**Day 25 Introduction to Mortgages Reading**

**In addition to taking notes on the reading below, make sure you understand the following vocabulary:**

|  |  |
| --- | --- |
| * Mortgage
 | * Escrow account
 |
| * Down payment
 | * Amortization
 |
| * Principal
 | * Fixed rate mortgage
 |
| * Interest
 | * Adjustable rate mortgage (ARM)
 |
| * Equity
 |  |

**What is a Mortgage?**
According to [Webster's](http://money.howstuffworks.com/framed.htm?parent=mortgage.htm&url=http://www.m-w.com/home.htm), a **mortgage** is "the pledging of property to a creditor as security for the payment of a debt." In plain terms, it is the legal contract that says if you don't pay the loan back (along with all of the fees and interest that are included with it), then the lender can have your house.

The lender holds the title to your house until the debt is completely paid off, and the lender will sell your house in order to get the money back if you can't make your mortgage payments.

Your **down payment** is the lump sum you pay upfront that reduces the amount of money you have to finance. You can put as much money down as you want, or you can sometimes pay as little as 3 to 5 percent of the purchase price. The more money you put down, though, the less you have to finance and the lower your monthly payment will be.

**The Mortgage Payment**
The mortgage payment is made up of:

* **Principal** - This is the total amount of money you are borrowing from the lender (after you've made your down payment). It is the amount of money you are financing.
* **Interest** - This is the money the lender charges you for the loan. It is a percentage of the total amount of money you are borrowing.
* **Taxes** - Money to pay your property taxes is often put into an escrow account, meaning that the money is placed in the hands of a third party until it is time to pay or certain conditions are met. A portion of your property tax is added to your monthly mortgage payment and held in escrow until it is due.
* **Insurance** - There are several types of insurance that can come into play when you get a mortgage. You'll have hazard insurance to protect against losses from [fire](http://money.howstuffworks.com/fire.htm), storms, theft, etc., and if your home is in a [flood](http://money.howstuffworks.com/flood.htm) risk zone and you're getting a federally insured loan, you'll have to get flood insurance. Unless you have at least 20 percent equity in your home, you'll also have to pay private mortgage insurance (PMI). This can sometimes be pretty expensive, so it makes sense to put as much into your down payment as you can. (Equity is the difference between the current market value of the property and the amount the owner still owes on the mortgage. It is the amount that the owner would receive after selling a property and paying off the mortgage.) These pieces of your mortgage payment are referred to as **PITI**. There are also closing costs that you will have to pay. We talk about them in detail later in this article.

**The APR**
Probably one of the most confusing things about mortgages and other loans is the calculation of interest. With variations in compounding, terms, and other factors, it's hard to compare apples to apples when comparing mortgages. Sometimes it seems like we're comparing apples to grapefruits. For example, what if you want to compare a 30-year fixed-rate mortgage at 7 percent with one point to a 15-year fixed-rate mortgage at 6 percent with one-and-a-half points. First, you have to remember to also consider the fees and other costs associated with each loan. How can you accurately compare the two? Luckily, there *is* a way to do that. Lenders are required by the [Federal Truth in Lending Act](http://money.howstuffworks.com/framed.htm?parent=mortgage.htm&url=http://www.smartagreements.com/bltopics/Bltopi41.html) to disclose the effective percentage rate as well as the total finance charge in dollars.

The **annual percentage rate** (APR) that you hear so much about allows you to make true comparisons of the actual costs of loans. The APR is the average annual finance charge (which includes fees and other loan costs) divided by the amount borrowed. It is expressed as an annual percentage rate -- hence, its name. The APR will be slightly higher than the interest rate the lender is charging because it includes all (or most) of the other fees that the loan carries with it, such as the origination fee, points, PMI premiums, etc.

**Paying Off Your Mortgage**
Mortgages are typically paid off in incremental payments that gradually chip away at the principal of the loan. This is called **amortization**. The portion of your payment that goes to pay the interest is much higher than the portion that goes to the principal -- at least for the first several years.

|  |
| --- |
| mortgage-amortization |

These payments are precisely calculated and scheduled to pay off the loan in a specified period of time. Try out this [mortgage calculator](http://money.howstuffworks.com/framed.htm?parent=mortgage.htm&url=http://www.ewmortgage.com/mortgage/javaamort.html) to see an example of an amortization schedule and how it changes based on the **term** (time span) of the loan.

