A Guide to Mortgage Products

and

A Glossary of Lending Terms

True

Know Before You Go...To Get A Mortgage

or False?

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Know Before You Go . . .To Get A Mortgage

Section 1

False: Currently, there are no federal or state laws requiring a mortgage lender to give you the best rate available. These days, many lenders offer a variety of mortgage products, some carrying higher interest rates than others.

For example, many lenders offer reduced-documentation loans, also known as low-doc. or no-doc. loans. These loans require the borrower to provide little financial documentation. They may, however, have pricing premiums attached and cost you more than a loan requiring full documentation (financial statements, proof of employment, etc.).

It is important to comparison shop and understand the loan terms and associated benefits and risks prior to choosing a product. Some mortgage lenders may advertise products that appear to carry substantially lower interest rates than others. These rates, however, may simply be introductory or "teaser" rates to attract customers. Typically, the introductory rate will adjust to a higher rate at some point in the loan term.

Federal law requires the lender to provide you with specific written disclosures during the application process. Federal Reserve Regulation Z, which implements the Truth in Lending Act, and the Real Estate Settlement Procedures Act (RESPA) mandate that the lender provide you with specific documents such as *The Good Faith Estimate* and the initial *Truth in Lending Disclosures.* These documents contain the terms of your loan: review them carefully before closing on your loan. They should accurately reflect the terms promised by your lender.

True or False?
Mortgage lenders are required to give me the lowest rate available.

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What you should ask the lender:

- Which of your products offers the lowest interest rate?
- Will my interest rate be fixed or variable (change periodically)?
- If the interest rate can change, when will it change and how high or low can it go?
- If the lender offers an introductory or "teaser" rate, ask, When does the rate expire and how will the new rate change my monthly payment amount?
- If the rate expires, what will the new rate be, and will it be fixed or variable?
- Would I qualify for a better interest rate if I went for a standard full-documentation loan rather than a low-doc. or no-doc. loan?

Terms you should know:

Annual Percentage Rate (APR)
Adjustable Rate Mortgage (ARM) Disclosure
Good Faith Estimate (GFE)
Initial Truth in Lending (TIL) Disclosure
Reduced Documentation Loan
Teaser Rate

It is important to comparison shop and understand the loan terms.

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False: If you have a conventional mortgage, (a 15 - or 30 - year fixed rate product), your principal balance **will** fall every month because the product requires you to pay down both interest and principal each month and allows you to reduce (amortize) your loan amount.

That, however, is not necessarily the case with some of today's nontraditional mortgage products such as option-ARMs and interest-onlys with teaser rates: your balance may not fall, and in some cases it may go up, even though you make all the required payments. This is called negative amortization; it can occur if you choose to make minimum monthly payments that typically cover only a part of the monthly interest owed and none of the principal for a certain period of time. The interest that is not paid is added to your principal balance. As a result, your loan balance increases and could exceed what you originally intended to borrow.

The lender should provide you with clear information about the benefits and risks of the products it offers so that you can make an informed decision.

What you should ask the lender:

If the product permits negative amortization:

(the loan balance can increase every month)

- May I have a repayment analysis that includes the initial loan amount plus any balance increase that may result from the negative amortization provision?

If the lender suggests an option-ARM:

(option to make minimum monthly payments OR interest only payments)

- What is the minimum monthly payment on the loan?
- If I make that payment, will my loan balance rise, fall, or stay the same?
- What effect will choosing minimum monthly payments have on how much of my home I actually own?

True or False?

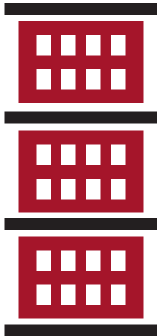
No matter what type of mortgage I have, as long as I continue to make monthly mortgage payments, my principal balance will fall every month.

- What effect will choosing interest-only payments have on my loan balance and my home equity (the amount of my home I own)?
- When I start paying down the principal, as required, how would the dollar amount of my payments compare to that of a conventional mortgage lasting the same number of years?

If the lender suggests an interest-only mortgage:

(allows you to pay only the interest and no principal for a set period of time)

- When my payments increase after the designated period (usually 3-5 years), will I still be able to afford my home?
- How does the interest rate on an interest-only compare to a conventional 15- or 30-year mortgage?
- When I start paying down the principal, as required, how will the dollar amount of my payments compare to that of a conventional mortgage lasting the same number of years?



