# The Massachusetts Homeownership Collaborative

## HOMEBUYER COUNSELING CORE CURRICULUM

## SECTION IV: OBTAINING A MORTGAGE

Section Objectives:

- To prepare participants for the mortgage application process
- To provide participants with information on mortgage costs
- To assist participants in finding the type of mortgage that best suits their needs

Core Handouts:

- Steps of a Mortgage Application
- Mortgage Application Checklist
- Uniform Residential Loan Application
- Loan Estimate (new)
- Pre-Qualification Worksheet
- Closing Disclosure (new)
- Predatory Lending Brochure

## A. TYPES OF LENDERS

**Many kinds of banks have developed in Massachusetts over time. Banks in Massachusetts are chartered either by the state or the federal government. There are commercial banks, co-operative banks, savings banks, and savings and loan associations.** Each one is a financial institution engaged in the business of receiving money on deposit (which is insured), making loans, performing other banking-related functions, and then investing those deposits in real estate loans, mortgages and other high-grade permissible securities.

**Mortgages are available from many different sources, including banks (as described above), mortgage companies, and credit unions.** A *mortgage company* is in the business of originating and closing mortgages, which are then assigned or sold to investors. A mortgage company is not a bank, but it can be affiliated with a bank or operated independently. A *credit union* is a cooperative association made up of members who may or may not share an affiliation (e.g. work for the same company, attend the same church, or live in the same neighborhood). A credit union can make home mortgage loans to its members.

Unlike a mortgage lender, a ***Mortgage Broker*** does not directly make loans to customers. Instead, a mortgage broker works with a homebuyer to find a mortgage, then places the buyer's financing application with a lender.

### Secondary Market

Some mortgages (generally called "portfolio" mortgages) are held as long-term investments by the originating lender. However, most mortgages are originated and sold to investors.

**The term "secondary market" refers to the investor market that buys mortgage loans from originating lenders. The major secondary market participants are Fannie Mae and Freddie Mac.** Both Fannie Mae and Freddie Mac are shareholder-owned corporations established by Congress. Fannie Mae was created by Congress in 1938 and evolved into a shareholder-owned company in 1968; Freddie Mac was established in 1970. **Both entities purchase mortgages from lenders, package them and sell them to investors, with the goal of increasing the availability and affordability of housing for low, moderate and middle income homebuyers.**

Homebuyers cannot directly access the secondary market (e.g. go to Fannie Mae or Freddie Mac for a loan). Both Fannie Mae and Freddie Mac have established standardized lending guidelines, documents, and loan approval processes. Through lending institutions, they both offer a variety of special programs targeted to first-time and low and moderate income homebuyers.

While lenders originate and often sell mortgage loans to the secondary market, some lenders will also service the loans they make (others will sell the servicing of the loan as well). This means that they retain the responsibility for collecting payments and paying taxes and insurance, etc. From a business perspective, the lenders that service the loans they originate continue to have the same relationship with the borrowers as they would if they continued to own the loans. The difference is that the lender/servicer sends the principal and interest payments to the investor who owns the mortgage. It is the investor who sets the rules governing the servicing of the mortgage. The originating lender is the first lender and the investor is the second – thus, the secondary market.

### Other Players

*MassHousing*. The Massachusetts Housing Finance Agency sells tax-exempt bonds to investors to raise money for mortgages. Because the bonds are exempt from federal income tax, the investors accept a lower rate of interest than for taxable bonds. The savings are passed on to the homebuyers, and result in mortgages at interest rates that are lower than the market rate. MassHousing mortgages are available through participating lenders for borrowers who meet income and other guidelines.

*Massachusetts Housing Partnership*. MHP is a public non-profit that supports and finances affordable housing. MHP partners with lenders to offer the ONE Mortgage product. The mortgage is available through participating lenders for borrowers who meet income and other guidelines.

*Federal Housing Administration*. The Federal Housing Administration (FHA) does not make direct loans; it insures lenders against default by borrowers. FHA loans are originated by many different FHA-approved lending institutions.

*Veterans Administration*. The Veterans Administration (VA) guarantees mortgages for veterans of the armed forces, those currently in the service, and their spouses.

## B. Four C's of Credit

In evaluating a mortgage application, lenders look most closely at the “four Cs of mortgage lending”:

a. CAPACITY: CAN THE BORROWER REPAY THE MORTGAGE?

**Capacity refers to the borrower’s ability to make the payments on the loan. To determine this, the underwriter will analyze the borrower’s employment, income, their current debt and their assets.**

While reviewing the borrower’s employment, the underwriter must determine the stability of the income. People who are employed by a company and earn hourly wages pose the lowest risk. Self-employed borrowers pose the highest risk, since they are typically responsible for the debt and well-being of the business in addition to their personal responsibilities. Commission income also carries similar risks in the stability of income because if for any reason the borrower fails to produce business, it directly influences the amount of income produced. Usually if self-employment or commission income is used to qualify for the mortgage, a two year history of receiving that income is required.

