

Mortgage Basics

Very few first-time home buyers are able to purchase a home using their savings alone. If you are like most people, you need to take out a **mortgage** loan in order to purchase your desired property. A mortgage is a loan from a financial institution (such as a bank), and this particular type of loan can be fairly complicated. The following are a few basics of how mortgages work to help guide you during the process of obtaining one.

MORTGAGE TERMS

The “term” of the mortgage simply indicates how many years it will take you to pay it back. The term of your loan also affects your payments. A shorter repayment period will make your monthly payments higher, but you’ll pay less interest over the life of the loan. A longer term means lower payments – but you’ll end up paying a lot more interest over the long haul. The conventional mortgage term is 30 years, although 15-year loans are also fairly common. Mortgage loans can range anywhere from ten to 40 years.

TYPES OF MORTGAGES

The most common mortgage loans are fixed-rate, adjustable, and interest-only, though there are several other types available.

A **fixed-rate mortgage** is just like it sounds: it has an interest rate that stays the same during the entire loan period. The most common are 30-year mortgages, but you may also obtain a 20-year, 15-year, and even 10-year fixed-rate mortgage. Some mortgage lenders will even offer 40 year-loans in areas where the real estate prices are especially high. The interest rate tends to be higher for this type of loan, but your payment will never change since it is fixed. In other words, fixed-rate mortgages are the most secure and offer stability where others might not.

Adjustable-rate mortgages (ARMs) are different in that they have a period of fixed interest, but when that period is over the payment changes according to the index on which the loan is based. The fixed interest phase may be three, five, or seven years. A 5/1 ARM would be one example: the 5 stands for how many years the initial fixed period will be, and the 1 indicates how frequently the new rate will adjust. Therefore, with a 5/1 ARM, the initial interest rate won’t change for the first five years, but then it will adjust annually for the remainder of the term.

An ARM loan can have several types of caps applied to it. There is the “overall cap,” which restricts the interest rate from rising past a certain point during the life of the loan. A “periodic cap” limits how much the interest can increase from one period of adjustment to the next. The “payment cap” places a limit on how much the monthly payment can increase at each adjustment.

It’s true that ARMs are less secure than fixed-rate mortgages. On the plus side, however, the initial interest rates tend to be lower, which will make your monthly payments lower as well. If

for some reason your budget is tight right now but you're certain of being able to meet future interest and payment increases, an ARM might be a viable option.

Finally, an **interest-only mortgage** is a loan on which you can pay just the interest for a three to ten year period. Once that period is over, the payment increases because you'll be paying principal and interest. It's usually easier to qualify for an interest-only mortgage, and your monthly costs might be lower than with other loan types. However, this type of loan can be a pretty big gamble. You could end up owing more than you own if there is a downturn in housing prices, and you might not be able to make your payments if the interest rate rises too high.

Obviously, each type of mortgage comes with benefits and drawbacks. Take a long time before borrowing to carefully consider each option, choosing the most appropriate one for your situation. Obtaining a mortgage is something you'll probably only do once or twice in your lifetime – it's a huge decision, and with so much money at stake, making the best choice is imperative.