REAL ESTATE CENTER

Consumer's Guide to Mortgage Finance

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Every year, thousands of Texans buy homes. The majority finance these purchases with mortgage loans. But as many consumers will testify, finding the right type of loan with reasonable terms and a good interest rate, and applying for the loan can be confusing and intimidating. This guide is designed for the homebuyer who would like to make an informed decision when financing a home. It covers how loan applications work, who makes loans and how mortgage loans can be tailored to different situations.

What Happens When You Apply for a Mortgage Loan?

At one time, mortgage lending was a local affair. To obtain a loan, homebuyers went to a local savings and loan association. The money came from other local residents who deposited their savings in the association for a modest return on their investment. Until the loan was paid off, the homebuyer continued to deal with that local association.

Today, a homebuyer may still get a loan from local lending institutions. However, most of the time the loan will be sold to a national organization and used as collateral for securities sold to investors all over the world. Often the loan is insured by a large national corporation or federal government agency. And the company that collects monthly payments and sends out annual statements may change several times over the life of the loan.

What does this mean to the person trying to obtain a loan? First, it means that the homebuying process is less personal. Your ability to get a loan depends less on how well you know the loan officer and more on your income and credit history. But it also means a better chance that a loan will be available when you need it, and that you will be able to choose from a greater variety of loans, including some aimed at individuals with poorer credit ratings. There are more ways to apply for a loan, some of which are much faster than previous methods.

Second, the changes in mortgage lending mean that a certain amount of savvy on the borrower's part can pay dividends, making it increasingly important that you, the consumer, be well informed. If a special type of loan is needed, do you know the best places to find it? How can you improve your chances of getting the loan you want? When you apply, should you lock in the interest rate? Should you pay discount points? Is private mortgage insurance (PMI) a good deal?

Origination and Underwriting

Loan *origination* is done by the lender and includes gathering information required to support the loan approval decision, the loan approval decision itself and issuance of a loan commitment. The loan application is completed after a sales contract is signed. The sales contract indicates the amount of the loan needed and when the loan will be closed.

When you apply for a mortgage loan, you will answer questions about your financial situation and the home you wish to purchase. You will authorize the lender to obtain information from your employer and bank about your income and deposits. Usually, you pay a loan application fee. A portion of that fee may go toward processing the paperwork involved, but the bulk of the fee pays for a copy of your credit report and an appraisal of the home you wish to buy.

A mortgage loan requires a long-term commitment from both borrower and lender. The lender must carefully evaluate the probability that the borrower will repay the loan on a timely basis. In some cases, lenders approve loans on the condition that the borrower will obtain insurance protecting the lender in case of default. A default occurs when the borrower fails to abide by the terms of the mortgage contract, most often by becoming delinquent on the monthly payments.

The lender must provide money to *fund* the loan. When the sale is closed, the lender must provide cash to satisfy the seller's contract price, less any down payment made by the borrower. Once the loan is closed, the borrower begins to incur interest on the loan, and the lender must set up a procedure to collect payments from the borrower, maintain any escrow accounts required to pay insurance premiums and property taxes and keep accurate loan records. These tasks are called *servicing* the loan. In today's market, loan origination, funding and servicing may be conducted by different companies and accomplished in different ways. There are things you should know about each of these processes.

Lender criteria. Lenders have specific criteria for new loans. They want borrowers who have a history of meeting financial obligations. Each person's bill-paying record is contained in a credit report compiled by companies that specialize in creating

and maintaining credit reports. Based on your credit report, you will be classified into one of several letter-grade classes of credit risk (see "Credit Scores"). Many lenders accept only the highest-rated borrowers, but others will make *sub-prime* loans at higher interest rates. If you have no credit record, you probably will be classified with those having bad credit, making it more difficult for you to get a loan.

Lenders also want the loan to be a reasonable financial burden for the borrower. That is, if they consider the monthly payment unaffordable, they will not approve the loan. Generally, lenders apply a two-part test to borrower income. First, they compare the borrower's income to the monthly payment, including payments to an escrow account, alone. Payments should represent no more than 25 to 30 percent of your gross monthly income. Then they add in payments on all long-term obligations the borrower has previously undertaken (such as auto and educational loans). Together, all debt payments should not be more than 35 to 40 percent of gross monthly income. If either of these ratios is too high, the loan may be disapproved.

If you have had credit problems or have been a slow payer in the past, there is not much you can do to improve your credit score despite what some "credit repair" companies claim. If you think your credit report contains errors, it is your right to get a copy and challenge any information found (see Credit Scores sidebar). If you have never borrowed money, you may want to take out a few small loans and repay them to establish a credit history. Obtaining a credit card also establishes a credit record.

Increasing your qualifying income is difficult. Lenders tend to discount or disregard income sources such as capital gains that are not reasonably expected to continue into the future. All income sources must be fully documented. Obviously, any debt you can pay off will boost your chances to qualify. If you have more than enough income to qualify for your mortgage loan, you may not want to list every source.

The lender will have the home appraised to determine how much security is available to back up the loan. Appraised value is used to calculate the *loan-to-value ratio,* which compares the amount borrowed to either the appraised value or sales price of the home, whichever is less. If you agreed to pay more than the appraised value, you may need to come up with additional cash because the loan will not be based on the price you paid. Lenders like to keep the loan-to-value ratio no higher than 80 percent. However, higher amounts can be borrowed when the loan is insured against default. This type of insurance is discussed in detail later.

Pre-qualifying and pre-approval. You can complete part of the loan approval process before you sign a sales contract. In fact, it benefits a prospective homebuyer to get *pre-qualified*. Pre-qualifying is a quick estimate of how much you can afford to borrow based on your income and debt situation. This helps you narrow your search to homes in a price range you would probably qualify for.

Lenders commonly provide pre-qualifying at no charge and may be able to complete the process over the telephone. However, pre-qualifying does not necessarily mean that you will be approved for a loan; it merely means the income you reported would normally allow a person to secure a loan for the stated amount.

A more involved process is *pre-approval*, in which a lender commits to making a loan up to a specified amount. The pre-approved borrower knows how much house he or she can afford and has a valuable negotiating tool, because the seller is assured the sale will go through once an agreement is reached. Pre-approval may require payment of a fee and requires more time to complete.

Credit Scores

Lenders have access to the credit records of individuals applying for loans, but they need some way to make sense of the data. They also need a method of evaluating the data that can be shown to be objective without taking into account personal characteristics such as race, ethnicity and sex. A person's tendency to default on a loan is measured by their credit "score." Most methods for computing credit scores consider the following:

- How much of the credit limit extended does the applicant use? The closer to the maximums, the more risky the debtor is considered.
- Is there any history of delinquencies and defaults? Obviously, if someone has abused credit in the past, they are likely to do it again, unless an extenuating circumstance prevailed, such as job loss or a run of unusual expenses.
- How long has the person used credit? Someone who has been borrowing money for a number of years is considered less risky than someone who has never borrowed before.
- How many times has the person requested credit? Someone with many credit cards and accounts may be too dependent on borrowing to make ends meet. This is why it's best to apply for credit only when you really need it, rather than accepting every credit opportunity extended to you. Recent improvements keep the scoring method from penalizing people who get several credit checks in the process of shopping for the best price. Multiple inquiries and applications within a 14-day period count as one application.

The scoring system assigns a numerical value to each factor and compiles an overall total. Under the Fair Isaac Company's system, the highest FICO score is 850. A score of 720 usually qualifies the borrower for the best interest rates and loan terms.

You are entitled to a free copy of your credit report if you are denied credit because of information in your report. You can get a copy of your FICO score from myfico.com for $12.95. Also available from the site is a service that shows how you can improve your score and one that alerts you via e-mail when your score changes.

Applying with little documentation. People who are self-employed or do not have a steady, verifiable income will have trouble getting a regular mortgage loan because documenting income is a big part of the loan-qualifying process. For those borrowers, there are *low doc* and *no doc* loans. As the names suggest, these loans require much less documentation than normal.

All loans require a credit check and appraisal. A low-doc loan may need verification that you have the money to make the down payment and enough income to make monthly payments (a bank statement and a pay stub). A no-doc loan needs no verifications.

To qualify with little or no documentation, a spotless credit record and a large down payment (at least 20 percent of costs) are needed. In addition, the interest rate may be one-half to 1 percentage point higher.

Mortgage insurance and guarantees. Borrowers may purchase mortgage insurance, which protects the lender in case of default and foreclosure, from two primary sources. The Federal Housing Administration (FHA), a part of the U.S. Department of Housing and Urban Development, insures loans made by private lenders. These loans are commonly called *FHA loans*. In addition, a number of private firms insure mortgages with private mortgage insurance (PMI). These are called *conventional* loans. Although both types of insurance work to reduce the amount of cash a borrower needs to buy a home, there are fundamental differences between the two.

- FHA qualifying criteria are a bit more lenient. A standard PMI loan requires monthly payments on total debt to be no more than 36 percent of gross income, FHA allows as much as 41 percent.
- FHA insures the whole loan, while PMI covers only a specified percentage of the loan. If the home is foreclosed, FHA usually buys the property for resale. The PMI company need only pay out damages incurred by the lender as covered in the insurance contract.
- FHA insurance cannot be written for loans exceeding a specified amount. This limit is intended to target the program to younger and lower-income homebuyers. The limit is periodically increased as home prices rise, and higher limits are set in areas with especially high home prices.
- In most cases, you can buy a home with less cash using an FHA loan than with a conventional (PMI) loan. The maximum loan-to-value on an FHA loan is more than 97 percent, and many closing costs, including the insurance premium, can be financed. In recent years, a special group of conventional loans have been created that also allow low down payments.
- The process by which premiums are charged differs significantly. For a conventional loan, the borrower may pay the entire premium at closing, pay an annual premium in monthly installments or pay a monthly premium. The amount of these premiums varies depending on the loan-to-value ratio, how much coverage the lender requires, whether the loan interest rate is fixed or adjustable and the term of the loan.

