OnLoan.com
MORTGAGES IN MINUTES

WEB SITE TEXT FOR THE EDUCATION SECTION

DRAFT 3

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WHAT TO EXPECT WITH ONLOAN

Welcome

We understand each borrower has different needs and circumstances, so the loan process may vary slightly to accommodate individual requirements. Our goal is simply to help you get the loan that's right for you quickly and efficiently. In the best case, a purchase loan can be funded in as little as a week and a half! Refinancing can be even quicker. OnLoan encourages our customers to learn as much as possible about the mortgage process, terms and loan types before applying. Visit OnLoan's "Understanding Mortgages" area first to help take the uncertainty and complexity out of home financing. Also, refer to the following features:

- Application Checklist
- How Much House Can I Afford? Calculator
- Today's Interest Rates

The Steps

Pre-Approval

Completion Time: 10 - 15 minutes

The first stage of the application process is getting pre-approved. All loan programs have different qualification guidelines. OnLoan's proprietary MortgageMatch^{TM} system ensure you apply for a loan that does matches your qualifications. This technology qualifies you for the best available loan programs within minutes by requesting some employment and asset information and ordering your credit report ($15 for each borrower) and a market valuation for the property ($20, if known). We will provide you with a secure credit card form to pay these fees directly online without delays. See our Security/Privacy Policy.

MortgageMatch^{TM} compares your financial data and credit analysis with the requirements of various loan programs. Within minutes, you'll receive a list of loans you qualify for, ranked by APR. See a sample of returned loan programs. Certain types of loans are not offered online, but can be obtained offline with an OnLoan loan strategist. Read more details at Loans Available with OnLoan.

You will need to review and compare the loans returned to you, then select the program you desire. You can go back and change your preferences to view a different list of programs. Once you choose a loan, OnLoan returns a Good Faith Estimate and Truth-in-Lending statement to you online, so you can review estimated closing costs right away.

Pre-approval status is granted! You will instantly receive a printable pre-approval letter directly online from OnLoan for your selected loan program. Pre-approval is subject to satisfactory property appraisal and verification of assets, employment and liabilities. Assuming your information is accurate and your credit profile does not change adversely, there is a high probability of approval for this loan. The actual interest rate may fluctuate until you lock in your rate.

Application

Completion Time: 20 - 30 minutes

To obtain final approval, you will need to provide further details of your financial picture by completing the online loan application, known in the industry as the Uniform Residential Loan Application, or Form 1003 (pronounced *ten-oh-three*). Our online version provides explanations for each field, which help to simplify and speed completion.

OnLoan analyzes your application and submits it to underwriting for initial review. In most instances, automated underwriting is used. Note: It is very important that you use OnTrack daily to check the status of your loan. Please respond quickly to any requests for information to prevent delays. You will be assigned a loan strategist and notified via email with your strategist's contact information. The loan strategist oversees your loan and provides assistance and guidance throughout the process, if needed.

Processing

Completion Time: Varies with borrower, as little as 4 days

OnLoan will overnight you a loan package with requests for signatures; payment for full credit and appraisal reports, if necessary; verification forms and supporting documents, such as W-2s, bank statements and pay stubs. These documents help support and verify the information you supply in the application. You should return the signed, completed loan package to OnLoan as soon as possible using the overnight return envelope provided for your convenience.

OnLoan reviews your package and sends you a friendly email reminder of any missing items. We also provide you the opportunity to lock in the current loan rate. See OnLoan's Rate Lock Policy for more information. A property appraisal is ordered, and if necessary, a full-factual credit report – or mortgage credit report – is ordered. If for any reason these reports are not ordered, funds will be returned to you or applied toward your closing costs. In addition, verification of employment, funds and current mortgagor or landlord is performed at this time.

OnLoan will email you with the property appraiser's information. A qualified appraiser will contact you and schedule a date and time to visit the property. OnLoan also arranges mortgage insurance if your loan-to-value (LTV) ratio is greater than 80 percent, (i.e., your down payment is less than 20 percent). OnLoan may request additional supporting documentation. If we do, please send us the requested documents as soon as you can using the overnight envelope.

Underwriting

Completion Time: Varies with borrower, as little as two days

Your loan package is given a final check for accuracy and completeness and submitted again to underwriting. Upon receipt of a satisfactory appraisal and all documents, a final underwriting determination can be made in as little as 48 hours.

OnLoan arranges a closing agent and orders a title search, title insurance, survey, pest inspection and any other required items, as dictated by locale. You may designate your own closing agent, but please notify us. Closing agent and title insurance information is sent to you via email. If all loan conditions have been satisfied, final approval is awarded to you.

Closing/Settlement

Completion Time: Varies with borrower, as little as three days

You will be asked to obtain home owner/hazard insurance and flood or earthquake insurance, if required, for the new property and send us this information. If you are refinancing, we will notify you of any required changes to loss payee or coverage amount for your existing insurance. OnLoan notifies your closing agent of the approval.

Shortly after, the closing agent contacts you and the seller to arrange the closing date and time. You will receive closing conditions and tips via email. The title company or an attorney prepares all required closing documents, including the HUD-1 settlement statement, which is sent to you for review. For purchases, loan funds are wired to the closing agent's or title company's escrow account.

Closing, also called *settlement*, occurs. All required documents are signed and funds are disbursed to appropriate parties. For refinances of primary residences, funds are disbursed three business days after closing. If you are purchasing a property, the closing agent records the deed and necessary instruments to give you legal ownership of the property. Copies of documents are supplied to appropriate parties.

Congratulations!

I'm ready to get pre-approved!

Mortgage ABCs

Choosing a Loan

Interest Rates, Loan Terms and Down Payments

Q. Is the interest rate the major consideration when shopping for a loan?

While one of the first options consumers consider in making an affordable home purchase (and erroneously, often where they stop shopping), the interest rate is certainly not the only factor in mortgage financing. The following is a quick checklist of questions the borrower should ask, followed by an explanation of each.

- What are the borrower's financing goals? The borrower should estimate the time he or she will own the property. Short-term owners could use an adjustable-rate mortgage (ARM) for short-term savings; elect for a higher interest rate with fewer discount points, which would not be recouped if the property were sold in a short time; or use a loan containing a balloon provision.
- Long-term owners could use a 15- or 10-year fixed-rate loan to build equity quickly and sidestep interest over the life of the loan; pay higher points to reduce the interest rate; or use a permanent buydown to reduce the interest rate for the life of the loan.
- If and when the borrower does sell, how important will it be to get all equity out immediately? If this is important, the borrower may wish to choose a loan that is assumable and would be market competitive when assumed.
- Will anyone else be participating as a co-borrower or cosigner on the loan? The answer to this question may dictate the type of loan available to the borrower, as not all loans allow multiple borrowers.
- How much savings does the borrower wish to use as a down payment? Is that including, or in addition to, the closing costs? This can help determine the size and type of loan.
- How much of a monthly payment is the borrower prepared to make? The answer to this question should be based not only on what the borrower can afford, but also on the size of the monthly payment he or she is psychologically prepared to make.
- What are the borrower's current mortgage or rent payments? A lender may hesitate to approve a loan with radically larger payments than a consumer is accustomed to paying without showing a substantial income increase. A severe payment difference may increase financial pressure on the borrower, perhaps enough to cause the loan to default.
- Would the borrower mind if the payment amount fluctuated? If so, it's probably not wise to take on an ARM or similar interest-sensitive loan.

15-Year versus 30-Year Loans

Q. How does one choose between a 15- and 30-year loan?

Many factors go into deciding which loan term best suits a buyer's needs and qualifying abilities. If a borrower qualifies for a 15-year loan, the savings in interest payments is substantial. The monthly principal and interest payment on a 15-year, $100,000 loan at seven percent is $899, compared to $665 on a 30-year term. Payments on the 15-year loan would total $161,820. The 30-year loan would cost a whopping $239,400— $77,580 more!

Q. Are there other financial benefits to using a 15- versus a 30-year loan?

Interest rates may be lower on the 15-year loan, depending on the lender and the loan program. Because equity builds faster on a 15-year loan, a low down payment may be less of a problem if the borrower has to resell in a short period of time.

Q. If a 15-year mortgage makes such good financial sense, why doesn't everyone get one?

First, not everyone can qualify for a 15-year loan. Because of the shorter amortization time, the monthly payment is larger. Going back to the earlier example comparing costs for the 15- versus 30-year loan: To qualify for a 30-year loan's $805 payment, the borrower would have to have $2,875 income per month to meet a lender's 28 percent housing ratio requirements. To qualify for the 15-year loan's $1,015 payment, however, the borrower would need $3,625 income per month, or $750 more than needed for the 30-year loan.

Second, some borrowers enjoy the peace of mind that comes with a lower monthly payment, enjoying the cushion were they to fall on tough financial times. In fact, approximately 80 percent of all loans made are 30-year loans. Borrowers could make prepayments on the 30-year loan to retire it early, if the loan program allowed, but with the 15-year loan they'd be saddled permanently with the higher payment.

