

SECTION 5: UNDERSTANDING HOW TO SHOP FOR THE RIGHT LENDER AND LOAN

Refinancing your mortgage for different terms or borrowing against your home equity can be advantageous. To ensure that you get the best possible loan product from a reputable lender, it is important that you understand exactly what you are buying and how much it really costs. By shopping around and making an informed choice, you can save tens of thousands of dollars and protect your investment in your home.

Key Financing Terms

But before you start shopping, let's review some of the terms you need to understand in order to find the loan product that is right for you. These terms might sound familiar to you because they are the same terms that you learned when you were shopping for your purchase mortgage. But it may have been awhile since you bought your home, and it never hurts to have a refresher course before you refinance your mortgage.

The following terms are important to know as you are searching for your refinance or equity loan:

Principal. This is the total amount of money you borrow from a lender, not including the interest you will pay on the loan.

Loan-to-Value (LTV). LTV is the ratio of the loan balance you owe to the appraised value of your home. Typically, a lender will loan you only a percentage of the appraised value, meaning that the LTV will be less than 100 percent.

Term. The term is the total amount of time you are given by a lender to repay the money you borrow. Many refinance loans have a 30-year term, meaning that you have 30 years to pay the lender back the full amount of money you borrowed. The longer the loan term, the longer you are stretching out your interest payments. You pay more money in interest for loans with longer terms than if you paid the loan off in a shorter period of time.

Interest. This is what lenders charge you to borrow their money. Interest accumulates over time on the unpaid balance of your loan and is expressed as a percentage called the interest rate. Unlike interest for credit cards or car loans, which is not deductible on your federal or state income tax return, mortgage interest is deductible. Deducting your mortgage interest payments on your tax return may result in savings on the income taxes you owe.

Annual Percentage Rate (APR). This is the total annual cost of borrowing money based on the loan amount, interest rate, added fees and term. The APR is expressed as a percentage. It includes the interest rate, points and certain other fees charged by the lender, which often makes it higher than the

➤ **Important Note About Tax Deductions**
Current law permits you to deduct all the interest you pay on acquisition and straight refinance mortgages from your total taxable income. You also can deduct the interest you pay on home equity debt of \$100,000 or less.

These **tax deductions** may reduce the federal (and in most cases, the state) income taxes you owe, and could save you money. This benefit works when your itemized deductions, including mortgage interest, property taxes and other home-related expenses in a given tax year, exceed your standard deduction. Your standard deduction is a dollar amount based on your filing status that reduces the amount of income on which you are taxed. For more information, see section 8, *Understanding Your Responsibilities After Loan Closing*, and Publications 501 and 936 from the Internal Revenue Service, which are downloadable from www.irs.gov.

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interest rate the lender will quote you. When looking at different loan products, the APR provides a more useful comparison than just the interest rate.

Points. A point equals one percent of your loan amount. So, if you are borrowing \$50,000, one point would equal \$500. Some refinance and equity loans require you to pay points. Points are generally paid at closing. There are different kinds of points: **discount points** and **origination fees**. A discount point is a prepaid finance charge. Often the lender will offer you a lower interest rate on your loan in exchange for paying discount points. Each discount point typically lowers your interest rate by 0.25 percent. An origination point is a fee charged by some lenders just to make the loan. It covers the administrative costs in preparing and evaluating your loan, and, when charged, is typically one point. The total number of points charged by a lender varies.

Loan Fees. These are the fees lender charges you to process, approve and make the loan. They may include origination fees, points and fees for the application, credit report and appraisal. While some loan fees may be paid at closing, others are often paid in advance, such as the fees for the credit report and appraisal. Be sure to ask your lender what each fee covers and to explain anything that is not clear to you. Keep in mind that fees vary from lender to lender, and you may be able to negotiate with lenders to pay lower fees. Below are some tips to get lower costs:

- Ask if the lender will waive any fees to get your business or if you opt out of a service. For instance, a lender may normally overnight documents back and forth for faster approval. If you are not in a hurry to close, you can ask the lender to send the documents via regular mail and drop the overnight charges.
- Ask if you really need a new title search and title insurance policy, especially if you are doing a straight refinance with your current lender. If the title search for your original mortgage was done recently, you may be able to get a re-issue policy at a discounted rate.
- Ask for lower-cost appraisers, and skip surveys. If you are refinancing with your current lender, you may be eligible for a less costly, expedited appraisal. If you had a survey done recently as part of your original mortgage, you probably do not need a new one.
- Look online for typical fees and costs, and use that to leverage your lender. Watch out for “junk fees” or additional charges.

