Mortgage 101

Worry less and feel more confident; **knowing the ins and outs of mortgages.**

There are many complicated aspects of buying a home, but perhaps one of the most daunting, and important, is the mortgage. Understanding your home loan is the first step to making home buying an easy process.

For most of us, it is more than intimidating to borrow a sum of $100,000, $200,000, $300,000 or more, even if you do get a house in return. Although mortgages are often little-understood and therefore very scary, they are really the key to your home, so to speak. A recent Yahoo Finance article guides home buyers through the ins and outs of mortgages, helping home buyers and potential home buyers to worry less and feel more confident.

Basically, a real estate loan has three parts. The first part is the size, or how much you need to borrow (this is the sum that may have given you heart palpitations when you took time to think about it). There isn't much to that one, so let's look at the second part, the interest.

Interest and the Calculation of Annual Percentage Rate (APR)

APR is "a method developed under federal law to disclose to loan applicants the actual amount of interest that will be paid on a given loan over the life of that loan." APR makes comparing one loan to another more simple, although you should always make sure to consider of aspects of a real estate loan before choosing the right loan for you.

You may have heard the term "points" when witnessing or taking part in discussions about loans. A point is a percentage point. Thus, a point is 1 percent of the loan, or $2,000 of a $200,000 loan. The two types of points are origination and discount points. Origination points are fees that are normally charged by lenders or mortgage brokers for starting your loan. Discount points are points charged for lowering your interest rate, which lowers your monthly payments.

Both origination and discount points should be considered to be interest that you pay up front. For example: If you have a loan for $120,000 at 9 percent interest for 30 years, and you're paying one origination point and one discount point, you're paying $2,400 for those two points, and your monthly payment would be $965.55. To calculate the correct APR on your loan, you have to include that $2,400 in your starting balance, since it is interest, even though it's prepaid. Your total loan will therefore be $122,400, or $984.00 monthly. To calculate the APR, return to the original loan amount and (don't worry if this part makes you shudder) "compute the polynomial backwards to reach the interest rate it would take to equal the payment on the total loan." In this example, the interest rate would equal approximately 9.23 percent.

If that part was confusing, remember this easy rule when considering whether to pay points to lower your interest rate: it will take you about five years to make up the additional point(s) paid and then you will start to save money over the remaining years of the loan. Also, remember that lenders are required by federal law to send you a Truth in Lending (TIL) statement within three days of applying for a real estate loan.

The Term

The term, or length, of a loan is the third part of a loan. Fixed-rate mortgages most commonly appear in 30-year or 15-year terms. There are advantages to both: although you will pay more interest over the life of the loan (about double) on a 30-year mortgage, your monthly payments will be cheaper. However, in the first 15 years of your loan, you will mainly be paying interest while not building up principal.

Therefore, a 30-year loan is good for long-term stability, but if you can afford a 15-year loan, you will build principal faster and pay less over the long-term. One more option would be to make payments on a 30-year loan as if you had a 15-year loan, which would mean that you pay the loan off in a little over 15 years.

Understanding the three basic components of a loan – the size, interest and term – will help you to take an active part in the home buying process, thereby making it smoother!