The exception to this school of thought is found in homeowners who are refinancing their existing loans. A much larger percentage of those individuals are using 15-year loans, and in some cases, 10-year loans, to reduce their purchasing costs. Remember that a borrower who is making a higher monthly payment will not have that money available for other investments. This could mean lost financial opportunities.

And finally, not everyone can access a 15-year loan on every mortgage available. Availability can vary based on the lender and the program. Lenders are usually more than happy to project costs to help buyers decide which loan term best suits their needs and means. Compare total borrowing costs for different loan terms.

Pros and Cons of Small Versus Large Down Payments

Q. How does a borrower weigh the advantages of making a small versus a large down payment, other than what the lender might require on a certain loan?

As discussed earlier, it may not be in the short-term buyer's best interest to invest lots of money in the property. Too small of a down payment, however, coupled with low property appreciation, may create a deficit if the owner needs to sell in a very short period of time. If the borrower knows this and is willing to take the risk, he or she should be prepared to make up the shortfall when he or she sells.

A second consideration is that the borrower may want to make a large down payment if it means securing a lower interest rate or sidestepping the costs of fees or PMI. A large down payment may even loosen some loan underwriting requirements because the lender's risk is reduced.

Fixed Rate versus Adjustable-rate

The lender offers a 90 percent conventional, fixed-rate loan at eight percent interest that will have total closing costs of $2,500. Costs for a 90 percent ARM at six percent interest, however, are $2,900; the loan also can be converted to a fixed-rate loan at any time during the first five years of the loan.

At first glance, it's virtually impossible to tell which is the better buy. The borrower needs to compare financially the two loan programs based on:

- how long he or she anticipates keeping the loan,
- what the conversion fees might be, and
- how the rate would adjust if the loan were converted to a fixed rate.

Lenders will prepare comparisons such as these if provided with the necessary information to plug into the scenario. This is the best way for borrowers to make sure they are not being led astray based only on bargain interest rates and low closing costs. View the loan comparison worksheet.

Closing Cost Categories

Q. What are the major categories of loan-related costs?

Loan-related costs vary depending on the type and size of loan. The following are some general loan-related cost categories that pertain to most buyers:

- **down payment**, minus any earnest money deposit
- **out-of-pocket costs:** fees for appraisal, credit report paid, and any loan application fee at the time of loan application, plus other costs such as home inspection, paid at time of loan application and paid at the time of closing
- **title insurance:** a one-time fee that varies among states and with the size of the loan
- **two months of escrow:** two months' impound of property tax, homeowner's insurance and PMI, if the loan so requires

- **private mortgage insurance initial premium**, if not financed into the loan
- **first year's homeowner's insurance:** a paid receipt showing payment or funds advanced to the lender to pay directly to the insurance company
- **discount points**, if applicable
- **prorated loan interest:** interest paid by the day for the closing month, to a maximum of 30 days
- **two months' cash reserves:** an equivalent of two months of mortgage payments left over in cash as financial padding (required on conventional loans; not given to the lender, just verified to be on hand; can be in savings, a 401(k), IRA, etc. On some home affordability mortgages, this could be reduced to one month of reserves.)

Fees to Negotiate

Q. What loan fees can be negotiated with the lender?

As with many things in this world, closing costs and discount points can be negotiated. But it's tougher for the borrower to obtain large concessions unless there are tradeoffs with the lender. For example, the lender may be much more willing to reduce closing fees or require fewer discount points if the borrower is well qualified and is making a substantial down payment. In addition, if a higher interest rate is being charged, it could bring other concessions from the lender.

The lender may be willing to entice a borrower by offering low fees when the company is seeking a larger business market share or introducing a new program. In addition, a lender may give incentives to faithful past customers, or to encourage a new borrower who may bring additional business to the lender. Low fees, however, can be smoke and mirrors obscuring an overall higher interest rate or other lender benefit. You can ask the lender to compare different financing options and determine the true cost of borrowing, or simply use OnLoan's loan comparison calculator.

Q. What types of loan costs generally vary widely from lender to lender?

Fees are as different as the lenders who charge them. The major differences can be found in the following three major categories:

- **loan origination fees**: Many companies don't charge this fee, but some do. It's usually considered another point (one percent of the loan amount) and can make a seemingly great loan package a bad choice. If charged, this is also a fee that may not be explained thoroughly up front.
- **separate application fees**: Most companies include the application fee in the out-of-pocket expense quote; others have this as a separate fee of perhaps several hundred dollars, which many not be explained until the borrower applies for the loan. Borrowers should ask about this when calling to check for rates and costs as the amount can vary significantly among lenders. **Note that OnLoan does NOT charge this fee.**
- **miscellaneous "fluff" or "garbage" fees**: As their name denotes, these are the most extraneous and negotiable of the bunch! They include document prep fees, courier charges, notary fees, administrative fees, document review fees, etc. Beware: the gravest problem here lies in that these fees do not have to be factored into calculating the Annual Percentage Rate (APR) quoted

to the borrower. So, it's totally possible that a lender quoting a low interest rate is actually making up for it by charging tons of garbage fees! Spend time reviewing the Good Faith estimate provided to you before committing to a certain loan program.

Determining Lock-ins

Q. When would it make sense for the borrower to lock in the interest rate?

With fluctuating interest rates, this has turned out to be the real estate "$64,000 Question". Locking in an interest rate means that if interest rates rise during a specific time frame, usually 45 to 60 days, the rate quoted will remain the same. Again, this depends on a variety of factors. The following are answers to the basic questions one might ask to decide whether it is advantageous to lock in an interest rate:

- If the borrower doesn't lock in and the rate increases, could he or she still qualify for the loan? Logic dictates that if a bump in the rate will disqualify the borrower, locking in is not only prudent, it's advised!
- How long is the lock-in and how far away is the closing? A 45-day lock will be useless if closing is projected for 60 days.
- Is there a fee for locking in? When is it paid? Is it refundable? This often applies to fees for extended rate lock-ins that extend an interest rate guarantee to 60, 80, or 110 days. It's therefore wise for the borrower to know what's being paid, when it's paid, and under what circumstances, if any, it can be refunded. See OnLoan's Rate Lock Policy.
- If rates drop, would the rate-lock float downward? Many lenders use this provision in order to stay competitive when interest rates drop. During times of falling interest rates, loan shoppers should make sure they have this float-down provision.

How long will the borrower keep the loan? Should he or she pay more points up front to get the lower interest rate, or less points and go with a higher interest rate? It's remarkable how many decisions are based on how long someone will keep the loan and the property. Again, the standard answer: Short-term ownership favors less points paid at closing and higher interest rates. Long-term ownership favors more points paid at closing to receive lower interest rates.

The borrower can check several sources before deciding to lock in the interest rate:

- What have been the lender's interest rate trends on that particular type of loan and what is projected?
- Check financial indicators: the federal discount rate—the rate at which banks borrow money from the Federal Reserve; actions of the Federal Reserve Board (which tightens or loosens monies in circulation); and especially the ten-year treasury note market, which has a big impact on determining short-term interest rates. These can be monitored through local papers such as the in-depth coverage in The Wall Street Journal. Also check online resources such as www.interest.com and www.hsh.com.
- Remember the role international events play in interest rates.

The U.S. does not exist independently of the global economy, and international events are major factors in the volatility of U.S. interest rates. In fact, many lenders advise that if negative world news is brewing, it probably makes sense to lock in the rate.

Discount Points

Q. What are discount points and how are they used?

One point is equal to 1 percent of the loan amount. Points are used to increase the lender's financial yield on the loan. For example, if the lender has the choice between making a loan at eight percent and one at 8.5 percent interest, it's pretty obvious which one he or she would choose.

Points bridge the gap between interest rates, allowing the lender to make the loan at a lower interest rate. While the value of points can vary, depending on financial markets, most lenders consider that it takes roughly four to six points to lower the interest rate by one percent. This can be illustrated through the following example:

Example: If a lender quotes that it will take two points (two percent) to lower a seven percent interest rate to 6.5 percent on an $80,000 loan, that's two percent, or $1,600, payable in cash at closing to bridge the financial gap in interest by one-half percent. Most loan types do allow the seller and buyer to negotiate payment of points in the purchase agreement.

Determining How Many Points to Pay

Q. If the lender gives the borrower the option of how many points to pay for a certain rate of interest, what's the best way to decide?

The prime factor to consider is the time the borrower will own the property and keep the loan. The following is a formula to help determine the dollars and sense, so to speak:

- Calculate the difference in the monthly payment amounts.
- Calculate the difference in the cost of the points.
- Divide the amount paid in points by the amount saved by the lower monthly payment to obtain a break-even mark for holding the property.