  Premiums may vary among companies. FHA loans require a premium at closing as well as a monthly premium (many borrowers finance the up-front premium). The *up-front mortgage insurance premium* (UFMIP) is 2.25 percent of the loan amount but can be reduced to 1.75 percent for first-time buyers willing to take a special homebuyer's seminar. The *monthly insurance premium* (MIP) is based on one-half percent of the outstanding balance per year.
- When conditions warrant, PMI can be cancelled, but FHA insurance may run the entire term of the loan. Under federal law, PMI companies must notify borrowers that they may cancel the insurance when the value of the home reaches 20 percent more than the loan balance.

  When value is more than 22 percent higher, the insurance is automatically cancelled. For the borrower, this means that premium payments stop (the up-front payer may be eligible for a refund). FHA coverage cannot be cancelled until the loan is repaid. However, the monthly premium runs for a limited time according to the loan-to-value ratio of the loan. At some point, the monthly premiums stop regardless of the home's current value.

Guaranteed loans also require lower down payments. The most common type of guarantee is provided by the U.S. government through the Veterans' Administration (VA). Military veterans who served during times of armed conflict are eligible for an entitlement that can be used somewhat like a down payment. VA loans have low down payments, and often a zero down payment, because of this entitlement guarantee. There is no limit to the loan amount, although larger loans require more cash down, and no premium for the guarantee.

Mortgage Application, Approval and Commitment

When you decide on a particular lender, you submit a loan application and, if necessary, pay an application fee. At the time of application, the lender may issue a *conditional commitment* to make the loan. This commitment means the lender will make the loan for a specified amount of money under certain terms, conditional on the borrower satisfying the requirements of the lender. The lender processes the application by reviewing your credit history and financial resources and checking to see if your credit risk conforms to its acceptable loan standards. The home is appraised to see if it is valuable enough to back the loan.

If your credit rating is too low, the lender will reject the application. Some lenders will make loans to borrowers with less than "A" credit status, but the terms of the loans reflect the increased risk for the lender. These loans are sometimes called *subprime* loans.

If the home is appraised for less than the sales price, the amount of the loan may be reduced, requiring you to come up with a larger down

payment. Another alternative would be a higher loan-to-value-ratio loan.

If the lender decides to make the loan, a *letter of commitment* is issued. This document states the lender's intention to fund a loan of a specified amount with specified terms. The lender may guarantee a specific interest rate at the time of application.

Often, you are given the choice of *locking in* the rate, which means you are guaranteed that rate even if rates rise before you close on your house. The down side of locking in a rate is that you must accept that rate even if interest rates fall before you close. A borrower could lock in a rate and choose to refuse the loan, but that would require that the application process be started over, including payment of another loan application fee.

The lender may or may not charge a fee for locking in the rate. If the borrower chooses to let the interest rate *float*, he or she must accept the current rate at closing. Some lenders offer loans that, for a fee, allow the borrower to get a lower rate if market rates decline during the approval period, yet lock in the offered rate if rates rise during the period.

Lock periods may vary, and the lender may require a slightly higher interest rate for a longer lock period. For example, a 30-day lock may be offered at an interest rate 1/8 of a percent more and a 60-day lock at a 1/4 of a percent above the no-lock rate. The cost and availability of locks should be ascertained as part of the loan-shopping process.

Loan disclosures and information. Mortgage lenders charge a number of special fees for the origination and funding of a home loan and require several services for which the borrower is charged. These charges are generally due at closing, with the exception of application fees. These fees add to the overall cost of the loan. Knowing the total *closing costs* is important in selecting a lender and type of loan.

To help borrowers compare loans, the federal government requires home loan lenders to provide certain information to borrowers, including:

- a good faith estimate of closing costs,
- a Truth-in-Lending disclosure of the full cost of the loan and
- other specified details about the loan contract.

The *good faith estimate* itemizes the costs you will be expected to pay (or negotiate with the seller to pay) at closing. Among closing costs commonly charged to the buyer are:

- *Points and origination fees*. Each point equals 1 percent of the amount borrowed. These fees represent additional interest income to the lender. Usually, the more points you pay, the lower the interest rate on the loan. If you are short of cash, look for a zero-point loan.
- *Loan application fee*. This is usually paid at the time of application and may include a charge for ordering a credit report and to have the home appraised. In some cases, the fee may cover only processing costs, with charges for the credit report and appraisal paid separately at closing.
- *Document preparation fee*. This is a nominal charge to cover the paperwork costs of the loan approval process.
- *Prepaid interest*. The first loan payment often is not due until the first of the month after the first full month of the loan term. This interest charge covers the period from closing until the start of that first full month.
- *Escrow account*. Many lenders require that account maintenance be used to pay annual property taxes and hazard insurance premiums for the home. This escrow account is funded by a monthly charge added to the mortgage payment. To get things started, a contribution to the fund is required at closing to provide a two- to three-month cushion over the expected amount needed to pay the bills when they arrive.
- *Title insurance*. The lender will require title insurance coverage, which is described later in this section.

The cost of the loan is expressed in two ways. Lenders are required to disclose a *finance charge* when making a loan. This charge is the amount of cash you will pay to secure the loan, including discount points and any other charges at closing associated with the loan. Not included are the expenses you will have to pay to buy the home regardless of how it is financed, such as title policies, inspections and prepaid insurance premiums.

The second way that loan cost is expressed is the *annual percentage rate* (APR). This rate may be different from the rate quoted by the lender and specified in the loan contract. The APR is the "true" cost of the loan expressed as an interest rate, taking into account any discount points paid. The APR provides a more accurate basis for comparing loans than using the contract rate alone. If the loan requires mortgage insurance (either PMI or FHA), the premiums are not reflected in the APR, even though they may be collected as part of the monthly payment.

The lender is required to disclose other items of information, including:

- The number of payments and when they are due.
- Rules for any late payments or prepayment penalties that may be charged. A fee may be charged for payments made after a specified grace period. Prepayment penalties may be charged when you want to pay off some or all of the loan balance before it is due.
- An account of the total amount financed, including any closing costs that may be included in the loan.

Discount points and origination fee. Mortgage loan terms often are quoted with *discount points* or *points* (for example, 7 percent plus 2 points). Points are essentially prepaid interest. In other words, when points are charged, the price of the loan is higher. Each point represents 1 percent of the loan amount (one point on a $100,000 loan costs $1,000). Points are paid by the borrower, unless the seller agrees to pay, at closing.

Discount points can be added to the interest paid during the year of loan origination and used as an itemized deduction for federal income taxes. Points paid to refinance an existing loan cannot be deducted in one year; they must be spread over the life of the loan.

Let's say you are approved for a loan of $100,000 at 7 percent interest for 30 years. The lender charges two points. The lender will discount the loan amount by 2 percent ($2,000, the amount equivalent to two points) and deliver $98,000 in funds at the closing. If the price of the home is $120,000, you must provide $20,000 in down payment cash and another $2,000 to make up the difference between the price and the loan proceeds. However, the monthly principal and interest payments are calculated on the full $100,000 ($665.30 per month in this case), and $100,000 of the total amount paid over the life of the loan will be considered repayment of principal.

In some areas, it is common practice for lenders to charge one or more *origination points* as a fee for making the loan. Origination points are not related to the interest rate in the same way true *discount points* are. Origination points cannot be deducted from taxable income.

Title insurance. When a home is financed, the lender often requires that a title insurance policy be taken out and paid for by the borrower. This is a specialized type of insurance that protects the lender from loss in case someone lodges a successful ownership claim to the property during the term of the loan.

People can have legitimate claims to property for a variety of reasons. They may be vendors or contractors who were not paid in full, a spouse of a former owner who did not legally relinquish all ownership rights when the home was sold or a lender whose lien was never released.

Whenever a change in ownership occurs or a lien is established, that fact should be recorded at the county courthouse. This establishes a public record that indicates the chain of ownership for the property. Attorneys conduct title searches of the public record to support a seller's claim of delivering clear title to the property.

However, the system has flaws. Legitimate claims can exist without being revealed in the record. A title search is no protection from such claims, which is why lenders insist on title insurance. The insurance company incurs any losses caused by title flaws.

The buyer-borrower customarily pays the premium on the title insurance policy that protects the lender. For an additional premium, the title company will write a policy protecting the buyer in the same way. It often is recommended that this type of policy be taken out as the lender's policy pays only up to the amount of outstanding mortgage debt. Without additional protection, the homeowner could lose any equity invested in the home. Often, the seller pays the premium for this policy as a way of enforcing the warranty deed issued at closing.

The premium is a one-time amount paid at closing. The policy remains in effect as long as the ownership interest of the beneficiary (either the lender or the buyer, depending on the policy) exists. In other words, if the loan is refinanced with another lender or if the property is sold, a new policy will be necessary.

Loan Servicing

Once a loan is approved, *closing* is scheduled. On closing day, title to the property passes from the seller to the buyer. The seller must receive the full price of the property, less any expenses he or she has agreed to pay. When lender financing is used, the lender pays out the proceeds of the loan at closing, making closing day the first day of the loan term. The lender begins earning interest that day.

Payment schedule. Payments on most mortgage loans are paid *in arrears,* meaning they are paid after interest has accrued. An exception to this occurs at closing, when the lender requires payment of the interest that will accrue from closing to the beginning of the first regular payment period. Most lenders make the due day for loan payments either the first or fifteenth day of the month. A payment due on the first of the month pays the preceding month's interest.

To illustrate, let's say you close on January 22, and payments are due on the first day of each month. Because payments are in arrears, your first payment is due March 1. The lender wants the first payment to be equal to all the others, except for changes in escrow payments, which will be explained later. At closing, you will pay the lender prorated interest that will accrue from January 22–31, a period of ten days.

Loan servicers. In today's market, it is common for the lender originating the loan to sell the loan to another lender, an investor or mortgage *conduits,* which are specialized companies that buy loans and use them to back securities sold in the bond markets. You probably will not know when your loan is sold. More than likely, you will continue to make payments to and communicate with the original lender.

