



# Mortgages

Personal Finance Basics



ABA Education Foundation  
1120 Connecticut Ave., NW  
Washington, DC 20036  
[www.aba.com](http://www.aba.com)

ABA EDUCATION  
FOUNDATION  
*A subsidiary of the*  
AMERICAN BANKERS ASSOCIATION®

From the ABA Education Foundation  
A subsidiary of the American Bankers Association



# Mortgages

Personal Finance Basics

*A series of consumer education booklets*

## *Welcome*

Managing your money is tough, and everyone has a different opinion. Once you get the hang of the basics of personal finance, you can feel more confident about what you do with your money.

This booklet is one in a series of short, easy-to-follow personal finance primers. Think of this booklet series as an instruction manual for managing your money and making the most of what you have. From the basics of budgeting and saving to the ins and outs of credit and checking accounts, the booklets in this series will help get you started on the road to a successful financial future.

Learning from the examples and exercises in these books will give you a good foundation, but it's important to speak with someone at your local bank. Forming a relationship with a banker is very important because you'll have a trusted expert available to answer your questions.

## *Table of Contents*

Introduction to Mortgages .....	1
Types of Mortgages .....	2-3
Determining Your Borrowing Power .....	4-7
Do You Qualify for a Loan?.....	8-9
The 4 Cs of Credit for Home Buying .....	10
Your Bank Can Help You Shop for a Loan and Lender ....	11
Sign on the Dotted Line .....	12-13
Loan Documentation Checklist Sample .....	14-15
Final Thoughts .....	16

## *Introduction to Mortgages*

Buying a home can be one of the best investments you will make in your lifetime. It's also one of the largest financial transactions you will ever make. Buying a home requires a great deal of planning and saving.

### **What is a Mortgage?**

Since most homebuyers cannot write a check for tens or hundreds of thousands of dollars, you likely will need to apply for a loan specifically for home-buying, which is known as a mortgage.

A mortgage is a type of loan used to finance the purchase of a home or piece of property. A loan for the purchase price of a home can often be double or triple your annual salary, so the lender is taking a risk in allowing you to pay back the loan over a certain period of time. Just as with an auto loan, if you do not pay in regular installments, the home or piece of property can be sold by the lender to repay the loan.

Because mortgage loans are for a large sum of money, borrowers pay back the amount owed plus interest over a long period of time, typically 15, 20 or 30 years. Monthly mortgage payments consist of principal (part of the original sum of money borrowed), interest (cost of borrowing), taxes and insurance.

## Types of Mortgages

There are several different types of mortgages available for purchasing a home. All mortgages involve a lender obtaining a lien or title to the property in return for the payment of the amount of money lent plus interest. Your lender will help you decide which loan is best for you and your individual situation. Don't ever take out a mortgage that you don't understand. The amount of your monthly payment and how it will change, if at all, should be very clear.

**Fixed Rate Mortgage** – With a fixed-rate mortgage, the interest rate does not change during the term of the loan. Fixed-rate mortgage terms are typically 15 or 30 years. This means that your monthly payment (interest and principal) will stay the same every month of the loan. Remember that homeowner's insurance and property taxes are often collected with your monthly mortgage payment. Insurance and taxes can change every year so be sure to budget for those changes.

**Adjustable Rate Mortgage (ARM)** – An adjustable rate mortgage offers a fixed initial interest rate and a fixed monthly payment over a shorter term, often three, five or seven years. After the introductory period is over, the interest rate and term of the mortgage adjusts to a new rate and, typically, a new higher payment. The interest rate and payment on an ARM loan will continue to adjust over the life of the loan. ARMs are available that adjust monthly, semi-annually or annually after the initial fixed period. Interest rates can go up or down significantly after the initial period ends.

**FHA Mortgage** – An FHA mortgage is a mortgage that is insured in whole or in part by the Federal Housing Authority. This mortgage type is for those with less-than-perfect credit or new homebuyers and provides the opportunity for homeownership without some of the costs associated with a conventional mortgage.

**Interest Only Mortgage** – With an interest only mortgage, you pay only the interest and do not reduce the principal during a fixed period only, typically the beginning of your mortgage term. This allows you to borrow more, while keeping payments low. These loans typically are used by more experienced borrowers who expect to sell the property before the interest and principal repayment begins.

**Other Types of Mortgages** – There are several other kinds of mortgages which are for more experienced property owners. You and your lender will decide what kind of mortgage is right for you.


## Determining Your Borrowing Power

Buying a home can be an emotional experience. You are in the best position to determine the amount of money you can afford to repay. When a lender qualifies you to borrow \$150,000 (for example), this means that the lender has determined that \$150,000 is the maximum amount of money you can borrow, based on your current income and other debts or expenses. Don't let your emotions push you into buying more home than you can afford. It is up to you to decide whether or not to borrow the full \$150,000. The house you choose might not require the full loan amount.