Terms you should know:

Adjustable-Rate Mortgage (ARM)
Amortization
Conventional (or traditional) Mortgage
Interest-Only Mortgage
Minimum Monthly Payment (MMP)
Negative Amortization
Nontraditional Mortgage
Option-ARM

The lender should provide you with clear information about the benefits and risks of its loan products.

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Section 3

True: Depending on the terms of your loan, your monthly payments could increase — in some cases dramatically. Nontraditional mortgage loan products such as interest-onlys and option-ARMS are more complex than traditional fixed or 15 - or 30 - year adjustable rate mortgages (ARMs) and can carry a significant risk of payment shock (a large and sudden increase in your monthly payment).

To avoid drastic increases in your monthly payments, it is important for you to understand loan terms and associated benefits and risks prior to choosing one of the many mortgage products available today. If you are considering an adjustable-rate mortgage, traditional or otherwise, make sure you have the ability to repay the debt.

Federal law requires the lender to provide you with specific disclosures about the terms of your loan during the application process. Review these disclosures carefully. The lending institution should provide you with enough information to make an informed decision.

True or False?

With many types of mortgages, my monthly payment could go up a lot from one month to the next.

What you should ask the lender:

- What is the most appropriate loan product for me?
- Can my monthly payments rise? If so, how much?

Terms you should know:

Interest-Only Mortgages
Nontraditional Mortgages
Option-ARMs
Payment Shock

How Your Payments Can Change

Example: option ARM
Loan Amount: $350,000
Interest Rate: 6.35% (variable rate)
Introductory "Teaser" Rate: 1%
(for the first year)
Payments:
30-Year Amortization: $1,960.00
(principal and interest)
Interest Only: $1,667.00
(at 6.35%)
Minimum "Teaser" Rate : $1,013.00
(at 1%)

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Section 4

True or False?

If the lender is willing to lend me the money for my dream house, I must be able to afford it!

False: Typically, reputable mortgage lenders will not lend to you beyond your means. But others will and may not properly take into account your ability to repay should loan terms or your financial circumstances change.

For example, if you are considering an interest-only mortgage, the lender may qualify you based on your ability to make those interest payments without considering the fact that later on in the loan term you will have to pay down principal as well.

Lenders offer a variety of products that can make it much easier for you to get a house that would otherwise be unaffordable. As with any mortgage, these products are appropriate for some and not others. An interest-only loan may be beneficial to you if you plan to own the house for a short term. If, however, you plan to stay long term, you need to be able to continue to pay your mortgage when the loan resets at a new rate and your monthly payments increase. A soft second or piggyback loan (a mortgage taken to cover your down payment), or private mortgage insurance (PMI) may save you from making a down payment on the house at closing (traditionally 20 percent of the cost). But that means you are starting out with little or no equity in your home.

To obtain your dream house, be sure to understand the risks associated with mortgage products. First and foremost, be sure you can repay the debt. For the unwary borrower, the dream can turn to a financial nightmare if the product is inappropriate or too risky.

It is important, therefore, that you do your homework: Evaluate your financial circumstances to determine what you can and cannot afford before you agree to a mortgage.

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Consider the following:

- Think about how long you plan to stay in the house: is this a long- or short-term investment?
- Do you anticipate any changes in your compensation?
- If you plan to stay long term, will you be able to cover changes in your monthly payment and thereby avoid foreclosure or financial disaster?

What you should ask the lender:

- Given my circumstances, is this loan suitable for me?
- If you are considering a piggyback loan (a simultaneous second loan) because you cannot afford to put a down payment on your dream house, ask, What will cost me more — a piggyback loan or PMI?
- Will I qualify for PMI?

Terms you should know:

Debt-to-Income Ratio (DTI)
Loan-to-Value Ratio (LTV)
Private Mortgage Insurance (PMI)
Simultaneous Second Lien Loan (Piggyback)

To obtain your dream house, be sure to understand the risks associated with mortgage products.

True or False?

I can always refinance my mortgage in the future.

Section 5

False: The truth is that in the following circumstances, it may be imprudent to refinance:

1) If home values stop going up, your original loan amount may exceed the value of your home;
2) If you have an adjustable-rate mortgage, it may be costly to refinance as interest rates start rising;
3) Prepayment penalties (fees charged for paying the loan off early) could limit your ability to get out of an unfavorable loan without substantial penalties; or
4) If your credit rating deteriorates, you may no longer qualify for the best rates.

Be cautious of lenders who want to steer you toward a particular product and make predictions about the future direction of interest rates. Telling you that you can always refinance at a later date is, in effect, making such a prediction.

