Common Financing Options for Buying a New Home

You've finally found your dream home after months of looking. It's got the perfect combination of bathrooms, dream kitchen, beautiful yard and a big soaker tub you've been looking for—in a neighborhood you love. Now you just need to figure out how to pay for it. Before you jump at the first mortgage loan you find, you make sure to review the variety of options available to you.

First, the basics: a mortgage is a long-term loan that uses real estate as collateral and is used to purchase a home. Sometimes, a home can serve as collateral for more than one mortgage. When this is the case, the second mortgage is typically used to finance home improvements or a major purchase. Mortgages most often are described by their terms, such as the time frame for repayment and whether the interest rate is fixed or adjustable. Here are a few of the most common options on the market today.

Conventional Mortgages

A conventional mortgage is a loan that is not insured or subsidized by the government. Lenders typically require a downpayment of at least 20 percent on a conventional loan, although you can put down less up front if you are willing to pay private mortgage insurance (PMI). PMI protects the lender if the homeowner defaults on the loan.

Conventional mortgage loans are typically fully amortized, meaning that the regular principal and interest payment will pay off the loan in the number of payments stipulated on the note. Most conventional mortgages have time frames of 15 to 30 years and may be either fixed-rate or adjustable. While most mortgages require monthly payments of principal and interest, some lenders also offer bi-weekly payment options.

With a 30-year fixed rate mortgage, the buyer pays off the principal and interest on the loan in 360 equal monthly payments. The monthly payment for principal and interest remains the same during the entire loan period.

The 15-year fixed-rate mortgage is paid off in 180 equal monthly payments over a 15-year-period. A 15-year mortgage typically requires larger monthly payments than a 30-year loan and allows an individual to pay off a mortgage in half the time as well as substantially save on interest payments.

Adjustable Rate Mortgages (ARMs)

With a fixed-rate mortgage, the interest rate stays the same during the life of the loan. But with an ARM, the interest rate changes periodically, usually in relation to a specific index such as the national average mortgage rate or the Treasury Bill rate.

Lenders generally charge lower initial interest rates for ARMs than for fixed-rate loans. This makes the ARM easier on your pocketbook at first; it also means that you might qualify for a larger loan because lenders sometimes make this decision on the basis of your current income and the first year's payments. Moreover, your ARM could be less expensive over a long period than a fixed-rate mortgage if interest rates remain steady or move lower.

Against these advantages, you have to weigh the risk that an increase in interest rates would lead to higher monthly payments in the future. It's a trade-off: you get a lower rate with an ARM in exchange for assuming more risk.

Other Types of Conventional Mortgages

A balloon mortgage is a non-amortizing loan. In other words, the periodic principal and interest payments do not pay off the loan. Some balloon mortgage loans may have a principal and interest payment that is calculated as if it would pay off the loan in 30 years, but the loan comes due in 5 or 7 years. Some lenders offer terms for renewal of the loan at the balloon date if certain conditions such as a history of timely payment are met. Some loans may contain provisions to be rewritten as 23- or 25-year fixed- or adjustable-rate amortizing loans with the monthly principal and interest payment based on the balance remaining on the balloon payment date.

Bi-weekly mortgages provide a means for paying off a mortgage more quickly. With a bi-weekly mortgage, the borrower makes half the regular monthly payment every two weeks. Because there are 26 two-week periods in the year, the borrower makes the equivalent of 13 monthly payments each year. This allows the borrower to complete payment on a 30-year mortgage within 16 to 22 years. The lower the interest rate, the longer the term of the mortgage. To reduce the paperwork associated with the extra payments, most lenders require that payments be deducted automatically from a borrower's checking account. Bi-weekly payments may be used with either 30-year or 15-year loans.

FHA Mortgages

The Federal Housing Administration (FHA) operates several low downpayment mortgage insurance programs that buyers can use to purchase a home with a downpayment of 5 percent or less. The most frequently used FHA program is the 203(b) program, which provides for low downpayment mortgages on one- to four-family residences. The maximum loan amount for a one-family home ranges from $67,500 to $152,362, depending on local median prices.

FHA-insured loans are available from most of the same lenders who offer conventional loans. Your lender can provide more details about FHA-insured mortgages and the maximum loan amount in your area.

VA Mortgages

If you are a veteran or active duty military personnel, you may be able to obtain a loan guaranteed by the Department of Veterans Affairs (VA). VA-guaranteed loans require little or no down payment.

State Housing Finance Agencies

These state agencies often offer loans with lower-than-market interest rates and favorable terms to first-time home buyers. Local lenders usually know if housing finance agency funds are available for these programs, or you may contact your state housing finance agency directly.

A number of sources of information about mortgage products are available to help home buyers. To learn more about the different types of mortgages, contact Fannie Mae's Consumer Resource Center toll-free at 1-800-732-6643 or www.fanniemae.com.