Documentation of the income also varies depending on the type of income. Hourly wage earners who have the lowest risks usually need to supply paystubs and W-2 statements. However, self-employed, commissioned and people who collect rent are required to provide tax returns. Retired people are required to evidence that they eligible for social security and document the receipt of payments, while people that receive income via cash investments must provide statements and determine the continuance of the income from those payments. **In short, the underwriter must determine and document that the income and employment is stable enough to pay the mortgage in years to come.**

**Furthermore, underwriters evaluate the capacity to pay the loan using a comparative method known as the debt to income ratio. This is calculated by adding up all of the monthly liabilities and obligations (mortgage payments, monthly credit and loan payments, child support, alimony, etc.) and dividing it by the monthly income.** For an example, if a borrower has a $500 car payment, $100 in credit and loan payments, pays $500 in child support and wants a mortgage with payments $1,000 per month, his total monthly obligations is $2100. If he makes $5,000 a month, his debt to income ratio is 42%. Typically the ratio must be below anywhere from 32% to 41% to qualify for any First Time Homebuyer Program.

b. CAPITAL: DOES THE BORROWER HAVE SUFFICIENT FUNDS TO ENTER INTO A MORTGAGE TRANSACTION?

**Assets are also considered when evaluating capacity. Borrowers who have an abundance of liquid assets at the time of closing statistically have lower rates of default on their mortgage. In particular, if the borrower’s employment is interrupted for any reason, the borrowers would have enough cash in reserve to pay**

their mortgage. The most typical asset is a borrower's checking and savings account. Other sources include retirement funds (401K, Individual Retirement Account), investments (stocks, mutual funds, CDs) and any other liquid source of funds. Funds that have penalties for withdrawing must be considered conservatively and are evaluated at 70% or less of their value. Accounts such as pensions and other accounts and personal property that lack liquidity may not be used as assets.

### DOWN PAYMENT FUNDS

The down payment is the money required by lender from the homebuyer as part of the buyer's contribution or investment into the transaction. Lenders need to verify that the source of the down payment is coming from the buyer's own savings. Gifts from relatives, grants from the city or towns, and grants from non-profit agencies are allowed as long as the buyer contributes some portion of his/her own funds, as required by the mortgage program.

Some cities and towns will help first time buyers become homeowners by helping them with closing costs and down payment assistance.

### CLOSING COSTS FUNDS

Closing costs are fees, in addition to the down payment, charged at the closing which include attorney's fees, points, title search, appraisal fee, credit report fee, title search and insurance, survey charges, and fees to record the deed, mortgage and other documents. Closing costs also include "pre-paids," which can include such things as your mortgage insurance premium, your hazard insurance premium, taxes, and interest on the mortgage from the date of settlement to the beginning of the period covered by the first monthly payment.

Closing costs can range widely, from as little as 1% to as much as 5% of the cost of the home, depending on the number of points, fees charged, and the size of the loan. The buyer and the buyer's attorney should review the costs closely.

### c. CREDIT: WILL THE BORROWER REPAY THE MORTGAGE?

Credit is what the underwriter uses to review how well a borrower manages his or her current and prior debts. Usually documented by a credit report from each of the three credit bureaus, Equifax, Transunion and Experian, the credit report provides information such as credit scores, the borrower's current and past information about credit cards, loans, collections, repossession and foreclosures and public records (tax liens, judgments and bankruptcies). Typically, a borrower's credit is highly related to the probability that the loan will go into default (failure to make monthly installments).

In reviewing a credit report, the credit score is considered. The credit score is an indicator of how well a borrower manages debt. Using a mathematical model, the data regarding each item on the credit report is used to produce a number between 350 and 850, known as the credit score. Higher scores represent those with less risk. When lenders refer to a representative credit score, they are referring to the median score. When multiple borrowers are involved typically the borrower with lowest median score is the one that is considered as the representative credit score. Other loan programs may consider the person who earns the most money, also known as the primary wage earner, as having the representative credit score. On many loan programs there are minimum score guidelines.

In addition, the history of payment of loans and revolving credit is considered. A lender may require that a certain number of accounts be opened for at least 24 months and have recent activity with on time payments to build a pattern of responsible use of credit.

The credit report also contains the borrowers past derogatory credit. This include collections, charge offs, repossession, foreclosures, bankruptcies, liens and judgments. Typically, if any of these items are present on the report, it increases the risk of the loan. For more serious blemishes such as foreclosures and bankruptcies, a lender may require up to two to seven years from the date of satisfaction indicated by the report before approving a loan. Furthermore, the lender may require the borrower to reestablish the credit by obtaining a certain amount of new credit to rebuild their credit. It is also the prerogative of the lender to require that all collections, charge offs, liens and judgments be paid prior to closing the loan.

d. COLLATERAL: WHAT IF THE BORROWER DOES NOT REPAY THE MORTGAGE?

Collateral refers to the type of property, value, the use of the property and everything related to these aspects. Property type can be classified as the following in the order of risk from lowest to highest: single family residence, duplex, townhouse, low rise condominium, high rise condominium, triplex and four-plexes and condotels. Occupancy is also considered part of collateral. A home can be owner occupied, used as second home or investment. Owner occupied and second homes have the least amount of default, while investment properties have higher occurrences of default. Depending on the combination of occupancy and type of collateral, the lender will adjust the amount of risk they are willing to take.

Besides occupancy and property type, value is also considered. It is important to realize price, value and cost are three different characteristics of a home. Price is the dollar amount that a seller agrees to sell a house to another party. Cost is the dollar amount needed to build the home including labor and materials. Value, which is usually the most important characteristic, is the dollar amount that is supported by recent sales of properties that have similar characteristics, in the same neighborhood and appeal to a consumer. Under fair marketing circumstances when the seller is not in distress and the housing market is not under volatile conditions, price and value should be very comparable.

