The Basics

What Is a Mortgage?

A mortgage is a loan secured by real estate. In other words, in return for the funds necessary to purchase a home, a lender gets your promise to pay back the funds over a certain period at a certain cost. Backing your promise to repay is the property. Should you default, or stop paying the loan, the lender would take over ownership of that property. Typically, the repayment of a mortgage occurs through monthly payments.

What Does My Mortgage Payment Include?

Usually, your monthly mortgage payment is made up of four parts: principal, interest, taxes and insurance (PITI), but it can also include maintenance expenses, such as condominium homeowners' association dues. The principal is the amount in your monthly payment that reduces the original amount borrowed. Over the life of a standard mortgage loan, the entire original amount borrowed is generally scheduled to be fully paid off, or amortized. The interest rate is the fee charged to borrow the outstanding balance for the past month. In addition, a monthly amount may be collected and held in a separate escrow account to cover property taxes, homeowner's insurance and mortgage insurance. Your lender uses the money in the escrow account to pay your tax and insurance bills, as they come due.

Mortgage Payment Breakdown

Principal + Interest + Taxes + Insurance = PITI

Principal is the amount of money you borrow based on the sale price of the home. In the early stages of your mortgage term, your monthly payment includes only a small portion that repays your original principal. As you continue to make payments through the years, a greater portion of your payment goes to reduce the principal.

Interest is the cost of borrowing money. In the early stages of your mortgage term, your monthly payment is mostly interest. As you continue to make payments through the years, a smaller portion of your payment goes to interest.

Taxes are paid by homeowners to local governments, and are usually charged as a percentage of the assessed property value. Tax amounts vary depending on where you live.

Insurance offers financial protection in the event of a loss and has two main components that can be included as part of your payment.

Homeowner's or hazard insurance protects you against financial losses on your property as a result of fire, wind, natural disasters or other hazards. Most lenders will require you to have a homeowner's insurance policy on your home because it will help protect their investment as well as yours.

- Mortgage insurance (MI) is required on certain loans to protect the lender against financial losses if the borrower fails to repay the loan. Usually, whenever the down payment is less than 20% of the home's purchase price, lenders require some type of insurance. Loans insured by FHA/HUD programs require a mortgage insurance premium (MIP), while VA loans require a funding fee. Conventional loans, or those without government backing, can be insured with Private Mortgage Insurance (PMI).

Typically, the portion of your monthly mortgage payment that covers taxes and insurance is held in a special account by your lender. Then, when these bills are due, the lender forwards payment on your behalf to the local government or insurance company. This process is known as escrow. Using escrow for taxes and insurance is an option for the homeowner and not a requirement. Once your mortgage is paid in full, you are still responsible for taxes and hazard insurance.

How Do I Qualify For a Mortgage?

In general, all lenders use the same four basic standards to approve applicants for a mortgage. Different mortgage products have varying guidelines within those standards. The lender looks at what is referred to as the "the four C's": capacity, character, capital and collateral.

Your past financial history is very important because it indicates your willingness and ability to handle the increased financial responsibility of repaying your home loan.

Income (Capacity)

Do you have steady and sufficient income to make the monthly payments? This income can come from a primary, second, or part-time job(s), overtime and bonuses, commissions, self-employment, retirement benefits, pensions and annuities, public assistance, child support, alimony or maintenance payments, veterans benefits, disability payments or rental property income. In most cases, you need to provide documentation regarding your income. Lenders also offer no documentation mortgage loans for borrowers who qualify based on other criteria. Alimony and child support need not be noted unless you want to have them included as the basis for repayment of the debt.

Credit History (Character)

Have you paid back money you borrowed in the past? Have you been late in making your payments? Have you filed for bankruptcy? Do you have a record of judgments and collection accounts filed? Some lenders do offer special products for homebuyers with past credit problems. If you have a limited or no credit history, a "nontraditional" credit history will be considered. You may need to show paid receipts and canceled checks for rent and utility payments that document a pattern of paying your monthly obligations on time.

Savings (Capital)

Have you saved any money that can be used toward the purchase of your home? The savings can be money in a savings account, certificate of deposit, retirement [401(k)] account, or a gift from a relative or friend. A lender wants to see that you have the capital to fulfill your current obligations as well as your new mortgage. Ideally, you should have enough savings to act as a source of funds for your down payment and several months of reserve funds to cover your anticipated monthly mortgage payments should anything happen to you or your job.

Property (Collateral)

Your lender will require an appraisal on your home to determine its market value in comparison to similar houses that sold recently in the neighborhood. Your lender will also look at the type of the property and whether there are additional fees such as homeowner's association dues.

If you'd like to be pre-approved for a mortgage loan, you do not need to have a property in mind. You can actually get a conditional approval pending the property appraisal, if you qualify. (Not available in New Jersey.)

How Much Home Can I Afford?

To answer that question, lenders look at all the elements that make up your financial profile, including your credit history, the cash you have available for a down payment and closing costs, your income and your existing debt and financial obligations. Then, taking the current market interest rate into account, a lender can give you an estimate of the maximum mortgage amount you can afford. By adding your maximum mortgage amount to the funds you plan to use for your down payment, you will know your home purchase price range.

How Large of a Loan Can I Be Approved For?

Two general guidelines are used by lenders to determine the loan amount for which you may qualify. Based on your individual financial profile, these guidelines ensure that your housing expenses and debt payments don't take up too much of your income. These guidelines can help you remain inside your financial comfort zone after you buy a home.