What you should ask the lender:

- How soon after I get the mortgage can I refinance?
- Are there penalties if I pay off the loan early?
- What is the dollar amount of the penalty?
- If the value of the house falls by 5 percent, for example, will I still qualify for the same type of mortgage when I refinance?

Terms you should know:

Credit Score
Credit Report
Prepayment Penalty

Beware of lenders who make predictions about the future direction of interest rates.

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Credit Score: Your credit score is a measure of the risk you pose to someone who wants to lend you money. It is calculated using a standardized formula. There are many factors that could damage a credit score, including late payments and poor credit card use. Lenders may use your credit score to determine whether to give you a loan and what rate to charge. The better your credit score, the better the rate you can get on a loan.

Debt-to-Income Ratio (DTI): This ratio represents your monthly fixed expenses divided by your gross monthly income (income before taxes and deductions). The lender uses this ratio to help determine how much it will lend you. If the percentage is greater than 36, the ratio could negatively impact your credit score because the lender considers you to have too much debt.

For Sale

Good Faith Estimate (GFE): In this document, the lender estimates the amount of or range of charges for the specific settlement services that you are likely to incur in connection with the loan closing. The lender is required to deliver or mail the GFE to you within three business days after receiving or preparing the loan application.

Initial Truth in Lending (TIL) Disclosure: This document reflects the terms of the legal obligation between you and the lender. The lender is required to deliver or mail the TIL disclosure within three business days after receiving or preparing your loan application.

Interest-Only Mortgage: The borrower is required only to make interest payments for a specified number of years. When this initial period expires, the loan changes so the monthly payment includes principal and interest. At this point, the mortgage begins to fully amortize and monthly payments could increase significantly. The monthly principal payment could be greater than the conventional fixed-rate mortgage payment because there are fewer years to pay down the principal.

Loan-to-Value Ratio (LTV): The ratio compares the value of the loan with the fair market value of the home. The lender uses it to determine if its potential losses (in the event that you do not pay) may be recouped by selling the house.

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Private Mortgage Insurance (PMI): PMI is required by lenders when a loan is originated and closed without a 20 percent down payment. This insurance protects the lender from default losses in the event a loan becomes delinquent. If you are approved for a mortgage that requires PMI, you still have to apply for PMI and you may not qualify. You can be approved for a mortgage and not qualify for PMI.

Reduced-Documentation Loan: Commonly referred to as a low-doc. or no-doc. loan, this is a loan for which the lender sets reduced or minimal standards for documenting the borrower's income and assets. For example, the borrower may state that her income is a certain amount, and the lender will accept that statement with little or no documentation. Low-doc. loans may charge a higher interest rate than traditional products.

Simultaneous Second-Lien Loan: This product, also called a *piggyback loan* or *soft second*, provides an alternative to paying private mortgage insurance. (Lenders typically require PMI if your down payment is less than 20 percent of the purchase price.) The loan is originated simultaneously with the first-lien mortgage. There are many government programs offering these products to low- and moderate-income first-time homebuyers.[2]

Be sure to compare the cost of this second mortgage with the cost of purchasing PMI. If you take a simultaneous second-lien loan in place of making a down payment, you reduce the equity you have in your home. Also, if your second-lien loan is a home equity line of credit (HELOC), you may be exposed to increasing interest rates and higher monthly payments.

Teaser Rates: These are low rates that lenders offer to make mortgage products more attractive. When the "teaser-rate" period expires, the lender raises the interest rate for the remainder of the loan period. This new rate may be fixed or change periodically, depending upon the terms of your loan.

Footnotes

[1] A recent amendment to the federal Fair Credit Reporting Act requires each of the national consumer reporting companies – Equifax, Experian, and TransUnion – to provide you with a free copy of your credit report, at your request, once every 12 months. To order, call (877) 322-8228, or visit **http://www.annualcreditreport.com** This is the only online source authorized to provide you with a free report: beware of other sites that may look and sound similar.

[2] The Massachusetts Department of Housing and Community Development offers a soft second loan program to low- and moderate-income first-time borrowers. For more information, contact the Division of Housing Development at (617) 727-7824.

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Remember, don't check your common sense at the door! Be sure to understand the benefits and risks of the product you are considering. If it sounds too good to be true, it probably is. Before you sign on the dotted line, contact the Federal Reserve Bank of Boston with any questions. The Federal Reserve Bank of Boston's Consumer Hotline is (617) 973-3755.
See also **http:\\www.federalreserve.gov** *or* **http:\\www.bos.frb.org.**

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