Defining Loan Types

In this Chapter you will learn:

- The Characteristics of various loan choices:
- Fixed rate mortgages.
- Adjustable rate mortgages.
- Government guaranteed loans.
- Home equity lines of credit and second mortgages.
- Construction and Rehab loans.

The purpose of this chapter is to briefly explain most of the different types of home loans offered. The two following chapters will thoroughly explain the most commonly used adjustable rate mortgages, Hybrid ARMs and Option ARMs (a.k.a. Negative Amortization loans[1]). The chapter following those chapters, titled "Truth or Consequences" will discuss calculating your possible future mortgage payment when your loan rate adjusts. Understanding your loan and being prepared for the future, are your best defenses against possibly losing your home because your payment grows beyond your budget.

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1 As of July 1st, 2008, most lenders suspended sales of Option ARM loans. I retained all the Option ARM information in this book, because I believe strongly that it is a good product for the right person, when used properly. It should become available again when the "fear storm" passes in the lending industry.

Definitions of Types of Home Loans

Fixed Rate Mortgage: A loan whose rate is fixed for the entire life of the loan (i.e. "loan term")

1. **Standard, fully amortized Fixed Rate Mortgages** – You pay both principal and interest with each monthly payment, so that your loan is paid in full by the end of the loan term. Loan terms are usually 15 or 30 years, however some lenders offer other options including 10-, 20- and 40-year terms.
2. **Interest Only Fixed Rate Mortgage** – Some fixed rate loans have a period of years that you can pay interest only, rather than principal and interest. That period is usually 10 years. Please think carefully before choosing a fixed rate loan with an interest only period. If you pay interest only for 10 years, you will still owe the same amount of money when the interest only period is over, but the **loan will be amortized over 20 years instead of 30 years**, (in the case of a 30-year loan, which is the most common). This translates to a higher monthly payment for the remaining loan term than if your principal were amortized over 30 years. Some lenders offer 40-year loans with an interest only option for the first 10 years, I prefer those loans if the initial rate is similar to the other choices.

Here is an example of what you could encounter if you pay interest only for 10 years, and then your monthly payment adjusts to principal and interest for the remaining 20 years:

30-year Fixed Rate Interest Only Loan Calculation

Loan Amount: $400,000
Rate fixed for 30 years: 6.5%
Interest only payment for the first 10 years: **$2,167**
Principal + Interest payment for $400,000 amortized over 20 years: **$2,982**

At the same time, it may be quite reasonable to expect that your income will increase enough in 10 years that you will be able to comfortably afford a payment that is $825 higher than you paid the first 10 years. You may also be smart enough to save the money you would be paying toward principal for the first 10 years; so that you have a nice little nest egg to cushion the blow when the payment increases. In summary, the interest only fixed rate loans are fine as long as you are fully prepared for the consequences.

Adjustable Rate Mortgage (a.k.a. ARM)

Loans whose interest rate adjusts during the life of the loan

1. **Hybrid ARM** – Loans whose rate is fixed for a number of years, and then the rate adjusts. These are so named because they are hybrids which combine fixed rate mortgages and fully adjustable mortgages. The fixed periods are usually 1, 2, 3, 5, 7, or 10 years.
2. **Option ARM (a.k.a. Negative Amortization Loan)** – Adjustable loans that offer you payment options. Options include a minimum payment, interest only payment and an amortized payment (i.e. principal and interest).
3. **Hybrid Option ARM** – Hybrid Option ARMs combine the characteristics of the two loans discussed above. They allow for a minimum payment that is less than the interest only payment, thereby adding principal to your balance. However, the actual rate and minimum payment rate are both fixed for a number of years. The most common Hybrid Option ARMs fix the interest rate for 5 years.
4. **Fully Adjustable Loans** – The third type of adjustable home loans are fully adjustable loans, whose rate adjusts monthly, or every few months, with no minimum payment option. Few people choose these because they are very risky. Few lenders offer them anymore.

Government Guaranteed Mortgages – FHA and VA Home Loans

All FHA and VA loans require the borrower to pay mortgage insurance premiums. The insurance coverage protects the lender in case of default.

FHA Loans

FHA loans allow low-to-moderate income borrowers to buy a home with a down payment as low as 3.5%. FHA loans began in the 1930s during the depression when conventional lenders had stopped lending altogether due to high default rates. They were designed to encourage lenders to lend to riskier borrowers by covering the lender with insurance.

