Mortgage Basics

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Introduction

A home of your own. That little phrase captures so much emotion, and so many hopes and dreams. It's a place to express yourself and somewhere you can do what you want to do when you want to do it. You can decorate, landscape and shape your surroundings with no limits other than your imagination and your budget. Quite simply, for many people, homeownership represents freedom.

Owning a home is also an opportunity to put down roots and get involved in the community. Buying a home is your chance to leave behind the transient lifestyle and rent increases of the apartment dweller, exchanging something temporary that belongs to someone else for something permanent that belongs to you. It's a powerful emotional pull that encourages millions of people to make the move from renting to buying. (For more on this, read *To Rent Or Buy? The Financial Issues - Part 1* and *To Rent Or Buy? There's More To It Than Money - Part 2*.)

Beyond all of the emotion invested in homeownership, owning a home can also be a powerful financial tool. Even if you don't have enough money left at the end of the month to invest in traditional wealth-building vehicles like stocks and bonds, simply paying for the place where you live can help you amass a substantial net worth. In fact, used properly, homeownership is often an individual's single largest source of wealth. Money paid into a house and not taken back out generally continues to grow over time as the value of the property appreciates. It is possible that in 30 years, that $100,000 house may be worth double or triple what you paid for it.

While buying home can give you a great place to live and a way to build wealth, all of these hopes, dreams and financial benefits come with a cost. For most people, the bulk of that cost is wrapped up in a mortgage.

At its most basic, a mortgage is a loan used to purchase a house. This definition is simple enough to capture the essence of the issue, but it barely scratches the surface of the complex issues that underlie this topic.

In this tutorial, we'll provide foundation you need to research and find a mortgage. We'll start by explaining the basic types of popular mortgages available in the marketplace, and then we'll review the costs associated with a mortgage and the process that you must go through in order to secure one. We'll also review the pros and cons of homeownership and highlight some tips for positioning your finances in a way that will help you qualify for a favorable interest rate. (For related reading, see *Shopping For A Mortgage*.)

Fixed-Rate Mortgages

A fixed-rate mortgage is a loan that charges a set rate of interest that does not change throughout the life of the loan. It is the traditional loan used to finance the purchase of a home and is what most people have in mind when they think about a mortgage. (For more insight, see *How Will Your Mortgage Rate?*)

Pros
Fixed-rate mortgages remain popular for a variety of reasons, the most obvious of which is that they enable buyers to spread out the cost of paying for an expensive purchase by making smaller, predictable payments over a long period of time. Because the interest rate does not change, homebuyers are protected from sudden and potentially significant increases in monthly mortgage payments if interest rates rise.

Another advantage of fixed-rate mortgages is that they are easy to understand. While some loan types include complicated payment schedules and shifting interest rates, fixed-rate mortgages are basic loans with much less complex payment schedules and stipulations. The loan's basic components, principal (the amount borrowed) and interest (the premium paid to the lender for granting the loan), are repaid in the form of monthly payments.

Once you know how much the monthly payment will be, you've got a pretty good overview of the loan's impact on your monthly finances. Most fixed-rate loans also permit borrowers to make extra payments in order to shorten the term of the loan or to make lump-sum payments to retire the loan early with no prepayment penalties.

Most fixed-rate mortgages can be categorized as "plain vanilla" financial products. While they are available in a variety of terms, including those that stretch payments out over anywhere between 10 and 50 years, there's nothing fancy or overly complicated about them.

Longer-term loans come with smaller monthly payments but lead to higher interest rate costs over the life of the mortgage. Shorter-term loans are paid off more quickly, and incur less interest costs over the mortgage life, but have higher monthly payments. Similar loans vary little from lender to lender in terms of costs, interest rates, payments and other variables. (To learn more about the mortgage payment structure, see *Paying Off Your Mortgage*.)

Non-traditional versions of the fixed-rate mortgage offer the option to pay only the interest for a set period of years before making a one-time change to the payment schedule to incorporate the interest payments as well as repayment on the loan's principal. These loans are a fairly recent development. They enable homeowners to purchase expensive homes with relatively small payments during the initial period of time in which the interest-only portion of the loan is in effect.