Here is an example. Mr. Fredericks is getting a $90,000 mortgage for 30 years. The lender tells him that there are two choices: He can pay 7.5 percent interest with zero points for a payment of $629.30 per month, or obtain a seven percent loan with two points for a payment of $598.78 per month.

The mortgage payment difference is $30.52. The difference in points is $1,800. So, to calculate the break-even point he would take the expense ($1,800) and divide it by the monthly payment savings ($30.52). We find that it would take Mr. Fredericks nearly 57 months to break even. Obviously, if he won't keep the house or the loan that long, it doesn't make financial sense to pay the extra points to obtain the lower interest rate.

Keep in mind that this example is a relatively simplistic analysis, and doesn't take into consideration time-value of money, including the lost financial opportunity of not investing the money; tax ramifications; or the long-term savings of the lower interest rate.

Q. Can a borrower negotiate points with a lender?

Possibly. Lenders determine points primarily based on the price they have to pay for funds, the type of loan involved, and other lender competition in the marketplace. If the lender does decide to charge fewer points, one or more of the following offsetting factors could be in the picture:

- Is the borrower willing to pay a premium rate of interest? Remember, points bridge the gap in the lender's financial yield on the loan, so this shortfall may need to be recouped somewhere.
- How strong is the borrower? If the lender could risk losing the applicant by not being competitive enough on the points, there may be a concession.

Remember, points are merely one piece of the borrowing puzzle. No amount of discount point concessions is worth dealing with a slow loan processor or unscrupulous lender.

Q. Are points tax deductible on mortgage loans?

For the purpose of acquiring residential real estate, discount points are tax deductible in the year paid. The IRS specifies that in order for points to be deducted, they must not exceed points generally charged in the area. In March of 1994, the IRS surprised everyone when it changed its policy to reflect who could deduct points on mortgages retroactively to January 1, 1991. The ruling allows buyers to deduct points on mortgages—even if paid by sellers. Previously, points were deductible only if the buyer paid them at closing.

The change comes after the IRS decided that the buyer really pays the points, even if the seller helps share the expense. The rationale was that the seller typically increases the sales price to include the points. Points paid in refinancing are handled differently. Owners who refinance must deduct points over the life of the loan, not all at once. For example, if a borrower paid $3,600 worth of points when refinancing to obtain a 30-year loan with a lower interest rate, he or she could deduct only $10 for each of the next 360 months, or $120 per year. For this reason, it may help to minimize points paid to refinance a loan

No Closing Cost Loans

Q. What are no closing cost loans?

No closing cost loans, available from lenders for new financing or refinancing, are loans in which the lender pays all closing costs. These nonrecurring closing costs—like title and escrow fees, appraisal and lender's fees—are one-time fees paid when obtaining the loan. They do not include recurring costs (like interest, property taxes, and insurance) paid in your monthly payment.

Q. Why would a lender agree to pay a borrower's closing costs?

As with most financing approaches, there are tradeoffs (and benefits to the lender). For example, the lender might offer you a 6.75 percent loan with one-half discount point, a seven percent loan with zero points, or a 7.25 percent mortgage with no closing costs all for a 30-year fixed-rate mortgage. Your choice could be based on:

- what you can qualify for,
- what you're trying to achieve financially, such as short vs. long-term ownership,
- the amount of funds you have for closing, and
- what you're comfortable with paying.

No closing cost loans are good when:

- you're tight on funds for closing or
- will hold the loan or the property only a short time and don't want to part with closing money you can't recoup.
- You might also select a no closing cost loan if you want to move quickly to obtain a loan, when interest rates are falling, for example. They are especially attractive when refinancing into a lower interest rate. Because there are no upfront costs, your savings are immediate.

If you're a real risk taker, you might consider refinancing your adjustable-rate mortgage every year with a no closing cost loan—keeping your initial discounted "teaser" rate intact! Rates for this type of loan are often two percent or more below 30-year fixed-rate mortgages.

Using Buydowns

Q. How does someone buy down an interest rate?

Buydowns are prepaid interest used to reduce the interest rate on a loan. The buyer or other party pays this money at closing, allowing him/her to qualify at the lower rate and reduce the monthly payment. Buydowns can either permanently lower the interest rate for the life of the loan or bring the interest rate down for a short period. The latter is called a *temporary buydown*. One of the more familiar approaches is the 3-2-1 buydown, where the interest rate is three percent lower than the note rate of the loan for the first year, two percent lower during the second year of the loan, and 1 percent lower during the third year of the loan, after which it stays at the note rate—the interest the borrower agreed to pay—for the life of the loan.

Q. If buydowns are used, does the borrower qualify at the buydown rate?

Because this varies among programs, refer to individual loan types.

Questions to Ask

Q. Once the lender has received information about the borrower and has discussed possible financing programs, what general loan questions should the borrower ask the lender before choosing the best loan?

The following are some questions a borrower might ask to clarify his or her loan choice:

- Is the loan assumable? Many originated today are not, so this might be a bonus, especially if the interest rate is low and you plan to sell in a short time. If it is assumable, under what circumstances, and would the interest rate change? How would that be determined?
- Can the buyer pay taxes and insurance outside of the loan payments? This is determined by the type of loan and lender requirements, but is great for the borrower's cash flow!
- Is there a prepayment penalty on the loan? In a return to the marketplace, many lenders are using this as a way to recoup profits should a borrower want to refinance or need to sell. The tradeoff for the borrower is a lower-than-market interest rate. If you anticipate refinancing in the short term, you'll want to avoid a loan with a prepayment penalty.
- Can prepayments be made on the principal? If so, is there any minimum payment? Some mortgages can only be prepaid in minimums of $100.

Adjustable-Rate Mortgages (ARMs)

The adjustable-rate mortgage (ARM) products of the early 1980s gave ARMs an initial black eye in the financial marketplace. Many of these early loans were actually RRMs—*renegotiable rate mortgages*—meaning that on an anniversary date, the mortgagor would have to renegotiate with the mortgagee. This was no easy task because inflation and interest rates were skyrocketing. Many consumers couldn't qualify for the higher loan rates, sometimes forcing them to sell the property or face foreclosure.

The ARMs of today are much better products, with caps (maximum limits set on mortgage adjustments) and strong secondary market underwriting guidelines, as well as mandatory rate disclosure regulations for lenders. Additionally, the secondary market is increasingly paring down the number of programs that could lend themselves to *negative amortization*, a payment shortfall insufficient to cover interest due on the loan that's added back onto the principal loan balance. Like any mortgage loan program, ARMs best serve buyers with particular needs to be satisfied and problems to be solved. After we examine how ARM products work, we'll be able to determine which buyers and situations are best suited for this type of loan.

ARM Basics

Q. What's the best way to learn how ARMs work?

To understand an ARM, you must have a working knowledge of its components. These components are:

- **index:** A financial indicator that rises and falls, based primarily on economic fluctuations. It is usually an indicator of inflation and is therefore the basis of all future interest adjustments on the loan. Mortgage lenders currently use a variety of indexes.
- **margin:** A lender's loan cost plus profit. The margin is added to the index to determine the interest rate because the index is the cost of funds and the margin is the lender's cost of doing business plus profit.
- **initial interest:** The rate during the initial period of the loan, which is sometimes lower than the note rate. This initial interest may be a teaser rate, an unusually low rate used to entice buyers and allow them to more readily qualify for the loan.
- **note rate:** The actual interest rate charged for a particular loan program.
- **adjustment period:** The interval at which the interest is scheduled to change during the life of the loan, for example, annually.
- **interest rate caps:** Limit placed on the up-and-down movement of the interest rate, specified per period adjustment and lifetime adjustment. For instance, a cap of 2 and 6 means two percent interest increase maximum per adjustment with a six percent interest increase maximum over the life of the loan.
- **negative amortization:** Occurs when a payment is insufficient to cover the interest on a loan. The shortfall amount is added back onto the principal balance.
- **convertibility:** The option to change from an ARM to a fixed-rate loan. A conversion fee may be charged.
- **carryover:** Interest rate increases in excess of the amount allowed by the caps that can be applied at later interest rate adjustments (a component that most newer ARMS are deleting).

Q. How are rates set for ARMs?

Rates are comprised of two components: the index and the margin. The index is an indicator of inflation and can come from a variety of sources. The margin is the cost of doing business for the lender, including profit, and is added on to the index to make the interest rate. This formula is used to determine each interest rate adjustment.

Q. What are teaser (discount) rates? Are they a good idea?

A teaser rate is an unrealistically low introductory rate, less than what the current index plus margin would total. Lenders may offer these to introduce a new program to the marketplace or to boost business. The benefit to the buyer is the lower initial interest and payments, although some lenders qualify the buyer at the fully indexed—post-introductory—rate. The danger is that when the payments do adjust, their increase may cause "payment shock" to the borrower who may fall behind or default on the loan. The borrower should go into this type of payment schedule with eyes wide open. Particularly if loan qualification is marginal, the borrower must realize how the full-rate mortgage payments will fit in the family budget.

