Home Loans

Insider information that can save you thousands $$$$

Some people who can pay cash for their homes may find compelling advantages in getting a home loan (mortgage.) For most of us, paying cash is not an option, (at least for a home we would want to occupy,) and we will be looking to a lender to provide a home loan, usually referred to as a mortgage loan.

This business relationship benefits the new homeowner by allowing them to buy a more expensive property and repay the loan over time. The lender benefits by earning interest and having your property as collateral. The large majority of real estate purchases include a mortgage loan, even for folks that can pay cash.

There are virtually thousands of different loans available, spending some time discussing your needs with your agent and lender will help you secure a loan tailored to your particular needs. The most common loan is a 30-year fixed rate loan, primarily because it is very simple. There are loans that are fixed in the interest rate or variable or fixed for a period and then later adjusted to the market (variable.) You can get loans for different periods, generally any number of years up to 40. You can get loans that have biweekly, monthly and annual payments. You can get loans with low, high and no down payments. It is the process of combining these variables into one loan that allows you to choose the loan that woks best for you.

Pricing loans

The lender will ***price loans according to the risk they perceive***. You see, a lender will be assessing what the likelihood and they will work something like this:

The higher your down payment, the less risk to the lender. This enables the lender to offer a lower interest rate. In fact, lenders will require loans with less than 20% down payment, to have mortgage insurance, which protects the lender if the borrower defaults, but adds to the borrower's monthly payment.

The shorter the length of the loan (15 years vs. 30 years) the less risk that the lender will have their money tied up in your loan if interest rates rise. So, the shorter the length, (term) the lower your interest rate.

Variable rate loans initially are lower interest rates than fixed rate. They are great when rates stay low, or the borrower is not likely to have the loan for more than 5 years or so. The lender can offer lower rates on these loans because if rates go up, so will the rates on their loan. In this way they do not have to "hedge" their rate as they do in a 30-year fixed rate. Variable rate loans are generally limited to how high they can go, how much and how often they can be adjusted.

Fixed rate loans are popular because they are safe. You know what your payment will be until it is retired, come-what-may, no surprises. These loans are particularly attractive for properties that will be held for a long period of time.

Other risk factors considered by the lender are:

* Credit-worthiness, those borrowers that have great credit, and secure income sources will enjoy better rates.

* Conformity of property, properties that are unusual or "one of a kind," are not as desirable as collateral, and rates on these properties will be higher.

Interest Rates

"Today's" interest rates are constantly changing, and in a simple explanation of competition, reflect the balance between how much money is available to lend, and how much money is being sought by borrowers.

* Rates are "discounted" (lowered) for loans that represent less risk, whether they are to more credible borrowers, offer stronger collateral, or shorter terms.

* Rates are set to a "premium"(raised) to offset the additional risks of low down payments, or long term fixed interest rates.

Length of Loan, or Term

Repayment of a loan can be of any length up to as long as 40 years. In each payment you make there are two parts, the interest and the principal. The longer the period you choose to pay the loan, the less you are contributing on each payment to the reduction of principal, so your monthly payments are lower. Lower payments also allow a borrower to qualify for a higher loan amount. The trade off here, are more payments, and more interest paid.

Loan Amount

How much will lenders loan? Lenders calculate the **maximum** amount they are willing to lend an individual based on the following formula:

The monthly payments including principal, interest, property tax and hazard insurance (PITI) shall not exceed 28% of the borrowers gross income **or**, the PITI monthly payment plus installment debt payments (car loan, student loans, child support, alimony, credit cards, etc.) shall not exceed 36% of his/her gross monthly income, whichever is less.

Let's take a look at a family for example. In this case, income is $10,0000 per mo. gross, property taxes are $250/mo., hazard insurance is $75 per month, interest rates are 8% for a 30-year fixed rate loan, and the family will be making a down payment of 20% (no mortgage insurance required).

* Income is $10,000 x 28%=$2,800 Maximum monthly payment (PITI)
* Deduct $250 for property tax, and $75 for hazard insurance = $2,475 per month
* This is the maximum amount available for principal and interest payments.
* $2,475 is the payment for a 30-year, 8% loan of **$337,300** (calculated on financial calculator)
* Add in the down payment of 20% and these folks can purchase a property priced up to **$421,600.**
* They can purchase a more expensive home by increasing their down payment, but the lender stops at $337,300.

What if the family has some other debts?