While such an arrangement certainly results in a lower monthly payment during the first pre-arranged payment period, the upward adjustment when the principal comes due defeats the primary benefit of a choosing a fixed-rate loan in order to have predictable, unchanging payments over the lifetime of the loan. However, this option may be suitable for younger homebuyers as the lower, interest-only payments won't break the budget for those in entry level jobs. Furthermore, when the upward adjustment comes into effect years later, the homeowner's financial situation should have improved to handle the extra financial burden.

Cons

While fixed-rate mortgages are is the most popular loan choice for homeowners, there are a variety of reasons why fixed-rate mortgages aren't the right choice for everyone. One concern about fixed-rate mortgages is that qualifying for a loan is more difficult because the payments are less affordable than those offered by other types of loans. This situation is particularly acute when interest rates are high, although fixed-rate mortgages generally charge interest rates that are slightly higher than the rates available on other types of loans, even when interest rates are low.

Higher interest rates enable borrowers to get predictable payments, but they also reduce the amount of money that a would-be homeowner can qualify to borrow, thus limiting the price of homes that can be considered.

Another downside to fixed-rate mortgages is that, if interest rates fall, the interest rate on the loan doesn't change and neither does the monthly payment. In order to reduce the interest rate and the accompanying payment, you would need to refinance the loan, which can be a costly endeavor. Even if you can afford to refinance, or are willing to refinance the fees associate with the new mortgage in addition to the actual amount of the mortgage itself, refinancing may cost more than it will save you in the long run.

The easiest way to determine whether refinancing is a financially viable choice involves calculating a simple payback period. This is accomplished by calculating the amount of savings that would be realized each month by refinancing into a new mortgage at a lower interest rate and determining the month in which that cumulative sum of monthly payment savings is greater than the costs of refinancing. (For more related reading on mortgage refinancing, please see: *The True Economics Of Refinancing A Mortgage*.)

When to Choose a Fixed-Rate Loan
Fixed-rate loans are generally the recommended option for people who have a steady source of predictable income and intend to own their homes for an extended period of time. The simplicity and predictability of fixed-rate mortgages make them a popular choice for first-time homebuyers.

Variable-Rate Mortgages

A variable-rate mortgage, also commonly referred to as an adjustable-rate mortgage or a floating-rate mortgage, is a loan in which the rate of interest is subject to change. When such a change occurs, the monthly payment is "adjusted" to reflect the new interest rate. Over long periods of time, interest rates generally increase. An increase in interest rates will cause the monthly payment on a variable-rate mortgage to move higher.

Pros
Variable-rate mortgages have enjoyed a surge in popularity as a result of increasing home prices. With the price of housing skyrocketing, many would-be homeowners are being priced out of the market when they attempt to cover the costs of a new home with a traditional, fixed-rate mortgage. Variable-rate mortgages have lower initial interest rates than fixed-rate mortgages, resulting in

lower monthly mortgage payments.

Qualifying for a variable-rate loan tends to be easier than qualifying for a fixed-rate loan because the payments are more affordable. This situation is particularly valuable when interest rates are high because lower payments enable buyers to afford more expensive homes.

Variable-rate mortgages have a set period of time during which an interest rate that is lower than the rate available on a fixed-rate mortgage remains in effect. This is commonly referred to as an introductory, or teaser, rate. This time period varies depending on the loan. After this period, the rate on the mortgage will vary based on the prevailing rates in the market.

Variable-rate mortgages are much more flexible than their fixed-rate counterparts, enabling buyers to choose terms that provide a lower initial payment for periods ranging anywhere from one month to 10 years.

Such flexibility enables buyers to account for things such as bonus payments, expected inheritances and economic environments where interest rates are falling, in which case the interest rate and monthly mortgage payment can actually decline over time. Variable-rate mortgages also provide lower monthly payments for people who do not expect to live in a home for more than a certain number of years and those who expect to be able to pay off their mortgages rapidly. (For related reading, see *Mortgages: Fixed-Rate Versus Adjustable-Rate*.)

Cons

One of the biggest risks for a homebuyer with a variable-rate mortgage is payment shock, which happens with interest rate increases. If interest rates increase rapidly, homebuyers may experience sudden and sizable increases in monthly mortgage payments, which they may have difficulty paying.