In such a case, the originating lender makes an arrangement with the buyer of the mortgage to provide the *servicing* on the loan. The servicer collects monthly payments, maintains the escrow account, reports interest paid and principal balance information to the borrower and handles any problems concerning the loan. In exchange, the servicing lender collects a fee equal to a percent of the loan balance.

Some companies that specialize in servicing, rather than originating, loans buy servicing contracts from lenders and other companies. When the servicing contract is sold, the borrower is informed of the sale and is instructed to begin sending payments to the new company. Because there are reported cases of borrowers being sent fraudulent notices instructing them to begin sending payments to a new address, **you should never send payments to a company unless the original servicing company instructs you to do so.** It is always wise to contact your current servicer to make sure the servicing change is legitimate.

Escrow accounts. Many mortgage lenders require the borrower to deposit money in an *escrow account,* from which expenses related to the property, such as hazard insurance premiums and local property taxes, are paid. The lender maintains the account and pays premiums and taxes as they are due, thus protecting its interest in the property. If a borrower failed to pay the premium on a homeowner's policy or failed to pay property taxes, the property (which is the lender's collateral) could be lost in a fire or a suit for back taxes.

The lender monitors the escrow account to ensure sufficient funds are in the account to pay bills when they are due. An estimate of the amount and due date of each payment is made. The borrower is required to deposit

money in the account at closing and make a contribution to the account with each monthly mortgage payment. The full mortgage payment, including the escrow contribution, is referred to as *PITI*, which stands for principal, interest, taxes and insurance.

Some lenders require the account to have a cushion equal to two to three months of contributions, in case expenses are higher than anticipated. If for any reason the account does not contain sufficient funds to pay the bills, the borrower is required to make up the shortage, either with a lump sum payment or an increment added to next year's monthly contribution.

Some lenders allow borrowers to make their own insurance and tax payments without an escrow account. As compensation, the lender may require a slightly higher interest rate or discount points. Though the lender saves the expense of managing the escrow, it loses potential income that could be derived from the funds in the account.

While lenders rarely pay interest on the escrow account balance, many borrowers still prefer having an escrow account to paying the bills themselves. Doing so allows property taxes and insurance expenses to be spread throughout the year in monthly payments and means the lender is responsible for keeping track of when the bills are due. Some lenders require escrow accounts on new loans but drop that requirement after the loan matures.

Escrow accounts are managed by the company servicing the loan. When servicing is transferred to another company, you should find out what bills have been paid by the former servicer. A statement should be received from both the former and new servicing company listing all bills paid and how much remains in the account. At the end of the year, you should receive statements of interest paid and the remaining balance from both companies. Remember that your total interest paid during the year, which is deductible, is the sum of the amounts reported on these two statements.

Mortage insurance premiums. Another fee often added to the monthly payment is *MIP*, mortgage insurance premium. If your loan is insured, you pay a premium for that insurance. Recall that two basic types of mortgage insurance are available: FHA insurance and PMI coverage. Although they serve the same purpose for the borrower, there are differences in the way premiums are charged. FHA requires an up-front premium that may be financed into the loan **and** a monthly premium added to the payment. PMI can be paid in a variety of ways, but most borrowers make monthly payments collected along with PITI.

FHA premiums run for a pre-established time, depending on the original loan-to-value ratio of the loan. Premiums for PMI loans run as long as the insurance stays in effect. However, at some point the loan balance will decline, and the value of the home appreciates to the point that insurance coverage is no longer needed. When that point occurs, the borrower may cancel the insurance and stop paying premiums.

Insurance cancellation was clarified by the Homeowners Protection Act of 1998. For mortgage loans originated after July 1999, lenders must tell borrowers how to cancel insurance when the loan balance falls to less than 80 percent of the home's value. When the balance is less than 78 percent, the insurance is automatically cancelled.

Even with loans originated before that date, it should be possible to cancel the coverage, as long as the insurance is PMI, not FHA, and:

- The value of the home is documented. If the loan is 80 percent or less compared to the original price of the home, you may not need documentation of current value. But if the house increased in value, verification will be required. In most cases, this means a professional appraisal. The property tax assessor's appraisal probably is not sufficient but might provide the signal that the home is worth enough to justify an appraisal.
- The loan should be in good standing, meaning that no payments have been delinquent. In fact, your payment record should be flawless to assure cancellation.

Contact the company servicing the loan to obtain the procedures for cancellation. Also check the mortgage contract or insurance policy for information on cancellation.

Special Situation Loan Origination

The involvement of government or government-related organizations, such as the FHA and Fannie Mae, has broadened and stabilized the availability of mortgage financing. By making home loans uniform enough that they can be bought and sold, these organizations have taken a lot of the volatility out of housing markets. In the past, lenders could not make loans if they lacked sufficient deposits to fund loans. Today, mortgages are funded by national sources resulting in a ready supply of money for home mortgages—as long as borrowers are willing to pay the going interest rate.

But this standardized mortgage market does not necessarily serve everyone's needs. Borrowers can have trouble getting a loan if they do not have an established, favorable credit history, if they need to use a second mortgage, if they are buying a manufactured home or if they do not have a verifiable, steady income.

Competition and technology have resulted in one response to this problem. Through automated underwriting, lenders are better able to tailor loans to the risk profile of individual borrowers. One result is so-called *subprime loan*, which can be offered to individuals who cannot quality through the standard home loan origination process. Subprime lenders realize these loans cannot be liquidated easily in the secondary market. They also know that they may have trouble collecting payments and will have more delinquencies than for standard loans. But they make the loans because they can charge higher interest rates to compensate for the risks involved. The most common subprime borrower is someone with a blemished credit record.

In addition to higher interest rates, subprime lenders may charge discount points and require tighter underwriting criteria, meaning the loan will be smaller for a given amount of borrower income, than for standard mortgage loans. Many borrowers accept these terms because they want to buy a home or refinance the home they already own as part of a plan to create or rebuild their credit record. Such borrowers may be able to refinance with better terms after a few years of timely payments.

Where Should You Go to Get a Mortgage Loan?

In years past, when someone wanted to buy a home, they went to an institution specializing in home mortgage loans, such as a savings and loan association. Today, savings and loans handle only a small part of the mortgage loan market. In fact, lending institutions, including banks and credit unions, are not major players in the mortgage market. Mortgage bankers and brokers are the primary source of home loans.

Most borrowers pay little attention to what type of lender offers them loans. But it can make a difference if you are looking for a certain type of loan.

Lenders who sell the loans they originate tend to offer only the most popular types of loans. They are the largest originators of FHA loans, largely because the addition of FHA insurance makes the loan more attractive to companies interested in buying loans. Lenders retaining loans may be more flexible about changing the mortgage contract terms and offer more adjustable-rate mortgages and no-documentation loans. The most flexible type of lender is the mortgage broker, who acts as an agent for a variety of lenders.

What to Look for in a Mortgage Lender

As a borrower, you have little control over who eventually holds your mortgage and, in truth, it makes little difference. But you can choose who originates the loan. This choice affects the terms of the loan and how well the mortgage selection process serves your personal needs. The four most important issues in choosing a mortgage originator are:

1. **Cost of the loan.** The easiest way to shop for a loan is to compare interest rates. Also check the number of discount points (or origination fee) charged. Comparison charts are often printed in the real estate section of local newspapers, providing quotes in terms of rate and points.

   Other fees and charges in addition to points add to the cost of the loan. Most of these are set by the lender and may vary from one lender to another. The government requires lenders to provide a good faith estimate of all closing costs within three days after a borrower applies for a loan, so ask for an itemized list of loan costs. If the loan requires private mortgage insurance, ask for an estimate of the monthly charge.

   All terms quoted should be currently available, and the lender should be willing to lock in the rate and points at the time of application. Also make sure that the terms quoted apply to the type of loan you need. In other words, if you are buying a condo, make sure the loan can be used for that purpose.

   How you weigh different critieria such as interest rate, fees and premiums will depend on whether cash available or income is most constraining on your purchase.
2. **Types of loans offered.** One of the functions of the originator is to help the borrower choose the right type of loan. This choice is most critical for borrowers with unusual constraints, such as lack of cash, low current income, poor credit history and self-employment. Individuals who qualify for a standard loan would not want to get saddled with a high-cost, specialized loan. And even for standard loans, terms vary from one originator to another.
3. **Quality of service.** Quality service from a lender should include prompt, conscientious processing of the application without unreasonable requests for additional information and with adequate communication to prevent bottlenecks. You should also expect the lender to stand behind promises made before and during the application process, including availability of locked-in interest rates. Research the reputation of the lender by asking friends and acquaintances what mortgage lenders they used and what types of experiences they had.
4. **Convenience.** Ease in communicating with the lender is important, particularly at the application stage. You should feel comfortable asking questions that will help you decide whether you want to do business with that lender.

Avoiding Predatory Lenders

Some lenders who target the poor-credit-risk "subprime" market have found they can take advantage of unknowledgeable, passive borrowers. There is a long list of loan features and tactics used by unscrupulous lenders, and each may appear to be legitimate to someone who knows little about financing. These tricks are designed to trap the borrower in an overpriced mortgage or to force the borrower to default and forfeit the property. Here are some of the more common techniques:

- high front-end fees financed into the loan principal combined with a prepayment penalty that keeps the borrower from refinancing;
- loan "flipping," or refinancing the loan repeatedly with no benefit to the borrower but high fee income to the lender;
- short-term balloon loans that force the borrower to refinance after a few years;
- leading a borrower to take a subprime loan when he or she actually qualifies for standard financing; and
- arranging a loan that the borrower cannot afford to force default and foreclosure.

The key to avoiding these problems is knowledge and comparison shopping. Know your credit rating. Get a copy of your credit score. Check many lenders for the best terms. Better yet, only deal with a lender or broker with a good reputation in the industry, and shun any lender using high-pressure sales tactics.

Who Makes Mortgage Loans?

