Mortgage Basics

- What is it?
- Prequalification vs. preapproval
- Applying for a mortgage
- Mortgage brokers
- Private mortgage insurance
- Escrow account
- Closing costs
- Buydowns
- Mortgage life/disability insurance

What is it?

So you're ready to buy a house. You're probably going to need help financing such a large purchase, which usually means getting a mortgage. A mortgage is an interest in property, created by a written document, that secures the repayment of a loan. When you take out a mortgage loan to buy a home, the home becomes the collateral for the loan. If you don't repay the loan as agreed, the lender may take your property and sell it to satisfy the debt.

Prequalification vs. preapproval

When you prequalify for a mortgage, you get a mortgage lender's estimate of how much you can borrow. Prequalification does not guarantee that the lender will grant you a loan, but it does give you a rough idea of where you stand. Many lenders will prequalify you for a mortgage over the phone, usually at no cost.

However, if you're really serious about buying a home, you may want to consider getting preapproved for a mortgage. Preapproval is when a lender, after verifying your income and checking your credit, gives you a letter of commitment stating that you'll be given a mortgage up to a certain amount (as long as certain conditions are met). Lenders usually charge a fee for mortgage preapproval.

> **Tip:** Keep in mind that the mortgage you qualify for or are approved for isn't necessarily what you can afford. You'll first need to examine your budget and lifestyle to make sure that your mortgage payment will be within your means. See How Much Can You Afford? for more information.

Applying for a mortgage

Do your homework ahead of time

Before you apply for a mortgage, do some homework. Know how large a mortgage payment your budget will allow, and research the various types of mortgages that are available. You'll also want to obtain a copy of your credit report to make sure that there are no errors on it. See Choosing a

Mortgage for more information.

Shop around

Shop around among various mortgage lenders. Start out by looking in the real estate section of the newspaper and surfing the Internet for information on different lenders. Also, be sure to ask friends, family, and real estate professionals (e.g., attorneys, real estate agents) for references.

In addition to low costs and rates, you'll want to consider the types of loans each lender offers, whether the lender has a good reputation for loan servicing, and the type of loan approval process the lender uses.

> **Tip:** Typically, the better your overall financial picture, the better the loan terms you'll be offered.

The application process

Once you have decided on a particular lender, you'll meet with that lender and be asked to fill out an application. The application will give the lender information on areas such as your employment history, your income/expenses, and your assets/liabilities. You'll also be asked to provide the following documents:

- Bank account numbers, the address of your bank, and account statements from the past three months
- All investment statements from the last three months
- Pay stubs, W−2 withholding forms, or other proof of employment and income verification
- Proof of payment history on revolving debt (e.g., credit card statements, canceled rent checks)
- Information on other consumer debt (e.g., car loans, student loans)
- Divorce settlement papers, if applicable

> **Tip:** Having all of your documentation in order ahead of time will speed up the application process.

> **Tip:** You may also have to pay an initial application fee.

Once you have completed the application and supplied the necessary paperwork, your lender will submit the application for underwriting, which means that the information you supplied on the application will be verified and submitted to an underwriter for approval. It is usually at this time that the lender will order an appraisal and perform a credit check.

If your loan application is approved, you will receive a letter from your lender that outlines the terms and amount of the loan. You'll then work with your lender and other individuals (e.g., closing agent) to schedule a date for the closing. See The Closing Process for more information.

If your application is rejected, your lender will usually try to work with you to fix any problems and resubmit the application for approval. If you are turned down for a loan, keep in mind that there are many lenders that deal in loans for people who have poor credit, people who make low down payments, etc. Chances are you'll be able to find another lender that will be able to meet your needs.

Mortgage brokers

When you get a mortgage from a bank, credit union, or mortgage company, you deal directly with the lending institution. However, if you don't have the time to evaluate the various mortgage programs available, or if you think you may have trouble qualifying for a mortgage, you may want to consider working with a mortgage broker. A mortgage broker acts as a middleman and works with a number of banks, mortgage companies, and other lenders to find the best mortgage for you. Although using a mortgage broker will save you time, it will cost you money. Typically, broker's fees are as much as 2 percent of the mortgage loan (or more if you have poor credit).

