a period of time, the remaining principal, or balloon payment, is due in a large final payment. If the final payment cannot be made, it will be necessary to refinance. Often the lender will offer automatic refinancing as one of the contract terms. If automatic

refinancing is not included in the contract, the borrower could be forced to start a mortgage search all over again and thus will have to pay closing costs and up-front charges again.

A balloon mortgage may be worthwhile if you plan to sell your house within a few years and expect the value of the house to appreciate quickly. Be sure there is an automatic refinancing clause that could save you from being forced to shop for another mortgage and pay closing costs again when the loan comes due.

Renegotiated Rate Mortgage. This is a variation of the balloon mortgage. The interest rate is fixed for a period of time, 3-5 years, after which it is renegotiated. The lender is obligated to offer refinancing with minimum or no fees, but the homeowner can shop around for more favorable terms. These are sometimes called rollover mortgages. The advantage is that monthly payments are fixed for 3-5 years and there is an agreement to refinance with the original lender.

Growing Equity Mortgage (GEM). This mortgage offers a fixed interest rate with a changing monthly payment that offers just what its name implies—speedy buildup of equity. The interest rate is usually a few points below market and does not change. However, the monthly payment increases according to an agreed-on index. These increases are then applied directly to the principal on the loan. Thus, a 30-year mortgage could be paid off in 15 to 20 years.

The advantages of this method are that equity is rapidly acquired and the loan is paid off much sooner with low interest costs. The disadvantage is that income over the life of the loan may not keep pace with the increased payments.

CREATIVE FINANCING MORTGAGE ALTERNATIVES

In recent years, a number of creative financing mortgage alternatives have appeared on the market. These include:

Shared Appreciation Mortgage (SAM). With this mortgage, the buyer must agree to share with the lender an agreed-upon amount of the home's appreciation value (usually 30-50 percent) when it is sold or transferred or after a specified number of years.

Advantages of the shared appreciation mortgage are a relatively low interest rate and lower monthly payments. The disadvantage of the SAM is that the buyer may not be able to buy out the lender when the specified payoff time

arrives. In that case, the buyer would be forced to refinance or sell the home. SAM is most advantageous when property values are rising. In declining real estate markets, the buyer may be liable for an additional amount of interest.

Assumable Mortgages. These mortgages became popular during periods of high interest rates. The seller of the home passes on the existing mortgage to the new owner, who takes over the remaining payments. The new owner assumes the lower interest rate, but the buyer must have a large enough down payment to make up the difference between the selling price of the home and the balance on the old mortgage.

Few lenders today allow mortgages to be assumed, so read all contracts carefully. Look for a "due-on-sale" clause, which means that the mortgage may not be assumable and that the seller must pay off any outstanding balance and the buyer must apply for an entirely new mortgage.

Seller Take-back Mortgages. If the buyer doesn't have a large enough down payment to cover the difference between the selling price and the balance on an assumable mortgage, a seller take-back mortgage may be used. It is considered a second mortgage because the buyer uses the new home as collateral and borrows an amount (from the seller) necessary to finance the down payment and equity buyout of the seller. Remember that the mortgage was assumed and is still outstanding.

These mortgages frequently involve paying only interest with the principal due in full at some later date. A borrower can take advantage of an assumable mortgage but will have to make a large balloon payment at maturity.

Wraparound Mortgage. This is a variation on the second mortgage. For example: Imagine a borrower has \$25,000 for a down payment on a \$75,000 condominium but cannot afford the payments because the current interest rate is 12 percent for the additional \$50,000. The present owner currently has a \$30,000 mortgage at 8 percent. The owner offers the borrower a \$50,000 mortgage at 10 percent—a blended rate of 8 percent on the \$30,000 and 13 percent on the remaining \$20,000. The new loan "wraps around" the existing mortgage of \$30,000. In essence, the borrower is assuming the existing mortgage and adding another. The borrower makes the payment through the seller, who then forwards the appropriate payment to the lending institution.

To take advantage of the wraparound, the borrower must make sure that the holder of the original mortgage is aware of the arrangement. Some lenders do not allow these mortgages, and may have the right to insist that the old mortgage be paid off immediately. Also, the borrower is relying on the seller to make the original mortgage payment on time. This can be very risky.

Buy-downs. In a buy-down, a developer or some other interested party offers to subsidize part of the interest for a set period of time (1-5 years) so the buyer has a lower initial monthly payment. Before choosing this type of mortgage, a borrower should consider what the payments will be after the subsidy period ends.