To determine the value, an appraisal is usually obtained. In addition to determining the value of the property, it is the appraiser's responsibility to identify the market conditions, the appeal and amenities of the neighborhood and the condition and characteristics of the property. Value is determined by comparing recent sales of similar neighboring properties. The appraiser may make reasonable adjustments to the sales price of the other properties for lot size, square footage of the home, number of bedrooms and bathrooms and other additions such as garages, swimming pools and decks. It is underwriter's responsibility to review the appraisal and request any further information necessary to support the value and marketability of the property. (*See the Appraisal chapter for more information.*) If the home needs to be foreclosed upon, the lender must be able to sell the property to recoup their losses.

The comparative analysis of the collateral is known as loan to value (LTV). Loan to value is a ratio of the loan amount to the value of the property. In addition, the combined loan to value (CLTV) is the sum of all liens against the property divided by the value. For example if the home is valued at $200,000 and the first mortgage is $100,000 with second mortgage of $50,000, the LTV is 50% while the CLTV is 75%. Naturally, a higher LTV and CLTV increase the risk of the loan. Furthermore, borrowers who contribute significant down payment (lowering the LTV) statistically have lower incidents of foreclosure.

## C. Anatomy of a Mortgage Payment (PITI)

Mortgages are typically paid monthly and the payment includes principal, interest, taxes and insurance, but not necessarily. Lenders often refer to these as PITI:

- Principal. This is the amount of money borrowed. As payments are made, a greater proportion of the payment goes to reduce the principal owed.
- Interest. The costs of borrowing money, usually expressed as an annual percentage of the loan amount.

With a fixed-rate mortgage, principal and interest payments will stay level throughout the life of the mortgage.

- Property Taxes. Taxes paid to local government, usually charged as a percentage of the property value.
- Hazard Insurance. Insurance that protects against financial losses on the property that might result from fire, wind or other "hazards."
- Private Mortgage Insurance (PMI). Lenders require PMI from homebuyers with less than a 20% down payment. PMI minimizes the risk of borrower default for the lender and it enables lenders to offer conventional mortgages with low down payments. Private mortgage insurance may be cancelled when the homeowner builds up enough equity in the home (generally once a buyer's equity reaches 20%). The Homeowner's Protection Act of 1998 requires lenders or servicers to provide certain disclosures concerning PMI that provide information on how and when homeowners can terminate their PMI. These disclosures are given to homebuyers at closing and on an annual basis. Some mortgage programs do not require private mortgage insurance.
- Flood Insurance, where applicable.

The amount of property taxes and insurance payments required is likely to change over the lifetime of the mortgage.

The taxes and insurance portion of the mortgage payment may be put into an escrow account. The bank pays the taxes and insurance from this account on your behalf when they are due, although you may have to notify the bank when the amounts are due by forwarding a copy of the bill (keep a copy for your files).

## D. Pre-Qualification Vs. Pre-Approval

Pre-qualification means that a lender has determined that the buyer qualifies for a certain mortgage amount based on information provided by the homebuyer. Most lenders perform this service for free. Pre-qualification does not guarantee a loan.

Pre-approval guarantees a mortgage loan in writing (typically for a period of 90 days). Pre-approvals are based on actual verification of employment history, credit report review, etc. Most lenders charge an application fee to provide this service. The application fee is generally credited towards the buyer's closing costs.

Neither a pre-qualification nor a pre-approval locks a homebuyer into a mortgage commitment.

## E. THE MORTGAGE APPLICATION PROCESS

The mortgage application process requires considerable paperwork. To figure the mortgage payment, the lender will begin by asking how much you want to borrow. The maximum loan amount will be determined by the value of the property and your personal financial condition. To estimate the value of the property, the lender will ask a real estate appraiser to give an opinion about its value. The appraiser's opinion can be an important factor in determining whether you qualify for the size of mortgage you want. Lenders usually will lend the borrower up to a certain percentage of the appraised value of the property, such as 80 or 90 percent, and will expect a down payment making up the difference. If the appraisal is below the asking price of the home, the down payment you planned to make and the amount the lender is willing to lend you may not be enough to cover the purchase price. In that case, the lender may suggest a larger down payment to make up the difference between the price of the house and its appraised value.

When looking at your projected mortgage payment and existing debt, some lenders might use ratios such as "30 and 38" to determine whether you qualify for the loan. These are commonly used ratios.

In the case of "30 and 38," the 30 refers to the percentage of your gross income (before taxes) that may be spent on housing expenses, including principal, interest, real estate taxes, condominiums fees and insurance. The 38 refers to the income that may be spent for payments on all your debts (including the mortgage): the monthly payments on your outstanding debts, when added to the monthly housing expenses, may not exceed 38 percent of your gross income. When you talk to a lender, find out what ratios will be used to evaluate your application.

Be prepared to provide certain documentation about your income (W2s for prior years and year-to-date pay stubs), current debts (account number, outstanding balance, and creditor's address for each), and the purchase contract for the home you want to buy. When you file your application, ask the lender how long the approval process will take. The time may vary depending on the complexity of your mortgage, current market conditions, and whether you have to provide additional information. It's common for a decision to be made within 30 days after the lender receives all the necessary information. Applications for FHA or VA loans may take longer.