Another potential disadvantage of fixed-rate mortgages is that they are significantly more complex than their fixed-rate counterparts. Because they are available in a variety of terms, choosing the right loan can be a challenge. Costs aren't easily compared, interest rates vary significantly by lender, shifting interest rates make it difficult to predict future payments and payment adjustments can make budgeting a challenge.

Some of these loans provide a period of time during which the borrower pays only the interest on the loan. When the loan's principal comes due, particularly if interest rates have risen, the amount required to service the monthly mortgage payment can increase by 100% or more. Also, many of these loans have complex terms, including penalties for loan prepayment and excessive fees for refinancing.

They also come with a complex vocabulary of terminology with which borrowers need to be familiar. A sampling of critical terms includes adjustment frequency, which refers to the frequency of time between interest rate adjustments; adjustment indexes, which help borrowers gauge the amount of expected interest rate change; margin, which helps borrowers understand the relationship between their loan rates and the underlying benchmarks used to set these rates; caps, which limit the amount by which the rate can rise with each adjustment; and ceiling, which refers to the maximum interest rate after all increases. (To learn more about drawbacks, read *American Dream Or Mortgage Nightmare?* and *ARMed And Dangerous*.)

When to Choose a Variable-Rate Loan
Variable-rate loans are generally the recommended option for people who anticipate declining interest rates, only plan to live in a particular home for a limited number of years, or anticipate being able to pay off their mortgages before the interest rate adjustment period is reached. Although they are often used by borrowers seeking to purchase more home than they can actually afford, this is not the financially prudent way to borrow money.

Likewise, even when a variable-rate mortgage is more cost effective than a traditional loan and the borrower can afford the property being purchased, the borrower also needs to be comfortable with the potential for the interest rate to increase and the payment to go up. If the thought of higher payment would keep you up at night, you might want to reconsider your choice of loan. While variable-rate loan are certainly more complicated than fixed-rate loans and are not the right choice for everyone, they can be a powerful tool that results in significant financial savings.

Costs

People generally think about a mortgage in terms of the monthly payment. While that payment represents the amount of money needed each month to cover the debt on the property, the payment itself is actually made up of a series of underlying expenses. The down payment and closing costs must also be taken into consideration.

Major Costs
Regardless of whether a mortgage is based on a fixed-rate loan or a variable-rate loan, the series of underlying components that combine to equal the amount of the monthly payment typically includes both principal and interest. Principal simply refers to the amount of money originally borrowed. Interest is a fee charged to the borrower for the privilege of borrowing money.

In a mortgage made up of just principal and interest, the payment will remain the same over time, but the amount of the payment dedicated to each of the underlying components will change. Consider, for example, a $1,000 monthly mortgage payment. The initial years of a mortgage payment consist primarily of interest payments, so the first payment might be $900 dollars in interest and $100 in principal. In later years, this equation reverses, because after each mortgage payment, a portion of the initial amount owed is reduced. Therefore, the majority of the monthly payment at this point in time goes towards principal repayments. Toward the end of the life of the mortgage, the $1,000 payment might consist of $900 in principal and $100 in interest.

Additional Direct Costs
The subcomponents of most, but not all, mortgages also include real estate taxes and insurance. The property tax component is determined by taking the amount of taxes assessed on the property and dividing the number by the number of monthly payments. For most borrowers, that number will be 12, but there are some mortgage programs that offer bi-weekly payments to enable borrowers to pay off their loans more quickly. The lender collects the payments and holds them in escrow until the taxes are due to be paid.

The insurance component will include property insurance, which protects the home and its contents from fire, theft and other disasters. There is another type of insurance that will need to be purchased if 80% or more of the home's purchase price was financed through a mortgage. In this case, the insurance component of the monthly mortgage payment will also include an allocation for private mortgage insurance (PMI). While property insurance protects the homeowner against hazards, PMI protects the lender by minimizing the risk to the lender if the borrower defaults on the mortgage. This safety net enables lenders to sell the loan to investors. (To learn more, read *Insurance Tips For Homeowners*.)