The mortgage loan market has changed over the past 20 years. The bulk of the business has moved away from specialized institutions, such as savings and loan associations, to mortgage bankers and brokers tied into the greater capital market. Each type of originator has distinct characteristics. Understanding these differences may help the

borrower start with the lender most likely to offer the type of loan appropriate for his or her situation. Of course, it is advisable to check the interest rates and terms offered by a selection of lenders before settling on a lender and a loan.

Financial institutions. Financial institutions—commercial banks, savings and loan associations, mutual savings banks and credit unions—take in deposits in the form of checking and savings accounts and certificates of deposit. The funds in these accounts are used to make loans. Institutions make their money by charging more for the loans than they pay on the deposits.

Traditionally, banks concentrated on short-term loans, such as consumer and business loans. Savings and loans and mutual savings banks, collectively referred to as thrifts, specialize in long-term home mortgages. Credit unions evolved as a limited membership financial service provider sponsored by an employer or organization for the benefit of its members. Today, all of these institutions offer mortgage loans.

Borrowers may want to use a bank, thrift or credit union if they:

- do not mind an adjustable rate loan (ARM), and the initial interest rate is attractive.
- have a checking or savings account at the institution and are offered a special rate or easier qualifying on a loan.
- need a large loan (more than $250,000).
- need a second mortgage in conjunction with a loan assumption or some other source of first mortgage.
- need to finance a property such as a manufactured home or town house, which mortgage companies are less likely to finance.

Mortgage bankers. Mortgage banking companies only make loans that can be sold in the secondary market. They should not be confused with home finance companies, which offer consumer loans backed by home equity. Mortgage bankers use their own capital to fund the loans they originate, rather than taking in deposits. They make money by selling loans for more than the cost of funding them and in some cases by servicing the loans they sell. Many of the best-known mortgage bankers are companies operating nationally.

Mortgage bankers generally:

- offer only the most popular types of mortgage loans—long- and mid-term fixed rate loans on one-to-four unit dwellings—and are major originators of FHA-insured loans and
- are competitive in rates and terms.

Mortgage brokers. Mortgage brokers do not originate or fund loans. Instead, they help borrowers find a lender who best satisfies their needs. Brokers have access to lenders who originate loans and use their own loan officers to handle applications as well as lenders who operate in the "wholesale" market and originate loans. Brokers make money from the fees that lenders pay them for bringing in creditworthy borrowers. They rarely charge the borrower for the service, although they may collect loan application fees required by lenders. Brokers may:

- offer specialized types of loans that other lenders do not handle,
- offer competitive rates and terms and
- be able to put together combinations of loans such as a first and second mortgage that requires no mortgage insurance or a mortgage that covers both personal and real property such as land and a manufactured home.

Point-of-sale origination. Increasingly, real estate brokerage offices are offering mortgage loans along with other services related to the purchase of a home. The broker's involvement can take a variety of forms:

- an affiliated mortgage broker may operate an office on site,
- the broker may offer special automated or electronic hook-ups to a mortgage lender or network of mortgage lenders,
- the agent or other personnel of the brokerage office may help you search a network of lenders and make a loan application or
- the broker may have an in-house mortgage banker to take applications.

These systems can be convenient and fast. The service often is free. In other cases, any fee you pay is credited toward your closing costs (the borrower only pays the fee if the loan is not closed). Rates and terms often are competitive.

Stock brokerage and financial firms. Borrowers with accounts at brokerage or financial services companies such as Merrill Lynch may have access to a variety of mortgage loans. Some types of loans are unique to this source, such as loans requiring no down payment but secured by a portfolio of stocks. These firms may be particularly good sources for mortgage loans for amounts more than $250,000.

Sellers and builders. Often sellers and builders will provide all or a portion of the financing needed to buy a home. Such financing is tied to a particular home, and the price of the home and terms of the financing may be connected. In other words, a seller might offer bargain financing to get a good price for the home. When this type of financing is offered, the loan and the home should be evaluated as a package deal.

Finding a Mortgage on the Internet

The Internet offers a wealth of mortgage loan information online. Unfortunately, a lot of this information can be misleading, sometimes because it is old, vague or false, or because there is just too much information for the borrower to take in.

Nevertheless, checking the Internet can be a good way to shop for current loan terms. A thorough market search might include a perusal of Internet lending sites along with inquiries at local lending sources. To make comparisons meaningful, gather as much information as possible in your search— contract interest rate, points, other fees and how long the rate is locked—for the same type of loan. Do not try to compare an adjustable-rate loan with a fixed-rate loan or a conventional loan with an FHA loan.

A variety of organizations advertise mortgages on the Internet. Some are lending institutions or mortgage bankers lending for their own accounts. Many are mortgage brokers representing a group of mortgage lenders. Others are "matchmakers" or "mortgage malls" allowing the user to compare the offerings of a number of lenders, then linking the

Calculating a Monthly Payment (PI) with a Financial Calculator

1. Make sure the calculator is set for 12 payments per year.
2. Enter the term in months, and press the "N" button (30 years = 360 months).
3. Enter the monthly interest rate, and press the "int" or "I/YR" button (some calculators automatically calculate this from the annual rate, otherwise
divide the annual rate by 12; 8 percent = .66667 percent per month).
4. Enter the amount borrowed and press the "PV" button (on some calculators this must be entered as a negative number; –100,000).
5. Press the "PMT" button to get the monthly PI payment ($733.76).

user to the chosen lender for application submittal. Some sites offer mortgage auctions, in which the borrower states the interest rate he or she is willing to pay and is contacted by a lender willing to make a loan at that rate. Other sites allow users to establish a rate watch, which consists of monitoring various lenders and informing the borrower by e-mail message if and when a lender offers a loan at the desired rate.

Many have found that a mortgage application over the Internet can be approved in a fraction of the time and with much less documentation than required for in-person applications. This is because most online mortgage originators use automated underwriting programs to process the application.

These programs are not exclusive to the Internet. Indeed, the most popular ones were developed by Freddie Mac and Fannie Mae and are available to all originators who sell loans to those entities. Many brick-and-mortar lenders use them as well, but they are essential to the Internet lender.

When applying online, a borrower usually fills out an application form by typing personal data into the computer. Armed with the applicant's Social Security number, the program can access employment and other financial data. If the applicant easily fits the criteria needed to qualify for the desired type of loan, the loan is approved in short order. If not, the application may be referred to a specialist who will work with the applicant on a more complicated application. Some have found that automated underwriting systems are less forgiving than human loan officers and may tend to reject applicants that otherwise might be approved.

Many sites offer special tools for finding the best loan. Some allow users to test various loan types to see which is most beneficial for their needs. Many allow prequalification and pre-approval, as well as programs to determine if refinancing would be a good idea. Most charge a fee for loan applications, some an extra fee for preapprovals. Many provide online monitoring of the loan approval process so you can track the progress of your loan.

Amortization Table

Loan = $100,000 **Interest rate** = 8% **Payment** = $733.76

Year	Total Payments	Interest Paid	Principal Paid	End of Year Balance
0				100,000.00
1	8,805.12	7,969.14	835.98	99,164.02
2	8,805.12	7,900.43	904.69	98,259.32
3	8,805.12	7,825.34	979.78	97,279.54
4	8,805.12	7,744.02	1,061.10	96,218.44
5	8,805.12	7,655.95	1,149.17	95,069.26
6	8,805.12	7,560.56	1,244.56	93,824.71
7	8,805.12	7,457.27	1,347.85	92,476.86
8	8,805.12	7,345.40	1,459.72	91,017.13
9	8,805.12	7,224.24	1,580.88	89,436.25
10	8,805.12	7,093.03	1,712.09	87,724.16
11	8,805.12	6,950.92	1,854.20	85,869.96
12	8,805.12	6,797.03	2,008.09	83,861.87
13	8,805.12	6,630.36	2,174.76	81,687.10
14	8,805.12	6,449.85	2,355.27	79,331.84
15	8,805.12	6,254.37	2,550.75	76,781.08
16	8,805.12	6,042.65	2,762.47	74,018.62
17	8,805.12	5,813.37	2,991.75	71,026.87
18	8,805.12	5,565.06	3,240.06	67,786.80
19	8,805.12	5,296.13	3,508.99	64,277.82
20	8,805.12	5,004.89	3,800.23	60,477.59
21	8,805.12	4,689.47	4,115.65	56,361.94
22	8,805.12	4,347.88	4,457.24	51,904.69
23	8,805.12	3,977.93	4,827.19	47,077.50
24	8,805.12	3,577.27	5,227.85	41,849.65
25	8,805.12	3,143.36	5,661.76	36,187.89
26	8,805.12	2,673.44	6,131.68	30,056.21
27	8,805.12	2,164.51	6,640.61	23,415.61
28	8,805.12	1,613.35	7,191.77	16,223.83
29	8,805.12	1,016.43	7,788.69	8,435.14
30	8,805.12	369.98	8,435.14	0.00

For those who are Internet proficient, a good place to visit before and during a search for a mortgage loan is the Inman News site, which specializes in mortgage news. Go to *http://news.inman.com*, and look for mortgage related items. In addition to current interest rates, you will find tips and advice for mortgage shoppers.

How Mortgage Loans Work

The terms of a mortgage loan can be arranged to suit the needs of the borrower or the lender or both. For example, the monthly payment amount may be structured to match the income of the borrower, which typically increases over time, or to protect the lender from the possibility of lost revenue on the money loaned if interest rates rise. To understand mortgage terms , and what the borrower gains and loses in each case, you need to know how a mortgage loan works.

How the Monthly Payment is Determined

There are two kinds of monthly payments. To most people, the monthly payment is the total amount that must be sent to the mortgage company each month. In real estate parlance, this is called the *PITI* (principal, interest, taxes and insurance). The PI is the amount of the payment allocated to principal and interest. The TI portion of the monthly payment goes into a special account called an escrow account, which is allocated for property taxes and hazard insurance premiums owed on the property. The terms of some loans allow borrowers to take responsibility for paying these expenses without an escrow account. In those cases, the monthly payment consists of PI and, if the loan includes mortgage insurance, a portion of the payment may also be used to pay the monthly premium.