Q. Is assuming an ARM possible?

Although it depends on the loan, many adjustable-rate loans are assumable at the lender's current rate and terms. Exceptions to assumability could be programs that have convertibility options. Once converted to fixed rates, they are no longer assumable. Other adjustables that are not assumable include the two-step program and Stable Mortgage^{SM}. The borrower should ask to see a copy of the current assumption guidelines prior to loan origination.

ARM Pros and Cons

Q. What are the advantages of ARMs?

The advantages are:

- Lower interest rates than for fixed-rate mortgages allow the buyer to qualify more easily for the loan or leverage into a more expensive property than he or she could otherwise afford.
- Rates adjust based on increases and decreases in the particular index used, which is a gauge of inflation. (Click here for further discussion of indexes, or indices.) This creates an equitable situation for lender and borrower alike, because the lender's costs are covered, while the borrower's wage increases cover the rise in payment amounts.
- Various indexes are available on which to base the ARM.
- Various adjustment periods are available to the borrower, e.g., six months, one year, three years, five years or ten years.
- Some ARMs can be converted to fixed-rate mortgages during a specific time frame in the loan.
- Initial lower-than-market teaser rates may drastically reduce the borrower's monthly payment in the first year of the loan.
- Many lenders keep ARMs in portfolio, allowing the buyer to request special concessions of the lender, such as no PMI or no reserve account for taxes and insurance.
- ARMs are more frequently assumable than are other types of mortgages.
- Adjustable-rate mortgages are good to use in times of low inflation as well as for short-term ownership.

Q. What are the disadvantages of ARMs?

The disadvantages are:

- There are no interest rate guarantees because indexes fluctuate with the economy.
- The buyer's financial situation may change after the loan is cast, making payment increases financially prohibitive for the borrower.
- The buyer may overleverage, using an unrealistically low initial teaser rate to get into the loan without being able to make the later, higher, payments.
- The loan may contain a negative amortization clause, allowing any shortfall of interest not paid monthly to be added back on to the principal balance. This could potentially cause a resale nightmare, should the buyer have to move while the loan is showing negative amortization. It may also create an unsalable property, with the loan balance exceeding the market value.
- The buyer may not fully understand ARMs and not be aware that the lender's program is using an unfavorable index as a base.

- The lender may be charging an unusually high margin, the lender's cost of doing business plus profit, which is added to the index to create the interest rate. This margin is set at loan origination and remains constant for the life of the loan.
- Convertible ARMs may have high interest rates or margins as a bonus to the lender. If the buyer chooses not to convert to a fixed-rate mortgage, this premium may defeat any cost savings with the ARM or perhaps make the program less cost-effective than a fixed-rate program might have been.
- Convertible ARMs have conversion fees for changing the interest to a fixed rate; the new fixed rate is not determined by the cost of the lender's current fixed-rate program. It is usually based on the note rate for that particular investor (e.g., FNMA securities) plus an additional 5/8 percent interest.

Convertibility Options

Q. Wouldn't it be best for the borrower to choose an ARM that could be converted to a fixed rate, in case interest rates went wild?

Although the convertibility option has gotten a lot of press since appearing in ARM programs, it is not for everyone. The convertibility option allows the borrower to convert the rate from adjustable status to a fixed rate, but not without a cost. Loan options are like cafeteria line items—the more you pile on your tray, the more you pay. The same is true of ARM options. The cost will be reflected in a higher lender's margin, a higher interest rate, or steeper origination fees.

A borrower who chooses the convertibility option in a loan and fails to use it is tacking on useless costs that may make the ARM less cost-effective than a fixed-rate program. The conversion option can be the cherry pie in the cafeteria line—eat the pie and the customer is glad to have paid the price—leave the pie on the table, and the customer has wasted money.

Q. When would a convertibility option in an ARM benefit a borrower?

Conversion options make sense in several circumstances. Firstly, when interest rates are high, but the borrower feels they will go down; a borrower can benefit initially by the adjustable-rate being lower than a fixed rate. When rates do fall, he or she can lock into a reasonable fixed-rate program without re-qualifying or paying the costs of refinancing.

Secondly, convertibility options make sense when an ARM is chosen for its attractive initial rates, but the borrower feels that rates in general are edging up. This may apply to a borrower who needs the initial qualifying leverage of the lower rate, but may be leery of being locked long-term into an adjustable-rate program. It's not just the cost of the convertibility option that is being weighed, but also the overall cost of the ARM loan package (including origination fees, margins, and the particular index), compared to the costs of the fixed-rate package.

How long one expects to hold the mortgage also affects the desirability of convertibility options. Obviously, if a borrower chooses the ARM for short-term ownership, he or she may not benefit from exercising a convertibility option to cover the extra cost of the option. On the other hand, if ARM programs are not the norm in a market area, having the convertibility option available to a new purchaser assuming a loan may be an enticement. Note: Once conversion options are exercised to change the loan to a fixed rate, most loans are no longer assumable.

Q. How long does a borrower have in which to exercise the conversion option?

The conversion option period varies from loan to loan, but is usually fixed in length. The most common period is between 13 months and 60 months. If not exercised, the option is lost. In addition, the conversion option may be void if the loan is assumed by another buyer when you sell. This is usually stated on an addendum to the ARM. It's critical that the borrower realize this before misrepresenting to a potential buyer that a loan is convertible.

Q. Can a borrower predict what the new fixed rate will be when he or she exercises the convertibility option?

It depends. A few lenders may quote a predetermined rate, but most will wait until the option is taken to compute the new rate. Contrary to popular belief, when an ARM is converted to a fixed-rate mortgage, most borrowers do not receive the lender's current 30-year interest rate for fixed-rate loans.

Adjustable-rate mortgages sold into the secondary market base the new rate on the 30-day commitment price of the index plus an additional percentage (e.g., 5/8). These commitment rates are typically higher than what you would expect to pay if you initially chose a fixed-rate loan. So, this rate, coupled with an additional 5/8 percent, may lessen the attractiveness of the conversion to a fixed-rate loan, and of the convertibility option in general.

Q. When should we ask what the cost of converting the loan from ARM to a fixed-rate mortgage will be?

This is one question the borrower should ask up front before closing the ARM. There should be no reason why a definitive answer regarding conversion fees can't be given at that time. In the past several years, these costs have become much more tempered. In fact, most fees to convert the adjustable-rate to a fixed rate range from $100 to $250, although loans held in portfolio might have substantially different fees.

Interest and Payment Caps

Q. What would prevent the fully indexed rate from hitting astronomical heights?

Caps. Caps are limits, specified per loan adjustment period (called adjustment caps) as well as for the life of the loan—the latter are called *lifetime caps*—that prevent interest rates from going through the ceiling. Just as they protect the upward movement, so too do they prevent the rate from falling to levels where the loan is no longer cost-effective for the lender.

Q. Besides knowing what they are, what does a borrower need to know about caps?

It's important to know whether they apply to the introductory rate or the note rate. And, particularly, if you're using a teaser rate, do the rate caps apply to the first adjustment?

Q. Is it possible to find an ARM program that has no caps?

Perhaps on an old loan you might be assuming, but not on a new loan. The Competitive Equality Banking Act of December 1987 prohibits lenders from originating programs without lifetime caps. Instead of a program having an interest adjustment cap, it might have a payment cap (e.g., 7.5 percent increase in payment per adjustment).

Q. Where do most lenders set caps?

The range swings are as wide as 1 to three percent for adjustment period caps, and from approximately three percent to six percent for lifetime caps. Some loans, however, may have flat rates stated for lifetime caps in lieu of interval amounts. For example, the rate cannot drop below 8 percent or exceed 14 percent during the life of the loan.

Q. How do payment caps work?

Just like the rate cap, a payment cap limits the amount a monthly payment can increase per adjustment period. A normal range of payment caps is anywhere between five to 12 percent, with 7.5 percent being the most common. This is because it takes a payment change of approximately 7.5 percent to offset a one percent of interest increase in a loan. It's also possible to have rate caps and payment caps in the same loan.

Q. What kinds of questions should borrowers ask themselves before getting into an ARM with a payment cap?

First of all, do they anticipate that their incomes will increase to cover the additional monthly payments? They should also ask themselves how much they could afford to have the loan increase—in other words, what is their financial threshold?

Next, they should ask whether the loan has a maximum amount of negative amortization allowed. This is important so that leverage can be controlled, particularly any in excess of the property value. Within this should be the question of whether the property's value will increase enough to offset any negative amortization.

Finally, but perhaps most important, borrowers should measure the gap between the interest rate and the payment cap. The greater the difference, the greater the risk of potential negative amortization. Obviously, payment caps, just as ARMs, need to be evaluated based on the desires and capabilities of the individual borrower.

