

FREQUENTLY ASKED QUESTIONS ABOUT FINANCING

What is a Mortgage?

Most of us are accustomed to calling our home loan a **mortgage**, but that isn't an accurate definition of the term. A mortgage is not a loan, and it is not something that the lender gives you. It is a security instrument that you give to the lender, a document that protects the lender's interests in your property.

How a Mortgage Works

- There are two parties to a mortgage. You are the mortgagor, or borrower, and the lender is the mortgagee.
- A mortgage document creates a lien on the property, which serves as a lender's security for the debt. The lien is recorded in public records, probably at your county courthouse.
- Ownership cannot be transferred to someone else until you pay the debt to release the lien.
- Even if your loan is secured by a mortgage, you still have full title to the property.

No one else has rights of ownership.

- A mortgage gives the lender the right to sell the secured property to recover funds if you do not pay the debt. The sales process is called foreclosure.
- When a mortgage is used for security, foreclosure must usually progress through the court system. That type of foreclosure is called a judicial foreclosure.

Deed of Trust

Over half of the states in the United States use mortgages as security instruments. The other states use a **deed of trust**, which serves the same purpose, but with a few important differences.

- A deed of trust is a special kind of deed that is recorded in public records, where it tells everyone that there is a lien on your property.
- A deed of trust involves three parties. You are the trustor, the lender is the beneficiary, and a third party is the trustee--someone who holds temporary (but not full) title until the lien is paid.
- The trustee should be a neutral third party, someone who won't favor either you or the lender if problems crop up. In some states, attorneys act as trustees, and in others, title insurance companies often provide the service.

- The trustee cannot take your property for no reason--documents are in place to protect against that.
- The deed of trust is cancelled when the debt is paid.

The Bottom Line

The differences between a mortgage and a deed of trust affect home buyers only when foreclosure is an issue, because the trustee has the power to sell the house if your loan becomes delinquent. The lender must give the trustee proof of the delinquency and ask the trustee to initiate foreclosure proceedings.

The trustee must progress as allowed by law and as dictated in your deed of trust, but the process bypasses the court system, making it a much faster and cheaper way for the lender to foreclose.

You cannot choose the way your loan is secured, that's determined by where you live, but it's important to have an understanding of the type of lien that secures the debt for your home.

What Can I Afford?

There is a rule of thumb that says that if you have the capacity to repay the mortgage, you can afford a single-family house that costs up to two and one-half times your annual gross income. (Annual gross income is the amount you make before taxes are deducted.) Like other rules of thumb, this is a general idea of how large a mortgage you can afford. But, because it is so simple, it doesn't take into account all the information that will help you feel comfortable with your mortgage payments.

If you are buying a house with someone else (spouse, parent, adult child, partner/companion, brother or sister or other relative), you should consider your co-purchaser's earnings and existing debts as well. Remember, if you apply for a loan with somebody else, you and your co-borrower are both legally responsible for repayment of the mortgage.

Your buying power depends on how much you have available for the down payment and how much a financial institution will agree to lend you.

Your down payment

If you are a first-time home buyer, the price you can afford to pay for a house may well be limited by your ability to come up with the required down payment and closing costs. If you haven't accumulated much savings, you may want to set aside funds for a down payment on a regular basis from your paycheck. Monies in your checking and savings accounts, mutual funds, stocks and bonds, the

cash value of your life insurance policy, and gifts from parents or other relatives may all be suitable sources for a down payment.

Private Mortgage Insurance

Depending on the lender and loan type, you may be able to get a mortgage with as little as 3 percent or 5 percent down. However, putting less than 20 percent down often means you will be required to purchase private mortgage insurance. Private Mortgage Insurance (PMI) helps protect the lending institution in case you fail to make payments on your mortgage.

Avoiding PMI

It is possible to get financing with 0-10% down and not pay PMI (Private Mortgage Insurance). This is why 80-10-10 financing was created. It is called 80-10-10 because a lender provides a traditional 80% first mortgage, a 10% second mortgage, and makes a cash down payment equal to 10% of the home's purchase price. The same principle applies if the borrower can only afford to make a 5% down payment: 80-15-5 financing is also available.

Your closing costs

In addition to the down payment, you will also need to consider closing costs. The closing is the final step during which ownership of the house is transferred to you. The purpose of the closing is to make sure the property is ready and able to be transferred from the seller to you.

Closing costs generally range from 3 percent to 6 percent of the amount of the mortgage. So, if you were to buy a \$100,000 house with a 5 percent (\$5,000) down payment, you could expect to pay between \$2,850 and \$5,700 on your \$95,000 mortgage. Sometimes, you can negotiate with the seller of a property to pay some of your closing costs, which will reduce the amount of money you will need to bring to closing.

How much a financial institution will lend you

Apart from having available funds for a down payment and closing costs, the other major factor limiting how expensive a house you can buy will be how much you can borrow.

When you apply for a mortgage, the lender will consider both your earnings and your existing debts in determining the size of your loan. Lenders generally use the following two qualifying guidelines to determine what size mortgage you are eligible for:

The amount of money you owe for mortgage payments, property taxes, insurance, and condominium or co-op fee, if applicable, should total no more than 28 percent of your monthly gross (before-tax) income. This is called the Housing Expense Ratio. The amount of money you owe for the above items plus

other long-term debts should total no more than 36 percent of your monthly gross income. This is called the total Debt-to-Income Ratio.