## What to Expect

### Information That May Be Required For the Mortgage Application:

- **Most recent current year-to-date pay stubs for all applicants**
- **At least 3 years of W-2s and signed federal income tax returns for all applicants**

*TIP:*
*If copies of tax returns are not available, homebuyers can request a three-year summary of tax returns from the IRS.*

**Note:** Income includes all verifiable salary from full or part-time jobs, overtime, commissions, bonuses, interest, Social Security, retirement, rental income and unemployment. At your option, you can also include alimony and child support. The lender is looking for all sources of income that have a reasonable probability of continuance.

- Current landlord name and your address for the past two years or the last twelve months canceled rent checks
- Employer name and address for the last two years
- Copy of the signed Purchase and Sale agreement
- Bank statements for the last 3-4 months for all accounts
- Quarterly stock and bond statements, 401K statements or IRA statements
- All existing loans, name of lender(s), addresses, account numbers, monthly payments and balances
- Green card – copies of front and back
- Name of your real estate agent
- Copy of canceled earnest money deposit
- Condominium documents and condo fee information, if applicable and 2 years of the condo budget.
- Copy of divorce decree, if applicable. (If receiving alimony and/or child support and you wish to have this income considered as a source of repayment, a copy of the divorce decree must be provided, along with 12 months cancelled checks to verify receipt of payments. If you are obligated to pay alimony and/or child support, a copy of the divorce decree must be provided.)
- Gift letter and verification of source, if applicable.

If a homebuyer is self-employed, he/she will need all of the above documents as well as:

- The previous 3 years signed federal tax returns with all schedules.
- A current YTD profit and loss statement.
- Homebuyers should also be prepared to answer the following questions and provide additional information:
    - If there is a change in jobs in the past two years, provide the dates at which each job started and ended.
    - If there is a gap in employment between jobs, provide an explanation in writing.
    - If the homebuyer has recently graduated from school and does not have a two-year work history, provide a copy of the degree.

What Happens Next?

1. **Application.** Within three days of submitting the application, the borrower should receive an estimate of the approximate costs associated with applying for a loan in the form of a **Loan Estimate.**

2. **Open the File.** The lender orders a property appraisal.

3. **Processing.** The loan processor reviews the credit report and verifies the borrower's debt and payment histories, including any Verification of Loans (VOLs) that are returned. If there are any delinquent payments, collections or judgments shown on the credit report, a written explanation is required from the borrower. The Bank will also make sure you are not on the OFAC list, they will makes sure your social security number is accurate by contacting the social security administration, and they will make sure the address you provided matches the records at the credit reporting agencies.

   The loan processor also reviews the bank statements and income documentation to verify the income and assets to support the loan and insure sufficient funds are available for the down payment and closing costs.

4. **Lender Underwriting.** The underwriter reviews the loan package to determine whether to approve the loan. If more information is needed to make a decision, the loan is put into suspense and information is requested from the borrower. The lender may withdraw the file for being incomplete.

   It is very important that the borrower respond immediately to requests for additional information at this point in the loan process. If not, the borrower risks delays and the possible expiration of a locked interest rate.

5. **Mortgage Insurance Underwriting.** If the borrower has less than a 20% down payment, the loan is submitted to a private mortgage insurer. The loan is usually submitted to the mortgage insurance company at the same time the lender underwrites the loan.

   The underwriter at the private mortgage insurance company reviews the loan package. If approved, the loan goes back to the closing department of the lending institution for closing and final packaging. Most loans are approved in 72 hours or less for mortgage insurance. If more information is needed to make a decision, the loan is put into suspense and additional information is requested from the lender.

6. **Pre-Closing.** Once the loan is approved:

   - Title insurance is ordered by the lender's attorney (The lender will require a lender's insurance policy, paid by the buyer. The buyer can also purchase an owner's title insurance policy.)
   - Approval contingencies are met.
   - FORM 4506 T is sent to the IRS for processing. The IRS will provide the Bank with a transcript of the last 3 years income. The Bank will make sure the information from the IRS matches the information provided by the applicant.
   - Five business days prior to the closing date, the bank will contact your employer. They will make certain that you are still employed and obtain the date of hire.
   - The borrower obtains a homeowners/hazard insurance binder.
   - If your loan is a condo, then prior to closing you must provide a copy of the condo insurance making sure the condo policy insures the inside of the dwelling (floor, walls, ceiling, etc.). If not, then the borrower will be required to obtain a policy providing that coverage.
   - If any document that is provided by the applicant is older than 60 days old before the closing date then updated documentation will be required.
   - A credit report may be obtain five days before closing.
   - The closing is scheduled.

8. **No later than three business days (which includes Saturdays)**

prior to the Closing, the buyer must receive the Closing Disclosure from the buyer's lender. This will tell you how much money to bring to Closing, and allows you the opportunity to carefully and comprehensively review all aspects of the loan and the closing costs/fees.

9. **Closing.** At the closing, the borrower obtains his/her loan proceeds and presents a certified check (made payable to themselves and signed over to the closing agent at closing) to cover the balance of the down payment and closing costs. The loan closes and the attorney records the deed transfer from the seller to the buyer. *(See the Legal Chapter for more details on the Closing.)*

## F. IF YOUR APPLICATION IS REJECTED

Lenders are required to explain in writing their decision to deny credit. If you are denied credit, you should immediately request a copy of your credit report from each of the three credit reporting agencies (*see chapter on Budgeting and Credit*). Additionally, you may appeal the decision to the Division of Banks for the following reasons:

<u>If you feel that your loan was unreasonably denied</u>

You may contact the Massachusetts Division of Banks who will send your case to the appropriate regional Mortgage Review Board which will review your case and loan.