Margins

Q. If a consumer shopped for the most stable and reasonable index, would that loan result in the lowest interest rate?

Not necessarily. The index could be a dream, while the loan's margin could be a nightmare! Even though searching for the best index is important, shopping for the lowest margin can make thousands of dollars' worth of difference over the life of a loan.

Q. Who sets an ARM's margin, and how does it affect the interest rate?

As stated previously, the lender determines the margin because it is the combination of his or her costs of making the loan, plus profit. The margin is set at the time of loan application and remains constant for the life of the loan. The index rate plus the margin combine to make the note or accrual rate, also called the fully indexed rate. So, even if the index is favorable, a high margin could counteract any expected interest savings.

In this example, the one-year treasury index is 3.75 percent. This index, added to the lender's margin of 2.75 percent, would make a note or accrual rate of 6.5 percent. (This note rate isn't necessarily the first-year rate charged by the lender, however, because it may have offered a lower or teaser rate to attract borrowers.) In the example, the lender gave the borrower the 6.5 percent initial interest rate—which is effective until the first interest rate adjustment—resulting in a monthly payment of $632.08.

When it's time for the annual review of the interest rate on the loan, the borrower finds that the index has increased two percent, to 5.75 percent. After adding the margin of 2.75 percent to the index, the interest rate escalates to 8.5 percent, and the payment jumps to $766.83. While the index may wax and wane, the margin remains fixed for the life of the loan. So, all other points being equal, the loan with the higher margin will end up costing the buyer more.

Q. Is there ever a time when it would benefit the buyer to take a program with a higher margin?

Perhaps, if that program had other redeeming characteristics such as low caps, a good index or a convertibility option to change the ARM into a fixed-rate mortgage. The benefits to the borrower should financially outweigh the higher margin.

Q. What percent could you expect to be charged for a margin?

Lenders quote margins anywhere from one percent to four percent.

Q. Do all ARMs have margins?

No. ARMs using the NMCR index mentioned previously do not use a margin in addition to the index. However, this index is typically .75 percent, or more, higher than other indexes.

Q. What factors would cause a lender to charge different margins on various programs?

Some programs might allow an ARM to be converted into a fixed-rate mortgage while other programs might charge higher margins for the privilege of using a more stable index. Or a lender might have a loan program that makes other concessions that it needs to cover in the form of a higher ongoing charge (margin). Some lenders may be willing to negotiate slightly on margins if they could be shown tradeoffs such as higher initial interest or loan origination fees, or the ability to do additional business with the borrower.

Fixed Rate Mortgages

Check with individual area lenders to apply information in this section to loan programs currently available. A conventional loan is any mortgage that is neither insured nor guaranteed by the government. Conventional loans were the first traditional loans made by local lenders. Loans were held in the lender's investment portfolio until they were paid in full or foreclosed upon.

The advent of the secondary market in the late 1930s allowed lenders to sell their loan packages to institutions such as the FNMA ("Fannie Mae") and the FHLMC ("Freddie Mac"), recycle lent funds (for a slight discount off the loans' interest) and bring funds back home to create new loans. Today, although some lenders still keep loans in portfolio, most sell their loans to the secondary market. Let's investigate the advantages and disadvantages of conventional lending and uncover little-known facts regarding underwriting that may help you get a loan.

Fixed-Rate Pros and Cons

Q. What are the advantages to the borrower of a conventional fixed-rate loan?

The advantages are:

- The interest rate is set for the life of the loan. This prevents escalating interest and payments.
- Lenders may be willing to keep the loan in their own lending portfolio, thus allowing more underwriting flexibility.
- Lenders may negotiate or eliminate certain loan fees.
- Lenders may allow co-mortgagors.
- A lender may allow collateral other than or in addition to the real property being mortgaged.
- A lender may be willing to finance personal property with the real estate loan; e.g., appliances and/or furniture. Such "package loans" may be made when a newly constructed property is sold furnished by the builder.
- Appraisals need to meet only the lender's guidelines, if the loan is held in portfolio, or the secondary market's guidelines, if applicable, instead of the strict FHA/VA appraisal standards.
- If PMI is required, its premiums are usually less expensive than with ARM programs or FHA mortgage insurance.
- For a borrower who may have difficulty obtaining PMI, the lender may self-insure the loan, increasing the interest rate to compensate for any potential loss.

- The lender can fund a portion of the closing costs in exchange for a higher interest rate. "Premium pricing" is addressed later in this section.

Home affordability programs allow buyers to purchase with as little as three percent down. Under some programs, the down payment can be borrowed on the buyer's credit card!

Q. What are the disadvantages to the borrower of the conventional fixed-rate loan?

The disadvantages are:

- The interest rate is set for the life of the loan. If interest rates fall, the purchaser's rate does not.
- Interest rates are set by each lender and can exceed those of FHA and VA.
- Origination fees and other loan costs are determined by each lender and can therefore be higher than similar programs.
- Because mortgage documents for fixed-rate loans can vary depending on state and lender, a lender could specify certain clauses to be included in a mortgage document. These include the alienation (or due-on-sale) clause, prepayment penalty, and acceleration clause.
- Most loans with greater than an 80 percent loan-to-value ratio will require the borrower to purchase PMI.
- Conventional loans may require larger down payments than government programs.
- Some lenders may require nonrefundable application and processing fees at the time of loan application.
- Lenders may not allow some creative financing options for the buyer.

Q. Who makes the rules regarding what a lender can and can't do in conventional mortgage lending?

It depends. A lender who wants to sell loans into the secondary mortgage market has one set of rules. If those borrowers require PMI, there's yet another set of rules. In addition, local lenders' boards of directors might be more restrictive still. Because a majority of all conventional loans are sold to the secondary market, these guidelines often apply and have become the benchmark for conventional mortgages.

Borrowers with Bankruptcy or Foreclosure Histories

Q. Can someone who has previously declared bankruptcy apply for a loan to be sold to the secondary market?

A bankruptcy must have been discharged fully and the borrower must have reestablished good credit. Usually, a two-year period between discharge of the bankruptcy and the mortgage application is required; but an exception may be made after one year if the lender is able to document that extraordinary circumstances caused the bankruptcy, such as extended illness not covered by health insurance.

Q. Can borrowers who have had previous foreclosures get conventional loans?

The secondary market usually won't purchase loans of borrowers who have had mortgage foreclosures within the last three years. As with bankruptcies, however, an exception might be made if extenuating circumstances show that a foreclosure was beyond a borrower's control. These circumstances might include a serious, long-term illness, death of a family's principal wage earner, or loss of employment due to industry reduction. The borrower must have established good credit and show an ability to manage his or her financial affairs.

Profile of a Fixed-Rate Borrower

Q. Is there a standard profile of a borrower who could best benefit by using a conventional fixed-rate loan?

In general, conventional-loan buyers:

- have at least a three to five percent down payment, or are making the purchase with a gift of 20 percent or more from a third party.
- have money for closing costs, plus reserves.
- have good to excellent credit.
- can qualify for loans using standard ratios and market-rate interest.
- don't usually need a lot of special loan underwriting considerations.
- desire a fixed-rate mortgage for financial or emotional stability.
- have fairly light debts in proportion to their income.
- might ask the lender to keep the loan in portfolio, particularly if they have been a long-time customer, or are using a large down payment.
- can wait the standard 30 to 45 days it takes to close the loan.
- may have jobs where income increases are either rare or nonexistent.
- have room in their qualifying and loan payments for PMI insurance.

If this profile fits you, maybe there's a conventional loan in your future!

Citizenship Not Required

Q. Does a borrower have to be a U.S. citizen to qualify for a loan to be sold to the secondary market?

No, mortgages can be made to resident aliens. A lawful, permanent U.S. resident can qualify under the same terms and conditions as a U.S. citizen. He or she must prove residency with an Alien Registration Card or a green card. Mortgages can be made to nonpermanent resident aliens as well, as long as the borrower occupies the property as a primary residence and the loan-to-value ratio does not exceed 75 percent.

Closing Costs

Q. Does the secondary market require that the borrower pay certain closing costs?

The secondary market requires that the borrower pay the following prepaid settlement costs:

- Interest charges and real estate taxes for any period after the settlement date
- Hazard insurance premiums
- Impounds for PMI, unless it is financed as part of the mortgage amount

Other costs may be paid by the buyer or seller, based on what they've negotiated. As discussed previously, however, costs paid for the buyer by the seller would be considered contribution amounts and maximum limits would apply before being subtracted from the appraised value of the property, prior to calculating the maximum loan available.

Exceptions to contributions are third parties who are not participants in the sale, including the buyer's relatives or an employer. There are no restrictions as to the amounts they can pay, but the funds might need to be tracked as gifted monies. The borrower should check with the lender regarding specific examples of non-participant funds that could be used. See buyer and seller cost estimate sheets.

Q. Besides 20-year and 30-year amortization schedules, what other types of conventional loan programs will the secondary market accept?