The first guideline, known as the housing expense-to-income ratio (or front-end ratio), compares your proposed monthly house payment (PITI) to your total household gross monthly income. The second guideline, known as the debt-to-income ratio (or back-end ratio), compares your anticipated monthly housing payment to your gross (pre-taxed) monthly earnings and your monthly debt requirements. Monthly debt includes expenses such as credit cards, car loans, student loans, consumer loans plus other financial obligations such as child support and alimony.

It used to be that most loan programs required 28/36 ratios , which meant you could devote up to 28% of your gross monthly income to housing expenses (the front-end ratio), while your monthly housing expenses plus your monthly debt combined could be as high as 36% (the back-end ratio).

Many of today's loan programs offer expanded guidelines and more flexible qualifying ratios (such as a 29/41 ratios) that allow you to devote more of your gross monthly income to your combined monthly debt.

Your home mortgage consultant can help you get a better idea of the maximum mortgage amount you can afford. Depending on your financial profile and the mortgage program you choose, your consultant may use standard or flexible ratios as a part of the qualifying process. Once you have this maximum figure, it's up to you to decide if this is the right amount for you, or if you would feel more comfortable with a smaller mortgage and a lower monthly payment.

How Important Is My Credit?

Your credit report is an important consideration to lenders reviewing your financial profile. If you have a history of paying your monthly obligations on time, that's a signal to a lender that you are likely to make your monthly mortgage payments on time as well. So your credit can be a factor in the kind of mortgage program you may qualify for.

Your credit history can also affect the amount required for a down payment, the amount of money you can borrow in relation to your income, and the interest rate you are offered. But keep in mind that even if you have no established credit history or less-than-perfect credit, there are still loan programs that can help you buy a home.

Here are some steps you can take to establish or improve your credit rating:

- If you've always paid cash or used checks to make purchases and haven't established a credit record, it's a good idea to do so before you buy a home. You can use credit to purchase low-priced items, make prompt payments and pay off the balance.
- Some loan program guidelines allow "alternative" credit records. If you have a limited credit history, your paid receipts and canceled checks for rent and utility payments can help you document a pattern of paying your monthly obligations on time.
- If you already have outstanding loans or credit card debts, try to pay off as many as possible. The amount of monthly debt you are responsible for paying reduces your capacity for taking on housing debt (via the back-end ratio, discussed above).
- Even if you are a consistent, on-time bill payer, you can damage your credit rating by just having a lot of credit cards with large credit lines. Contact any creditors for accounts which you no longer use and request that they close the account.

How Much Do I Need for a Down Payment?

In the past, saving money for a down payment on a home was often the largest obstacle to home ownership with lenders requiring a minimum of a 20% down payment. But today's flexible home loan programs make this issue less of a challenge, with some programs allowing you to put very little down (3% or less). In fact, you may qualify for programs that don't require down payments at all.

Today's flexible home loan programs make the down payment less of a challenge than it was in the past.

Some homebuyers may be eligible for local down payment assistance programs. If one is available in your area, your home mortgage consultant can give you further details.

If you decide to use less than a 20% down payment, your lender may require Private Mortgage Insurance (PMI). These insurance programs protect the lender in the event you do not fulfill your commitment to repay the mortgage.

What About Closing Costs?

Closing costs cover the amount of money you pay to close a mortgage loan aside from the down payment. The amount you pay in closing costs varies among lenders, mortgage products and localities. The closing cost fees generally fall into one of three categories: *out-of-pocket expenses, pre-paid items and points.*

Out-of-pocket expenses usually cover third-party services that are directly charged to you, such as fees for appraisals, attorneys, credit reports, title (deed recording), or tax services. Which services you must pay for varies on the property location and home financing program. If you don't understand what a particular fee covers, or why you are required to pay it, ask your home mortgage consultant to explain.

Prepaid items can vary based on the type of property and the time of the closing, but they generally include homeowner's insurance, mortgage insurance, and fees associated with establishing an escrow account. Escrow accounts are set up by lenders to pay property tax and insurance premiums. Instead of paying the entire premium every six or twelve months, the borrower pays a portion of the cost along with every monthly mortgage payment. This helps the borrower avoid the hassle of planning for the large payments, while reassuring the lender that tax and insurance payments are always up to date. Using an escrow account is an option and not a requirement

Points are fees, with each point representing 1% of your loan amount, that cover the cost of your mortgage loan. Generally, points can be split into two categories:

- Origination points: This is an amount collected by the lender for making the loan.
- Discount points: As discussed elsewhere in this handbook, this is a fee that allows you to buy down your interest rate. In other words, in return for paying more discount points upfront, you can lower your interest rate and thus your monthly payment.

What About Closing Costs?

(continued)

To make the best apples-to-apples comparison on lenders and home financing packages, be sure that the rates all have the same number of total points and that you factor in the total amount you will be paying in closing costs. While one loan may offer a lower rate, it may also require you to pay a higher number of points at closing and more money out of pocket for you. Also, don't forget to consider loan features and service after closing in addition to the rate, APR, and points when you compare different loan programs.

Your home mortgage consultant can give you information on average closing cost percentages for specific areas and loan programs. And, shortly after you apply for a home mortgage, you will be sent a Good Faith Estimate, which provides details on the approximate costs you will be required to pay at or before closing. While it is only an estimate, it can help you budget for your closing.