While principal, interest, taxes and insurance comprise a typical mortgage, some borrowers opt for mortgages that do not include taxes or insurance as part of the monthly payment. When borrowers choose a loan structure that does not account for taxes or insurance, the borrowers are responsible for making those payments on their own, outside of the mortgage payment.

More Than Just the Mortgage
In addition to the money required to cover the mortgage, simply obtaining a mortgage often requires a substantial amount of money to cover the down payment and closing costs. Ideally, the down payment is equal to or greater than 20% of the price of the dwelling. The 20% number is significant because anything below that requires the purchase of PMI, which increases the amount of the monthly mortgage payment.

Closing costs include a variety of expenses over and above the price of the property. These can be divided into two categories: recurring costs and non-recurring costs. Recurring costs include property taxes and homeowner's insurance; one year's worth of each must be paid in advance and put in an escrow account to ensure that the cash is available when it is time for the bills to be paid. Non-recurring costs include fees related to conducting a real estate transaction, and include loan origination costs, title search fees, surveys, credit report costs, origination points, discount points and other miscellaneous expenses. (To learn more, check out *Mortgage Points - What's The Point?*)

Origination points, which generally equal 1% of the cost of the loan, are a fee paid to the lender for giving out a loan (a transaction cost). Discount points, on the other hand, are prepaid interest used to reduce the interest rate on the loan. Like origination points, each discount point is equal to 1% of the amount of the loan. Purchasing up to three discount points is not unusual. Paying discounts points reduces subsequent monthly mortgage payments.

Some lenders permit points and closing costs to be financed in the mortgage. Because these costs can be significant, often averaging more than 5% of the amount of the loan, rolling them into the mortgage can result in a notable increase in the monthly mortgage payment.

Initially, borrowers often focus on the amount of money required to purchase the home of their dreams and the resulting monthly payment that will accompany that purchase. Later in the process, they realize that a $300,000 loan is likely to be accompanied by an additional $20,000 to $30,000 in closing costs. Keep these costs in mind when you are shopping for a new home.

The Amortization Schedule

The amortization schedule for a residential mortgage is a table that provides a breakdown of the schedule of payments from the loan's first required payment to the loan's final payment. It details the amount of principal and the amount of interest paid each month. The amortization schedule is one of the most important, yet overlooked, documents involved in the mortgage process, as it shows the true cost of the house. For example:

Loan amount: $100,000
Interest rate: 6%
Mortgage term: 30 years
Number of payments: 360
Monthly payment: $599.55
Total interest paid: $115,838.19

Month	Interest	Principal	Remaining Principal Balance
1	$500	$99.55	$99,900.45
223 (18.5 years)	$298.31	$301.24	$59.361.34
360 (30 years)	$2.98	$596.57	0

In this case, by the time the mortgage is paid off in 30 years, the total interest paid is $115,838.19, bringing the actual cost of that $100,000 house to $215,838.19. The interest on the loan literally adds up to more than the cost of the house itself.

Building Equity

In our example of a $100,000, 30-year mortgage, the complete amortization schedule would consist of 360 payments. As the table shows, each of the required payments is $599.55, but the amount dedicated toward principal and interest varies from payment to payment. The balance between principal and interest payments reverses over time as early payments consist primarily of interest and later payments consist primarily of principal. Because of the inverse relationship between principal and interest paid, the rate at which you gain equity in your home is much slower in the initial years of the mortgage than in later years. This demonstrates the value of making extra principal payments if the mortgage permits prepayment. Each extra payment results in a larger repaid portion of the principal, and reduces the interest due on each future payment, moving you toward the ultimate goal: paying off the mortgage.

Consider what would happen if you make one extra payment of $600 in a year. Typically, the entire value of any extra payments will go toward paying down the mortgage's principal. The partial amortization schedule below demonstrates that making just one extra mortgage payment during the first year of your mortgage will give you nearly as much equity as you would have earned in half a year of making your standard payments. Continue making just one extra payment per year and you can shave years off of your mortgage and eventually save thousands of dollars in interest.