### How Much Home Can You Afford?

Before visiting a lender to find out what loan amount you will qualify for, it is a good idea to review your own finances and determine the range of home prices you can afford. If you are curious about how much home you can afford, here is a quick rule of thumb: Most people who have good credit and a steady income and do not owe a lot of money can afford to buy a home that costs 2½ to 3 times their gross annual income. It's important to remember that unlike renting, as a homeowner you are responsible for any repairs, upkeep, insurance, utilities and taxes, so be sure that you have a buffer each month (or better yet a healthy savings) to cover unexpected costs.

The Housing Affordability Worksheet (next page) can help you find your gross annual income using the amount of your paycheck before taxes, insurance and other expenses are taken out. Remember, the worksheet is just an estimate. The actual amount you can pay for a home varies with the type of loan program, interest rates and your situation. Ask your banker for the Budgeting booklet in this series, which will help you organize your income and expenses.

Housing Affordability Worksheet		
If you are paid <b>WEEKLY</b>	\$ _____ (before pay deductions) x 52	\$ _____ <b>Annual Income</b>
If you are paid <b>TWICE A MONTH</b>	\$ _____ (before pay deductions) x 24	\$ _____ <b>Annual Income</b>
If you are paid <b>ONCE A MONTH</b>	\$ _____ (before pay deductions) x 12	\$ _____ <b>Annual Income</b>
<b>Other Monthly Income</b> This figure should include annual income from all co-borrowers [e.g. your spouse] on your loan.	\$ _____ (other monthly income) x 12	\$ _____ <b>Annual Income</b>
<b>TOTALS</b>	<b>TOTAL GROSS ANNUAL INCOME</b>	\$ _____
 <b>How much house can you afford?</b>	<b>GROSS ANNUAL INCOME</b> x 2.5	\$ _____ <b>Low Range of Housing Cost</b>
	<b>GROSS ANNUAL INCOME</b> x 3	\$ _____ <b>High Range of Housing Cost</b>

## Determining Your Borrowing Power *(continued)*

### What Other Costs Should You Expect?

Other than the estimated monthly mortgage payments, the following is a list of the other costs you should budget for when planning to buy a home:

**Down Payment** – The down payment is your first investment in the house. The minimum amount of the down payment is decided by the lender, and is typically between 10 and 20 percent depending on the loan program and the amount you are able to afford. You can make a larger down payment and reduce the amount you have to pay back and also the amount of your monthly payments. If you pay less than 20 percent down, you will be required to buy mortgage insurance to offset the added risk to the lender of having less of your own equity invested.

**Closing Costs** – Closing costs are usually paid at the closing, or settlement, of the home buying process. They include money paid to the lender to review the loan (application or processing fee), money paid to the city, county or state for transfer taxes or recording fees, and fees paid to businesses that provide services to make the sale go smoothly, such as lawyers and escrow agents. Depending on the loan program and state, closing costs can range from \$100 to 3 to 5 percent of the price of a home. Some lenders will pay for closing costs, but in return will charge a higher interest rate to recover their cost over time.

There are loan programs that allow the homebuyer to borrow the down payment and closing costs, or some portion of them. Some community-based organizations can help borrowers pay their down payment and closing costs with grant money or low-interest loans.

**Escrows** – In addition to the money that you pay to the lender each month for principal and interest, your mortgage payment will probably also include an amount of money for property taxes and insurance. The whole payment is known as the PITI (P = principal, I = interest, T = taxes, and I = insurance). At the beginning of the loan and at the beginning of every year, the lender estimates how much the taxes and insurance will cost for the year and divides the cost by 12. The lender collects the money monthly and saves it in a special account called an escrow account. When the tax and insurance bills are due, the lender pays them out of the escrow account. Be sure you know the total payment (principal, interest, taxes and insurance) you will pay each month.

At closing, the lender may require that you put an amount of money in the escrow account equal to two or three months of property taxes and up to six months of insurance.

**Moving Costs** – These costs may include renting a moving van, deposits for utilities, new appliances, furniture and immediate home repairs.

**Maintenance and Upkeep** – Because you are solely responsible for the home you have purchased, you are responsible for its maintenance and upkeep. Schedule a home inspection before you complete the purchase so you know what shape your home is in currently.

**Condominium and Homeowners Association Fees** – If you are purchasing a condominium or townhome, there are monthly fees that must be paid to the association for neighborhood maintenance and any extras, such as pool or neighborhood parks, as well as the exterior of the home and landscaping, which often fall under the responsibility of the condominium or homeowners association.

