UNIT 7 – 3

Applying for a Home Mortgage

Regardless of where you get your mortgage, the issuer is not likely to keep the mortgage for the duration of the loan. So, if you get your mortgage at a local bank, through a mortgage broker, or a firm on the internet, it wil usually be resold to another buyer, usually in a matter of weeks or months. The field of mortgage finance is too complex to explain fully, but basically the buyer of the individual mortgages is likely to bundle the mortgages together and use the bundle as an asset against which bonds can be issued. So, as long as homeowners keep making monthly payments on (say) 8% mortgages, the firm that holds the bundle of mortgages can make (say) 5% interest payments on the bonds and pocket the difference as profit. Turning a bundle of mortgages into an income-earning asset is a process called **securitizing mortgages**. While the process is complex, all is well as long as everyone keeps making the payments.

Because so many mortgages are sold and then securitized once they are issued, the initial lender tries to make their profit up front – with the use of fees and other charges that are paid by the borrower. Sometimes the issuer will receive a fee to service the mortgage – or receive a fee for collecting monthly payments and then forwarding the payment on to the holder of the mortgage – but in general the original seller receives very little of the future monthly mortgage payments.

Case Study Application:

To give you an idea of what these fees look like, and how they might appear to differ from one lender to another, we'll start with a case study that highlights some of the fees that a borrower is likely to encounter when they go after a loan. While the two options look quite different, we'll see that they are actually fairly similar. Also, for now we'll assume that the borrowers in our case study have a suitable credit history and that they will be a pose an acceptable risk to the lender so that we can focus more on the application process and the fees.

CASE STUDY: BILL AND RHONDA'S OPTIONS

Bill and Rhonda have decided to approach two local banks to see if they can obtain a modest $140,000 mortgage for their dream home. They have a satisfactory credit history and can afford the mortgage, so their decision at this point is to find the option that suits them the best.

Much to their surprise, interest rates have gone down and it now looks as if they can apply for a 5.875%, 30-year loan.

According to the first bank, they can borrow the full $140,000 they need if they pay 4 points plus $1,805 in administrative, attorney, and title insurance fees. The second bank will offer the same loan at the same rate, but they will waive the points and add 12 separate fees amounting to $7,405 instead.

Now they wonder – is one offer better than the other?

The Credit Check

At some stage in the process, you will have to go through a credit check. After all, a lender is not going to make the biggest loan that you will ever have without some assurances that you are able to pay it back, or that you have a suitable record of paying off past debt on a timely basis.

Exactly when you do the credit check, however, may vary from one borrower to another. Clearly you will have to go through the process with the lender you finally select, but this will involve some expense, so you want to get some idea of the lender first, before you actually apply for the loan.

And, since the topic of building your credit history has already been covered in another lesson, we'll assume for now that you are already familiar with how to check your credit history, get a credit report, interpret the report, and correct any problems that you may have discovered.

So, for purposes here, we'll assume that your credit is good, and that your credit history will not be a problem. That will allow us to focus on the down payment that is needed and the actual costs of the loan.

The Down Payment

The **down payment** is computed as a percent of the purchase price and may range from 3 to 10 percent of the purchase price. The purpose of the down payment is to protect the lender in the event that the borrower does not repay the mortgage. For example, if Bill and Rhonda want to by a property with a purchase price of $150,500, and if the bank requires a 7 percent down payment, they will first have to come up with $10,500 before they can go ahead and borrow the $140,000 they are seeking.

The down payment acts as a protection for the lender, because if the borrower fails to pay the monthly mortgage payment, the lender can seize the property, and then try to sell it again. As long as the value of the property ($150,500) exceeds the amount of the loan ($140,000) the lender can absorb the costs of repossession and resale without losing any money. Because of this, the lender generally likes to see a larger down payment than a smaller one.

Points and Fees that You May Face

Because fees are so important to the lender, expect to see a lot of them, and be assured that the lender will claim that they are all legitimate. Even a partial list of potential mortgage fees will disclose some, if not all, of the following:

Administrative fee	Agent fees
Application fee	Appraiser fee
Attorney fees	Credit reporting/check fee
Discount fee	Flood certification fee
Funding fee	Loan set-up fee
Origination fee	Processing fee
Tax service fee	Title insurance fee
Transfer fee	Underwriter's fee
Wiring fee	

A lender will usually refer to the sum of the individual fees as **closing costs**, a collective term representing the sum of the individual fees charged to originate the mortgage. Lenders may also charge one or more **points**, where one point is one percent of the loan, in addition to, or in place of, some fees. For example, one point on a $140,000 loan would be $1,400, and a lender might opt to charge 4 points ($1,400 times 4 or $5,600) as part of the closing costs.

