Mortgages 101:
What You Need to Know

Coldwell Banker Bain

Mortgages 101: What You Need to Know

Until you have one, getting a mortgage may seem daunting. But knowing the basics makes it easier than you think. Use this primer to take the fear out of getting a home loan.

Your parents had one. Your grandparents had one too. Your uncle threw a party when he burned his. What is it? It's a mortgage, and it's a loan that uses your house and the land it sits on as security; if you don't repay the loan your lender will foreclose and, well, you're out of a home. That's a worst-case scenario that no one wants. So understanding mortgages and how they work will help keep the odds in your favor.

Most people shop for a house before they shop for a mortgage. But try it in reverse. Knowing from the outset which mortgage is right for you and how much money you can borrow will take a lot of the anxiety out of the process, making your house hunt more successful and fun.

Types of mortgages

There are a variety of loans used to finance a house, but the two most common are fixed-rate mortgages and adjustable-rate mortgages, or ARMs.

Fixed-rate

As the name suggests, a fixed-rate mortgage comes with a monthly payment – a combination of principal and interest – that remains constant throughout the life of the loan. Changes in the economy or blips in interest rates won't alter your mortgage payment. However, if property taxes are part of the monthly payment, it's possible that the amount you pay will vary as taxes rise or fall – but your principal and interest will always remain the same. Many people prefer the stability of a fixed-rate loan because it makes budgeting and long-term financial planning easier.

Fixed-rate mortgages typically come in 30- and 15-year terms. You'll pay less each month with a 30-year mortgage but will incur more interest over the life of the loan. If you can afford the higher payments of a 15-year fixed, this may be a better choice as you'll own your home sooner and save thousands in interest.

Adjustable-rate

Unlike fixed-rate loans, adjustable-rate mortgages, or ARMs, start with a low fixed rate for an initial period – this can be as short as a month or as long as 10 years. Then the adjustable part kicks in, and the loan shifts to a longer period where the interest rate changes according to an index – such as the 30-year Treasury bill performance or the LIBOR rate (what banks charge each other for short-term loans) – at preset intervals. Rates may increase every year, though most ARMs have caps limiting how high those rates can go.

Many people choose an ARM, even if they qualify for a fixed-rate loan, because with it they can buy a home they may not otherwise be able to afford. By choosing an ARM, these buyers are banking on salary increases to cover the higher payments when their mortgage rate changes.

Fixed-rate vs. ARM: Which is right for you?

For many people, the stability of a fixed-rate mortgage makes the most dollars and cents, and gives them the security of having a home where they can raise a family and be rooted in a community. Fixed-rate loans typically have slightly higher interest rates than ARMs, but borrowers are protected against rising interest rates with a fixed loan. On the other hand, if interest rates drop tantalizingly enough, fixed-rate loans can be refinanced at a lower rate, reducing the monthly mortgage and saving money.

With a fixed-rate mortgage, borrowers have the option to make a larger monthly payment and apply the added portion to the principal; this lowers the balance and helps pay off the loan faster. Similarly, experts recommend paying half your mortgage every two weeks for a total of 26 payments each year, the equivalent of making an extra monthly payment. Or you could just make an extra mortgage payment once a year. Either way will shave about 7 to 8 years off your mortgage, saving interest and putting more money in your pocket.

Adjustable-rate mortgages' lower cost makes them attractive to many buyers, but they're not without risk. Rates and payments can rise sharply over the life of a loan. Even with rate caps, a person with a 6% ARM could wind up paying 11% in just three years if interest rates skyrocket.

Because ARMs are cheaper early on, borrowers could take their savings and invest it elsewhere. For example, if you save $100 month with an adjustable-rate mortgage, you could put it in a higher-yield instrument and earn more money on the investment. When interest rates fall, people with ARMs aren't locked in and can more easily refinance to a lower rate. Plus, if you don't think you'll be in your house for a long time because of a job or other circumstance, an adjustable-rate mortgage is a good way to go.

With so many flavors of mortgages to choose from, each with different options, consider consulting a lending professional to help find the right mortgage for you.

© Copyright 2014 Coldwell Banker Bain