When you apply for a loan, the lender must provide you with a **Good Faith Estimate** of the settlement costs you are likely to pay, within three business days of applying for a loan. The amounts listed on the Good Faith Estimate are only estimates, so the actual costs may vary. It is a good idea to keep your Good Faith Estimate so you can compare it with the final settlement costs that will be listed on your **HUD-1 Settlement Statement**. You can and should ask the lender questions about any differences between the two.

Closing Costs. These are expenses that you incur by refinancing your home or obtaining a home-equity loan. Closing costs vary from loan to loan. Closing costs normally include:

➤ Important Note

About Discount Points

Paying discount points, or up-front interest, should always be optional. The key factor to consider when determining whether you want to pay points in exchange for a lower interest rate is how long you plan to own your home or keep this particular loan. If you plan to stay in your home for a long time, it may be worth paying discount points upfront to ensure lower interest rates in the long run. If you opt to pay discount points, the amount of the points should be stated clearly and reduce the loan's interest rate.

It may be possible to finance the cost of the discount points into the loan, but doing this will increase your loan amount and, therefore, your total costs over the life of the loan. This could offset any savings you would have had with the lower interest rate.

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- Charges associated with the loan. These are the fees that lenders charge to process, approve and make the loan, which are described in greater detail below.
- Government recording fees. These consist of any **document recording** fees for registering the mortgage with your local government agency when a mortgage loan is made.
- Title charges. These cover the costs for services performed by title companies and others, such as the title search and the **title insurance** policy. The title search is an examination of public records to confirm ownership of the real estate, and the title insurance policy insures the lender for a specific amount for any loss caused by discrepancies in the title to the property. On a refinance loan, lenders typically require title insurance up to the value of the loan. If the title search for your original mortgage was done in the past five to 10 years, your current title insurance company may be able to re-issue your policy at a discounted rate. Be sure to ask for this discount if applicable.

Just as with purchase mortgages, closing costs for refinance loans usually total between two and seven percent of the loan amount. That is because your refinance loan will have many of the same closing costs as your original home loan. Closing costs on home-equity loans or lines of credit may be lower, however, because lenders do not have to perform many of the same closing and underwriting steps required on first mortgages. On a home-equity loan or line of credit, you may be able to opt for a computerized property valuation rather than a full appraisal, or agree to a title search, but not new title insurance.

Closing costs are normally paid at **closing**. As you probably did when you purchased your home, you can bring a cashier's check to your closing. With refinance and equity loans, you may have two other options for how you handle your closing costs. You could finance them into the principal balance of your loan, or you could agree to a slightly higher interest rate to cover them. Keep in mind that both of these options raise the total cost to you over the life of the loan.

Escrow Account. A special account set up by your lender to pay for your real estate property taxes and homeowners insurance, and mortgage insurance if required, when they are collected as part of your monthly loan payment. Your current mortgage loan may include an escrow account to pay for your taxes and insurance.

If you do not have an escrow account, here is how it works. At the beginning of the loan and again at the beginning of every year, the lender estimates how much the taxes and insurance will cost for the year and divides the cost by 12. The lender collects the money monthly as an add-on to the mortgage and interest payment and saves it in a special account called an escrow account. When the bills are due the lender pays them.

When you refinance your mortgage, you will need to set up a new escrow account (even if you already have one with the same lender) if such a service is offered by the lender. If your lender does not set up an escrow account for you, you will need to pay those bills on your own. In such cases, it is important for you to plan for those expenses by setting aside enough money on a regular basis in a savings account

➤ *Important Note*
About Escrow Accounts
Many refinance loans, especially those offered by nonprime lenders, are advertised without escrow payments. This makes a loan's monthly payments look lower, but can cause a huge payment shock when the tax or insurance bill comes due.