Besides the 30 types of ARMs that the secondary market will purchase, some of which are discussed in the ARMs section, lenders can originate a myriad programs. Programs vary from somewhat common construction-permanent financing to infrequently used leasehold estate. There are loans for cooperative housing, energy improvement, rehabilitation of properties, and manufactured housing. Biweekly, growing equity and balloon mortgage programs give borrowers differing degrees of leverage to help them purchase.

Compensating Factors When Ratios Don't Fit

Q. If a borrower's ratios exceed the standard guidelines, could he or she ever qualify for a loan?

Possibly. While secondary market qualifying guidelines set the standard for granting loans, there can be exceptions to the rules. Examples might include a borrower with a history of handling a higher-than-average rent payment—especially if other long-term debt is relatively low, or a borrower who consistently saves a high percentage of his or her annual income. Situations such as these are what the secondary market terms "compensating factors." Fully documented compensating factors can be used to approve conventional fixed-rate loans with loan-to-value ratios of 90 percent or less when borrowers:

- make a large down payment.
- purchase a property that qualifies as "energy efficient." This can add two percent to both the housing and long-term debt ratios to equal 30 percent and 38 percent, respectively.

- demonstrate the ability to devote a greater portion of their incomes to housing expenses (especially if they've paid rent equal to or exceeding the payment they want to qualify for).
- show a consistent pattern of saving, maintain a good credit history, or have a debt-free position.
- demonstrate a potential for increased earnings due to recent education or job training.
- have short-term income (Social Security income, child support, etc.) that traditionally is not counted in qualifying because it would not continue three years or more beyond the date of the mortgage application.
- purchase a home due to corporate relocation of the primary wage-earner and the secondary wage-earner (with a previous work history) is expected to find employment (called a trailing spouse).
- have substantial net worth.
- fully documented compensating factors can be used with 90 percent or greater loan-to-value ratios if, in addition to meeting one or more of the criteria listed earlier, borrowers meet one of the following conditions:

    - Have financial reserves that can be used to carry the mortgage debt, part of which must be in the form of liquid assets equal to at least two months of PITI payments.
    - Demonstrate that they are able to carry a substantial housing payment, new housing expenses don't exceed their old expenses, and they have a good prior mortgage payment record and acceptable credit.
    - Have a total long-term debt ratio of 30 percent or less, excellent payment histories on prior mortgages or rent, and acceptable credit.

Having one or more of these compensating factors can serve as strong leverage for the borrower who needs a little extra oomph in qualifying for a loan.

Types of Qualifying Income and Verification

Q. What kind of income will conventional lenders accept and how is it verified?

In general, the lender wants to determine the probability and stability of the borrower's income sources. This means verifying two years' history for all income, full-time or part-time.

The secondary market verifies income in one of two ways. The lender may request that the employer fill in and return via regular mail "verification of employment" forms, or the lender could use a streamlined verification method which allows the lender to contact the employer's personnel office by phone, fax, or other electronic medium to verify employment and income. If a borrower is employed by a relative or family-owned business, federal income tax returns must be provided to the lender. The following is a checklist of additional income sources that might be considered:

- **part-time income** can be counted, provided it has been uninterrupted for the past two years and is anticipated to continue; seasonal work is acceptable and the borrower requires reasonable assurance that he or she will be hired back for the next season.
- **overtime and bonus income** that has occurred for the past two years and which will probably continue can be counted. (If the employer doesn't say that the overtime will end, it can be considered to continue.) The lender will average the past two years of such income; if this

income is more than 25 percent of borrower's total income, income tax returns must be provided.

- **raises** guaranteed to occur within 60 days of loan closing may be included for the purpose of qualifying.
- **other income sources** could include:
    - retirement income
    - military income
    - veteran's benefits
    - social security income
    - alimony
    - child support
    - notes receivable
    - Interest and dividend income
    - employer-subsidized mortgage payments
    - trust income
    - unemployment benefits
    - rental income
    - auto allowances and expense account payments

Verifying the Down Payment

Q. Does the lender have to verify that the borrower has the down payment?

Yes. The lender can use methods similar to those previously mentioned for verifying employment: sending out a "verification of deposit" form to be signed by the depository institution where the funds are held, or have the borrower provide the last three bank statements to verify the funds. In addition to the down payment, the lender needs to verify that the required cash reserves are available in an account (usually equal to two months of mortgage payments) after closing monies are paid out.

Using Gifted Funds as Leverage

Q. It's great that a borrower can use down payment funds given by a relative or institution, but what kind of documentation has to be shown to the lender?

A gift from a relative must be evidenced by a letter signed by the donor. It must specify the dollar amount of the gift and the date the funds were transferred; list the donor's name, address, phone number, and relationship to the borrower; and include the donor's signed statement that no repayment is expected.

The lender must verify that the funds are in the donor's account or have been transferred to the borrower's account. This could mean obtaining a copy of the donor's withdrawal slip and the borrower's deposit slip, or a copy of the donor's canceled check.

If funds haven't been transferred prior to settlement, the donor can give the closing agent a certified check for the amount of the gift. Because funds borrowed by a donor as a gift to a buyer might later put strain on the buyer to repay the amount, some lenders will want to check the donor's account history to determine the original source of the gift (for example, to ensure that the donor has been accumulating it in a savings account). The donor should be advised that this investigation could occur so that he or she won't be personally offended if it does.

If a gift or grant comes from a church, municipality, or nonprofit organization, it must be evidenced by a copy of an award, gift letter, or the legal agreement that specifies the grant or gift's terms and conditions. In addition, the lender must include a copy of the documents showing the transfer of the funds. TIP: It's a good idea to put donated funds in your account about six months prior to application. This raises your average monthly balance and helps you look better to an underwriter.

Refinancing

Q. What kinds of refinancing guidelines does the secondary market use?

Guidelines for Changing Loan Interest Rate or Term

- Loan-to-value ratio on owner-occupied properties can't exceed 95 percent.
- When subordinate financing (a second mortgage) is less than one year old, FNMA will not allow it to be paid off from the proceeds of a no-cashout refinance.
- Junior liens (second mortgages) obtained through FHLMC must have had at least one year of payments from the origination date of the mortgage in order to be refinanced. If not, it is considered as a cashout and all applicable guidelines apply.
- Loan-to-value ratios on investment property and second homes cannot exceed 70 percent.
- Loan-to-value ratios on owner-occupied properties cannot exceed 75 percent. This option is not available on second homes or investor properties.

Guidelines for Pulling Equity (Cash) Out

Q. Does an owner who refinances have to re-qualify with the lender, just as with a new loan?

A streamlined refinance procedure is available to the borrower who doesn't have to requalify based on ratios. This option is available only if the new loan will be placed with the same lender, the loan will remain a conventional loan, and the borrower's income has not declined. In addition, the borrower's mortgage payment record has to be satisfactory for the past 1two months and the new mortgage payment can't exceed the old payment by more than 1five percent.

Secondary Market Guidelines

Q. If a borrower's loan is sold to FNMA or FHLMC in the secondary market, what kind of qualifying ratios are required?

Fannie Mae (FNMA) and Freddie Mac (FHLMC) Loan Underwriting Guidelines for Fixed-Rate Loans

Qualifying ratios are based on the type of loan program and its underwriting guidelines.
Qualifying ratios. For owner-occupied, single-family residences (excluding Affordable Housing programs) and for second home and investor loans, PITI can't exceed 28 percent of the borrower's gross monthly income; and PITI plus long-term debt (any debt that extends ten months or more) can't exceed 36 percent of the borrower's gross monthly income. This ratio is expressed as a 28 percent housing ratio/36 percent total long-term debt ratio.

Loan-to-Value Ratios

The maximum loan-to-value ratio is 95 percent on single-family residences, excluding Affordable Housing programs, 80 percent on second homes, and 70 percent on investor loans. FNMA is fixed-rate only; FHLMC negotiates investor loans on a case-by-case basis.

On owner-occupied and second home purchases with subordinate financing (a second mortgage), the first mortgage cannot represent more than 75 percent of the lesser of the sales price or appraised value. This requirement also applies to owner-occupied refinances.

Maximum loan-to-value ratio based on size of primary residence is:

Number of Units	Loan-to-Value Ratio
1	95 percent
2	90 percent
3	85 percent
4	80 percent

See a qualifying sheet for conventional loans to help assist in calculating loan payments.

Affordable Housing Programs

Affordable housing programs were created by the federal government's Community Redevelopment Act to provide affordable housing to a larger sector of Americans.

As seen previously, qualifying ratios are easier, cash reserves to close are less and compensating factors can be used, such as a history of paying high rent. In addition, Mortgage Credit Certificate tax credits may be used with some programs to whittle down the PITI and allow buyers to qualify for more home. Most programs cap the price of the home as well as the maximum income allowable to qualify.

Both FNMA and FHLMC in the secondary market have a variety of home affordability programs. The following is an overview of some of the loan programs available.

