Fact Sheet HE 3225

UNIVERSITY OF FLORIDA
Cooperative Extension Service
Institute of Food and Agricultural Sciences

Questions to Ask Before Choosing a Mortgage[1]

Virginia Peart, Ph.D.[2]

Failing to shop comparatively among local mortgage sources can be costly. For example, the difference between an 8-percent and 9-percent simple interest rate on a $60,000 fixed rate mortgage will save $35 per month and $12,600 over 30 years. A difference of three discount points will save $1,800 in closing costs.

To make a good decision about the "best mortgage" for you, you need basic knowledge of current mortgage alternatives. But, that knowledge alone is not enough. You also need to find and analyze available options. All mortgages of the same type are not exactly alike.

MORTGAGE SOURCES

Traditional home mortgage lenders — savings and loans, banks, mortgage finance companies, and Farmers Home Administration offices — are the most readily available sources of mortgage loans.

More and more credit unions offer the same kinds of mortgage instruments, rates, and terms as are available from traditional mortgage lenders, but they tend to favor 15-year instead of 30-year loans.

SEARCH METHODS

Here are some ideas on how you might locate your mortgage options and narrow the list to a few prospects:

- Some newspapers publish a weekly mortgage rate report in the Sunday paper. If all local lenders do not choose to participate, the list is not complete. Still, it helps if you follow rate trends and weed out some choices to provide you with a basis for comparison.

- Check mortgage advertisements in newspapers and direct-mail promotions. Ads should be interpreted carefully and not become the sole basis for a selection decision. They do not usually contain enough information for a fair comparison.

- Local realtors are often an excellent source of current information about mortgage rates and terms. Most agencies survey (by phone) all major lenders in town every week or two as a service to their clientele (and the buyers of their clients' homes). Here again, the information gathered is probably not enough to make a good choice.

1. This document is Fact Sheet HE 3225, a series of the Home Economics Department, Florida Cooperative Extension Service, Institute of Food and Agricultural Sciences, University of Florida. Publication date: September 1995. Originally published as Fact Sheet HB-11 in July 1993. Adapted for use in Florida from "Questions to Ask Before Choosing a Mortgage" by Wanda W. Shelby, Family Resource Management, and Eleanor J. Walls, Housing Specialist, Arkansas Cooperative Extension Service. Reviewed by Laura Fuller, Head of Mortgage Department, Assistant Vice President, SunBank of Gainesville, Florida. Reviewed: September 1995.

2. Virginia Peart, associate professor, Housing, Home Economics Department, Cooperative Extension Service, Institute of Food and Agricultural Sciences, University of Florida, Gainesville FL 32611.

If you cannot get a comprehensive mortgage report, invest the time to call several financial institutions for their rates and basic credit terms. Call various types of lenders, including savings and loans, banks, mortgage companies, your credit union (if applicable), and any other available type of lender.

MORTGAGE AFFORDABILITY

The maximum amount of your income that may be spent on your home mortgage is set by the lender or specified in the mortgage instrument. This is calculated when you apply for a loan to see if you qualify for a particular mortgage.

When you compare mortgage alternatives, it may be helpful to estimate their affordability before you apply. Lenders usually follow these basic guidelines to determine how large a mortgage to grant.

- Your total monthly housing expense (principal, interest, taxes, and insurance) should not exceed 29 percent of your stable monthly income.
- Your total monthly debt should not exceed 41 percent of your stable monthly income.

It is also helpful to see how various interest rates affect the monthly payment amount. You can buy an inexpensive paperback book of amortization tables to find the monthly principal and interest payment amounts for the mortgages you are considering. The *payment table* can also be used to calculate an estimate.

Table 1.

PAYMENT TABLE

(Monthly payment for each 1,000 borrowed)			
Interest Rate	15 years	25 years	30 years
7.0%	$8.98	$7.07	$6.65
8.0	$9.56	$7.72	$7.34
9.0	$10.15	$8.39	$8.05
10.0	$10.75	$9.09	$8.78

MORTGAGE ANALYSIS TOOLS

Once you have completed the mortgage search, narrow your list to the two or three most appealing mortgages and make a thorough investigation and analysis. Answers to the following questions are your tools for making a comparative mortgage analysis — the only way to reduce your risk and increase your opportunity for savings.

QUESTIONS FOR ALL TYPES OF MORTGAGES

- What is the simple interest rate and number of discount points?
- What other rate/point combinations are available?
- Discount points are a form of interest which is paid up front at closing. Each point equals 1 percent of the loan amount.
- Most lenders offer a choice of interest rates and discount points — the lower the interest rate, the more points charged (one point equals approximately 1/4 of 1 percent of the interest rate).
- As a general rule, the longer you plan to stay in your home, the greater the advantage of paying more points to get a lower interest rate.
- An additional consideration is that (for new loans only, not refinancing) points are fully tax deductible in the year paid (unless they are financed).
- What is the annual percentage rate (APR)?

  The APR takes into account all costs of financing — including the interest, discount points, mortgage insurance, etc. — and amortizes them over the full term of the loan. This gives you an easy way to compare mortgages, if you keep that loan until you pay it off. If you don't intend to stay in the home that long, the APR becomes biased and is not the best basis for comparison.
- Will you lock in the interest rate until closing?