An FHA loan may be a good choice if:

1. Your credit score is in the low-to-mid 600s
2. You only have 3.5% to offer as a down payment
3. You need multiple co-borrowers to qualify for the loan. Co-borrowers do not have to live in the home being purchased. In that case are called "non-occupant co-borrowers." Non-occupant co-borrowers are people willing to co-sign the loan with you, who will not live in the home.

FHA loans are the replacement for sub-prime loans that no longer exist in the marketplace. Before the liquidity crisis that began in 2007, FHA loan limits were so low that they were not a reasonable choice for many homebuyers. However, now the limits are substantially higher, so FHA loans can be an excellent choice for many people, even those with excellent credit.

VA Loans

VA loans are exclusively offered to men and women who have served in our armed forces. They allow the purchase of a home with no down payment. Some unscrupulous lenders charge higher rates for VA loans, so that they can make more money at the borrower's expense. Do not trust the rates they quote. VA, FHA and conventional conforming loans are normally all about the same rate.

Home Equity Lines of Credit and Second Mortgages

All the loans listed above are in "first lien position." This means that if the lender(s) have to foreclose, the lender in first lien position gets his money first. The lender in second position gets his money if there is anything left over. Consequently, taking second lien position is riskier for lenders than offering first lien loans. For that reason, the rates for fixed rate second loans are typically higher than fixed rate first lien loans.

A Home Equity Line of Credit (HELOC) is like a big credit card that uses your home as security for the loan. Home equity lines can be in first or second lien position. However, they are usually in second position. The rate is usually fully adjustable and is tied to the "Prime Rate." The Prime Rate is 3% higher than the Fed Funds Rate [2]. So when you hear in the news that "the Fed" is raising or lowering rates, you will know that your HELOC will change accordingly on your next statement.

Construction Loans

Residential Construction loans are offered for ground-up construction of homes. "Ground up" construction starts with an empty lot upon which you build the entire home to your specifications. Lenders often base the loan amount on the finished value of the home, or a percentage of the total cost, not the current value of the lot. The rates for construction loans are usually also tied to the Prime Rate.

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2 In the **United States**, the **federal funds rate** is the **interest rate** at which private **depository institutions** (mostly **banks**) lend balances (**federal funds**) at the **Federal Reserve** to other depository institutions, usually overnight. (Wikipedia)

The benefits of choosing a construction loan are:

1. You do not have to make a loan payment during the construction period. Interest due the lender is added to the amounts loaned during construction. The total amount loaned, plus interest, becomes your new "permanent" loan balance upon completion of construction.
2. If the lender allows you to use the future value of your home in their loan-to-value ratio, and you have substantial equity in the value of the land or other pre-construction costs, you may not have to come up with any more money out of pocket to complete construction.

Rehab Loans

Rehab loans are semi-construction loans. They are designed to help homeowners do major reconstruction on a home, but not to build from the ground up. They are helpful when you buy a home that is in major disrepair, or you want to add on to a home.

Conventional lenders may call your home loan due if they find out that you tore down a good portion of the home. The reason for this is simple: If the lenders have to foreclose, they need a home they can sell. A home that is in mid-construction when it defaults is difficult to sell.

FHA offers a wonderful rehab loan called a "203K." If the acquisition of the property, plus improvements, falls within the FHA loan limit for your area, this is an excellent loan to consider. FHA would like the rehabilitation to take 6 months or less from the time of funding to complete. In this situation, you can either do the work yourself, hire a contractor, or do a combination of the two. FHA 203K loans are helpful if you find a home that needs work and you see the potential, but you do not have all the money needed to repair it within your own funds. Like a construction loan, a 203K loan bases the loan amount on a percentage of the estimated future value after repairs are completed. It is unlike a construction loan in that the rate is not fully adjustable and tied to the Prime Rate. It is a fixed rate, permanent loan that does not have to be converted after construction.

Chapter Summary:

Fixed rate loans offer security, but security often has a price. The interest rate for the life of a fixed rate loan will usually be higher than the start rate of an adjustable rate loan. Everything in life is a balance of risks and rewards. Home loans are no different.

But please keep in mind this important fact: When it comes to your home loan, you are gambling with one of your most significant assets—your own home. It is important to first carefully examine the risks and rewards, and then plan for the worst, in case the risks that come with the loan you choose result in a significantly higher payment.

The Option ARM loans are an example of why you need to balance risks and rewards. They are the most misunderstood loans in the market. The media loves to bash them, but anyone who fully understands Option ARMs will know their place, and that they are good loans when used wisely. Chapter 9 discusses the Option ARM loan in great detail. If you are thinking about getting one, please read it. The information there could save you money, as well as a lot of grief.