Month	Interest	Principal	Balance
	$500	$99.55	$99,900.45
2	$499.50	$100.05	$99,800.40
3	$499.00	$100.55	$99,699.85
4	$498.50	$101.05	$99,598.80
5	$497.99	$101.56	$99,497.24
6	$497.49	$102.06	$99,395.18

Refinancing

The amortization schedule also plays a role when you refinance a mortgage. The rule of thumb is that an interest rate deduction of 1% or greater may be worth doing and that an interest rate deduction of 2% is almost always worth doing. The truth is, you won't really know if refinancing is worth the money until you look at the new amortization schedule because the amount owed, the interest rate, and the length of time that you plan to own the home all play a role in determining whether refinancing is cost effective. (For more insight, see *Mortgages: The ABCs Of Refinancing* and *The True Economics Of Refinancing A Mortgage*.)

Consider our example. If you had been making only the standard mortgage payment on the $100,000 loan for five years and then interest rates fell to 4.5%, you would owe $94,015.39 on the balance of the loan. The monthly interest payment would be $549.10 and the amount going toward principal would be $116.20.

By refinancing to a 30 year loan at a 4.5% interest rate, your monthly payment would decrease to $476.36, with $352.56 going toward interest and $123.80 toward principal. These numbers assume that you pay cash for the closing costs, which could be in the neighborhood of several thousand dollars for this loan. Not only is the new monthly mortgage payment smaller and the amount going toward principal larger, but you will save approximately $8,000 in interest over the lifetime of this loan by refinancing. Just keep in mind that if you sell the house within a few year of refinancing, the cost of refinancing will eliminate the savings in interest.

Negative Amortization

While amortization schedules are typically thought about in terms of paying down a mortgage, they also play a role when the loan agreement allows for scheduled payments that are less than the interest payments over that same time period. To look back at our example, it is possible to get a loan with a monthly payment of $467.36 and a contract that permits you to pay only $367.36. The $100 difference, known as deferred interest, is added to the principal of the loan. Over time, the amount owed on the loan increases, a scenario known as negative amortization.

Negative amortization has become a more common scenario with the increased popularity of certain types of adjustable-rate mortgages, particularly those known as interest-only loans. While these mortgages can provide borrowers with the ability to initially make low monthly payments, the downside is that the monthly payments must increase substantially at some point over the term of the mortgage. Some homeowners find themselves unable to make more than the initial minimum payment and unable to make the higher payment when it adjusts upward. Because the principal of the loan increases over time, refinancing what is now a larger debt than originally financed may be impossible, which can eventually lead to foreclosure. (To learn how to avoid this fate, see *Saving Your Home From Foreclosure*.)

While the numbers on an amortization sheet can take some of the excitement out of the home buying process, the mortgage payment must still be made long after the thrill of moving into a new home is gone. A careful review of the amortization schedule prior to making a home purchase can help you to determine whether you will be able to meet your financial obligations over the long term.

Loan Eligibility

"How much house can I afford?" It's a critical question that every homebuyer faces, and one that many people answer by going to a lender and taking out the largest mortgage that the lender will approve. While this strategy will help you get the largest, most expensive house that you can qualify for, being eligible for a loan and being able to afford the property aren't necessarily the same thing. (For more insight, see *Mortgages: How Much Can You Afford?*)

From a lender's perspective, loan eligibility is based on a formula. The most common rule of thumb is that your monthly mortgage payment should not exceed 28% of your gross income. This calculation includes more than just the base price of the house. Consider, for example, a $50,000 gross income. Based on 28% of that amount, the mortgage payment would be $14,000 per year or $1,166.66 per month. That $1,166.66 needs to cover all four potential components of a mortgage: principal, interest, taxes and insurance, often referred to as PITI.

If your credit history is good, the lender may let you take out a mortgage with a monthly payment equal to 30% or even 40% of your gross monthly income. In our example, 40% would get you a yearly mortgage payment of $20,000 or

$1,666.66 per month. The $500 per month difference would let you afford a more expensive home, but you should take a close look at your finances before making such a decision.