If the loan has a fixed rate, the payment will rise to the actual amount of principal and interest. If it is a variable rate, the payment may go up even higher depending on the index to which it is tied. Borrowers need to give careful consideration about their ability to make future payments before getting a mortgage like this.

Buyers and builders may offer buy-downs to make financing arrangements look more attractive. They may increase the price of the home to make up for the money paid to the financial institution to buy down the interest rate for the first several years. Borrowers should inquire what the price of the property would be if they did not choose the buy-down mortgage. They may realize substantial savings by taking a lower price and finding a mortgage elsewhere.

Personal Loans. Family or friends may be possible sources for a mortgage or a second mortgage. Because of the large amounts of money that may be involved, be sure to have a legal contract that spells out the rights and responsibilities of all parties. This is important at tax time since mortgage interest payments are deductible, but personal loan interest payments are not.

OTHER CONSIDERATIONS

In addition to choosing among the various fixed and adjustable mortgages, you can choose the way in which to make your monthly payments. The most popular **payment formats** are:

Regular	1 payment/month	= 12 payments/year
Bimonthly	2 payments/month	= 24 payments/year
Biweekly	payments every other week	= 26 payments/ year

How much interest you pay on the overall mortgage will depend on how often the principal is reduced. If you make a bimonthly payment in which you pay \$250 twice a month rather than \$500 monthly, you will pay less total interest because you reduce the principal every time you make a payment. Even minimal reduction of principal can greatly reduce interest costs.

Biweekly mortgages save interest costs in two ways. First, with a regular monthly mortgage, you usually pay at the beginning of the month for using the bank's money for the previous month. With a biweekly payment, the financial institution doesn't have to wait for four weeks for their money — it gets half the monthly payment every other week and can use it to loan to other customers. In essence, you are paying off some of the principal earlier in the month.

Second, you are making two extra payments every year, which reduces the principal and also reduces the time needed to repay the principal. This is the equivalent of an extra month. If you select this option, you must be prepared twice during the year to make three payments within a one-month period. Although the loan is amortized over 30 years, you usually pay it off in 18 to 21 years. In the example, you would save over \$39,000 in interest costs on a \$50,000 mortgage and over \$117,000 on a \$150,000 mortgage. Check to see if there is a prepayment penalty clause.

Points may or may not be charged, depending upon the money market situation and other factors. A point is equal to one percent of the mortgage loan. Points are a one-time charge collected by the lender at closing to increase the return on the loan. By paying points, you may reduce the interest rate charged by the lender. On a conventional mortgage, points may be paid by either the buyer or seller or split between them. In FHA or VA loans, the borrower is not allowed to pay any points.

At some point in the application and settlement process, the points and interest rate to be paid are **locked-in**. Some lenders will lock in the rate and points at the time an application for a loan is made or when they approve the loan application. Some lenders will allow points and interest to float up to the time of closing. Others will lock in the interest rate but let the points float.

When shopping for a mortgage, find out what will happen to the rate if market rates go up or down. Ask the lender when the interest rate and points can be locked in. Be sure to get any agreement of this type in writing. Some lenders charge a fee for locking in interest rates and points. How long the lock-in lasts may vary (30, 60, 90, and 120

days are most common), as does what happens to the interest and points if the lock-in period expires before closing.

Not every mortgage will fit all your specific needs, but once you determine your personal goals, you will have made a good start. To keep monthly housing costs down, consider the following:

- Make as large a down payment as possible.
- Take the mortgage over a longer period of time (although this will cost more total dollars to pay off the loan).
- Shop for the lowest interest rate.

- Keep the mortgage payment within affordable limits.

If you would like additional information on selecting a home, you may wish to request other publications in the *A Home For Your Family* series. Single copies of North Carolina Cooperative Extension Service publications are available free of charge at your county extension center.

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Shelby, Wanda W. and Eleanor J. Walls. 1991. *Mortgage Alternatives: The Risk and Opportunities*. University of Arkansas Cooperative Extension Service, Little Rock, AR.

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Hogarth, Jeanne M. 1991. *Financing Your Homes. Home Buyer's Guide: Financing and Evaluating Prospective Homes*. Cornell University Cooperative Extension Service, Ithaca, NY.

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Fannie Mae. 1991. *A Guide to Homeownership*. Washington, DC.

You may be interested in other North Carolina Cooperative Extension Service publications:

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