<u>If you feel that your loan was denied on a prohibited basis</u>

An applicant who believes that his/her loan application was denied on a prohibited basis (i.e. on the basis of race, color, religion, national origin, ethnic origin, sex, marital status, age, income derived from public assistance, sexual orientation or handicap) may proceed independently of the Mortgage Review Board by contacting the Massachusetts Commission Against Discrimination.

If you have additional questions regarding the Mortgage Review Boards or the appeal process, please contact the CRA and Outreach Unit of the Division of Banks at (617) 956-1500 ext. 1560. Outside the Metropolitan Boston area, call 1-800-495-BANK (2265) or write to:

Administrative Secretary
Mortgage Review Boards
Division of Banks 1000 Washington Street, 10th Floor
Boston, MA 02118-6400

If your loan application is rejected, you can certainly apply somewhere else. But, before you do this, you'll want to know why your loan was turned down. There are several reasons why a loan may not be approved, for example:

- Poor Credit History. Did the lender uncover unpaid collections or judgments against you? Have you failed to pay your bills on time consistently? If you have credit problems, you may need to take some time to clear up your credit before you re-apply. You should do this on your own or with the help of a counselor at a local non-profit housing counseling agency. Do not pay money to groups that claim they can "repair" your credit.

- Low Appraisal. If the contract sales price on your house is higher than the appraised value, the lender may reject your loan. You may be able to use the low appraisal to help you renegotiate the purchase price to an amount the lender would agree to finance, provided you included this contingency in your Offer to Purchase and the Purchase and Sale agreement. The state has regional mortgage review boards that will review an appraisal in the event a loan is rejected because of a low appraisal. The board is supposed to determine whether an appraiser in unfairly treating a neighborhood. Also, if a loan is rejected because of a low appraisal, the mortgage lender is supposed to provide the applicant with written notification concerning contesting the appraisal.

- Insufficient Income or Assets. Although you may have been pre-qualified by the lender before your application is taken, sometimes a more thorough look at your income, assets and debts shows that you don't fall within the lender's underwriting guidelines. Talk to the lender about ways to improve your situation.

## G. Types of Mortgages

There are two basic types of mortgage loans: fixed-rate and adjustable rate.

### Fixed-Rate Mortgage

A standard fixed-rate mortgage loan has a set interest rate, a fixed monthly payment, and is fully amortized over a given number of years (for example, 15 or 30 years). A portion of each monthly payment covers the interest due on the loan. The remaining portion is applied toward the reduction of the principal balance.

The standard fixed-rate mortgage is still the most popular mortgage loan type because it offers predictability in that the interest rate and monthly payment (minus taxes and insurance) remain the same for the life of the loan.

There are different fixed-rate loan terms available. For example, with a standard, 30-year, fixed-rate mortgage, the borrower pays down the entire principal in 360 equal monthly payments. During the first 10 years, more than 84% of the monthly payment is applied to interest and, therefore, is tax deductible. Pay-down of principal occurs slowly. It is not until the 22nd year that 50% of the principal balance is paid off. Therefore, the 30-year term is appropriate for borrowers for whom an affordable monthly payment is more important than the rapid reduction of principal.

Other fixed-rate terms:

- Standard 15-year, fixed-rate mortgage
- Fixed-rate balloon mortgage
- Fixed Rate with buy down
- Interest Only
- Negative Amortization

A first time homebuyer should usually avoid the above products. A 15 year amortization schedule might be too large to handle if life changes; Children, unemployment etc. Instead, during the strong earning years, consider making extra payments to principal to affect the same. The other types are more suited to investors.

## Adjustable Rate Mortgages

A mortgage loan in which the interest rate varies in accordance with changes in a specified index and pre-determined margin, and may result in changed monthly payments. Most adjustable rate loans also have an interest rate cap, which applies at adjustment and over the life of the mortgage. In exchange for borrowers sharing the risk of rising interest rates, lenders offer an initial interest rate that's substantially lower than the rate for fixed-rate loans.

Adjustable-rate mortgages (ARMs) also come with various terms but are generally defined by the adjustment period, usually every year, every three years or every five years. Other adjustment periods vary from six months to ten years. Some ARMs combine two adjustment periods. For example, a 3/1 ARM has a fixed-rate for the first three years and then adjusts annually for the remaining life of the loan. Some ARM programs also offer the option to convert from an adjustable rate to a fixed rate at specified times during the term of the loan. ARMs generally also include "caps," which limit the amount that the rate may be adjusted.

Borrowers should ask their lender for an example of how the loan may change over time. They should also ask whether the interest rate may decrease (and the likelihood of it doing so), and what the highest rate, also known as the cap, could be over the term of the loan.

Factors to Consider in Deciding on the Best Type of Loan:

In general, the advantages of a fixed-rate mortgage are:

- The principal and interest portion of the mortgage payment is always the same
- It allows you to budget more easily
- As inflation rises, the mortgage interest rate does not increase
- You can take advantage of today's low interest rates for the next 30 years

In general, an adjustable-rate mortgage may work best for people who:

- Intend to stay in their home for only 5-7 years
- Have a limited monthly income at present, but potential for increased income later on
- Are willing to take the risk of the rate fluctuating up or down during the term of the loan

## H. Special Mortgage Programs

Massachusetts offers several state-sponsored mortgage programs for low and moderate income individuals and families:

- ONE Mortgage is offered by the Massachusetts Housing Partnership (MHP) and features low, fixed-rate financing and a state-backed reserve that relieves homebuyers from the cost of private mortgage insurance.