Gross Vs. Net Income
Although mortgage eligibility is based on gross income, your monthly payments are made from your net income. This means that your ability to afford the payments can look quite different once the mortgage actually needs to be paid. That $50,000 gross income is reduced to $36,000 net after 28% goes to pay taxes. Taking $20,000 out of that to pay the mortgage leaves you $16,000 to live on for the year. On a monthly basis, that's $1,333.33. Factor in a car payment, credit cards and student loans to cover the cost of your education or tuition bills for your children and there might not be much left over at the end of the month. Although you may be able to qualify for that $1,666.66 loan on paper, actually taking it might not be the best financial move that you could make. On the other hand, if you are debt free and have a rainy-day fund stashed away in case of emergencies, a mortgage that takes up such a large chunk of your gross income may not be a problem. (For more insight, read *Are You Living Too Close To The Edge?*)

Another rule of thumb to consider is that your debt-to-income ratio should not exceed 36% of your gross income. To calculate your maximum monthly debt based on this ratio, multiply your gross income by 0.36 and divide by 12. For example, if you earn $50,000 per year, your maximum monthly debt expenses should not exceed $1,500, which would include your mortgage. Referring back to our example, the $1,333.33 monthly mortgage payment might be enough to break the bank for someone with heavy debts or big spending habits, while the $1,666.66 monthly payment is just slightly more than the 36% of gross income and perhaps well within the means of a prudent spender.

Determining Eligibility
Sitting down with a calculator will give you a good idea of where you stand in relationship to the loan amount you can probably qualify for and the debt-to-income ratio that you can actually afford. In the excitement to purchase a new home, don't lose sight of the reality that lenders are in business to make loans. They will let you borrow the maximum amount that you can qualify for because they charge interest on that amount. The more money you borrow, the more money the lender earns in interest. Also, many lenders sell their loans to investors, so the lender itself many not stand to lose anything at all if you default on your loan.

House Poor
Taking out a large loan often results in a situation referred to as being "house poor". Being house poor is generally not a good idea. While you may be able to make the monthly mortgage payments and even pay your other bills too, you are

one large expense away from disaster. Should you need to make a major repair to your car, purchase a new appliance, or encounter any other scenario that requires a substantial outlay of cash, you are going find yourself in a tough spot and could end up losing your home, filing bankruptcy, or both.

Play It Safe

Regardless of the size of the loan a lender offers, don't buy more house than you can afford. If you purchase a home and, after making the payments for a few years, find that you have considerable discretionary income left or have substantially increased your income since making the purchase, you can always move. Of course, if you like where you live, you can make extra payments and potentially retire your mortgage early.

The Big Picture

Buying a home involves more than just getting a loan and making a payment. Financial issues aside, there is a tremendous mental satisfaction to be had from having a castle of your own. It's an opportunity to create an environment that is as unique as your personality. Whether it's a farmhouse in the country, a sprawling ranch in the suburbs, or a condominium in the heart of the city, you can create a space the fits your personality and enhances your lifestyle.

From a financial perspective, homeownership is a wealth builder, and home equity is often an individual's single largest source of wealth. Not only can the value of a home be unlocked when the home is sold, but real estate generally increases in value over time. Of course, owning a castle comes with its own substantial set of challenges. Time and money are two of the biggest.

Maintenance and Repair

For all but the wealthiest among us, maintaining a home requires a tremendous investment of time. Unless you can afford to hire a landscaper, a handyman and a maid, the move from renter to owner means that you have become your own landlord.

Consider the tasks that a homeowner needs to take care of: Decks need to be stained, flowerbeds need to be mulched, grass needs to be cut, bushes need to be trimmed and driveways need to be maintained. Likewise, every room in the house needs to cleaned, light bulbs need to be changed, insects and pests need to be repelled or removed, and broken items need to be repaired or replaced. Not only does each of these tasks require frequent contributions of time, many of them also require substantial contributions of money.

Unfortunately, the monetary requirements start early and never really stop. Paying a mover is likely to be your first expense. Putting curtains on the windows and decorations on the walls also comes with a cost. Buying a lawnmower, a rake, and a snow shovel are also on the agenda. If you don't have a garage, and sometimes even if you do, buying a shed to store your new tools may be on your list as well. Similarly, furnishing your new home can be an expensive proposition, and the bigger the house the more furniture required. The futon that looked so cute in your apartment may look lonely and lost in that new McMansion. Replacing your tiny television with a home entertainment system will also set you back more than just a couple of dollars. (For related reading, see *McMansion: A Closer Look At The Big House Trend*.)