Before you go ahead and choose a mortgage broker, take some steps to make sure the company is reputable. Ask for referrals from friends and associates. You can even call your state's banking regulatory agency to check your broker's record.

Private mortgage insurance

What is it?

Most lenders feel that borrowers who make low down payments (and therefore have little equity in the property) are more likely to default on a mortgage loan. As a result, they generally require you to purchase private mortgage insurance (PMI) if you are borrowing more than 80 percent of the value of the home you are purchasing (i.e., your down payment is less than 20 percent). PMI guarantees that your lender will be paid if you default on your mortgage.

> **Tip:** Some mortgages (e.g., VA loans) do not require PMI.

How much does it cost?

PMI premiums vary depending on the insurance company, but they are usually based on factors such as the type of mortgage loan and the loan amount. Although PMI can be expensive, you may be unable to qualify for a mortgage without it.

Can you cancel it?

If you are concerned about taking on PMI payments, keep in mind that you may not have to pay PMI forever. If you have a good payment history and reach 20 percent equity in your home, you can petition your lender to remove the PMI. For loans that originated after July 29, 1999, your lender is obligated to remove PMI once you have reached 22 percent equity in your home, provided you have a good payment history.

Are there any alternatives?

If you're confident that you won't default on your loan, consider asking if your lender is willing to increase your mortgage interest rate rather than require PMI coverage. Your monthly payment will

See disclaimer on final page.

increase by roughly the same amount as the monthly PMI premium. However, mortgage interest is generally tax deductible, whereas PMI payments are not.

> **Caution:** With this arrangement, you'll pay interest for the life of the loan. In contrast, you can generally remove PMI once you obtain a certain amount of equity in your home.

Another alternative to PMI is to obtain 80−10−10 financing, where a lender provides a traditional 80 percent first mortgage, and you then obtain a 10 percent second mortgage and make a 10 percent down payment.

See Private Mortgage Insurance (PMI) for more information.

Escrow account

An escrow account (also known as an impound account), is an account set up by a mortgage lender to hold money for escrow items that are due from a borrower, such as property taxes and homeowners insurance. If your lender has set up an escrow account for you, you will pay your lender for your escrow items in addition to your mortgage principal and interest. Your lender will then pay the appropriate parties for any escrow items on your behalf.

> **Tip:** Since the amount due for certain escrow items (e.g., taxes, insurance) can change, the amounts due in your escrow account can also change. This can cause your monthly payment to your lender to either increase or decrease.

Closing costs

What are they?

Closing costs, also called settlement costs, are the fees and other charges you pay to your lender at the closing or settlement. Closing costs generally include the appraisal fee, points, credit report fee, loan application/processing fee, recording fee, title search fee, and other expenses. Your lender is required by law to give you an itemized estimate of what your closing costs will be (known as the good faith estimate of closing costs) shortly after you submit a mortgage application.

How much are closing costs?

On average, closing costs amount to approximately 3 to 7 percent of a home's selling price. Keep in mind that while some lenders advertise "no closing costs" loans, these loans often roll the costs into your overall loan balance or charge a higher interest rate.

> **Tip:** Your lender may allow you to either pay your closing costs up front or finance them.

Buydowns

A buydown is when a lender is paid points (interest that is paid up front) in exchange for a lower interest rate on a mortgage. Buydowns can either permanently or temporarily reduce the interest rate. Some even work on a graduated basis. If you are considering a permanent buydown option, it is important to first determine whether or not it would be worthwhile. You can calculate your break−even point by determining how many months it would take for the money you'd save with a buydown to exceed the cost of the points you paid.

Mortgage life/disability insurance

Mortgage life insurance pays off your mortgage if you die, while mortgage disability insurance covers your mortgage payments if you become disabled. Mortgage life/disability insurance may be appropriate if you want to make sure that your family would be able to continue to make mortgage payments if you were to die or become disabled. It is important to note, however, that there may be other, more affordable ways to provide this type of protection (e.g., individual life and/or disability insurance policies). Consult an insurance professional for more information.

See disclaimer on final page.

Final Page - Disclaimer

See disclaimer on final page.