- MassHousing offers several mortgage products, including a mortgage with no private mortgage insurance and a purchase and rehab loan. The MassHousing loans also feature low, fixed-rate financing.

These mortgage products are offered by participating lenders in partnership with the Commonwealth of Massachusetts and local homeownership counseling agencies. Consumers are encouraged to see if they qualify for these loans, as they offer affordable alternatives to many other products on the market.

*TIP:*

*Refer clients to the MyMassMortgage website:*
*http://www.mymassmortgage.org/*

Many lenders offer other programs targeted to low and moderate income, first-time homebuyers as well, including:

- Federal Housing Administration (FHA)
- USDA Rural Housing
- Veterans Administration (VA)
- Individual lender programs

CAUTION:

*"First-time homebuyer programs" are not necessarily the same as "affordable" mortgage programs. Homebuyers should be encouraged to ask about specific terms and not be guided by program titles.*

Program terms vary and can include below-market interest rates, low down payment requirements and low/no closing cost options. In addition, some cities and towns offer down payment or closing cost assistance to eligible homebuyers.

*TIP:*
*Inform clients about how to access these programs in their communities. For instance, down payment assistance is available through the City of Boston's Home Center:*
*http://dnd.cityofboston.gov/#page/FinancialAssistanceProgram*

## I. SHOPPING AROUND FOR THE BEST MORTGAGE

Once you have found the home of your choice, you may think that your shopping days are over. Actually, only the first phase has been completed. Next comes finding a mortgage and payment terms that fit your budget. Where you shop and what you look for are important.

You might start by looking for a mortgage at the bank where you have your checking or savings account. But don't limit yourself. A wide variety of institutions make home mortgage loans, including savings and loan associations, commercial banks, mutual savings banks, and mortgage companies. The mortgages these institutions offer will have varying features.

You should have in mind some of the things to look for in a mortgage loan. For example, what types of loans are available from a given institution? Does the lender make privately or federally insured or guaranteed loans? Loans that are not government-insured are called conventional mortgages. Insured mortgages may be more attractive than conventional mortgages in some ways--such as lower down payment requirements. But they may be more restrictive in other ways; for example, they may be available only for certain kinds of homes, or for properties whose value is below a specified price.

Other factors important to your mortgage decision are the length of the loan and the down payment required by the lender. The longer the term and the larger the down payment, the smaller your monthly payments will be. The interest rate is important too, and in some cases the amount of the down-payment will influence the interest rate that you pay (the larger the down payment, the lower the interest rate). In addition, mortgage loans may have interest rates that will stay fixed for the life of the loan (fixed-rate mortgages), that may change (adjustable-rate mortgages, or ARMs). The initial rate of an ARM is generally lower than the rate available on a fixed-rate mortgage; but remember, the rate may change during the lifetime of the loan. Don't hesitate to ask the lender how one loan differs from another, how the different features of the loan will affect the mortgage, or whether your chances to qualify would improve if you made a higher down payment.

When you're shopping around, you will find that some home mortgage lenders have special programs to assist veterans and low-income or first-time homebuyers. Ask the lender if such programs are available.

**Once you have determined the type of mortgage (fixed-rate vs. adjustable) that is right for you, it is important to shop around for the best mortgage terms and rates available because this will influence not only the closing costs but also your monthly payment. Although a buyer may have a lender in mind, or even be pre-qualified, competitive shopping can save a lot of money over the life of a mortgage. Be sure to compare the following:**

**Interest Rate.** One place to begin to compare interest rates is the newspaper. The Boston Sunday Globe and the Boston Herald, as well as many local newspapers, provide lists of mortgage lenders and their mortgage interest rates. Banker and Tradesman is a weekly newspaper that provides this information as well. These publications can be found in local newspaper stands or on line.

**Interest Rate Lock-In.** The interest rate that is quoted at the time of your application may not be the same rate that is available at the time of closing. Since a higher rate may affect your ability to qualify, you will want to know if the lender will hold, or lock-in, the rate until closing. Be sure to find out how long it will be in effect and if there are any fees associated with the lock.

**Points.** A point represents one percent of the loan amount (on a $100,000 loan, one point would be $1,000). Points can be thought of as pre-paid interest. Points increase the lender's yield on a loan without raising the interest rate. Some borrowers may decide to pay points to keep the interest rate lower and, thereby, lower their monthly payments. Points are usually paid as a one-time expense at closing, and generally they can be claimed as deductions for federal income tax purposes.

*TIP:*

*The long-term cost implications of paying points can be most effectively demonstrated to participants by calculating out a hypothetical situation, using real numbers.*

**Annual Percentage Rate (APR).** To easily compare the various combinations of interest rates and number of points that lenders quote, ask for the APR of a particular mortgage. This is the total yearly cost of a mortgage, stated as a percentage of the loan amount. The APR includes the base interest rate, private mortgage insurance, and loan origination fees (points).

**Application Fee.** Lenders frequently charge an application fee to cover the costs of credit reports, appraisal fees and other miscellaneous expenses related to determining whether the borrower qualifies for the requested loan.

**Down Payment Requirement.** The down payment is the money required from the homebuyer as part of the buyer's contribution or investment in the transaction. It is the part of the purchase price the buyer pays in cash, and does not finance with the mortgage. Different programs require different down payments.

