E*TRADE®

Understanding Mortgages

Part 1: Your Loan's Interest Rate and APR

Related Topics

- Part 2: Your Decision to Pay or Not Pay Points
- Part 3: Your Loan's Prepayment Penalty

Quick Summary:

- A loan's interest rate and its APR (annual percentage rate) are not the same.
- It's the interest rate that's used to calculate your monthly payments on a loan.
- In theory, you should be able to compare APRs of different lenders to see which loan is less expensive. In reality, APRs are of limited use because different lenders may calculate the APR differently.

APR vs. interest rate

APR stands for the *annual percentage rate*. When you look at home loan rates, you generally see two numbers: an interest rate and the APR.

It's the interest rate and *not the APR* that's used with your loan's length and size to calculate your monthly payments.

The APR is supposed to show what the "real" interest rate is by taking into account the estimated loan closing costs. The problem is that a lender just needs to estimate its closing costs so it's sometimes difficult to truly compare the APRs of different lenders. Different lenders calculate the APR differently.

That's not to say comparing APRs is a waste of time. To compare loans from different lenders, see which fees are *included* and which fees are *excluded* in calculating the APRs.

Fees that *may* be included in APR

- Discount points
- Loan origination points
- PMI (private mortgage insurance)
- Fees for loan processing, underwriting and application
- Fee for document preparation
- Prepaid interest

Construct your own APRs

Once you determine which fees are included and excluded by various lenders, you'll be able to make your own apples-to-apples comparison of APRs.

However your APR is calculated, you'll still need to know whether paying points to reduce your interest rate is a good idea.

Your Decision to Pay or Not Pay Points >>

Understanding Mortgages

Part 2: Your Decision to Pay Points or Not Pay Points

Related Topics

- Part 1: Your Loan's Interest Rate and APR
- Part 3: Your Loan's Prepayment Penalty

Quick Summary:

- There are two kinds of points: (1) discount points and (2) loan origination fee points. Discount points (often just referred to as *points*) are dollars you pay upfront on a home loan (or possibly have added to the size of your home loan) in return for a lower interest rate and monthly payment.
- Each point equals one percent of your home loan amount. Two points equals two percent. Two points on $100,000 loan equals $2,000.
- Whether paying points is a good idea depends on (1) how many points you'll be paying, (2) how much cash you have, (3) whether you have a better use for that cash, (4) how much you can afford to pay each month on your home loan, (5) the amount of the interest rate reduction from paying points and (6) how long you'll keep your loan.

Two types of points

The two types of points are:

1. Discount points and

2. Loan origination fee points.

Discount points

Usually, when you hear someone talking about paying or not paying points, they're referring to discount points, *not* loan origination fee points.

Discounts points are a form of prepaid interest. Discount points are dollars you pay upfront (when you take out your home loan) in return for getting a lower interest rate and monthly payment over the life of the loan. In some cases, you don't pay the points from your cash. Instead, the points are added to the size of your home loan to conserve your cash.

Loan origination fee points

Loan origination fee points are lender charges for making a loan.

Points are percentages

One point equals 1% of the loan amount. For example, 1½ points on a loan amount of $100,000 equals $1,500. Points are paid at the closing—when you get the deed and ownership of your home.

Determining how many or any points you should pay

The more you pay in points at the loan's closing, the lower your interest rate will be over the life of the loan. Sometimes it pays to pay points but it can take years to recoup this cost. You may end up selling your home or refinancing it before you've recouped the cost of the points.

To decide whether to pay any points, you need to consider:

1. The interest rate reduction from paying points
2. How much your monthly payment would be reduced by paying points
3. How much cash you have to pay any points
4. Whether that cash would be better used to increase the size of your downpayment or for investment purposes
5. The value of any income tax deduction from paying points
6. How long you'll need to keep the loan and
7. Any income tax deduction for paying points.

Instead of paying points, you may want to use more of your cash for a larger downpayment. This may help you avoid taking out a second loan (a piggyback loan) or paying PMI (private mortgage insurance).

Your Loan's Prepayment Penalty >>

Understanding Mortgages

Part 3: Your Loan's Prepayment Penalty

Related Topics

- Part 1: Your Loan's Interest Rate and APR
- Part 2: Your Decision to Pay or Not Pay Points

Quick Summary:

- If you pay off your home loan before the end of its loan term, you *may* have to pay a prepayment penalty to the lender. The penalty may apply just on a refinancing or also on a home sale during the specified penalty period.
- Before you apply for a loan, find out (1) whether there's a penalty, (2) what triggers the penalty, (3) exceptions to the penalty, (4) the size of the penalty and (5) when the penalty period ends—this information could change your decision as to which lender to use and the type of home loan you want to get.
- If there's a prepayment penalty, see whether you can renegotiate the penalty terms or eliminate it altogether.

Not every loan has a prepayment penalty

If you pay off your home loan before the end of its loan term, you *may* have to pay a prepayment penalty to the lender. It depends on the terms of your loan. Ask about prepayment penalties before you apply for a loan.

What triggers a penalty?

The penalty could apply if (1) you've sold your home, (2) refinanced your home loan or (3) just paid it off early from your own funds. It may apply for any or all of those events.

Exceptions to the penalty

Even if a penalty would usually apply, the lender may not charge it if you refinance with the lender or the buyer of your home takes out a loan with the lender. The penalty may not apply if your loan balance is below a specified amount.

Also, regardless of the loan balance, a loan with a prepayment penalty might allow you to pay off 20% of the existing balance each calendar year without any penalty. Again, this may be negotiable.

Size of typical penalty

How much is the penalty? It depends on the terms of your loan.

Often times, it's six months interest on 80% of the *remaining loan balance* being paid off early. If you took out a loan for $200,000 but the remaining balance was reduced to $100,000, the prepayment might be based on 80 percent of the current $100,000 owed, not 80 percent of the original $200,000 balance. For example, if you had an 8% loan with a $100,000 remaining balance, the prepayment penalty might be $3,200 (8% times $80,000 (80% of $100,000) times ½ (year)).

When does the penalty end?

The penalty will usually last a specified period of time (e.g., two or five years) from the start of the loan.

Negotiate upfront on the penalty

Before you apply for a loan, see if there's a prepayment penalty and whether you can renegotiate the penalty terms or eliminate it altogether.

For example, a lender might agree to reduce the time period of the penalty from five years to three years or one year. If you don't ask, you don't get. A lender *may* work with you on changing the prepayment penalty provision.

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