Understanding Mortgages

Most people cannot afford to pay for a home with cash, so they must qualify for a mortgage - a home loan from a financial institution.

A mortgage is made of three components:

- Down Payment – This is the amount of cash you bring to the purchase. Typical down payments range between 3% and 20% of the home's price – the higher the down payment, the lower the mortgage. Making a down payment of 20% or more allows you to avoid the purchase of private mortgage insurance, saving hundreds of dollars per year.

- Fees – These are one-time costs associated with taking out the mortgage. They include processing fees, title fees, local government fees, recording the deed fees, among others. These fees typically account for 1% to 3% of the price of the home.

- Monthly Payment – This is your ongoing monthly financial commitment. The payment includes both the principal (the amount you owe) and interest, as well as other responsibilities including local taxes, home owner's insurance, and possibly private mortgage insurance.

There are several types of mortgages, each of which offers some variation of a monthly payment versus total cost equation.

Fixed Rate Mortgage

One of the most popular types of mortgages is the fixed-rate mortgage. These are the most predictable mortgages since the interest rate and payment remains the same over the term (repayment period) of the loan. Terms are typically 15 or 30 years.

Longer terms offer a lower monthly payment, but a higher overall cost. Shorter terms offer a higher monthly payment, a somewhat lower interest rate on average, and a lower overall cost.

Adjustable Rate Mortgage

Unlike a fixed rate mortgage, the interest rate of an adjustable rate mortgage may change over the term of the loan. Interest rates are typically determined by a widely accepted standard, such as federal interest rates, and vary as that key rate changes. In the event of a large interest rate increase, the amount of a mortgage payment could go up significantly.

Adjustable rate mortgages are popular since they enable people to buy a more expensive home than they would otherwise be able to afford. Interest rates are typically fixed at a very low rate (up to 40% below the prevailing rate for a 30 year fixed mortgage) and are guaranteed not to increase for a certain number of years. The interest rate will then adjust annually after that – almost invariably going up to make up for the artificially low fixed period.

Adjustable rate mortgages can be risky, and are best left to those with the resources to recover if something does not workout as planned.

Please note: There are many other types of mortgages that involve more risk than either fixed or adjustable rate mortgages. These loans are best left to financially advanced homeowners.

Government Loans

The following loans involve a government agency that guarantees the loan – typically making the loans less expensive than the conventional options outlined above.

- Veterans Administration (VA) Loans – If you are a veteran, the Veterans Administration offers very favorable loan options.

- Federal Housing Administration (FHA) Loans – These loans are backed by the US government and tend to be the cheapest non-veteran loans available. There is more red tape involved with these loans, and not all sellers will agree to a FHA loan. Homes purchased with these loans must also pass a rigorous FHA inspection, meaning the fixer-upper homes may not qualify.