Community Homebuyer Programs

These loans were the pioneers of the affordable housing movement. Designed to assist low- and moderate-income first-time homebuyers, this three to five percent low down payment mortgage allows debt ratios of 33 percent and 38 percent. No cash reserves are required, and homebuyer education is required but can be waived under certain circumstances.

3/2 Option Programs

These programs allow the borrower to use only three percent down payment from their own funds, with the remainder coming from a family member gift, or a grant or unsecured loan from a nonprofit organization or government agency. Ratios of up to 33 percent and 38 percent are allowed and there are no cash reserves required to close the loan. Homebuyer education is required prior to closing the loan.

97 Percent Mortgages

Geared to the first-time buyer who can financially handle the monthly payment but hasn't accumulated the down payment, these programs allow the buyer to borrow the down payment—even on a credit card! Borrowers can choose either 25-year mortgages with qualifying ratios of 33 percent and 36 percent, or 30-year loans requiring ratios of 28 percent and 36 percent. Only one month of PITI reserves is required for closing.

Start-Up Mortgage℠?

This is a 30-year fixed rate graduated-payment mortgage featuring interest-only payments during the first year. After the first year, the monthly payment (but not the interest rate) increases two percent each year until the loan becomes fully amortizing. At that point, the monthly payment is fixed for the balance of the term. Debt-to-income ratios are 33 percent and 36 percent. Only one month's reserves are required at closing. Borrowers must use five percent of their own cash as the minimum down payment.

Guidelines for Condominium and Townhouse Purchases

Q. What about loans for condominiums and townhouses? Are they underwritten the same way as detached housing?

Lenders will generally lend up to 95 percent loan-to-value ratio for fixed-rate loans on owner-occupied condos and townhouses, but only up to 90 percent when an adjustable-rate is used. Condos and townhouses as second-home purchases usually require a 20 percent down payment.

There are no specified minimum square footage restrictions in the secondary market, because lending is based solely on the unit's marketability. The development project must be FNMA or FHLMC accepted or have lender warranties. In addition, the project cannot have heavier investor concentration (non-owner-occupied units) than a certain percentage of the total—usually approximately 40 percent for established projects and 30 percent for new developments.

Q. What Counts as Long-Term Debt?

The secondary market considers long-term debt to be any debt that can't be paid off in ten months.

Q. Could the lender choose to be more restrictive?

Yes, if the lender found the borrower marginally qualified or determined that payments were a substantial percentage of gross income and could affect the repayment of the loan. An example would be a marginally qualified buyer, making a small down payment, who has a $450 car payment with five payments remaining.

The lender could also choose to be more restrictive if defaults in the area are high. A cautious lender could allocate a minimum payment of five percent of the outstanding balance, or a minimum of $10 per month, to revolving debts for the purpose of calculating long-term debt. Short-term obligations or others that don't have set monthly payments may be considered to have at least the interest due monthly.

Contributions Help the Buyer Qualify

Q. What contributions does the secondary market allow the seller to make?

A contribution, also called a financing concession, is the payment of a cost that is typically paid by the buyer, but instead is paid by the seller or a third party.

Such items can include transfer taxes, cost of title insurance policies and surveys, recording fees, tax stamps, attorneys' fees and any seller-paid buydown or seller-paid financing costs.

Seller contributions that can be made over and above the following limits are those that occurred when market interest rates shifted and the seller used points to buy down the interest rate. Lender-paid buydowns and lender-funded transaction costs do not have to be counted against what the seller can contribute to the buyer.

If contributions exceed the following limits, any excess will be subtracted from the sales price before the loan amount is calculated:

Maximum Contributions for Owner-Occupied Property

- three percent of the property value on a 95 percent loan
- six percent of the property value on a 90 percent loan

Secondary Market Maximum Second-Home Contribution Limits

- six percent of property value on an 80 percent loan

Guidelines for the Property

Q. What are the standard property guidelines for the secondary market?

Although properties are approved on a case-by-case basis, properties must generally meet the following guidelines:

- The property should be in an area with properties of comparable value and quality.
- Streets must be dedicated and properly maintained.
- Land value cannot be excessive compared to the improvements on the property.

An estimate of value from an appraiser is used to substantiate all loans sold to the secondary market.

Little-Known Facts about Underwriting

Q. Are there differences between what local lenders allow and what the secondary market will accept?

There certainly are. In fact, if the borrower knows what to ask for, some of the following little-known facts can help put loans together:

- The lender will allow qualifying ratios to be exceeded by two percent on the housing and long-term debt ratio if a purchaser is buying an energy-efficient house.
- The secondary market will allow the seller to take the borrower's existing property or an asset other than real estate in trade as part of the down payment on the property, as long as the borrower has made a five percent cash down payment on the new loan.
- The seller can give the purchaser credit toward the down payment for a portion of previous rent payments made under a rental purchase agreement. The minimum original term of the rental must be 1two months, and only those rents that exceeded the market rent, as determined by an appraiser, can be counted. For example, if market rent is $800, but the purchaser actually paid $900, the monthly credit toward purchase would be $100.
- A borrower can pool his or her funds with funds received as a gift from a relative who lives with him or her in order to come up with the minimum five percent cash down payment. But the giver of the funds does not have to qualify, nor does he or she take title. Both parties must reside in the new residence. In addition to these funds, the borrower could receive an additional down payment gift from a relative or a gift or grant from a church, municipality, or nonprofit organization.
- When the loan-to-value ratio for a mortgage is 80 percent or less, the full down payment may come from a gift from a relative or a gift or grant from a church, municipality, or nonprofit organization. This means that one of these parties would make the entire 20 percent down payment and the borrower would not have to make any other down payment from his or her own funds.

Q. How can a prospective borrower take advantage of all these great underwriting exceptions and little-known facts?

If a lender doesn't qualify the borrower, or claims that borrower resources are marginal for the loan size, the borrower could use this information to negotiate additional purchasing leverage. It can't hurt!

Q. Does the secondary market have any maximum loan limits for loans it purchases?

Yes. These are recalculated every year to reflect increases in purchase prices. Single-family one-unit dwellings have maximum loan limits for 1999 of $240,000, with multiple-unit financing available up to $461,350 for four-family properties. The borrower should check with the lender to determine the current maximum loan amount available for the property he or she wishes to purchase.

Loans in excess of these secondary market loan ceilings can still be made by a lender. These are called "jumbo loans" and are sold separately to investors rather than through the usual secondary market channels. Because these loans are not the standard size, the borrower may have to pay a higher interest and other lender incentives, such as additional points.

Q. Does the secondary market limit making loans based on the number of properties held by an owner?

Yes, with clarification. The secondary market will allow a borrower to have any number of properties with financing on them as long as the property currently being purchased will be a principal residence. The borrower can have no more than four properties currently financed if the new property being purchased is a second home or investment property. These guidelines apply to all properties held by the borrower, not just those purchased by the secondary market, but do not apply to properties that are free and clear with no outstanding financing.

Other Fixed-Rate Programs

Pledged-Asset Mortgage

These programs allow homebuyers to borrow up to 100 percent of the sale price (or appraised value, if less) of a home when they pledge a stable financial asset (typically certificates of deposit). Assets can come from the borrower or a family member and can range from a minimum 10 percent pledge from the borrower to a maximum 30 percent pledge from a family member. The borrower is required to make a down payment of between 3 and five percent, depending on the chosen loan program.

Two-Step Mortgage®

This program combines the benefits of shorter-term pricing with the stability of longer-term financing and is great for borrowers who move frequently. As the name implies, the Two-Step is an adjustable-rate mortgage for five or seven years (depending on the plan you choose). Then it adjusts one time to a fixed rate not to exceed (currently a 6 percent increase). A 10 percent down payment is required, and temporary buydowns are permitted to lower the initial interest rate.

Balloon Mortgages

Balloons are short-term mortgages that have some features of a fixed-rate mortgage. First, they provide level monthly payments that amortize over a stated period of time (i.e., 30 years), but provide for a balloon payment that is due at the end of an earlier specified term (e.g., five, seven, ten or 15 years). Depending on the program chosen, at the end of the balloon term (e.g., five years), the borrower can convert the loan into a fully amortizing market-rate loan (e.g., for 25 years) in either fixed-rate or adjustable-rate formats. Because balloon mortgages are considered short-term mortgages, interest rates are generally lower than traditional 30-year fixed mortgages.

THE APPLICATION PROCESS

Preparation

You may be anxious to dive right in and apply for a mortgage, but like most things in life, a little preparation and organization go a long way. Just completing the application may seem daunting, if you don't know what to expect. Rest assured, we're not going to make you jump through hoops unnecessarily.

The information we do request of you is what the government says we must. These are their hoops, not ours! You will enter information into the Uniform Residential Loan Application, also called Form 1003 (pronounced "ten-oh-three"), including, facts about your employment, assets, liabilities and property. The idea is to give a lender and underwriter a clear enough picture to assess your likelihood of repaying the loan.