* Consider that their income x 28% is $2,800 (front ratio), x 36% is $3,600 (back ratio).
* The difference between $2,800 and $3,600 is $800.
* This means that they can have up to $800 per month in other debts before it will begin to compromise the maximum loan amount of $337,300.
* For each dollar their monthly income exceeds $800, their "qualifying" monthly payment of $2,475 is reduced by a dollar. The lower their "qualifying" monthly payment, the lower the maximum loan.
* The higher the interest rate, or shorter the term, the less the "qualifying" monthly payment will borrow.

These guidelines are used by most lenders, ***but are not cast in stone***. Often times there are *"mitigating circumstances"* that allow lenders to stretch these guidelines. The best way to determine you maximum borrowing capacity is to spend 30 minutes on the phone with a lender recommended by your agent, and let them tell you based on your situation and preferences.

Loan Types

Conventional loans comprise the largest percentage of mortgages, and there are FHA and VA loans too. HUD insures FHA loans, while the government guarantees VA loans. Both VA and FHA loans are designed to allow buyers to purchase entry-level homes with low down payments, and more flexible qualifying terms.

Most loans, FHA, VA and Conventional loans, will be originated by a lender, pooled with others, and immediately sold to investors (secondary market.) This sale returns the cash to the lender so they can now make more loans. Because most lenders have their eye on selling your loan, they will want to make sure the terms of the loan they provide are within the guidelines of the loan purchaser. Otherwise, they get stuck holding your loan, a place they don't want to be. When loans are turned down, it is not because the lender doesn't want to make the loan, they do, that is how they make money. However, if they feel they cannot sell the loan later, they will refuse the loan.

Some lenders make what are called "portfolio loans." These are loans that make sense, but may not meet the guidelines of the secondary market. In this case, these lenders will make the loan and keep it for themselves (in-house).

Down Payments

This is the amount the borrower is investing into the purchase of a property. The larger the down payment, the less risk to the lender. In loans that involve down payments of less than 20% of the purchase price, lenders will require mortgage insurance.

When a lender makes a loan on a property, they are first asking themselves, *"what happens if the borrower fails to pay?"* The lender will protect themselves by place a lien against the property for the amount of the loan. If the borrower fails to pay (defaults) the lender can foreclose, boot the borrower out, and take possession of the property. If the lender then has to turn around and fix up the property and pay an agent to sell it, that will cost money. They estimate that they will be able to cover the cost of foreclosure and reselling the property with your 20% (or more) down payment (equity position.) If you place a down payment lower than 20% on the property, the lender will have you purchase an insurance policy, to cover any shortfalls in the event of a foreclosure.

Until recently, many lenders offered as a minimum, down payments of 5%. Today lenders are offering loans with **down payments of ZERO percent.** In fact, lenders are making **mortgage loans up to 125% of your purchase price!**

This sounds crazy, and maybe it is, but let's not fear for the lenders, they know what they are doing. First, if you are the borrower that wants a zero down payment because you have zero down payment, forget it. This program is for the folks that can make the down payment but prefer to borrow more (this actually makes sense and we will discuss why and when later.) The loans for up to 125% of you homes value are tools that allow lenders to combine your mortgage, student loans, credit card balances, medical payments, etc. into one, **secured** loan.

For example, instead of a lender making a $80,000 mortgage loan on a $100,000 property secured by a first mortgage lien, and carrying another $45,000 in unsecured loans, the lender can make one loan of $125,000,

secured with a first mortgage lien on your property and insured. In the event of a bankruptcy, this lender holds a secured debt as opposed to an unsecured debt.

Locking a loan

We already pointed out that loan rates fluctuate all the time. If you apply for a loan today, it is possible that the rate will be different in the time elapsed until you close your loan. If the rate goes up, you may not be able to qualify for the loan you need. To help borrowers sleep at night, lenders have offered loan lock programs that allow them to "lock the loan" at today's rate regardless of market fluctuations up or down. Lock rates will differ depending on the length of their coverage. Typically, the longer the lock period, the higher the rate or, you may be asked to pay a non-refundable lock fee.

Choosing a lock fee or not is all about your personal tolerance to risk. Realize, if the rates fall at the time of your closing, you will likely be at a higher than market rate. Conversely, a rise in the market will allow you a below market rate.

Please remember that **a loan lock should** *always* ***be in writing,*** and a lock promise is only as good as the word of the lender that offered it. This is another good reason to always use the lender referred by your agent.