**Types of Mortgages**
There are many types of mortgages you can choose from. Which type you choose usually depends on the length of time you think you'll be in your home or the other financial obligations you have. If you think you'll be there for the long haul, then you may want a fixed rate mortgage with the lowest interest rate you can get.

There may be other considerations, however. What if you have kids who are going to be entering college in 10 years? In that case, you might consider getting an adjustable rate mortgage, or a mortgage with a balloon payment so you can keep your payments low for the first few years in order to [save for college](http://money.howstuffworks.com/529.htm). Once the kids are out of college, you can refinance at the current rate. If you don't think you'll be in your home for that long, then you may also want to look at other options.

|  |
| --- |
| mortgage-types |

In the next few sections, we'll discuss some of the mortgage choices you'll find.

**Fixed-rate Mortgages**
This mortgage offers an interest rate that will never change over the entire life of the loan. If you lock in a rate of 7 percent that calculates a payment of $1,247 per month, then you know that in 20 years you'll still be paying $1,247 per month. The only things that will change will be the property tax and any insurance payments that are included in your monthly payment.

The length (known as the term) of your fixed rate mortgage can be 15, 20 or 30 years. These terms have an affect on the various benefits you'll get from your mortgage.

* **30-year fixed-rate** - The 30-year term gives you the maximum tax advantage by having the greatest interest deduction. While the fact that you're paying more interest may not seem like a benefit, you make lower payments with the longer term fixed-rate loan and you get a bigger tax deduction. If you will be staying in your home for many years (especially if you think your income may not increase tremendously), this may be the best option. This type of loan is also the easiest to qualify for.
* **20-year fixed-rate** - You can shorten your mortgage by 10 years and usually get a lower interest rate with the 20-year mortgage. These aren't offered through as many banks and lenders, however, so you may have to shop around to get one. The advantage with the shorter term, besides paying your loan off sooner, is that you'll also have more equity in your home sooner than you will with a 30-year loan. Your payments will be higher, however.
* **15-year fixed-rate** - This loan term has the same benefits as the 20-year term (i.e., quicker pay-off, higher equity, lower interest rate), but you will also have a higher monthly payment.

Adjustable-rate and Balloon Mortgage
An adjustable-rate mortgage (ARM) has an interest rate that changes based on changing market rates and economic trends. They usually offer an initial interest rate that is two to three percentage points lower than fixed-rate mortgages, but they don't offer the stability or assurance of a known mortgage payment in the years to come. If you don't expect to be in your home for many years, however, an ARM may be just what you need.

* **How often your interest rate adjusts** is determined by the terms of the loan. You may choose a six-month ARM, a one-year ARM, a two-year ARM, or some other term. There is usually an initial period of time during which the rate won't change. This might be anywhere from six months to several years. For example, a **5/1 year ARM** would mean the initial interest rate would stay the same for the first five years and then would adjust each year beginning with the sixth year. A **3/3 year ARM** would mean the initial interest rate would stay the same for the first three years and then would adjust every three years beginning with the fourth year.
* There will also be **caps**, or limits to how high your interest rate can go over the life of the loan and how much it may change with each adjustment. Interim or periodic caps dictate how much the interest rate may rise with each adjustment. For example, the terms of the loan may be that the rate can go up as high as one percentage point each year depending on the market. Lifetime caps specify how high the rate can go over the life of the loan. For example, the terms of the loan might specify that the rate cannot go up by more than a total of six percentage points.
* The **interest rates** for ARMs can be tied to one-year U.S. Treasury bills, certificates of deposit (CDs), the London Inter-Bank Offer Rate (LIBOR), or other indexes. When mortgage lenders come up with their rates for ARMs, they look at the index and add a margin of two to four percentage points. Being "tied" to these index rates means that when those rates go up, your interest goes up with it. The flip side is that if they go down, your rate also goes down. Try this [ARM calculator](http://money.howstuffworks.com/framed.htm?parent=mortgage.htm&url=http://www.dinkytown.net/java/MortgageAdjustable.html) to see how your payments might change with an adjustable rate mortgage.

**Balloon Mortgage**
A balloon mortgage offers an initial interest rate that is lower than fixed-rate mortgages. It keeps this low fixed rate for five to seven years and then requires a "balloon" payment. The balloon payment is the final payment of the loan and pays off the entire balance.

Monthly payments are low because the payments for those first five to seven years are amortized at a low interest rate over the total length of the loan. If you plan on either selling your home, paying it off, or refinancing it before the balloon payment is due, then this type of mortgage is good deal.

Excerpted from: <http://money.howstuffworks.com/mortgage.htm/printable>