One of the best tools for managing tax and insurance payments is an escrow account. If an escrow account is not included with your refinance loan, ask your lender about setting one up. While establishing an escrow account requires time from the lender and an initial investment and higher monthly payments from you, it makes it easier to pay your tax and insurance bills when they are due. Keep in mind that tax bills are usually significant amounts. If you do not pay your property taxes, you can lose your home.

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earmarked for taxes and insurance. Penalty fees can be high if you do not pay your property taxes or insurance when they are due.

Amortization. This is the process of reducing or “paying down” the principal of your mortgage loan by making periodic payments throughout the loan term. In most cases, loans are amortized, or repaid, through monthly payments that consist of principal and interest. When your loan is fully amortized, it will be repaid in full and you will no longer owe your lender any money.

Interest Rate Lock-In. A rate lock is a legal commitment between you and the lender, where the lender promises you a loan at a specified interest rate for a certain period of time. You may have to pay a fee to lock in your rate, especially if you wish to lock beyond 30 days. Interest rates can change frequently during the period of time that you are shopping for a loan and finally closing on one. Once you find a loan that meets your needs, it is important to ask if the lender will lock in your rate. This guarantees you the rate as long as the loan is closed within a set period of time, even if rates rise. If interest rates fall during your lock-in period, some lenders will allow your rate to float down, meaning that it will decrease with the falling interest rates, thereby saving you money. If you plan to get a loan during a period when interest rates are falling, you should make sure your loan has a float-down provision. When you apply for the loan, you should ask the lender how long it will take to close the loan. If your lock-in period expires before you go to closing, your lender is not required to offer you the same interest rate you had locked in earlier. Be sure that you lock in for a period that is long enough to cover the time until your expected closing date.

There are many things to think about when deciding what type of loan product to select when you refinance your home or borrow against your home equity. Below are some of the questions you will need to answer to ensure that you choose the best loan for you.

How Do I Choose Between a Fixed-Rate and Adjustable-rate Mortgage Loan?

There are two basic loan types: fixed-rate mortgages and adjustable-rate mortgages.

A *fixed-rate mortgage loan* has an interest rate and a monthly principal and interest payment that do not change throughout the term of the loan. Fixed-rate mortgage loan terms are typically 15 or 30 years. Whatever term you choose, a fixed-rate mortgage ensures that every month your principal and interest portions of the mortgage payment will remain exactly the same until you refinance again or until you pay off your entire loan and own your home outright. Keep in mind that property tax and homeowners insurance rates may change during the duration of the loan, and if money for taxes and insurance are collected as part of your monthly loan payment, this could affect your total monthly mortgage payment.

If you choose a fixed-rate loan, even if market interest rates rise, your principal and interest payments do not increase. At the same time, when interest rates fall, your principal and interest payments do not decrease. The predictability of your monthly mortgage payment makes budgeting and planning for other expenses easier because you always know exactly how much money you need to pay toward the principal and interest portion of your mortgage every month. Of course, if interest rates fall and you

find out that you could save a lot of money on your mortgage payments, you can always refinance again, but remember that refinancing takes time and costs money. Before you decide to refinance again, you should be sure that the savings in your monthly payments are worth these added costs.

As a general rule, the shorter the term of the loan, the lower the interest rate. So, a 15-year, fixed-rate mortgage usually has a lower interest rate than a 30-year, fixed-rate mortgage. Although shorter repayment periods have higher monthly payments, your total loan costs will be less since a larger amount of your monthly payment is applied to pay down the principal balance and you are paying interest on the borrowed money for a shorter time. Selecting a loan term involves striking a balance between how low you want your monthly mortgage payments to be versus how quickly you want and can afford to own your home outright.