## *Do You Qualify For A Loan?*

Before you begin looking for your dream home, it would be helpful to know how much you will be able to borrow. Most lenders are willing to prequalify you. There is generally no charge for prequalification and you are not required to get your loan through a lender who prequalifies you. This process will give you a better sense of what you can afford and allow you to focus on finding the right home in your price range.

### **Appraisals**

Appraisers are qualified professionals who visit the home you have decided to purchase and determine its market value. It is important to hire an appraiser to estimate the value of the property so you know you're not paying too much for your chosen home.

### **Getting Prequalified by a Lender vs. Getting Preapproved**

If you want to know how much home you can afford, ask a lender to prequalify you. However, if you have already found a home you would like to purchase and are serious about putting an offer on that house, consider getting preapproved for a loan.

### **Prequalification**

To begin the **prequalification** process, the lender will ask for information described in the **4 Cs of Credit** (see page 10). From this information, the lender will calculate how much you can afford to spend each month for housing. Finally, using the current interest rates and loan programs available, the lender will estimate how much you can borrow. Typically, lenders do not charge a fee for this service and will also provide you with a certificate or prequalification letter you can show to a home seller as proof that you can afford the home you wish to buy.

**Note:** Prequalification is an informal process and is not a guarantee that the lender will give you a loan.

### **Preapproval**

The **preapproval** process is more formal. The lender will examine your credit and finances thoroughly and provide you with a guarantee that if you buy a home within a certain time period (usually 45 days) and it is valued (determined by appraisers) for the amount of money for which you have been preapproved, the lender will make you a loan.

### **Points**

If you are a first-time homebuyer, often your loan will have a fixed interest rate plus points. Points are a form of prepaid interest. The lender can offer you a lower interest rate in exchange for adding points to the loan portfolio because the lender receives more money in the long run from the points, without increasing the interest rate. One point equals 1 percent of the loan amount. Borrowers who pay points receive a lower interest rate in exchange for this up-front payment.

## *The 4 Cs of Credit for Home Buying*

**Capital** – Capital is the amount of money you have to use for your down payment, closing costs and reserves. Reserves are an amount of money set aside to make home repairs. This is held in your savings account. Lenders may ask that you have an amount of money at least equal to two months' mortgage payments at the time of closing. Lenders will ask you how much capital you have and where it came from. Lenders will not accept a down payment that is borrowed from some other source.

**Capacity** – Capacity refers to your ability to make the monthly mortgage loan payments and also pay all of your other bills. Lenders will ask you for a verification of employment, how much you earn, and how much long-term debt you owe. Then, based on the size of your family, a lender will estimate how much of your income you need for food, clothing and basic expenses and how much you should have left over to pay the mortgage payments.

**Credit History** – Lenders want to know how much money you owe to others, how often you use credit and if you pay your bills on time. Lenders get most of this credit history from a credit report, which often is converted into a credit score. For more information about credit and credit scores, see the Personal Finance Basics booklet titled Credit.

**Collateral** – The home you are buying will be collateral or security for the loan. When you borrow money to buy a home you not only give the lender your promise to repay the mortgage, you must also give the lender the right to sell the house if you are unable to pay back the loan for any reason. The collateral protection for lenders is the reason mortgage interest rates are much lower than on credit cards, which are loans not secured by property.

## *Your Bank Can Help You Shop For a Loan and Lender*

Shopping for a mortgage loan is easier than it might sound. Your goal is to get the best interest rate, but you also want to find a lender who will take the time to understand your situation; especially if you have had credit problems in the past or much of your income is from sources other than a full-time job, such as disability, child support or part-time work.

While a real estate agent can be a good source, remember that the agent is working for the seller and may not direct you to a lender who will help you determine what you can truly afford.

Your best bet is to visit your local bank and several other banks and ask what kind of mortgage they can offer you. Remember to consult your own bank first, as they know you better and often are more willing to work within your specific circumstances.

### **What are mortgage brokers?**

A mortgage broker is an individual or company that brings borrowers and lenders together for the purpose of loan origination. Mortgage brokers typically require a fee or a commission for their services. This fee can be paid by the lender, the borrower or both. Mortgage brokers are helpful if you don't want to shop around for a mortgage loan on your own, or if you have a blemished credit report. When you talk to a broker you are considering using, ask for details about the pros and cons of each loan you are considering, and about how the broker will be compensated for services rendered. This will help you to judge if the broker is willing to take time to help you understand the process, and to know what services you will be paying for and how those services will be paid.

## Sign on the Dotted Line

Once you have found a home and your purchase offer has been accepted, you will need to get a mortgage loan.