When adding up the costs of homeownership, keep in mind that everything new eventually gets old. Roofs will some day need to be replaced, furnaces go bad, kitchens go out of style, carpet wears out, hardwood floors need to be refinished, siding needs to replaced, brick needs to be repointed, and hot water tanks leak. While these items don't occur on a regular basis, when they do come up, they cost a lot of money.

Paying off the house, which often takes a full thirty years to accomplish, only brings partial financial relief. While you won't owe anything more to the bank, real estate taxes will still take a chunk out of your paycheck. For this reason, you should pay careful attention to the tax millage rate when you are looking for new place to live.

Location, Location, Location
If you are financially prepared to address the challenges of homeownership, you'll also want to put some thought into the old mantra "location, location, location". Choosing where you are going to live should be done with care. That beautiful countryside lot that you envision could one day have a parking lot built next door. The nice people across the street could move away and be replaced by less-than-friendly new neighbors. Prisons, cell phone towers, industrial complexes, sewage treatment plants and highways get built in somebody's back yard. It could be yours.

When you are renting, it's easy enough to pack up and go someplace else if the neighborhood changes in a way that is not to your liking. When you own, you need to sell before you can leave, and selling can be costly. Everything from paying a realtor and making changes to bring your property up to par with local zoning codes to updating the property in order to make it more appealing to potential buyers could be on the menu. If the unpleasant development that is making you contemplate relocation causes your property value to fall, moving could be a costly venture indeed. (To read more about selling your home, read *Need Retirement Income? Sell Your House!*)

Although there are many challenges and potential pitfalls to homeownership, millions of happy homeowners have taken the plunge. While there is certainly a lot of work that comes with owning a house, consider taking a drive on a sunny Saturday morning, and you'll see that in neighborhoods across the country, happy homeowners are planting flowers, working in gardens, painting garage doors and showing pride and satisfaction in doing all of the little things that transform a house into a home.

How To Get A Mortgage

Once you've learned the terminology and figured out how much you can afford to spend on a new house, the next thing you will need to do is get a mortgage. Because you will be borrowing money, lenders will examine your credit score, a metric used by lenders to determine the likelihood of an individual paying back the money he or she has borrowed.

Clean Up Your Credit
Higher credit scores translate into the ability to borrow more money at lower interest rates. To make sure you get the best possible deal, you should check out your credit score by ordering a copy of your full credit report. (The free reports that you can get list your creditors but don't list your numerical score, often referred to as a FICO score). Check your score well in advance of when you need the loan, so that you will have time to take any necessary steps to improve your credit prior to applying for a mortgage or fix any inaccuracies that may have occurred. (To learn more, read *Consumer Credit Report: What's On It* and *The Importance Of Your Credit Rating*.)

If your score is lower that you would like it to be, spend six months making all loan payments on time, paying down or paying off the balances on your credit cards, closing cards that you don't use, and refraining from opening new cards or incurring other debt. Keep in mind that good credit is not built overnight. It's better to provide creditors with a longer historical time frame to review: a longer history of good credit is always favored over a shorter period of good history. (For related reading, check out *How Credit Cards Affect Your Credit Rating*.)

Pre-Qualification and Pre-Approval
To get a good idea of how much you can borrow, a lender can pre-qualify you for a mortgage. To pre-qualify, you meet with a lender and provide information about your assets, income and liabilities. Based on that information, the lender will provide an estimate how much money you will be able to borrow. Knowing this amount beforehand will allow you to determine the price range of homes before you go house hunting.

The entire pre-qualification process is informal. The lender does not verify the information provided, does not charge you a fee and does not formally agree to approve a mortgage for the amount you are pre-qualified to borrow.

However, if you are serious about buying a house, you will want to get pre-approved for a loan. With pre-approval, the lender checks your credit, verifies your financial and employment information and confirms your ability to qualify for a mortgage. Pre-approval strengthens your position to make an offer when you find a property that you like. Sellers are generally more willing to accept offers from pre-approved buyers, because it shows that the buyer actually possesses sufficient resources available to purchase the house.