The PI is a predictable amount determined by the interest rate, term and principal amount of the loan. If the loan is a fixed-rate, fixed-payment loan, the PI will not change over the life of the loan. However, each payment is composed of an interest portion and a principal portion, and these amounts do change each month. The interest portion equals one month's interest on the principal outstanding.

For example, let's say a loan of $100,000 is taken out at 8 percent annual interest. Payments are made in arrears at the end of the month. The amount of the monthly PI payment is calculated using a mathematical factor called the *mortgage constant,* which calculates PI payments for any combination of interest rate, term and principal amount. You can find books of tables with PI payments or the PI payment can be calculated using a financial calculator (see Calculating Monthly Payment with a Financial Calculator). For this example, we'll say the loan runs 30 years, which would make the PI payment $733.76.

One month's interest equals the annual rate (8 percent) divided by 12, or .66667 percent. So after the first month, interest on the principal amount ($100,000) is calculated by multiplying $100,000 x .66667 percent, which equals $666.67. In the first month, $666.67 of the $733.76 payment goes to interest. The remaining $67.09 goes to reduce the principal, which becomes $99,932.91. The second month's interest is calculated by multiplying the new outstanding principal of $99,933 by .66667 percent, which equals $666.22. Subtract that amount of interest from the PI, $733.76, and you get the second month's principal payment, $67.54. This process continues until the principal balance is reduced to zero.

In the example, the outstanding principal is reduced ever so slightly with each payment, meaning that the portion of the payment going toward interest is lower each month. This process of reducing the principal is called *amortization*. An *amortization table* can be calculated for any fixed-rate loan. Table 1 is an amortization table showing how much principal remains at the end of each year in the term of the example loan discussed above. Notice how amortization accelerates over the term, so that most of the principal is repaid in the last few years. This is because as the principal decreases, less of the fixed payment goes toward interest, meaning that a larger amount goes toward the principal each month. At the end of the term, the principal outstanding is zero.

Monitoring Your Mortgage Loan

Whether you have a fixed-rate or adjustable-rate loan, there are advantages to monitoring your loan payments and amortization. Of course, the lender or the company that services your loan will keep records and be able to provide you with a status report on your loan. But lenders have

Table 2. Example of Loan Monitoring Table

Year of Loan	Month of Loan	PITI	PI (PITI minus Escrow)	Interest	Principal	Escrow	Expenses	Escrow account balance	Loan balance	Date of payment	Check number
0	0							$400	$100,000.00		
1	1	$883.76	$733.76	$666.67	$67.09	$150		$550	$99,932.91		
1	2	$883.76	$733.76	$666.22	$67.54	$150		$700	$99,865.37		
1	3	$883.76	$733.76	$665.77	$67.99	$150	$495	$355	$99,797.38		
1	4	$1000.00	$850.00	$665.32	$184.68	$150		$505	$99,612.69		
1	5	$883.76	$733.76	$664.08	$69.68	$150		$655	$99,543.02		
1	6	$883.76	$733.76	$663.62	$70.14	$150		$805	$99,472.88		

*You may want to use the actual dates for your records.

been known to make mistakes, and mistakes could cost you a lot in overpayments. Here are some things you may want to track:

- What is the current outstanding loan balance?
- How much will I still owe if I make an extra payment to principal?
- How much can I save by refinancing the loan at a lower interest rate?
- What should the new payment amount be after adjusting the interest rate on an adjustable-rate mortgage?
- How much is in my escrow account?

Monitoring a mortgage loan requires a bit of diligence and enough math ability to be able to multiply and subtract. If you have a computer, you can keep an electronic record of the loan's progress. You can also do the calculations by hand or using a calculator. Either way, the set-up and method are the same.

Table 2 is an example of a loan monitoring table. The easiest way to do this is using a computer and a spreadsheet program such as Excel or Lotus 123, but you can do it the old-fashioned way using the special lined paper that accountants use. This table can be used to track any loan at any stage, as long as the current balance and the number of remaining payments are known.

This type of table is appropriate for a *fully-amortizing* loan, which is a loan in which the monthly payment fully pays back the loan amount over the life of the loan. It also works for loans that must be repaid before the end of the term (a so-called *balloon* loan) and for adjustable-rate mortgages. It is not appropriate for graduated rate mortgage loans or temporary buy-down mortgage loans.

Let's look at the example loan discussed in "How the Monthly Payment is Determined." The amount borrowed is $100,000, the term is 30 years, and the interest rate is 8 percent per year. At closing, $400 is contributed to the escrow account. In the first year, a monthly payment to escrow of $150 is required. For this example, assume that the loan is new.

On the first line after the headings, enter the year and month as "0" and "0," to indicate loan origination. Then skip to the "escrow account balance" and enter $400, the amount deposited into the escrow account at closing (your settlement statement from closing would be your source for this amount). Enter the amount of the loan ($100,000) under "loan balance." If the loan is an FHA loan and closing costs were financed into the loan, be sure to include that amount with the total.

The second row of the table shows the results of the first monthly payment. The year and month are entered "1" and "1," for first year, first month.* The monthly payment ($833.76) is entered in the PITI column. The PI portion of the payment is $733.76. This amount should be identified in the mortgage contract for the first year. When the escrow payment or interest rate changes, or at the end of the tax year, you will receive a special statement informing you of the new amount.

Because most mortgages require payment in arrears, the first payment on the loan is not due until after the first whole month of the term. This may be a little confusing, because the interest accrued in month one actually is paid in month two. You could clarify this by adding a column for the date the payment was made.

The interest portion of the PI payment is calculated by multiplying the loan balance at the beginning of the month by the monthly interest rate, which is the annual rate divided by 12. In our example, interest equals the balance before the payment ($100,000) times the interest rate (.08) divided by 12, or $666.67. The rest of the PI payment ($733.76 minus $666.67, or $67.09) goes to principal. The principal amount of the payment is subtracted from the previous loan balance to get the new loan balance ($100,000 minus $67.09 equals $99,932.91). The escrow account started with $400, but $150 of the PITI was deposited in the account, so it now contains $550.

Each succeeding month is entered in the same way. Now look at the line reflecting Year 1 Month 2. For the *second payment*, the interest amount is lower, because the loan balance is lower. Interest for that period is $99,932.91 times .08 divided by 12. The principal amount is slightly larger, and the loan balance has been reduced further. This loan balance determines how much interest is paid in the next payment. Note also that the escrow has grown by $150.

In *month three*, a homeowner's insurance (hazard insurance) payment of $495 is paid, so that amount is listed in the expenses column. The escrow account balance is reduced by $495, but the regular $150 contribution from PITI also is made, resulting in an escrow balance of $355. At the end of the first year, the lender will reconcile any shortages or surplus in the escrow account and will change the amount of your monthly escrow contribution if necessary. If that happens, be sure to enter the new escrow amount when it becomes effective.

By diligently making entries in this table after each payment, you create a loan record that can be used to check the accuracy of reports prepared by the lender. Recording the check number of your monthly payments makes it easier to find cancelled checks if they are needed for verification.

Making additional payments to principal. Most mortgage lenders allow borrowers to make larger-than-normal payments, with the excess amount being applied to the loan principal. Some lenders make this process convenient by including a place on the payment coupon for listing an additional amount toward the principal. These payments actually are partial loan prepayments. If the mortgage contract has a *prepayment* clause, the borrower can retire some of the loan principal under the conditions stated in the clause. In most cases, a borrower can prepay at any time. Most borrowers prepay the entire loan when they sell the home or refinance the loan. However, there may be a penalty for prepayment under certain conditions. Texas law prohibits a prepayment penalty on loans secured by a person's residence if the interest rate is more than 12 percent.

Why would anyone want to prepay some of the loan principal? Doing so does not reduce subsequent monthly loan payments. They remain unchanged. However, the "split" of those payments between interest and principal changes in such a way as to accelerate the amortization process. As a result, the loan is retired earlier and requires less interest over the term. If the loan is refinanced, the outstand-

ing principal is lower. Furthermore, if the loan requires PMI, that coverage can be cancelled sooner (however, amortization does not affect coverage under FHA insurance). In effect, prepaying principal is equivalent to investing the money in a risk-free asset with a yield equal to the mortgage interest rate.

Returning to our previous example, assume that in the *fourth month* of the term, the borrower decides to make a payment of $1,000. The larger payment is entered under PITI. From this payment, subtract the interest due (8 percent of $99,797.38 divided by 12) and the escrow payment. The remainder of the payment goes to reduce the principal. Using a financial calculator, enter the interest rate (8) under "i" or "I/YR." On some calculators, it is necessary to divide the interest rate by 12 for monthly payments. Enter the outstanding principal ($99,612.70) under "PV" and the PI payment ($733.76) under "PMT." Press the "N" button to get 354.33, the number of payments left to retire the loan. The loan will be paid off after 29½ years, thanks to this additional payment, cutting almost two months off the loan term. Interest savings over the life of the loan (that is, the amount of the payments that will not be required with the shorter term) amount to $1,247.

Monitoring Escrow Accounts

Not all loans require escrow accounts. Instead, you may be responsible for paying hazard insurance (homeowner's insurance) premiums and property taxes yourself. If your loan has no escrow account, the PI payment is the same as the PITI payment. In the example loan monitoring chart, you would not need the Escrow, Expenses and Escrow Account Balance columns of the worksheet.

Monitoring an escrow account is straightforward if you use the system described in "Monitoring Your Mortgage Loan." For each loan payment you make, identify the amount that goes into the escrow account and enter that amount in the Escrow column. When an expense is paid, enter the amount in the Expenses column. Because your loan servicer will receive the bills for your homeowner's insurance premiums and property taxes, you may not know exactly when an expense is paid. You should know when the expenses are due, because you will most likely receive copies of the bills sent to your lender. Local tax assessors usually send notices of taxes due several months prior to the payment deadline. (Incidentally, if the home being taxed is your residence, verify that you are receiving a homestead exemption on your local property taxes. This exemption varies by locality. Some places also have exemptions for senior homeowners). If you do not receive a notice, verify with the assessor's office that you are on record as the owner of the property. At the end of the year, the lender should send you a report showing when the bill was paid, and you can correct the record at that time.