**Eligibility Criteria.** Most lenders evaluate borrowers on the same issues (the applicant's income, assets, credit history and the property involved). However, some lenders are more flexible than others in interpreting these guidelines. For example, some lenders will accept non-traditional methods of establishing a good credit history if you don't use credit. Some lenders require eligible borrowers to have been on the same job for the past two years, while other lenders will accept one year on the same job.

**Qualifying Ratios.** Lenders use two qualifying guidelines to determine what size mortgage you are eligible for: (1) Your monthly housing costs as a percentage of your monthly gross (pre-tax) income and (2) your monthly housing costs plus other long-term debts as a percentage of your monthly gross income. For example, many standard mortgage products have qualifying ratios of 28% (monthly housing costs) and 36% (total indebtedness). Special mortgage programs often offer more flexibility (such as ratios of 33% – 38%).

**Closing Cost Estimates.** There are certain closing costs that are associated with all mortgages, but the fees can vary among lenders. Closing costs can range from as little as 1% to as much as 5% of the cost of the home, depending on the number of points, fees charged, and the size of the loan. Buyers should always ask for a full breakout of closing costs, including prepayment requirements for private mortgage insurance, hazard insurance, taxes, etc.

**Processing Time.** How long does the lender normally take to process a loan application?

**Additional questions apply to adjustable rate mortgages.**

It is important to compare rates and terms from a variety of local lenders and to choose the best mortgage for your situation. You are not obligated in any way to stay with any lender, even one that has pre-qualified you.

## J. Determining Which Program Best Suits Your Needs

To determine which mortgage program has the most favorable terms for you, you can "pre-qualify" yourself for various mortgage programs before you submit an application:

- Learn all that you can about loans and their eligibility requirements.
- Review your financial situation. How much can you afford for the down payment and closing costs? How much can you comfortably pay in monthly mortgage payments? Although you may qualify for a certain amount of loan that does not mean it is right for you. Decide how much you want to pay per month. You may have other wants and needs that command money from your budget that the loan officer has not taken into consideration. Also beware of payment shock. You may have been paying little or no rent and now have to adjust to a much larger payment. Although on paper you can handle that payment, it might be difficult to readjust your lifestyle.
- Match up the best type of loan with your financial situation and the property you wish to buy. Does the house need repair or renovation before you can rent space to a tenant?

*TIP:*
*Encourage participants to ask lenders WHY they may be recommending a particular mortgage product or program and how it compares with other available programs.*

## K. Sub Prime and Predatory Lending

Some people believe or have been told they do not qualify for a conventional mortgage program. This could be due to past credit problems or income that is lower than required to make the proposed mortgage payments. **However, it is important to always shop around when looking for a mortgage. Start with local lenders. While one lender may tell you that you do not qualify for the best loan terms, another lender may say that you do.**

**For those borrowers who have already shopped around and still do not qualify for a conventional mortgage program, it may be in their best interest to work on addressing the issues that have prevented them from obtaining a standard loan, and apply again at a later date when they qualify. For borrowers who do not want to wait, there are two types of non-conventional mortgage products offered by some lenders: High-Cost Loans, formerly known has subprime lending**

**and predatory. High cost loans do not offer the best terms, but may help a borrower who is not in a position to wait. Predatory Loans are NEVER in a homebuyer's best interest. It is critical to understand the difference when shopping for a mortgage.**

## High-Cost Lending

If you think of a report card from school, "A" is the highest mark. A borrower who meets all the guidelines for a conventional mortgage is considered "prime" and is eligible for an "A" loan. If there are issues, usually credit related, then borrowers are considered "subprime" and might be eligible for a "B" or "C" loan. Interest rates are determined by the risk to the lender. Statistically, the lower the credit score, the higher the likelihood of default. As a result, lenders base the interest rate on the grade - the lower the grade, the higher the interest rate.

Some high cost loan programs are structured to help borrowers over time. If after a few years of good payment history, such as no late payments, the borrower may be able to improve their rating and might be able to refinance to a new "A" loan at a current market rate. If a borrower is interested in pursuing a loan featuring this option, it is important to be sure that the terms of the rate-improving refinance are clear, concise and verified in writing. If you have decided to consider a high cost loan, it is important to shop around and obtain the best terms possible.

Some of the reasons a borrower may be directed to a high cost loan are:

- A credit score of less than what is acceptable for prime programs.
- A high debt to income ratio.
- A recent bankruptcy (less than three years)

**The Dodd-Frank Act amended the Home Ownership and equity Protection Act (HOEPA), which was enacted in 1999 to address abusive practices in financing home loans with high interest rates or high fees. The Dodd-Frank Act defines a transaction as a high-cost mortgage if any of the following are true:**

- The annual percentage rate exceeds the applicable average prime offer rate by 6.5-8.5 percentage points,
- Excessive points and fees, or
- Some prepayment penalties.

If a loan is a high-cost mortgage, it must meet the following requirements:

- No balloon payments,
- No prepayment penalties or financing of points and fees, and
- Creditors are required to establish escrow accounts in some cases.

The Dodd-Frank Act dictates that before making a high-cost mortgage, creditors are required to confirm that the borrower has received counseling on the advisability of the mortgage from a federally certified or approved homeownership counselor. Counseling is also required before making a loan that provides for or permits negative amortization.