An *adjustable-rate mortgage* (ARM) is a loan whose interest rate adjusts, or changes, during the loan term at specified intervals. The interest-rate adjustment is tied to an index determined by the lender. This index rises and falls as interest rates change in the market. It is important to ask the lender about the history, or past performance, of the index so you have a sense of how the ARMs have changed in the past. All ARMs have an interest rate that is fixed until the first adjustment date. Most start with relatively low interest rates and then adjust every six to 12 months, although they can adjust more often. When the rate adjusts, your monthly payment may change. If the index has risen when the time comes for a rate adjustment, your interest rate and monthly payment will also increase. Of course, if the index has fallen, your interest rate and mortgage payments can end up being less than what you have been paying, but probably not less than what you started out paying.

Many times the initial interest rate on an ARM is a “teaser rate” — a rate lower than the index used when the rate on the loan adjusts. The low introductory or beginning rate on an ARM may be attractive. But before you choose this type of mortgage, it is critical to understand two elements: how often the rate adjusts, and whether there are limits, or caps, both on each interest-rate adjustment and on the total amount of change in the interest rate allowed during the term of the loan.

There are two types of caps related to an ARM that you should ask the lender about. An adjustment cap limits the amount of change (increases or decreases) that can occur each time the loan adjusts. Adjustment caps can vary substantially among lenders. Some may set the adjustment cap at one percent, and others may set it as high as three percent higher than the initial start rate. The other type of cap, a lifetime cap, limits the total amount of interest rate change allowed during the term of the loan. Again, these can vary substantially among lenders. Without a lifetime cap, your loan could continue to increase as the interest rate rises, and this could have a dramatic effect on your budget and your ability to afford your home. Be sure that your ARM has caps in place and that you ask your lender to tell you the exact dollar amount that you will have to pay if your loan adjusts to the maximum possible payment.

When considering an ARM, it is critical that you look at your budget and understand how much you could afford to have your monthly payment increase. Think hard about whether or not you are able to afford the maximum possible payment allowed. Think about how the need to pay the maximum possible payment will affect your ability to accomplish your other financial goals. If your loan hit its

➤ *Important Note About Interest-Only Mortgages*

An **interest-only mortgage** allows you to pay only monthly interest payments during an initial period of time. Interest-only loans can have fixed or adjustable interest rates. If you chose an interest-only mortgage, your initial payments would be lower than they would be with a fully amortizing loan because they do not include principal payments. The interest rate, however, may or may not be lower than the rate you would get on a fixed- or adjustable-rate loan that does include principal payments. At the end of the interest-only period, the loan becomes fully amortizing for the remainder of the loan term. At this point, the monthly payment could rise dramatically, especially if you have an ARM whose interest rate has increased due to rising interest rates.

The greatest danger of an interest-only mortgage is that it may tempt you to borrow more money than you can realistically afford. Another danger is limited equity building. During the interest-only period, you build equity only if your home's value appreciates. If **depreciation** occurs, you could end up owing more than your home is worth.

Before you decide to choose an interest-only mortgage, visit a reputable housing counselor.

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maximum, could you still afford to pay for your car, childcare or medical expenses? If you cannot afford to make this payment over a period of time, you should think very carefully about the risks to you and your family associated with taking this type of loan.

If you already have an ARM, you may choose to refinance with a fixed-rate loan when interest rates are low, so you can have a consistent and reliable low monthly mortgage payment and avoid the risk of rising interest rates in the future.

How Do I Decide Whether To Pay Discount Points on My Loan?

Whether shopping for a fixed-rate mortgage or an ARM, you need to think about whether you would prefer to pay discount points in exchange for a lower interest rate, versus paying fewer or no points in exchange for a higher interest rate. If you plan to live in your home for a long time, eventually you may save money by paying discount points in exchange for smaller monthly mortgage payments and lower total loan costs. But if you think you will be in your home for a short time, you may decide that it is not financially worth it to pay points. You may remember that when you first bought your home, you were able to get a tax deduction for the points you paid at closing during the year that you paid for them. When you get a refinance or home-equity loan, you generally cannot deduct the money you paid for discount points up-front. Instead, you deduct them over the life of the loan.

How Do I Choose Between Private and Government-Assisted Loan Products?

Refinance and equity loans fall into two broad categories: private loan products and government-assisted loan products. Not all government-assisted loan products allow you to borrow against your home equity.