### The Mortgage Loan Process:

- 1. Mortgage Loan Application:** Arrange for a meeting with a loan officer. Together, fill out a standard loan application form. When the application is complete, all of the borrowers must sign it and pay an application fee and credit report fee. The fees vary with each lender and are not refunded if you do not get the loan.
- 2. Good Faith Estimate and Truth-in-Lending Statement:** Within three business days the lender is required by law to send you two documents: a Good Faith Estimate of your settlement (closing) costs and a Truth-in-Lending statement. The Truth-in-Lending Statement gives the terms and cost of your mortgage loan including the loan amount, the interest rate, the total amount of money you will pay over the life of the loan, the amount of interest you will have to pay in advance (called “points”), and the annual percentage rate (APR). APR is the actual interest rate you are paying when you add the points (interest paid in advance) and interest paid monthly. The Truth-in-Lending Statement also includes a provision called the Right of Rescission, which allows a buyer three days from the signing of the mortgage to change his or her mind and choose not to go through with the purchase of the home.
- 3. Verification:** Next the loan officer turns your application over to a loan processor who orders a credit report, an appraisal on your future home, and verifications including employment and income.
- 4. Processing:** You may receive letters from the loan processor telling you what documentation has not yet been received. You must provide all necessary explanations, receipts and other documents the processor asks for. At times when application volumes are high, be sure to keep in contact with the processor or lender to ensure that nothing falls through the cracks.
- 5. Underwriting:** The underwriter is the person who recommends whether or not you qualify for a mortgage loan. The underwriter will base the decision on the 4 Cs of Credit you read about on page 10 and may request more information to confirm that that information in your application is true.
- 6. Loan Commitment/Closing the Loan:** If the underwriter decides that you are a good credit risk, you will receive a commitment letter stating that the lender will loan you a certain amount of money for the purchase of your new home. The letter will also state what your monthly payments will be. The commitment letter is a legal document you must read carefully, sign and send back to the lender. The signing normally takes place in front of a notary public.  
  
Bring a cashier’s check for your down payment and closing costs if required. Personal checks are normally not accepted. You can ask to review the closing statement a day ahead of the closing. Ask the loan officer who handles your loan for the closing statement. You should know exactly how much you will need to pay at the closing.

## Loan Documentation Checklist Sample

While working through this checklist, keep in mind that all of the items may not apply to you. If you have scheduled a meeting with a lender, it is a good idea to call the lender ahead of time and ask what documentation you will need to bring.

### General Documents:

- Social Security card, driver's license or other picture ID

### Documents to Support Income:

- The name, address, phone number and fax number for every employer you have had in the last two years
- Most recent two months' pay stubs
- Income tax returns for the last two years if you are self-employed

### Evidence of All Other Income, Including:

- Child support payments
- Pension payments
- Seasonal employment
- Government assistance/SSI benefits
- Social Security benefits
- Statements of stock dividends
- Income tax returns for the last three years, including W-2s and all attached schedules

### Documents to Support History of Consistently Paying Housing Expenses:

- Letters from landlords stating where you lived for the last two years, dates you lived there, rent per month and how many times you were late with your rent payment. If you cannot get a letter from the landlord, you should provide the name, address and phone number of each landlord for the past two years, and the amount of your monthly rent payments.

### Documents to Support Recent Bank Activity:

- Most recent savings account statement(s)
- Most recent checking account statement(s)
- Most recent brokerage statements showing stock and bond balances and recent transactions

### Documents to Support Current Debts:

- For each creditor (bank, credit card or person) with whom you have an outstanding debt: name, address, account number, balance and monthly payment.

### Documents to Explain Irregularities:

- Letter of explanation for any negative credit items
- Letter of explanation for any gap in employment
- Chapter 7 or Chapter 13 bankruptcy discharge papers and list of creditors

### Other:

- Veteran's certificate of eligibility
- Certified copies of divorce decree and separation agreement
- Name, address and phone number of the person to whom you pay child support

## *Final Thoughts*

Buying a home is one of the biggest financial transactions you will make, so be sure you are well informed. Many lenders offer classes for first-time homebuyers. Attending one of these sessions will help you navigate the complicated world of mortgages.

Your ability to repay a debt is one of the most important factors in determining your borrowing power, so be sure to pay your credit card or car loan on time each month.

### **The Possibility of Rejection**

If the underwriter determines that you are not a good risk, you will receive a rejection letter. By law, the lender must tell you why your request for a mortgage loan was denied. Some reasons for denying credit include:

- Poor credit
- Low appraisal value of the house compared with what you contracted to buy it
- Insufficient funds for a down payment
- High debt

By using the information in our Personal Finance Basics booklet series, you will move toward achieving your personal financial goals. As you do, contact your local banker for guidance. The important thing is to get started right away — then watch your money grow and your dreams come true.