THE DEFINITIVE GUIDE TO BUYING YOUR FIRST HOME

# 'The most important financial decision' of your life—what you need to know about mortgages

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do mortgages work? What kind of mortgage is right for me? Will I ever be able to afford one?

"Borrowing to purchase property is probably the most important financial decision that most people are ever going to make in their life," she says. "Sometimes you see numbers on TV or advertisements with interest rates, and it can get scary."

Fear not. Instead, take a step back and make sure you understand what taking out a mortgage actually means before wading into any of those numbers.

Read on for the answers to all the big-picture questions you have about mortgages, but were maybe afraid to ask.

## What is a mortgage?

A mortgage is a type of loan used to purchase a home or other type of real estate, as an alternative for paying the entire purchase price up front.

When you apply for a mortgage through a lender, they'll ensure you meet specific requirements, such as having a certain credit score and being able to pay at least part of the home's value.

The portion of the home's price you pay up front is called the down payment. Increasing the size of your down payment decreases what you'll owe on a monthly basis as you pay back the loan.

Generally, the balance of what you owe on the house is divided over a series of regular payments over a fixed period of time. Money you put toward paying back your mortgage is divided into interest payments and payments toward the loan's principal.

While your payment is likely to be the same every month, early payments you make will be much more heavily weighted toward interest, while later payments will chisel down the principal.



house, which is collateral for the loan. (For more, check out this list of best mortgage lenders from CNBC Select.)

The most popular mortgage choice among homebuyers is a so-called “conventional loan” — a mortgage that isn’t backed by the government, and is instead offered by a bank, credit union or online lender.

Terms for these loans can come in different lengths and structures, but lenders typically offer 15-year and, most commonly, 30-year mortgages. You pay a fixed interest rate throughout the life of the loan, and the longer the term, the lower the monthly payments.

“For first-time buyers, a 30-year fixed-rate loan is probably going to give you the best combination of good rates and a relatively low monthly payment,” says Jeff Ostrowski, an analyst at Bankrate who covers mortgages and the housing market.

The rate you pay on a mortgage depends on factors such as your credit score, employment history and level of debt as it compares to your income. And even then, different lenders may offer you different deals.

“There can be quite a bit of variance in the rates that lenders quote and also some variance in the fees that they’re charging,” says Ostrowski. “Make sure you get multiple bids and then compare the details in terms of the rate and any additional costs.”

## Aren’t mortgage rates high right now?

The rate that lenders charge for mortgages is related, among other factors, to short-term interest rates set by the Federal Reserve. As the Fed has steadily hiked rates in an effort to cool the economy and tamp down on inflation, the average mortgage rate has climbed.

The average rate on a 30-year fixed-rate mortgage is 7.3%, up from a December 2020 low below 3%, according to Bankrate.

That may seem dire to millennial and Gen Z homebuyers who saw friends purchase property at ultralow rates during the pandemic. But before you lament too much, ask your parents

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Realtors, recently told CNBC Make It.

"One can never truly predict the future, but I don't see mortgage rates returning back to the 3% range in the remainder of my lifetime," he says.

## What's a normal down payment?

Financial experts typically recommend a down payment worth 20% of the home's purchase price, but that's not always realistic.

In fact, the median down payment for all homebuyers is 13%, according to a 2022 report from the National Association of Realtors. That drops to 10% for buyers between ages 32 and 41 and to 8% for those 23 to 31.

If you have a conventional mortgage and make a down payment of less than 20%, you're typically required to buy private mortgage insurance, a policy that protects your lender in the event that you're unable to pay your mortgage.

Like everything else when it comes to mortgages, what you pay for PMI depends on financial factors such as your credit score. Generally, you can expect to pay $30 and $70 per month in PMI for every $100,000 you borrowed, according to Freddie Mac.

On conventional mortgages, once you've built 20% equity (i.e. the amount you still owe on the home is 80% or less of its value), you can ask your lender to cancel your PMI. By law, the insurance must automatically terminate when your loan balance reaches 78% of the original value of your home.

## Are there mortgages designed for people with less cash and lower credit scores?

Certain loans backed by the government are aimed at borrowers who may have lower credit

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have a FICO score of at least 620, FHA loans are available to borrowers with a score of 580 or above if you're making the minimum 3.5% down payment, or 500 and up if you've put down 10% or more.