Private loan products. These loans are not insured by the federal government and include conforming conventional and nonprime loans. **Conforming conventional loans**, which are often called “prime” or “A-paper” loans, meet specific eligibility criteria to be sold to **secondary market** investors. These loans are made by lenders to the most creditworthy borrowers at the prime interest rate — the best rate available according to market conditions. Lenders set their own interest rates and fees for conventional refinance loans and determine the maximum amount they will lend under each program. **Nonprime loans** have higher interest rates than conforming conventional loans. Nonprime loans are typically used by lenders to serve borrowers who cannot qualify for **prime loans** due to poor credit, unverifiable income or employment, loan size, loan position or other factors. Nonprime loans rely on what is called “**risk-based pricing.**” That is, your interest rate and fees are based on your default probability and the lender’s risk of loss. Your price is based on a number of factors, including your credit score, debt-to-income ratios and LTV ratios.

Government-assisted loan products. These loans are insured or guaranteed by the federal government. While government-assisted loan products may have lower interest rates and fees or more liberal qualification standards than private loan products, they typically have lower maximum mortgage amounts and very specific eligibility criteria. They also may take longer for loan approval and funding. And, as

mentioned above, not all government-assisted loan products allow for you to borrow against your home equity.

There are three primary types of government refinance loans:

- FHA streamline refinance loans are available through participating lenders to homeowners who already have an FHA-insured mortgage that is being paid on time (not delinquent). The streamline refers only to the amount of documentation and underwriting the lender requires to process the loan, and does not mean that there are no costs involved in the transaction. Lenders may offer FHA streamline refinances in several ways. Some lenders offer no out-of-pocket expenses by charging you a higher interest rate on the new loan than if you financed or paid the closing costs in cash. Others include the closing costs in the mortgage amount if you have enough equity in your home, as determined by an appraisal, not to exceed the original loan amount. The refinance results in lower monthly principal and interest payments. No cash may be taken out on mortgages refinanced using the streamline refinance process. For more information, contact a participating lender or visit HUD's Web site at www.hud.gov.
- VA refinance loans are available to eligible people on active duty and veterans of the U.S. armed forces with VA or conventional loans through participating lenders. The government has provided special benefits to veterans who want to refinance their mortgages. Regardless of whether you currently have a VA loan or a conventional loan, if you qualify, you can take advantage of VA refinancing benefits. Similar to FHA, the VA streamline refinance program is available, with a **funding fee** of one half of one percent that may be paid in cash or included in the loan, if you currently have a VA loan and simply wish to lower your rate. If you have a conventional loan and qualify to refinance into a VA loan, there is 2.2 percent funding fee. It may be possible to do a VA cash-out refinance loan if have built up some equity. More information on these programs can be found by contacting a participating lender or visiting the Department of Veterans Affairs Web site at www.homeloans.va.gov.
- USDA Rural Development, Rural Housing Service Guaranteed Rural Housing loan program offers refinancing to homeowners with existing Rural Housing Service Section 502 Guaranteed or Direct Loans who live in rural areas through participating lenders and Rural Development offices. A fee of one half of one percent applies, which can be paid in cash or financed along with other closing costs.

How to Find the Best Lender

Now that you are familiar with a variety of options to consider, it is time to search for the lender that can offer you the best refinance product. These days it is not difficult to find a lender who will loan you the money you need to refinance or borrow against your home equity. Thus, it is critical to understand exactly what the lender is offering you so you can be sure to get the very best priced loan you can. Before you choose your lender, be sure that you shop around, compare costs and loan terms, and negotiate the best deal.

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As you probably remember from your experience buying your home, your credit rating will influence the loan products you will be offered. Those with good credit are rewarded with lower interest rates because they have a history of repaying their debt. Conversely, those who have had past credit problems are often charged higher interest rates to offset the possibility that they will fall behind in their payments. But do not assume that minor credit problems caused by past illness or temporary job loss limit your loan choices to only high-cost lenders. Be sure that you explain your situation to the lender and ask how your credit history will affect the price of your loan. Ask what you can do to get a better price. Take your time and find the best product you can.