Lenders, Lenders Everywhere

Turn on the television, read the newspaper, or just drive down the street and read the signs along the roadway, and you will quickly see that there is no shortage of businesses that want to give you a mortgage. Banks, mortgage brokers and online vendors are all working hard to capture your attention and offer you the opportunity to borrow some cash from them.

Banks are the traditional source of mortgage funding. They offer face-to-face service, recognized name-brands and fees that are generally competitive with other lenders. What they may lack is a broad variety of loan programs, which may mean that they may not offer the lowest interest rates or the lowest fees.

Mortgage brokers generally offer a large variety of loans, which includes loans for people with bad credit. Variety also often results in the lowest interest rate and the most convenient one-stop-shopping for comparison purposes. Because you can physically meet with a broker, the face-to-face service is another plus. In the minus column, mortgage brokers are often more expensive than other funding sources.

Online mortgage providers offer a large variety of loans, convenient round-the-clock shopping and instant comparisons between multiple loans. They often lack personal service - in some cases even reaching a human being by telephone can be nearly impossible to do in a timely manner.

As the variety of lenders suggests, there is no single source of mortgage financing that works best for everyone. Searching for the best deal among all of the potential providers or working with the provider that best meets your personal needs from either a comfort perspective or loan type are both viable ways to address the issue.

Time to Shop

Once you've chosen a lender and received your pre-approval, you are ready to shop. Unlike a trip to the mall or even a trip to the car dealer, home shopping can often involve hundreds of hours and months of effort. Don't get discouraged if you don't find the house of your dreams on your first try. Take your time, tour a lot of properties and don't spend your money until you are sure that you've found a place that is right for you.

Conclusion

Let's recap what we've learned in this tutorial:

- At its most basic, a mortgage is a loan used to purchase a house.
- There are two primary types of mortgages: fixed rate and variable rate.
- A fixed-rate mortgage is a loan that charges a set rate of interest that typically does not change throughout the life of the loan.
- Fixed-rate mortgages enable buyers to spread out the cost of paying for an expensive purchase by making smaller, predictable payments over a long period of time.
- A variable-rate mortgage, also commonly referred to as an adjustable-rate mortgage or a floating-rate mortgage, is a loan where the rate of interest can change over time. When such a change occurs, the monthly payment is "adjusted" to reflect the new interest rate. Over long periods of time, interest rates generally increase. An increase in interest rates will cause the monthly payment on a variable-rate mortgage to move higher.
- Variable-rate mortgages have lower initial interest rates than fixed-rate mortgages, resulting in lower monthly mortgage payments, enabling buyers to afford more expensive homes than they would be able to purchase with a fixed-rate mortgage.
- Fixed-rate mortgages are significantly more complex than their fixed-rate counterparts, and homebuyers may experience sudden and potentially significant increases in monthly mortgage payments if interest rates rise.
- A monthly mortgage payment consists of a series of underlying components that include principal, interest, taxes and insurance.
- In addition to the money required to cover the mortgage, obtaining a mortgage often requires a substantial amount of money to cover the down payment and closing costs.
- The amortization schedule is one of the most important, yet overlooked, documents involved in the mortgage process. This schedule shows the true cost of purchasing a home, including the amount of interest paid.
- Being eligible for a loan and being able to afford the property aren't necessarily the same. Regardless of the size of a loan a lender offers, don't buy more house than you can afford.
- A solid credit rating and a mortgage pre-approval will both be beneficial when you are shopping for a home. Pre-approval show buyers that you are able to make the purchase.
- There are many types of loan and many potential lenders. When shopping for a loan, take your time and search for the best deal.

Shopping for a new home is exciting. It is also a little bit complicated. There's a lot to think about and plenty of opportunities to spend more than you should. Like all major financial decisions, home shopping should not be a decision made in haste.

A careful look at your finances, a thorough review of the amount you wish to spend, and some consideration of the type of loan that you will comfortable with should all be part of your pre-planning process. With just a little bit of careful planning and some patience, your search for the home of your dreams can be a rewarding and financially responsible experience that gives you a great place to live without breaking the bank.