Be sure to keep documents handy while completing the application to prevent mistakes and "guesstimates." The information you provide will be verified, so please be as accurate as possible. Not only does accuracy prevent delays and disappointments, but deliberately providing false information is against the law!

Supporting Documents

Automated underwriting and OnLoan's advanced technology help reduce paperwork by streamlining the approval process. Keep in mind, though, that underwriting guidelines still require supporting documents like W-2s, bank statements and paycheck stubs. All of the documents discussed in this section and shown on the checklist may not be needed. We will not ask you for more information than absolutely necessary to process and fund your loan.

Your financial picture and the underwriting guidelines of your specific loan program dictate what supporting items are required. Generally, the more complicated your financial situation is, the more documentation will be needed for verification. OnLoan also offers low documentation and alternative documentation loans that may be appropriate for some borrowers.

Print the Application Checklist

Application Checklist

Purchase Contract and Property Information

- ☐ Complete copy of the sales contract and/or plans and specifications for new construction or copy of deed for refinance
- ☐ Mailing address and property description
- ☐ Contact information (real estate broker/agent, buyer, seller and attorneys)
- ☐ Copy of survey or title policy
- ☐ If you are selling current residence, prepare a copy of the listing agreement and a copy of the sales contract if the home is
- ☐ under contract
- ☐ A copy of the front and back of the canceled earnest money check when available

Personal Information

- ☐ Social security number
- ☐ Age
- ☐ Years of schooling
- ☐ Marital status
- ☐ Number and age of dependents
- ☐ Current address and telephone number
- ☐ Former addresses
- ☐ Landlord or mortgage holder (past two years)
- ☐ Current housing expenses

Employment History and Income

- ☐ Two years of employment history with details of each job
- ☐ Recent pay stubs and two years of W-2 forms or 1099s
- ☐ Written explanation of employment gaps
- ☐ Past two years' tax returns and current profit-and-loss statements if self-employed; also, if employed in a family business, a tradesman, receiving 25 percent or more income from bonuses, commissions, partnership or trust income, own rental property, or earning income from non-verifiable source, such as corporate ownership, installments sales and tips.
- ☐ Proof of other income if used for qualifying, such as rental property income, alimony, disability, etc.

Assets

- ☐ Current statements of money market accounts
- ☐ Value of life insurance policy
- ☐ Current values and quarterly statements of stocks, bonds, mutual funds and other investments
- ☐ Two months of bank statements for all accounts
- ☐ Proof of other income if used for qualifying, such as rental property income, alimony, disability, etc.
- ☐ Information on any real estate you own that has a lien against it
- ☐ Vested interest in retirement funds – annual statement
- ☐ Value of any significant personal property you own

Liabilities and Debts

- ☐ Written explanation of any past credit problems
- ☐ Full details of bankruptcy, foreclosure or judgments

Miscellaneous

- ☐ Alimony, child support and separation maintenance payments due (copy of divorce decree or separation agreement)
- ☐ Condominium or co-op documents (if applicable)
- ☐ Deposits over $1,000 made in the last two months require source of funds verification and explanation.

Funds

- ☐ Credit report and appraisal fees
- ☐ Closing costs - approximately two percent to six percent of purchase price
- ☐ Reserves - two months of housing expenses, or PITI, saved. (PITI= principal, interest, taxes, insurance)
- ☐ Down Payment - at least five percent is required for most loan programs. Some programs underwritten by Fannie Mae and Freddie Mac require only three percent. You can avoid paying mortgage insurance by making at least a 20 percent down payment or take two mortgages on the property.

What You'll Need and Why

Personal Information

This provides a detailed and accurate picture of your financial situation.

- Social security number, age, years of schooling, marital status, number of dependents
- Current address and telephone number (Prior addresses if you've occupied your current residence less than two years.)
- Current housing expenses, including rent or mortgage payments, real estate taxes and homeowner's insurance
- Name and address of landlord(s) or mortgage lender(s) for the past two years

Employment History and Sources of Income

These are strong indicators of whether a borrower can comfortably make monthly mortgage payments and afford the other costs of homeownership.

- **employment history** for at least two years. This includes employer's name, address and telephone number, your job title/position; how long you held the job; and all financial information including salary, average bonuses, commissions and overtime pay. If there are gaps in your employment history for the last two years, a letter of explanation may be required.
- **pay stubs and W-2 forms or 1099s** for last two years
- **tax returns** for past two years and current profit-and-loss statement, if self-employed or employed in a family business; work as a tradesman; receive 25 percent or more income from bonuses, commissions, partnership or trust income; own rental property or earn income from a non-verifiable source, such as corporate ownership, installments sales and tips.
- **investment income records:** Documentation that shows dividends and interest received from any investments you have. The 1099 forms you receive annually for tax purposes are best.
- **other income:** This can include rental properties, child support, social security or disability payments. Provide cancelled checks, copies of leases, certification of benefits, divorce decrees or other written evidence.

Assets

It's also necessary for a lender to know where you will get the funds for your down payment, closing costs and reserves. Information about your bank accounts, investments, real estate and personal assets paint a picture of the financial resources available to you.

- **bank accounts:** Be prepared to provide copies of statements for at least the last two months on all accounts. Include all pages, even if blank.
- **gift letter:** Gifted funds may be used for down payment, closing costs and other fees, but they must be verified in writing with a gift letter. The gift letter should state the donor's relationship to you and indicate the funds were a gift and the donor does not expect repayment. The giver must also provide proof that he or she had the money to give, such as a copy of the giver's

recent bank statement. A copy of the deposit slip that verifies it was deposited into your account may also be requested.

- **stocks, bonds, CDs, mutual funds, money market funds, retirement funds:** Include account number, bank name, address, current value and approximate balance of each account, plus provide copies of brokerage statements or stock certificates. Supply annual or quarterly reports for all vested interest in retirement funds, including IRAs, SEP-IRAs, Keogh plans, or other personal or company-maintained retirement funds.
- **family trusts, pensions and other annuities**
- **life insurance:** Include the face amount and cash value of any life insurance policies in force, as indicated in the insurance company's annual or quarterly report or in the policy.
- **automobiles:** Provide make, model, year and copy of title for any vehicles owned.
- **statement of personal property:** Estimate value of significant personal possessions, such as furniture, artwork, jewelry, photographic or computer equipment.
- **real estate:** Provide the address, market value and type of property owned, gross rental income, amount of mortgages or other liens on the property, monthly mortgage payments and insurance, maintenance and tax amounts.

Debt

Your financial liabilities, credit history and debt-to-income ratio help a lender determine your capacity to carry and repay debt and your overall economic stability.

- **current debts and pledged assets:** OnLoan.com will use your credit report to complete the liabilities section of the loan application for you. When you receive your loan package in the mail, please check your debt information for accuracy. You can make any corrections directly on the application.
- **credit report:** Your credit report lists creditors' names, addresses, account numbers, balances owed and monthly payments in addition to public record information. Types of debt that may appear on your report include, automobile loans or leases, credit cards, student loans, personal loans, real estate loans, alimony, child support, etc. OnLoan orders a merged credit report for its independent use of approving a borrower. However, it's a good idea to order your own credit reports prior to submitting an application. Try to correct inaccuracies and remedy problems in advance that might otherwise delay or prevent an approval.
- **credit problem explanations:** If you have credit problems, you will be asked for a written explanation as part of the underwriting analysis. Generally, if the problem has been corrected and your payments have been on time for a year or more, your credit will likely be considered satisfactory. If you have experienced bankruptcy or foreclosure, be prepared to give full details and copies of supporting documents. Judgments against you require legal documentation of the outcome of the proceedings.

Purchase Contract /Property Information

- **copy of signed sales contract** for home purchase or copy of deed for a refinance. It must include all riders and addenda, signed by all parties; the full names of the sellers and buyers as they will appear on the new deed; the amount of earnest money deposited with the seller; and who will be responsible for the closing costs, origination fees, etc. Provide a copy of the front and back of the canceled earnest money check, when available.
- **survey and title policy:** Provide copies of the survey or title policy for the home you are buying or refinancing.
- **listing agreement:** If you are selling a current residence, you will need to provide a copy of the listing agreement and a copy of the sales contract if the home is under contract.
- **property information:** Provide complete mailing address of the property and indicate the type of property, e.g., single family home, condominium, etc.
- **contact information:** Provide the name, address and telephone number of the real estate brokers, seller of the property and attorneys involved, if any.
- **plans and specifications**, if new construction. A complete set of plans and architectural specification is required if the home is to be built or is under construction.

Additional Information

- **condo or co-op documents**, if applicable
- **alimony, child support and separation maintenance payments** due (copy of divorce decree or separation agreement)
- **copy of real estate tax bill** for the past year
- **deposits over $1,000** made in the last two months require source of funds verification and explanation.