Some escrow accounts pay interest. In that case, the interest should compound monthly, just as mortgage interest does, and it should be credited to your escrow account. Suppose the escrow account pays 3 percent per year on the account balance. That works out to 0.25 percent per month. If the balance in the account at the beginning of the month is $500, the interest earned by the end of the month is 0.0025 times $500, or $1.25. At the end of the month, the account balance would be $501.25 plus any amount paid in from PITI and less any expenses paid.

Refinancing Your Mortgage Loan

Refinancing a mortgage means taking out a new mortgage loan to repay your existing mortgage loan, usually to change the terms of the financing. Most commonly, homeowners refinance to lower the interest rate (*rate-reduction refinancing*) or to take cash out of the house (*cash-out refinancing*). Sometimes, people refinance for both reasons.

Rate reduction refinancing is possible when current interest rates are lower than the rate on the existing loan. Because refinancing involves costs, the current rate must have decreased enough to compensate for the expenses, which may include an application fee, survey, appraisal, title insurance premium, discount points and origination fees and prepayment penalties.

A cash-out refinancing requires that the new loan's principal be larger than that of the old loan. This is possible if the home has increased in value, or the loan-to-value ratio of the new loan is higher than that of the old one. If the new loan requires mortgage insurance, and the existing loan did not, the borrower might be better off keeping the existing loan and getting a home equity second mortgage. The second mortgage will have an interest rate slightly higher than the first mortgage, but you will save the costs of refinancing and mortgage insurance.

Information from the loan monitoring system described previously can be helpful in determining whether refinancing would be beneficial for you. Continuing with our previous example, let's assume that we want to refinance the loan to reduce the interest rate (no cash-out). For simplicity, assume that closing is scheduled so that the existing loan is retired at the end of month five and the new loan takes effect in month six. The amount to be refinanced would be the principle outstanding after the payment for month five, or $99,660.04. Suppose the new loan would decrease your interest rate from 8 percent to 7.5 percent and that it will be another 30-year fixed-rate term. Using a financial calculator, estimate the new PI payment at the new interest rate. On the calculator,

- Enter the term 360 months (30 years), and press "N."
- Enter the new interest rate, 7.5 percent, and press "int" or "I/YR."
- Enter the loan principal, $99,660.04, and press "PV."
- Press "PMT" to calculate the monthly PI payment, which will be $696.84.

The difference between the PI payments on the existing loan and the new loan represents the monthly savings from refinancing. In our example, $733.76 (the existing PI payment) minus $696.84 (the new PI payment) equals $36.92 per month.

You can use the same procedure to calculate how much cash you could take out of the house on a cash-out refinancing. The idea is to calculate the loan amount that would require the same PI payment as the old loan, but at the lower interest rate. Using the financial calculator:

- Enter the term, 360 months, and press "N."
- Enter the new interest rate, 7.5 percent, and press "int" or "I/YR."
- Enter the original PI payment, $733.76, and press "PMT."
- Press "PV" to calculate the new loan amount, $104,940.61.

In this example, the borrower cashes out $5,280.57 ($104,940.61 minus $99,660.042) from the proceeds of the loan, minus whatever it costs to complete the refinancing.

Adjustable Rate Mortgages

An adjustable rate mortgage (ARM) allows the lender to change the interest rate applied to the loan during the term. The mortgage contract states how often the rate can be changed and how it is to be changed. The most common adjustment period is once per year. All adjustments are governed by the behavior of a specified market index. Typically, the index reflects interest rates in the market, such as the average interest rate on recently closed mortgage loans or the yield on newly issued government bonds. As a reassurance to the borrower, many ARMs also place limits, called *caps*, on the rate adjustment. Indexes and caps are explained in more detail in the following discussion.

When an ARM is adjusted, the loan is recalculated at a new interest rate, with the loan amount equal to the old balance outstanding and the term equal to the remaining term of the loan at the time of the adjustment. The loan servicer adjusts the monthly PI payment accordingly and sends the borrower an adjustment notice indicating the date when the adjustment takes effect, the new interest rate and the amount of the new payment (both PI and PITI). This notice generally is sent one or two months before the new payment is due, allowing for time to challenge the adjustment or refinance the loan. To challenge, the borrower must prove that the lender has made an error in calculation. Such errors are not uncommon.

You can check the accuracy of ARM adjustments using the system described in "Monitoring Your Mortgage Loan." Let's return to the loan example used earlier (see Table 2). Suppose the interest rate is to be adjusted after the first six months. The new interest rate will be 8.5 percent. That rate will be applied to the loan balance in month seven, with the payment due on the first day of month eight. To calculate what the new payment should be, use a financial calculator and enter the:

- term, 29½ years or 354 months, under "N;"
- new interest rate, 8.5, under "i" or "I/YR;"
- loan balance, $99,472.88, under "PV;" and
- new PI payment is found by pressing "PMT."

The answer should be $767.77. Allow for some discrepancy because of differences in rounding, but the amount the lender reports should be within a few dollars of your estimate. The new payment is in effect until the next adjustment period.

It is wise for you to know how the interest rate is determined so you can verify the lender's calculation of the new monthly payment. The interest rate on your loan is related to an index specified in the contract. By law, the index is something the lender does not control and that you, the borrower, can verify. Index values are reported in the *Wall Street Journal* or are available from government sources. The loan contract states how the interest rate will be related to the index value, usually specifying a *margin* by which the interest rate will exceed the index.

Suppose the index for your loan was the national average mortgage contract rate, and the margin is one-half percentage point. When your loan was originated, the index was at 7.5 percent. Your interest rate was therefore .5 percent above the index's 7.5 percent, or 8 percent.

Some loans are originated at a temporary *teaser rate*. After the introductory period, these rates are adjusted upward to match the index plus margin specified in the contract. Usually, interest rate changes are made to the closest one-eighth of a percentage point.

Rate adjustments are often governed by caps. An *annual adjustment cap* limits how much the interest rate can change at any one time. For example, if the cap is one percentage point per year, then the new interest rate will rise or fall no more than one percentage point no matter how much the index changes. However, if an adjustment is restricted by the cap, the rate may be changed during the following adjustment period to make up that difference. *Lifetime caps* also are common. They place a limit on how high or low the interest rate may be over the life of the loan. For example, a lifetime cap of 5 percentage points means that a loan originated at 7 percent may never go higher than 12 percent or lower than 2 percent, regardless of the behavior of the index. Both annual and lifetime caps apply to the initial interest rate, even if it is a teaser rate.

A popular alternative to a straight ARM is the hybrid loan. Hybrids fix the interest rate for the first several years, after which the rate is adjusted annually as with a regular ARM. Loans are available with fixed periods from three to ten years. If you think you will retire the loan during the initial period (sell the home or refinance the loan), a hybrid may be a good bet. By retiring the loan early, you never enter the adjustable portion of the term. If you keep the loan through the fixed period, you are no worse off than other ARM borrowers, as most hybrids do have caps that apply to the adjustments. At the same time, hybrids often are originated at rates lower than those on fixed loans.

Tailoring Loans to Borrower Needs

Although the fixed-rate, fixed-PI loan is the most popular type of loan, other loan types have found acceptance in the market because they solve problems facing some borrowers. These loans are created by changing certain terms of a loan.

Changing how interest is paid. The *interest rate* is the price you pay for borrowed money. Unless there is a subsidy involved, the interest rate on a loan must be sufficient to allow lenders to receive a competitive yield; otherwise, the loan is not made. However, the payment amount can be reduced by changing the way interest is paid on the loan. Here are some examples of loan innovations that can be used to change the monthly payment amount.

- **Interest only**. Some loans eliminate the principal payment temporarily or for the entire term. For a prescribed period, loan

payments cover only interest accrued. This type of loan is usually short-term or requires payment of the principal (referred to as a balloon payment) or refinancing after a few years.

- **Longer terms**. If loan payments are stretched over a longer period, payments are reduced. The longer term gives the borrower more time to repay principal, so that each payment is closer to interest only. As loan terms exceed 30 years, however, the amount of reduction becomes insignificant, so few mortgage loans have terms longer than 30 years.
- **Buy down.** Many lenders charge *discount points* as a requirement of originating the loan. A discount point is a charge equal to 1 percent of the loan amount. The effect is to raise the percentage return on the loan. Lenders can charge a lower rate of interest if a larger number of points are paid at closing. In the industry, this is called *buying down* the interest rate, or buydown for short. A borrower who has ample cash but limited income (for example, an elderly homebuyer) may wish to buy down the rate to improve his or her chance of qualifying for the loan. In some cases, sellers or builders provide the funds needed for buying down the rate to improve the chance of selling a property.
- **Municipal revenue bond mortgages.** State and local governments may borrow at below-market interest rates because the bonds they issue pay interest that is exempt from federal income tax. Most states and some cities have programs that fund mortgage loans with this tax-exempt borrowing, so interest rates are lower than the going rate on mortgages.
- **Adjustable rate mortgages**. When a lender makes a mortgage loan with a fixed interest rate, it commits to a fixed stream of revenue. If interest rates rise, the revenue generated from the loan is less than that earned on new investments. If rates fall, revenue is greater, but most borrowers refinance when rates fall, so lenders seldom reap the higher profit for long. Because of this risk of lower revenue caused by rising interest rates, lenders demand higher interest rates for long-term commitments. A borrower who agrees to an ARM reduces the lender's exposure to such risk. That's why interest rates are lower for ARM loans compared to fixed-rate loans. Many homebuyers consider adjustable mortgages an alternative to fixed-rate financing when interest rates are relatively high.
- **Variable payment loans.** Because most people's incomes increase over time, loan payments that are lower in the early period of the loan and increase as the borrower's earnings increase would benefit many borrowers. There are mortgages loans designed to meet this need. A *graduated payment mortgage* (GPM) has a fixed interest rate, but payments in the first several years are reduced by deferring amortization and in some cases, even part of the interest payment. A *price level adjusted mortgage* (PLAM) has a low interest rate but the loan principal is increased by the rate of inflation each year. The increase in the principal raises the payment amount to match the inflation rate. Payments in the early period of this type of loan are lower than for standard mortgage loans. For various reasons, inflation-adjusted loans have not been popular in this country but have been used in countries with histories of high inflation.