If you have had a good experience with your current lender, start shopping for a loan there. Ask your lender for information on loan products, costs and terms, and compare the products to others found in your local newspaper and from referrals. You may find that your current lender has comparable rates, but lower fees. You can use the Internet to shop, but be careful about extra costs, payments without escrow accounts and your privacy. Be wary of lenders who advertise on television, knock on your door or send you offers without your asking. These offers often sound much better than they are.

It is a good idea to contact several lenders for price quotes so you can compare and contrast what they have to offer before you make a decision. Also remember that there are local nonprofit housing counseling agencies that can provide you with information and insights to assist you in your decision-making. Do not let anyone pressure you to make a decision before you are ready. See section 7: Understanding How To Avoid Predatory Lending, for more warning signs of predatory lending.

In order to compare various mortgage products, it is important to compare the same combination of interest rates, points and fees being offered by each lender. Ask each lender to tell you exactly how much your monthly mortgage payment will be and the total dollar amount you will have to pay at closing. Better yet, ask each lender for a Good Faith Estimate of your anticipated closing costs. To keep track of what you learn, use the worksheet on page 37 to enter information on each lender.

If you are dealing with a mortgage broker, be sure to ask how much commission he or she is being paid and who is paying for it — you, the lender or both. Be sure that the broker is not pushing you into a higher priced product to generate a higher commission from the lender. Again, if you do your homework and get the information in the loan comparison worksheet from at least three lenders or brokers, you should be able to tell which loan is priced best.

How Do I Select the Best Loan?

After you have completed the worksheet, you should have all the information you need to select the loan that best meets your needs. Remember to consider the total cost of your loan, not just the interest rate. Be sure you are comfortable with your decision. Do not let anyone pressure you to choose something that you do not want.

Refinance and Home-Equity Loan Comparison Worksheet

	Lender 1	Lender 2	Lender 3	Current Mortgage
Name of Lender				
Name of Loan Officer/Contact				
Phone Number				
Date				
Basic Information on the Loan				
Loan program (straight refinance, cash-out refinance, home-equity loan, home-equity line of credit or reverse mortgage)				
Loan amount requested				
Type of loan category (conforming conventional, nonprime, FHA, VA or RD)				
Type of loan (fixed-rate, adjustable-rate*, interest-only, balloon-payment or other)				
Loan term				
Interest rate				
Annual percentage rate (APR)				
Points				
Loan-to-value or combined LTV				
Mortgage insurance requirements (if conventional or FHA first mortgage >80% LTV)				
Estimated monthly escrow for taxes and homeowners insurance				
Debt-to-income ratio				
Estimated monthly payments for all loans				

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	Lender 1	Lender 2	Lender 3	Current Mortgage
Loan Fees (Different lenders have different names for fees and may charge different fees)				
Application fee				
Origination fee				
Processing fee				
Underwriting fee				
Appraisal fee				
Credit report fee				
Document preparation fee				
Broker fee				
Other fees				
Total loan fees				
Are any of the fees negotiable?				
Are any of the fees refundable if the loan is denied?				
Other Loan Considerations				
Prepayment penalties				
Is there a prepayment penalty?				
How much is the penalty?				
How long does the penalty period last?				
Are extra principal payments allowed?				
Rate lock-in				
Is the rate lock-in in writing?				
Is there a fee?				
When does lock-in occur?				
How long will the lock-in last?				
Is there a float-down provision if the rate drops before closing?				
Credit life insurance				
Does the monthly amount quoted include an optional charge for credit life insurance?				
How much lower would the payments be without credit life insurance?				

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	Lender 1	Lender 2	Lender 3	Current Mortgage
Balloon-payment				
Does the loan have a balloon payment?				
When is it due?				
*Adjustable-Rate Loan Considerations				
What is the initial rate?				
How long does the initial rate last?				
How frequently does the rate change after the initial period?				
What are the rate caps for the first adjustment, each adjustment after that and over the life of the loan?				
What index will be used?				
What is the margin?				
What could the highest monthly payment be?				
Can the loan be converted to a fixed-rate?				
Cost of conversion option				
Personal Considerations				
Your credit score				
Can you afford this loan?				

Sources: Federal Interagency Task Force on Fair Lending and the Federal Trade Commission.