



Qualifying For A Mortgage

Owning a home, and incurring a mortgage is usually one of the most important financial aspects of a person's life. It has significant impact on one's tax picture since mortgage interest and property taxes may be deductible; it has a tremendous impact on one psychologically since a house represents a form of freedom and life style choice; and, it has a major impact on one's sense of financial security since a house has historically been the largest piece of one's investment portfolio at retirement. In effect, for the average homeowner, paying off a mortgage is a forced savings plan toward retirement.

Mortgage Qualifying Methodology

Mortgages come in two main forms: conventional, "Fannie Mae" types and privately-funded types. "Fannie Mae" loans are the type most people get through banks, and they are handled through the Federal National Mortgage Association. These are mortgages that must meet certain financial criteria in order to "conform" so that they have a secondary market. Believe it or not, most banks do not keep the mortgages they give out. Rather, they sell them off to a secondary market, and only serve as a type of "frontman."

By the way, this is where the mortgage-qualifying rules come into play. In order to be able to sell off these mortgages, banks must conform to "Fannie Mae" rules as to what portion of your total income the mortgage debt can be. These are the so-called standard "28/33" or "28/36" ratio tests, depending on how much you put down for a downpayment. If you put down less than 10% you must meet the 28/33 test. Otherwise, you can qualify with the 28/36 test.

This means the monthly mortgage payment, plus monthly property taxes, plus monthly house insurance may not exceed 28% of gross monthly income. The second ratio refers to the fact that total long term debt from all sources may not exceed 33%(or 36% with the larger downpayment) of gross monthly income. Long term debt is generally defined as any debts with more than 10 monthly payments still outstanding.

There are variations to this rule depending on whether you have a fixed or variable mortgage. Variable mortgages usually must meet the 28/36 test based on the maximum rate increase permitted after the first adjustment period, which is usually the end of the first year. Thus, a 6% variable(or adjustable rate) mortgage with a maximum 2 point increase each year would require using an 8% calculation rate for qualification. However, for most people variable loans are easier to mathematically qualify for than fixed.

Private, or non-conventional mortgages—such as those issued by mortgage companies—do not have to follow these rules. Since these companies are "Carrying their own paper" they can make their own rules. However, you will find that many of them still use a variation on the "Fannie Mae" rules.



Keep in mind that the "Fannie Mae" guidelines have some leeway. If you are putting down more than 20%, or in the case of a refinance your house equity is more than 20%, the 28% ratio can go higher. Or if you have other real property with less than normal debt it can be in your favor. Again in the case of a refinance, if your previous mortgage payment has been a higher ratio, then a refinance may be allowed for a higher amount as well. Certain mortgages that are accompanied by PMI (Private Mortgage Insurance) allow for higher ratios as well. Finally, there are various federal and state mortgage programs (mostly for first time home buyers and veterans) that allow these ratios to be expanded.

Points

"Points" are a euphemism for fees charged by the lender for the use of their assets. They are called by various terms depending on the institution and the geographical regions: "loan origination fees," "points," or "loan discount fees", are several terms used.

These points are a percentage of the amount financed. Thus, 2 points means you will pay 2% extra up front on the mortgage amount. If points are paid on a purchase of a primary residence, they can be deducted on your tax return in the year paid. To qualify, you must pay for these separately from your mortgage. If they are "added on" to the mortgage balance, then you may have to deduct these over the life of the mortgage. Similarly, points paid on a refinancing, or points paid for a property other than a personal residence must normally be deducted over the life of the loan (this is called amortization of points).

Usually when you go for a mortgage, you are given choices in which the more points you pay, the lower the interest rate that you will pay on the loan. Which way you should go depends on the length of time you know you will keep the loan. The longer the period, the more you should consider paying more points for a lower fixed mortgage rate. If you are certain as to how long you will keep the loan, deciding which option is a basic financial "numbers crunching" exercise that can be done quite readily.

Tips on "Iffy" Qualifiers

If you don't qualify for a certain-size conventional mortgage, you may try stacking the deck in your favor with ways to enhance your credit worthiness. A co-signer can make the difference. Adding another investor can also swing the deal. Relatives can participate in various ways. Convincing the seller to take back a second mortgage is an option to reduce the amount of downpayment you will need to do the deal. Using a variable rate mortgage can sometimes reduce the monthly qualifying numbers. Making a qualified loan from your retirement plan can sometimes help. Finally, going to mortgage companies that don't use "Fannie Mae" rules can swing the deal, although you probably will pay a higher interest rate.



Mortgages and Your Taxes

A big benefit to having a mortgage is that the current tax laws favor home ownership. You are allowed to deduct your mortgage interest and property taxes if you itemize your deductions. This can save taxes which means your actual after-tax mortgage payment is lower so your true cost of ownership is actually less than you may think. As an example, let's assume the monthly interest and taxes you pay on your mortgage is \$1,000. Further, let's assume you are in the 28% marginal tax bracket such that for every extra dollar of deductions you save 28 cents. Thus, on your \$1,000 per month payment, you may save \$280 in income taxes. So your true, after-tax cost of this payment is really \$720. In effect, your mortgage payment is being subsidized by Uncle Sam.

In fact, you can take into account this tax savings throughout the year instead of waiting until tax time by adjusting your W-4 form at work, and/or adjusting your estimated tax payments if you are filing such. In this way, your net take home pay can be increased in anticipation of the extra deductions on your mortgage.