Predatory Lending

With the advent of Dodd-Frank and Massachusetts Banking reform, predatory lending is scarce but still available. Predatory lending involves abusive or deceptive loan practices with the intent to make as much income as possible from a home purchase transaction, without regard to the impact on the borrower or the borrower's ability to repay the loan. Predatory lenders try to take advantage of a borrower's inability to obtain a standard mortgage because of low or inconsistent income, poor credit (or perceived poor credit) or high debt. They count on the desire of a borrower to get the loan at any cost, without looking carefully at all the documents. Predatory lenders do not support the borrower, but rather they set them up to fail.

Predatory lending can also be defined as putting a borrower into a loan program that is higher cost when in fact they are eligible for a more affordable program.

Predatory lending in the market today is most prevalent through private unregulated lenders. Make sure the institution you are dealing with is federally or state regulated. And beware of rent to own scams.

Many homebuyers across the country who unknowingly obtained predatory loans have lost their homes. If a deal sounds "too good to be true," it probably is. If you have any doubts about a particular lender call the Attorney General's Consumer Hotline at 617-727-8400, the Division of Banks at 800-495-2265, or to find the Better Business Bureau that serves your area, visit www.bbb.org.

Two important mortgage industry regulations, the Real Estate Settlement Procedures Act (RESPA) and the Truth in Lending Act (TILA), were instituted to promote consumer understanding of the direct and indirect costs, terms, and conditions of their credit agreements.

The final word: Don't take one lender's word that you do not qualify for the best loan terms; shop around. If you find that you *truly* you don't qualify for a standard loan, you might want to wait and address the issues that have prevented you from obtaining a standard loan. If you decide that a high-cost loan is your best option, proceed with extreme caution. Read every document carefully and seek the advice of an attorney and/or a homebuyer counselor. A loan product or lending practice may not seem predatory until you compare it to similar loan products offered by other lenders.

## L. FAIR LENDING

Federal law protects every homebuyer looking for a mortgage loan against discrimination on the basis of race, color, national origin, religion, sex, marital status, age, receipt of public assistance funds, familial status (having children under the age of 18), handicap, or exercising your rights under other consumer credit protection laws. Lenders may not take any of these factors into account in their dealings with you.

For instance, lenders may not discourage you because of your race or national origin from applying for a mortgage loan. Whatever your background, they must offer you the same credit terms as other applicants with similar loan requests. They may not treat your application differently because of your sex or marital status or familial status. In short, they are barred from taking into account any of the factors listed here in their dealings with applicants or with potential applicants. They should:

- Willingly give you an application and other information you need on how to apply for a loan
- Willingly discuss with you the various mortgage loans they offer and give you an idea whether you can qualify for them
- Diligently act to make a decision--without undue delay--once you provide all the information asked for (including, for example, written evidence of how much you make or how much you have in savings), and once they receive other paperwork required for processing the application (such as a property appraisal)
- Not be influenced by the racial or ethnic composition of the neighborhood where the home you want to buy is located.

If you apply for a mortgage and are turned down, remember that not all institutions have the same lending standards. Shop around for another lender. But if the way you were treated suggests the possibility of unlawful discrimination, you might talk to:

**Human rights agencies.** These are government agencies set up by a city, county, or state government to deal with discrimination.

**Attorneys.** They can advise you whether the treatment you received gives you legal grounds for bringing a lawsuit against the lender. They can tell you about monetary damages and other types of relief available to individuals who can prove that illegal discrimination occurred.

**Federal or state enforcement agencies.** They can check the activities of mortgage lenders to make sure they complied with the laws against lending discrimination. When you write, include your name and address; name and address of the lending institution you are complaining about; address of the house involved; and a short description and the date of the alleged violation.

**Fair lending means equal access to credit for anyone who is qualified.**

In mortgage lending, it is illegal to take any of the following actions based on any of the protected classes:

- Refuse to make a mortgage loan
- Refuse to provide information regarding loan products, application procedures or other credit services
- Discourage applicants with respect to inquiries about applications for credit
- Use different standards in determining approval of a loan
- Impose different terms or conditions on a loan, including the amount, interest rate or duration
- Discriminate in appraising property
- Refuse to purchase a loan
- Set different terms or conditions for purchasing a loan
- Threaten, coerce, intimidate or interfere with anyone exercising the right to equal access or assisting others who exercise that right
- Give differential treatment to Native Americans, especially those living on reservations
- Fail to provide specific and truthful reasons for credit denial

**ECOA also requires these actions on the part of the lender:**

- A written notice informing the applicant of action taken on any application
- A written notice of the applicant's right to see a copy of any appraisal done on the property
- A written explanation of declination of a loan

Other lending laws include:

**The Community Reinvestment Act (CRA)** requires that state and federally chartered banks and state-chartered credit unions meet the credit needs of the community, including low and moderate income neighborhoods, in which they do business.

**The Real Estate Settlement Procedures Act (RESPA)** is designed to regulate and standardize real estate settlement practices when federally regulated mortgage loans are made on one to four-family homes, condominiums, and cooperatives.

**The Fair Credit Reporting Act** regulates the activities of credit reporting agencies and users of the reports and defines the rights of customers affected by credit reports.

**The Truth in Lending Act** requires lenders to clearly inform applicants about the amount they are paying for credit in monetary and percentage terms before they commit to a loan and gives borrowers the right to cancel loan transactions under specific circumstances. Additionally, the Act details rules for financing terms used in advertising.