Decreasing loan term. *Short-term loans* are for borrowers who can afford to make higher monthly payments in return for a lower interest rate. These loans greatly reduce the interest paid on the loan over its life. This would be true even if the interest rates were not lower, simply because the principal remains outstanding for a shorter period. These loans appeal to people who are concerned with the overall costs of a loan, and who like the idea of paying off debt early. Of course, no matter what the loan term, a borrower usually has the option of paying off a loan faster by making additional payments toward the loan principal, but to get a lower interest rate, you must be willing to commit to faster amortization.

Short-term loans take a variety of forms.

- **15-year fixed-rate loans.** While 15-year mortgage terms are popular, they are not appropriate for borrowers needing to reduce the monthly out-of-pocket cost of the loan or needing a lower payment to qualify for the loan. With an amortizing loan, the shorter the term, the larger the monthly payment. As the chart shows, the monthly payment on a $100,000 loan at 8 percent interest varies significanting depending on the loan term.

Loan Term (years)	Monthly PI Payment
40	$695.31
30	733.76
20	836.44
15	955.65
10	1,213.28

- **Balloon loans**. These loans have short terms —five to ten years— but longer amortization terms. The monthly payment amount is based on the longer term, so it is no higher than a conventional long-term mortgage. However, when the maturity date is reached, the outstanding balance of the loan must be repaid. Because much of the principal will still be outstanding, paying off the loan requires a large, lump-sum payment, called a *balloon payment.* In most cases, the borrower refinances the loan at or before the balloon payment becomes due.
- **ARMs.** ARMs in general carry lower interest rates than do fixed-rate loans, and ARMs with more frequent adjustment periods have lower initial rates than those with longer frequencies. Even though the frequent adjustments do not pay back principal earlier, it does reduce the lender's risk by allowing the lender to receive something closer to a market rate yield.

Loans with prepayment penalties. During the 1990s, interest rates were predominantly on a downward trend. In response, homeowners refinanced their mortgages every time rates fell significantly. Borrowers with ARMs took advantage of rate declines to switch to fixed-rate loans. In late 1999, some lenders began offering discounts to borrowers who agreed to *prepayment penalties*.

Prepayment penalties are charged to a borrower who pays off the loan before it is due. They equal a specific percent of the outstanding principal of the loan. Penalties are in effect for a one-to-five-year period at the beginning of the loan term. In some cases, the penalties decrease as the loan matures. For example, the contract might call for a 3 percent penalty if the loan is paid off in the first year, with a decrease to 1 percent if the loan is paid off in years two or three. Some lenders allow limited reduction of principal each year without penalty.

These loans are ARMs and generally, when the loans are made, the lenders expect interest rates to rise. Lenders are willing to offer a lower current rate to borrowers who commit to paying a higher rate in the future.

Down payment considerations. First-time homebuyers typically look for loans with the lowest possible cash down payment. They usually have no cash on hand from a previous sale, and are faced with raising cash for the down payment from savings or relatives. Borrowers who do have cash to invest may wonder how large a down payment they should make. A number of considerations come into play here.

- *Liquidity*. The down payment is not the only cash required when buying a home. Numerous other needs invariably arise (furniture and a lawnmower, for example) as the homebuyer moves into the home. Be sure sufficient cash is available to cover these needs and to use for emergencies. Never put emergency cash into an investment that is difficult to liquidate at short notice.
- *Monthly payment and qualifying*. The larger the down payment, the smaller the loan and the easier it is to qualify. Lenders may offer lower interest rates on loans that are smaller compared to the value of the home.
- *Mortgage insurance*. Most first mortgage loans that are greater than 80 percent of the home's value require mortgage insurance, either PMI or FHA insurance (for qualified military veterans, VA loans serve the same purpose but operate differently than insured loans). The cost of insuring a loan increases as the loan-to-value ratio rises, but it does so in increments. Therefore, if the loan is just above 80 percent or 90 percent, it may be worthwhile to increase the down payment to reduce the loan and save on insurance costs.
- *For the self-employed* or those with a history of credit problems, a higher down payment may be required just to get the loan.
- Money invested in a down payment has a guaranteed return equal to the interest rate on the mortgage. Your return on the investment is the reduced amount of interest paid. If you have other opportunities to get a higher return with comparable risk, a smaller down payment might be warranted. Mortgage interest is, for the most part, deductible on your income taxes, and therefore the real cost is lower. However, by taking itemized deductions, the homeowner foregoes the standard deduction, so a portion of the tax benefit is offset by loss of the standard deduction.

For example, suppose a taxpayer paid $6,000 in mortgage interest and $1,500 in property taxes in 1998. There were no other expenses eligible for deduction, so total itemized deductions were $7,500. At a marginal tax rate of 15 percent, these deductions would trim $1,125 from the tax bill. But without itemizing, the taxpayer, married and filing jointly, could claim a standard deduction of $7,100. The deductible items boost the total deduction by only $400, which translates to tax savings of only $60.

Default and Foreclosure

When a borrower defaults on the mortgage contract by failing to make scheduled payments, the lender takes action to protect the investment. At first, the *delinquent* borrower will be notified of the default and may be given a few months to catch up on the payments. Once the lender is convinced that the borrower cannot make up the default, a foreclosure action is initiated, which makes all outstanding payments due immediately.

The foreclosure process closes out the borrower's rights to the property so it can be sold to satisfy the debt. In most cases, the lender purchases the home at the foreclosure sale and attempts to resell it to recoup the amount of money the borrower failed to pay. Lenders usually retain the right to sue the borrower for costs over and above the proceeds from sale of the home. This is called a *deficiency judgement*.

Most lenders originate loans in a conservative manner so that borrowers will not default. Lenders desire as low a foreclosure rate as possible. From the borrower's perspective, foreclosure is a disaster as well. The default will appear in the borrower's credit record and may hamper future attempts to get financing at reasonable costs. Any equity in the home could be lost. There may be a deficiency judgement in addition to losing the home. In most cases, it is in the interest of both lender and borrower to avoid default and foreclosure.

If something occurs that makes it difficult to meet your monthly payment obligation – an extraordinary expense, loss of income – take action to avoid default as soon as possible. Unless the home has lost value, you may want to sell the home and move into something less expensive. Working with the lender, you may be able to sell the home to someone who also takes over the mortgage obligation as well. Indeed, there may be advantages to assuming the loan for the buyer that translates into a higher price. However, beware of the person who offers a deal contingent on the lender not finding out about the transaction. You may end up still liable for the mortgage but without the home. If your financial difficulties appear to be temporary, the lender may be willing to forbear a period of reduced or deferred loan payments or

restructure the loan to ease the burden. For any of these strategies to work, you must notify the lender at the first sign of a problem.

The decision to work with you on your loan will be made by the lender who holds the loan, not the company that services it. However, Fannie Mae, holder of a large percentage of home loans, has a program designed to help borrowers avoid foreclosure. FHA has a similar program for loans it insures. The first point of contact, however, is the servicing company.

Mortgage finance can be complex and confusing. To make things clearer, do some homework and shop around before you decide on a loan. The professionals in the mortgage field can be helpful but only if you know enough to understand what they are telling you. You also need to know a good deal when you see it. This guide is dedicated to those borrowers who want to make informed decisions.

Appendix A

Glossary of Terms

Adjustment period. For adjustable rate mortgages (ARMs), the length of time between dates the interest rate can be adjusted. A common adjustment period is one year.

Amortization. The process of reducing the principal balance on a loan over time. A loan that requires payments to principal as part of the monthly payment is said to be a self-amortizing loan. In most cases, the loan is designed so that the entire principal is repaid by the end of the term.

Annual Adjustment Cap. See Caps.

Appraisal. An estimate of the value of property. An appraisal is usually performed during loan approval to establish the loan-to-value ratio (LTV).

APR (annual percentage rate). An estimate of the annual effective interest rate on a loan made at the time of application. The estimate takes into account any discount points paid and any possibility that the interest rate will change over time, as is the case with an adjustable rate mortgage.

ARM (adjustable rate mortgage). A mortgage loan that provides for periodic adjustments of the applicable interest rate according to an established index of related interest rates.

Automated underwriting. A system of loan processing using a computerized system for much or all of the information gathering, analysis and loan approval.

Balloon payment. A lump-sum payment of all outstanding principal. Required when the term of the loan is less than the period over which the loan is amortized. Most borrowers refinance the loan before the balloon payment is reached.

Buy down. Payment of cash to reduce the interest rate on a loan. Often the cash is provided by a seller or builder to induce a home sale. The reduced interest rate from a buy down may extend over the entire term of the loan or only for the first several years.

Caps. As applied to adjustable rate mortgages (ARMs), caps limit the extent to which the interest rate can be adjusted. An annual cap places a limit on how much the rate can be changed within any one 12-month period. A lifetime cap places an absolute limit on the rate over the life of the loan.

Cash-Out Refinancing. Replacement of an existing loan with one of a larger amount, thereby providing cash income to the borrower.

Closing. The time when ownership of a property is formally transferred from the seller to the buyer. Loan funds are distributed at this time and the loan term begins.

Closing costs. Various fees and charges paid by the buyer and seller at closing to complete a sales transaction. These costs include brokerage commissions, discount points, appraisal fees, attorney fees, title expenses and recording fees.

Commitment. An agreement made by a lender to fund a loan at specified terms. The agreement is usually good for a limited period. A loan commitment allows the borrower to proceed with the closing of a house purchase.

Conduit. A firm or organization that buys mortgage loans and uses them as collateral for securities sold in the bond markets. The major conduits are Fannie Mae and Freddie Mac.