Sellers providing home loans

Some sellers may be excellent candidates for your next home loan. When a seller that owns a property free and clear sells, they often receive their proceeds all at once, in cash. In many circumstances, they will be taxable on the capital gain they experienced on the property. The typical seller then pays tax on their gain, leaving a diminished after tax balance for reinvestment into a savings account or similar investment. However, if the seller offers the new buyer a home loan, they will not be immediately taxable on their "gain" because they have not yet received it. The money they loan the buyer is secured by the property, and now all of their before tax equity is earning interest at a mortgage rate, which is higher than typical investments. The seller also receives the down payment, and monthly payments (mostly interest) which they tend to enjoy.

Assuming loans

Assuming a seller's existing loan is one way to reduce new loan origination costs, and take over attractive rate loans. In some cases, there are no qualifying guidelines, which can work well for people that cannot get a new loan. These non-qualifying assumptions, are for FHA loans originated before Dec. 18, 1989. Needless to say these loans are rare.

Most conventional, and current FHA loans have a provision called "due on sale" clause in the mortgage note that allow a lender to call a loan due upon the transference of property ownership or interest. This is unfortunate, as many conventional loans originated in the 90's are at very low interest rates. In some circumstances, **these loans may be assumed by the purchaser**, even though the terms of the loan do not allow it. This type of transaction can be **very attractive to the purchaser**, and save them thousands of dollars. **A seller offering this advantage may be able to sell their property at a premium**. However, to effect a transaction like I am describing, takes very special knowledge held by very few agents, and a carefully prepared agreement by one of just a few attorneys familiar with making this strategy legal.

Why get a home loan if you can pay cash?

Many savvy financial minds choose to get a home loan even though they could pay cash. They have discovered that the interest paid on their mortgage is, after the mortgage deduction tax saving, fairly inexpensive. **An 8%**

mortgage really only costs 5.3% to a person in the 28% tax bracket (5% state.) So the question to them is simple really, if they could borrow money at 5.3%, could they reinvest it at an equal or higher return? Usually the answer is yes! In addition to making more with their investments, they also enjoy the liquidity of cash over equity in a property. Equity in a property is nice, it feels good, but it just sits there. Equity is like putting money under your mattress. Remember, a property will appreciate whether it is free and clear or mortgaged to the hilt.

How do lenders get paid?

You can pay attention, or you can pay cash. Everyone wants a good deal. Let's take a look at what makes a deal (loan) good. First let me assure you, the lender is not your friend, they are not helping you, they represent only themselves. Lenders are not licensed, or regulated. Therefore, a referral from your agent that does repeat business with this lender can help you gain some control and leverage. This referral should also be based on exemplary past performance. After all, the biggest frustration likely to occur in any real estate transaction, is a problem with the lender/loan. Bear this in mind if you are considering a lender other than one(s) referred by your agent.

The obvious places a lender gets paid will be shown on the settlement statement, and listed in the Good Faith Estimate they are required to provide you up front. Typical fees will be loan origination, usually 1% of the loan amount, garbage fees, like underwriting fee, document preparation, administration fees, courier fees, etc. Pay attention to high appraisal and survey fees (as these people could be kicking cash back to the lender.) These fees will be a part of a loan, more with some lenders than others, so compare these as best you can. However, **where lenders can get you the most, is where you won't see it, and when you are most vulnerable.**

You see, when you shop interest rates, lenders know it, and some will tell you what you want to hear. They may even promise you loan terms that they cannot provide. This is how it works.

You shop rates on the phone until you find XYZ lender offering a rate 1/4 % lower than the others, and you start your loan application. You may be asked to pay for credit report and appraisal fees up front which is usual. You may be even told that your loan rate is "locked." Everything is going great, your stuff is on the moving van, your closing is set for in few days, and all of the sudden, the "everything is great," turns to, "we have a few issues to resolve", to "we have a problem." It would seem, that the lender is now moving heaven and earth to make things work for you, and they have just found another loan program for you. Relieved that you can regain your schedule, you may only at the closing discover, that there are some fees with this "new" loan that were not a part of your original Good Faith Estimate. And well, your interest rate is a bit higher too, because rates have gone up a bit, it's only $71 a month, but after all, this is a new loan, and your lender is doing you a "*big favor*". Frustrating, but you are stuck, lacking the time to start the borrowing process over. That extra 1/2% or so your interest rose, was not the market fluctuation, it was the premium the lender will realize on this loan's sale, it could be thousands. $71 a month, over the life of the loan is $25,500! It happens all the time. Choose your lender wisely.