  The loan approval process typically takes from three to eight weeks — longer if applications have backed up. If not "locked in," the mortgage

interest rate could change (upward or downward) before closing.

Some lenders will lock in rates at no charge for 45 to 60 days; others charge a fee. Some allow you to lock in by telephone at any time during loan processing. This is advantageous when market rates fall.

- What is the required down payment?

- What will mortgage insurance cost?

Most mortgages require a 20-percent down payment unless you pay for mortgage insurance to protect the lender in case you default. Getting mortgage insurance can reduce your down payment to as little as 5 percent of the home's appraised value. However, many companies no longer insure low down payment loans in Florida because of current economic conditions.

Private mortgage insurance usually requires you to pay a first-year premium (up to 1 percent of the loan amount). After that, you pay a smaller percentage each year until your loan balance is reduced to 80 percent of your home's value. At that point your insurance payments and coverage should stop.

For Federal Housing Administration (FHA) loans, you are charged a fixed insurance premium (between 2 percent and 4 percent of the loan amount), depending on the length of the mortgage term and whether the premium is paid up front or financed.

- Is there an application fee?

- Is the application fee refundable?

Some lenders have no application fee. Others may charge as much as $250 and may or may not refund it if the loan is not approved or if you decide not to take the loan.

- What are the closing costs?

The closing costs can total 2 to 4 percent of the loan amount. Most lenders can give you a form which estimates closing costs for your potential loan. This estimate may include the origination fees (for making the loan) and title changes and items (such as insurance and taxes) which must be paid at closing. There may be additional expenses that are not listed on the form, and some of the fees may be paid by either the seller or buyer. Ask the lender about any other possible closing costs, in addition to those on the standard form.

In general, the actual closing and document preparations may be conducted by an attorney or a title insurance company (usually at no additional charge if title insurance is purchased).

- Are there any prepayment penalties?

Today, most mortgages do not charge penalties for prepayment of principal. This is important if you later decide to sell your home or if you want to make extra payments to shorten the loan term.

However, loans with prepayment penalties may have lower finance costs. Such a loan may be a good choice if you do not intend to pre-pay or sell the home within the penalty period.

- Is the loan assumable?

An assumable loan can be passed on to the buyer of your home if you sell. It may or may not guarantee the same interest rate. Either way, the closing costs on an assumed loan are less than for a new loan, so that characteristic of a loan may help you sell your home in the future.

Today, fixed rate mortgages are rarely assumable. They have a "due-on-sale" clause. However, most adjustable rate mortgages are assumable.

- Is there a late payment charge?

Most lenders charge a late payment fee, but they vary in how much is charged and when the fee is imposed.

QUESTIONS FOR ADJUSTABLE RATE MORTGAGES (ARMS)

- Is the initial interest rate discounted?

- When and how will the interest rate ever change?

Some lenders (and builders) may offer very low initial interest rates to attract borrowers. At the end of a time span (usually one year) the interest

rate is raised to its normal level according to the loan agreement's formula.

Unless you intend to have the mortgage for only a short time, it is better to make comparisons based on the "formula" interest rate rather than the initial rate. But, if you plan to sell soon, the savings from the initial discounted interest rate can mean substantial savings for you.

- How often can the interest rate and payment amount change?

  In general, the shorter the rate adjustment period, the lower the interest rate and vice versa. Frequent adjustments are advantageous when rates are falling but offer less protection when rates rise.

- What is an adjustment index and when is it used?

  The interest rate of an adjustable rate mortgage follows a published market "index." Indexes based upon U.S. Treasury securities reflect true economic conditions. Indexes based upon "cost of funds" to financial institutions nationwide reflect what financial institutions must pay to attract deposits.

  In general, indexes tied to long-term indicators (such as three-year and five-year securities) are less volatile than those tied to short-term indicators (such as three-month Treasury bills). Long term is advantageous when rates are rising; short term is better when rates are falling.

- What is the margin?

  The margin or spread above the index determines what your mortgage interest rate will be at each adjustment date. The smaller the margin, the closer your interest rate is to the index rate and the less you pay. Remember that the same margin over two different indexes may produce two different interest rates — if the indexes are different.

- Are there periodic and life-of-loan rate caps?

  Rate caps limit how much the interest rate can rise or fall at the adjustment dates and over the life of the loan. In general, the lower the rate caps, the smaller the risk — but the higher the starting interest rate. Most ARMs today have 5-percent to 7-percent lifetime rate caps and 1-percent to 2-percent annual rate caps.

  It is a good idea to figure out (or ask the lender to provide) what happens to the monthly payment amount if: (a) rates rise to the upper limits of the caps (the "worst—case scenario") and (b) if rates drop 2 or 3 percent. This provides a clear picture of the risk and the realistic opportunity for savings if rates fall.

- Are there payment caps?

- Is negative amortization possible?

  If interest rates rise, payment caps (limits on your monthly payment) can change when the interest rate changes, causing your debt to grow instead of shrink. Loans which allow your debt to grow (negative amortization) are **low** rate because of their high risk. However, loans with payment caps can be structured with rate caps to avoid negative amortization.