The Basics of Financing Your New Home

If you are in the market for a new home, interest rates are favorable, and good deals are not difficult to find in many areas of the country. Buying a home is the single largest purchase most people will ever make, and for first-time homebuyers especially, the financing process can appear complicated. The following information provides you with some preliminary information to understand how mortgages work.

The two basic mortgage types are fixed rate mortgages and adjustable rate mortgages (ARMs). Deciding which is right for *you* depends on a number of factors, including the spread between the prevailing fixed and variable mortgage rates, the length of time you expect to own your home, the current inflation rate, and the tax savings you expect to receive from the home mortgage interest deduction.

Fixed Rate Mortgages

A fixed rate mortgage is characterized by an interest rate that remains the *same* for the life of the loan, consistent monthly payments, and a principal that will be fully repaid at the end of the loan. The total amount of interest you will pay on a fixed rate mortgage increases with the term, which generally ranges from 15 to 30 years.

One major advantage of a fixed rate mortgage is the certainty of knowing your monthly payments will not increase over the life of the loan, even if interest rates rise. On the other hand, the major disadvantage is that if interest rates drop, your monthly payment will not decrease. The only way you will be able to take advantage of a drop in interest rates is to refinance the loan, which may or may not be costly, depending on rates at the time.

Adjustable Rate Mortgages (ARMs)

An adjustable rate mortgage carries an interest rate that a lender can *vary* during the loan term. ARMs are designed to shift the risk of rising interest rates from the lender to the borrower. To offset the increased interest rate risk, ARMs usually offer borrowers a lower rate—compared to a fixed rate mortgage—during the first year. If you are considering an ARM, you will probably encounter the following terms:

Index. An index is a benchmark used by a lender to adjust an ARM's interest rate. Commonly used indexes include the rate on U.S. Treasury securities and the average cost of Federally-insured savings and loan funds.

Margin. Also called the "spread," this is the amount a lender can add to the value of the index specified in the loan agreement.

Initial Rate and Adjusted Effective Rate. The initial rate is the interest rate at the start of the mortgage. It is typically lower than the amount you would owe on a fixed rate mortgage. Very low initial rates, called "teasers," are designed to persuade you to enter into the loan.

The adjusted effective rate is the rate you pay when the adjustments kick in. It is calculated as the value of the index specified in the loan agreement plus the margin. For example, if the index value rises to 8% and the margin is 2%, the adjusted effective rate is 10%. (The adjusted effective rate is not the same as the annual percentage rate (APR), which includes the points levied on the mortgage.)

Adjustment Period. Mortgage payments or interest rates may change—every six months, annually, or every three years—according to the length of the adjustment period.

Caps. ARMs may include several kinds of caps. A payment cap limits the increase in monthly payments at each adjustment period. An interest adjustment cap limits the amount by which the interest rate can rise or fall at each adjustment period. A lifetime interest cap limits the maximum interest the lender can charge during the loan term. A lifetime payment cap limits the percentage by which principal and interest payments can increase during the loan term.

Negative Amortization. Negative amortization occurs when your mortgage payment is less than the amount necessary to cover the interest on the loan. As a result, the unpaid interest is added to the loan principal. The loan agreement may cap the amount of negative amortization allowable.

Understand Your Options

There is no "right" way to finance a home. All financing arrangements involve trade-offs. The more informed you are about your options, the better equipped you will be to arrange a mortgage that suits your needs.

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