"I bought my first home with an FHA mortgage. I was a little strapped for cash, and we did a 3.5% down payment," says O'Sullivan. "FHA mortgages can be a wonderful option if you have a lower credit score. It also opens up mortgage availability to those with higher debt-to-income ratios."

Similar to PMI for conventional mortgage borrowers, FHA loans come with a mortgage insurance premium. It includes an upfront payment equivalent to 1.75% of your loan plus an annual payment that lasts the entire term of your loan.

Financial researchers, including those at the Urban Institute, have explored whether borrowers with low down payments would come out ahead paying PMI or the premiums on an FHA loan, but whether one or the other makes sense for you will come down to your unique financial situation. Generally, they found, PMI becomes a more attractive deal for those with higher credit scores.

## Any other types of mortgages I'm likely to hear about?

Given the recent movements in interest rates, you're likely to hear about adjustable-rate mortgages, which come with a rate that fluctuates depending on market conditions. ARMs start with a fixed interest rate for a set amount of time, which is typically lower than the rate on a fixed-rate mortgage. But after the set period, the rate can change — sometimes in your favor, sometimes not.

Under a so-called 5/1 ARM, the introductory rate lasts five years and then adjusts every year thereafter. The introductory rate on such loans is currently 6.26%, according to Bankrate.

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monthly payment," says Kashif Ahmed, a certified financial planner and president of

Even if you expect rates to fall, there's no way of really knowing. An ARM may make sense for someone who knows they're going to sell when the adjustable rate kicks in, says O'Sullivan. But it's a risky move for the average homebuyer — especially someone who may have trouble making payments if the rate bounced.

"With the adjustable rate, you're just gambling a little bit," O'Sullivan says.

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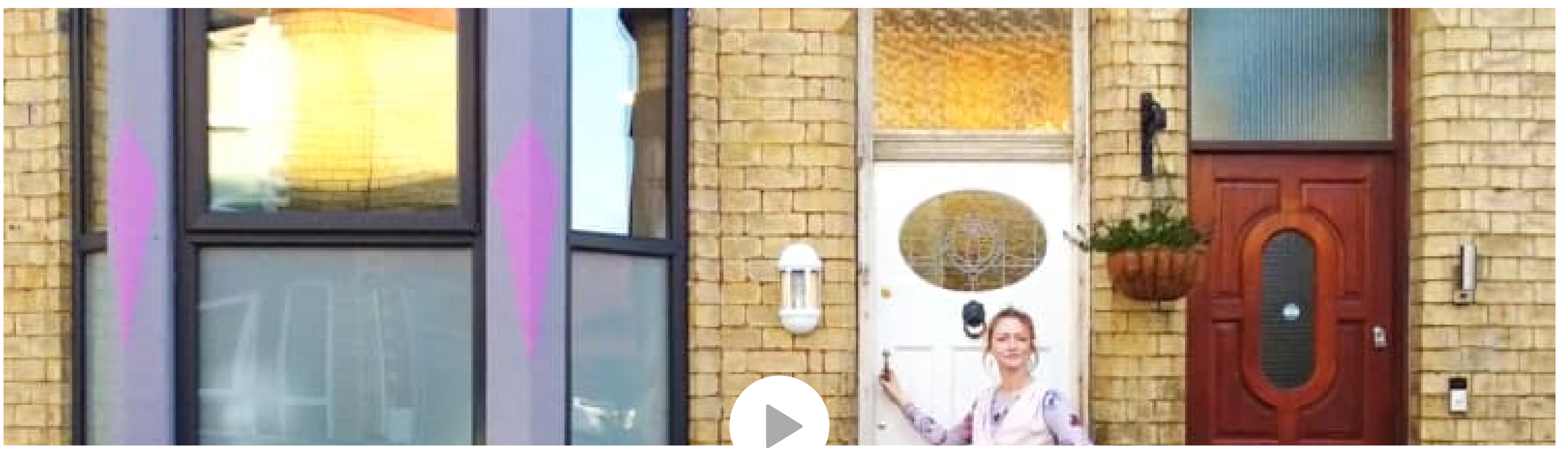

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