Basically, lenders are saying that a household should spend no more than about one-fourth of its income (up to 28 percent) on housing and no more than about one-third of its income (up to 36 percent) on total indebtedness (housing plus other debts). Lenders feel that if they follow these guidelines, homeowners will be able to pay off their mortgages fairly comfortably.

These lender ratios are flexible guidelines. If you have a consistent record of paying rent that is very close in amount to your proposed monthly mortgage payments or if you make a large down payment, you may be able to use somewhat higher ratios. Some lenders offer special loans for low- and moderate-income home buyers that allow them to use as much as 33 percent of their gross monthly income for housing expenses and 38 percent for total debt.

Don't Despair, There is a Loan For You

When you go to apply for a mortgage, the lender will use all the relevant data -- your income, your existing debts, the purchase price of the house, your down payment, the interest rate on the loan, and the cost of property taxes and insurance -- and calculate whether you qualify to borrow the amount of money you need to buy the house.

Are You Really Pre-Approved for a Mortgage?

Most home buyers will hear these terms during their search for a home:

- Pre-Qualified
- Pre-Approved
- Loan Commitment

Sometimes even real estate agents are confused by the terms, so it's no wonder that home buyers and sellers are, too. Although related, the three terms each signify a different level of approval from a lender.

Pre-Qualified

You can be pre-qualified by a lender, by an agent, by yourself. The term means that someone has taken a general look at your income and expenses and plugged them in to a debt-to-income ratio formula. Loan pre-qualification does

not include an analysis of your credit report or an in-depth look at your potential to buy a home.

Bottom Line: Pre-qualifying yourself before you start looking for a home will give you a *general* idea of the price range you can afford.

Pre-Approval

When you are pre-approved, it means a lender has looked closely at both your credit report and your income. The lender will tell you the maximum amount of loan they will offer, and which loan programs you qualify for. You'll also have a better idea about your interest rate, or you might lock-in a specific rate.

Bottom Line: Now you can go shopping for a home with confidence about your buying power--but it still doesn't mean the bank will approve the loan. Your income and credit report will be checked again before closing, and the home itself must be approved.

Loan Commitment

The bank will not issue a loan commitment until it has approved both the house and you. The home appraisal must meet the lender's guidelines--usually meaning the home must appraise at or higher than the sales price.

The bank may require more information if the appraiser mentions anything the bank feels should be checked.

- A comment such as "observed a crack in the foundation and basement appears wet," will raise a red flag to the lender--and likely generate a structural inspection (which you must pay for unless the seller agrees to share or absorb the expense).
- If the bank reads "home accessible only with a 4-wheel drive vehicle," you can be sure they'll want to know more about ongoing road maintenance. Where I work, we have thousands of mountain roads that are maintained by groups of home owners. Many lenders verify that there's a written road maintenance agreement before they will lend. Other banks don't seem to care as long as no derogatory comments are made about the road.

Other things that affect a loan commitment:

- The home's title must be cloud-free, meaning there are no problems associated with it (no outstanding liens that can't be paid at closing; no right-of-way problems; no litigation in progress, etc.).

- Your credit profile will be checked again to make sure it hasn't changed in a negative way.

Bottom Line: The loan commitment letter is issued only when the bank is sure it will lend, so the commitment date on your contract to purchase should normally be closer to closing than to the date you make the offer. The home seller can demand to see that letter as soon as the date has passed, so question anyone who tries to insert an early commitment date in your contract.

Since terminology sometimes differs in different regions, ask your lender to explain all of the terms associated with their approval process.

What is Your Debt to Income Ratio

The ratio affects your buying power...

Your debt to income ratio is a simple way of showing what percentage of your income is available for a mortgage payment after all other continuing obligations are met. The ratio is one of the many things a lender considers before approving your home loan.

You may see conventional loan debt limits referred to as the *28/36 qualifying ratio*. Those numbers refer to two percentages that are used to examine two aspects of your debt load.

The First Number, 28%

This number indicates the maximum percentage of your monthly gross income that the lender allows for housing expenses. The total includes payments on the loan principal and interest, private mortgage insurance, hazard insurance, property taxes, and homeowner's association dues. (Often referred to by the acronym PITI.)

The Second Number, 36%

This number refers to the maximum percentage of your monthly gross income that the lender allows for housing expenses plus recurring debt.

Recurring debt includes credit card payments, child support, car loans, and other obligations that will not be paid off within a relatively short period of time (6-10 months).

Debt to Income Example

Yearly Gross Income = \$45,000 / Divided by 12 = \$3,750 per month income

\$3,750 Monthly Income x .28 = \$1,050 allowed for housing expense

\$3,750 Monthly Income x .36 = \$1,350 allowed for housing expense plus recurring debt.

Not All Loans Are the Same

FHA loan ratios are typically 29/41, allowing a higher debt load for both housing expenses and recurring debt.

- For the above example, FHA would allow \$1087 for housing and \$1538 for housing plus recurring debt.
- For a VA loan, the debt to income ratio should not exceed 41% of your monthly gross income.

Get Pre-Approved

Staying within the lender's debt to income ratio limits is only one part of qualifying for a home loan.

If the overall picture looks good, a lender may allow you to carry more debt. It's always best to be pre-approved before you begin home shopping, so that you'll know exactly what price range (and loan payment) fits your budget.