Conforming loan. A mortgage loan that fits the criteria set by Freddie Mac and Fannie Mae and is eligible for purchase by those entities. Conforming loans have the most favorable terms available in the market because the lender can sell the loan readily in the secondary market. "Jumbo" loans are nonconforming because they are too large for purchase by the major secondary market companies.

Credit rating. An evaluation of a person's past performance in handling debts and credit.

Credit report. A document that contains information used to compile a credit rating.

Credit score. A numerical expression of someone's credit rating. Your credit score helps determine whether your loan will be approved and what terms you will be offered.

Default. Failure to comply with the requirements of a loan contract. Generally, default refers to the failure to make timely loan payments, which leads to loan foreclosure.

Deficiency judgement. Legal liability of a borrower to reimburse the lender for any losses not recovered in a foreclosure sale.

Disclosure. Legal obligation to provide information important to the home-buying or financing decision. The seller is required to disclose certain information about the house, the lender is required to disclose information about the loan and the sales agent is required to disclose the nature of his or her agency's relationship to the seller.

Discount points. Additional interest collected by the lender in the form of a lump sum payment at closing. Each point is 1 percent of the loan amount. Points increase the lender's profit from making the loan.

Down payment. The amount of cash a borrower must provide to make up the difference between the price of a home and the amount of the mortgage loan.

Escrow. Funds held by a third party until a transaction is completed. A deposit on the purchase of a house is held in escrow until closing or until the contract is terminated. Lenders hold funds in escrow to pay property-related expenses.

FHA (**Federal Housing Administration).** A unit of the U.S. Department of Housing and Urban Development (HUD). The FHA insures home mortgage loans.

Foreclosure. The legal process of selling property to pay the debt when a borrower defaults on a mortgage loan.

Fully amortizing loan. A loan in which payments include debt reduction so that at the end of the loan term, the principal of the loan is fully repaid.

Good-faith estimate. An estimate of the settlement costs of a sale based on expected pricing and level of services. This estimate allows the consumer to shop for services and to plan for closing costs.

GPM (Graduated payment mortgage). A loan with gradually rising payments for the first several years of the term, intended to coincide with the borrower's gradually increasing income.

In arrears. Due at the end of the period, as opposed to payments due "in advance" or prior to the provision of the service.

Index. For Adjustable Rate Mortgages, the statistic that determines how the interest rate is adjusted. Most indexes used are average interest rates for a type of debt (mortgages, treasury bonds) for a region or nationally. The index is specified in the mortgage contract.

Interest rate. The percentage of outstanding principal that is accrued as interest, usually expressed on an annual basis. This is the main indicator of the price of a loan.

Lifetime cap. See Caps.

Loan application. Paperwork requesting a loan from a specific lender. Lenders may or may not commit to specific loan terms at the time of application.

Loan application fee. A fee collected at the time a loan application is submitted. The fee usually pays for a credit report, an appraisal of the property and other processing costs.

Loan originator. See originator.

Loan term. The length of time that a loan is scheduled to run. Also called the "maturity."

Loan-to-value ratio (LTV). The amount of the loan compared to the price or value of the home. An indicator of the risk that the borrower will default on the loan.

Locking in the rate. An agreement from a lender to provide a loan at a specified interest rate if it is closed within a specified period, usually 30 to 60 days after loan application.

Margin. For Adjustable Rate Mortgages, the difference between the interest rate applied to the loan and the value of the index. The margin is constant and is specified in the loan contract. The interest rate applied may differ from the sum of the index and margin when caps limit the adjustment of the interest rate.

Maturity. The period over which interest is earned on a loan. By maturity, the principal balance of the loan has been retired, and no more interest is due.

MIP (mortgage insurance premium). The charge to the borrower for mortgage insurance, which may be either FHA insurance or PMI. It may be collected as a one-time charge at closing, as an annual or monthly fee or both.

Monthly payment. The periodic payment on a loan, including provisions for interest due, principal reduction, MIP and, often, contributions to an escrow account from which hazard insurance premiums and property taxes are paid.

Mortgage. An obligation to repay a loan backed up by a pledge of the property being financed. A borrower gives a mortgage to the lender in exchange for the loan needed to buy the property.

Mortgage banker. A firm that originates mortgage loans and sells them to investors, lenders and mortgage conduits.

Mortgage broker. An agent that brings together borrowers and lenders. The broker may perform loan application processing duties as well.

Mortgage constant. The ratio of the monthly payment of principal and interest on a loan to the amount borrowed. The constant depends on the interest rate and term of the loan and is used to calculate the payment on a fixed-payment, fully amortizing loan.

Mortgage insurance. Insurance to protect the lender in case the borrower defaults on the loan, forcing the lender to foreclose the loan.

Mortgage loan. A loan secured by a mortgage. A lender making a mortgage loan has a claim to the property if the borrower fails to keep the promises made in the loan contract.

No-doc loan. A mortgage loan originated without the usual documentation or verification of the borrower's income and wealth. Used when speed of approval is important or when documentation is difficult to obtain.

Origination. The process of making a new mortgage loan, including processing of the application, underwriting the loan and arranging funding.

Origination fee. A charge for originating a mortgage loan. The fee is charged as a discount point and is paid at closing. An origination fee is not considered interest and cannot be itemized as a deduction on income taxes.

Originator. The lending institution or agent originating a mortgage. The process includes loan application processing, underwriting and funding the loan. An originator may hold or sell the loan after it has closed.

PITI (Principal, interest, taxes and insurance). The components of the monthly payment on a typical mortgage loan, which are a payment to principal reduction, accrued interest, and a contribution to an escrow account from which property taxes and insurance premiums are paid.

PMI (Private mortgage insurance). Insurance that allows the lender to make low down payment mortgage loans. Similar to the insurage coverage provided by the FHA, but the provider is a privately owned company.

Point-of-sale origination. Loan application and processing that occurs within the real estate brokerage office as a convenience to the buyer.

Points. See Discount points.

Portfolio lender. A lending institution that retains and services at least some of the loans it originates, rather than selling them into the secondary market. Most portfolio lenders are depository institutions such as commercial banks and savings and loan associations. Because they are retained in the lender's portfolio, the loans do not have to conform to the

requirements of secondary market investors. Therefore, the lender may be more able to tailor loan terms to fit the needs of individual borrowers.

Prepaid interest. Interest paid before it is due. A payment of interest that will accrue from the closing date until the first day of the loan term usually is required at the closing.

Prepayment. Payment of some or all of the principal of a loan prior to scheduled payment as set forth in the loan contract. Prepayment may take the form of additional payments to principal accompanying the usual monthly payment or retirement of the entire loan in conjunction with a sale or refinancing.

Prepayment penalty. A fee, usually based on a percentage of the outstanding principal, charged for paying off the loan before the end of the term.

Qualifying. The lender's process of determining whether the risk of borrower default is within acceptable limits so that a loan can be approved. Lenders examine borrower income and debts, credit history and the loan-to-value ratio in qualifying a borrower.

Rate reduction refinancing. Loan refinancing for the purpose of reducing the interest rate on the loan.

Refinancing. Restructuring of the debt on a property. In most cases, refinancing means taking out a new mortgage loan used to repay the existing loan. Refinancing may be used to reduce debt service, derive cash or both.

Secondary market. The market in which existing loans are sold to lenders, investors and conduits.

Servicing. Collecting loan payments, maintaining any escrow account and keeping all records necessary for taxation and accounting purposes. A company servicing a loan need not be the holder of the loan.

Subprime loan. A mortgage loan in which the borrower has an inferior or nonexistent credit rating. Such loans carry higher interest rates and less favorable terms compared to standard mortgage loans.

Teaser rate. Introductory rate applied to an Adjustable Rate Mortgage. The rate is lower than that justified by the index and margin and remains in effect only for the first adjustment period. All caps apply to this rate.

Title insurance. Insurance policy that protects the beneficiary from future claims against the title (ownership) to a property. There are often two title policies taken out when property is transferred. The first protects the lender against title defects and the second protects the buyer from defects.

Up-front mortgage insurance premium (UPMIP). Premium for mortgage insurance that is due in full at the closing. In some cases, the UFMIP may be financed into the loan.

VA (Veterans Administration) loan. A loan guarantee that provides mortgage financing with no cash down payment as a benefit to military veterans.

Variable payment loan. Any loan that requires principal and interest payments that change during the term.

Appendix B

Internet Resources

Cost of Funds Index
http://www.ots.treas.gov/docs/23002.pdf (access requires use of Adobe Acrobat reader)

Credit Reporting Companies
Equifax — www.Equifax.com
Experian — www.Experian.com
Transunion — www.Transunion.com

Current loan rates and indexes
http://www.bankrate.com/ust/rate/avg_natl.asp

Fannie Mae
http://www.homepath.com Provides consumer information on home buying and Fannie Mae sponsored lending programs.

Fair Isaac Company
http://myfico.com Information on personal credit score.

Federal Home Finance Board
http://www.fhfb.gov/prgmoffices/mirs/idx_hist.htm Official values for the national average contract rate index used to adjust some ARMs.

Freddie Mac
http://www.freddiemac.com/pmms Current mortgage rate information.

http://www.freddiemac.com/homebuyers Consumer information and descriptions of Freddie Mac programs.

HUD/FHA
http://www.hud.gov/buyhome.html Homebuyer's kit, a series of tips and information for first-time homebuyers.

http://www.hud.gov/progdesc/snglindx.html Descriptions of HUD/FHA's programs for single-family homes.

National Average Contract Interest Rate on Mortgage Loans Index
http://www.fhfb.gov/prgmoffices/mirs/armindex.htm

Real Estate News
http://news.inman.com/inmanconsumer.asp Tips and answers to questions concerning buying and financing homes.

http://www.bankrate.com/inm/rate/mtg_home.asp?web=inm Mortgage interest rates and articles on home financing topics.

Treasury Rates/Bank Prime Rate Indexes
http://www.federalreserve.gov/releases/G13/current/G13.pdf
for historical rates, see
http://www.federalreserve.gov/releases/H15/datga.htm