

Finding the Right Mortgage

Buying a home is one of the most important financial commitments you will ever make. Therefore, you need to carefully consider the many types of available mortgages to find the best loan to fit your individual needs. With so many choices, the variety of available interest rates, terms and other features can seem confusing. The purpose of this article is to help you better understand some of the different options you may encounter as you shop for a mortgage. As you review your options, keep two things in mind:

- The length of time you expect to live in the home
- Your tolerance for increases in your monthly payment over time

Fixed-Rate Mortgages

As the name implies, with a fixed-rate mortgage, the interest rate is set at the time you take out the mortgage and remains constant over the life of the loan. The monthly payment amount also remains constant. Knowing what your monthly payment will be can be reassuring and make planning your budget an easier process. Because a fixed-rate mortgage provides permanent protection from interest rate increases, it is a great option if you plan to stay in this home for the long term.

Each monthly payment is comprised of interest and principal. Payments in the early years of the mortgage are primarily applied to interest, and payments toward the end of the mortgage are applied mostly to principal. The greater part of a mortgage pay-down comes late in the term of the mortgage.

Most institutions offer fixed-rate mortgage terms of 15 years and 30 years. Choosing the term of a fixed-rate mortgage is usually a function of the level of monthly payment you can afford and how eager you are to pay off the entire mortgage.

Comparing a 15-year mortgage and a 30-year mortgage with equal interest rates		
	15-year mortgage	30-year mortgage
Mortgage amount	\$150,000	\$150,000
Interest rate	6%	6%
Monthly payments	\$1265.79	\$899.33
Total monthly payments over the term of the mortgage	\$227,840.88	\$323,754.89
Total principal paid over the term of the mortgage	\$150,000.00	\$150,000.00
Total interest paid over the term of the mortgage	\$77,840.88	\$173,754.89

The benefit of the shorter-term mortgage is that after 15 years you will have paid off the mortgage loan to own your home free and clear. You will also pay less interest over the life of the mortgage. A disadvantage is that your monthly payments will be higher than with a 30-year mortgage.

Adjustable Rate Mortgages (ARMs)

With an adjustable-rate mortgage, the interest rate and monthly payments can change as interest rates change. The rate is fixed initially and is subject to being reset based on changes in a predetermined interest-rate benchmark. A key benefit of ARMs is that they usually offer initial interest rates that are lower (sometimes 1½ to 2½% less) than the rates available on fixed-rate mortgages.

There are several features of ARMs that you should evaluate if you are considering this type of mortgage:

1. **Initial Rate.** Be careful if the initial rate seems particularly low. It could be a "teaser" rate that only lasts for a short time before the rate is adjusted upward. At a minimum, ask what the rate would be adjusted to if the initial rate were to end today.
2. **Benchmark for the ARM.** ARM rates are usually tied to a "published" index that reflects the general interest rate market. Usually, the ARM rate is adjusted to that benchmark plus some percent of margin. Ask the lender how this works and how much the benchmark rate has changed recently.
3. **The Cap.** Most ARMs have limits on how much the rate can rise in any one year. Some ARMs have a limit, or cap, defining a maximum amount the rate can increase over the life of the mortgage. Understanding how the caps work will help you decide whether the ARM can fit your budget over the long term.
4. **Length of the Rate Periods.** ARMs have terms such as 7/1, 3/1, and 1/1, and the like. These terms refer to the length of time the initial rate lasts and the frequency of rate adjustments after that. So, a "7/1" ARM would have a fixed rate for 7 years, and then annual rate changes through the remaining term of the mortgage.

Adjustable rate mortgages are attractive because of their lower initial rate. Your risk is that your rate and monthly payment may rise in the future. You may be comfortable with an increased payment if you believe that your income will also rise over time. Another important consideration relates to how long you plan to stay in this house. If it is for a relatively short time, you may realize substantial savings with an ARM.

Other Types of Mortgages

Negative amortization: Amortization refers to the process of paying down a mortgage. Some lenders offer mortgages with lower monthly payments than required to pay the interest and ultimately pay off the mortgage. This means the amount due on your mortgage increases over time. It is best to avoid this type of mortgage.

Balloon mortgages: Balloon mortgages are similar to fixed-rate mortgages with steady monthly payments using a 15- or 30-year amortization. With a balloon, however, the mortgage must be paid off before the full 15- or 30-year amortization period. Usually, the term is between three and seven years. Most balloon mortgages offer lower interest rates than traditional 15- or 30-year fixed-rate mortgages, but you must be prepared to pay off the balance or refinance the loan on a predetermined date.

Talk with a qualified mortgage professional (such as your local bank) for help in determining which mortgage offers the best fit for you.