All of this can get fairly complicated, of course, so the best thing to do is to focus on the total amount of closing costs rather than worry about any of the individual fees that make up the total. Another reason for doing this, as we saw in the case study, is that different lenders will cite a different list of fees for a mortgage, even if the two quotes are for the same amount and interest rate.

If we go back to our case study, it should be evident that the closing costs are identical for the two banks, amounting to $7,405 for each – so neither offer is superior on this measure.

Closing Costs Can Vary Widely

If we were to search the Internet for information on mortgages, we would get a slightly different perspective on closing fees. For example, a recent search on the web revealed the following table for a 30-year, $140,000, fixed-rate mortgage. The mortgages were available from multiple lenders, and they are ranked from lowest rates to higher ones.

30 Year Fixed				
Rate	Payment	All Lender Fees & Points	Attorney & Agent Fees	Total Closing Costs
5.63%	$806	$7,946	$1,335	$9,281
5.75%	$817	$6,945	$1,335	$8,280
5.88%	$828	$6,070	$1,335	$7,405
6.00%	$839	$5,195	$1,335	$6,530
6.13%	$851	$4,418	$1,335	$5,753
6.25%	$862	$3,716	$1,335	$5,051
6.38%	$873	$3,083	$1,335	$4,418
6.50%	$885	$2,358	$1,335	$3,693
6.63%	$896	$1,699	$1,335	$3,034
6.75%	$908	$1,073	$1,335	$2,408
6.88%	$920	$498	$1,335	$1,833
7.00%	$931	($144)	$1,335	$1,191
7.13%	$943	($694)	$1,335	$641
7.25%	$955	($1,174)	$1,335	$161
7.38%	$967	($1,671)	$1,335	($336)
7.50%	$979	($2,175)	$1,335	($840)

The lender that generated the table provides the services that generated the attorney and agent fees shown in the next-to-last column, while the lender supplying the mortgage charged the points and remainder of the fees shown in the middle column. The combined result is that there is a considerable trade-off between the size of the monthly payment and the size of the total closing costs.

The number of points charged by the lender are the main reason for the considerable variation in closing costs in the table. For example, a lender that charges more points up front will usually offer a lower rate on the mortgage, while the lender that charges fewer points will usually charge a higher rate.

Should You Try to Pay or Avoid Points on a Mortgage?

There is no clear answer to this question, but it is still one worth pondering. For example, there is a considerable difference between a monthly mortgage of $806 and $979, so you want to give a lot of thought to what you really can and want to pay in the future.

The lower monthly payment of $806 will cost more up front – $9,281 to be exact – while the one with the higher monthly payment will give you a credit of $840 when you close. If you decide to avoid the points and pay the difference over time, the $173 monthly difference between the two payments will be paid 360 times in the future, which amounts to an additional $62,280 over the life of the loan!

So, if you have enough money saved for the purchase, you might be wise to pay the points and get some of the costs out of the way immediately. On the other hand, if your funds are more limited, then you may want to forgo the points and spread the closing costs out over time.[1]

Getting Preapproved for a Loan

Once you have an idea of where you want to get your mortgage, and once you have an idea of the fee structure you will face, you may want to get "preapproved" for a loan. Preapproval simply means that your lender has approved of your financial situation and agrees to lend you a certain amount of money if you find a property that meets the lender's approval. This is usually in the form of a letter from the lender to you, the borrower, stating that for a short period (normally about 60 days), the lender will give you a mortgage up to a certain amount. The interest rate may not be set until the loan is actually made.

This can be an advantage when dealing with someone who wants to sell a home because the seller will know that they are talking to someone who is clearly able to buy. This may also give you an advantage when negotiating a purchase price. On the other hand, getting preapproved by one lender does not mean that you are preapproved by another. There is some cost to being preapproved, so you will still have to do some research to find the lender that you want to use.

Getting a "Good Faith" Estimate

As you can see from the above, the closing costs can be fairly extensive when it comes to getting a mortgage – and the closing costs are in *addition* to the

[1] While we have tried to avoid some of the more complex mathematical calculations, we should point out that the present value of $173/mo for 360 months at 7.5% is $24,742, so this is one measure of the cost of avoiding the points. In other words, the difference in total closing costs between the two loans is $9,281 less $840 or $8,441. So, what are you better off paying, the $8,441 actual difference today, or the $24,742 present value equivalent of financing the cost over time?

down payment.   When we consider the situation in the case study above, it is clear that the borrowers could need as little as $10,000 (or $10,500 less $840) to nearly $20,000 (or $10,500 plus $9,281) in order to get a loan on a $150,500 property.

To get a better handle on the closing costs, you should be able to get a **good faith estimate** on the total closing costs from you lender. Federal Legislation called the Real Estate Settlement Procedures Act (RESPA) requires that your lender give you a good faith estimate within three business days of submitting your loan application. The actual expenses at closing may be a bit different, but this will avoid a nasty surprise later on, so it is a good idea to examine this document carefully.