A user's guide to mortgage lending terminology

Relocation Perspectives

At the intersection of lending, relocation and real estate, lots of technical terms describe the fundamental processes used when getting a mortgage. While relocation and lending professionals may prefer using technical terms for their precision, new homebuyers may find the jargon confusing.

In this issue, we spell out the meanings behind the industry terms commonly used by lenders and other professionals.

- **Adjustable-rate mortgage (ARM):** A type of loan in which the interest rate and monthly payments are subject to change throughout the life of the loan, as the rate is based on the fluctuations of an index. ARM loans are generally available for terms of 15 or 30 years. The interest rate and payments remain unchanged for a specified term. Afterward, they adjust every year until they are paid in full.
- **Amortization:** The mathematical process of allocating interest and principal for each monthly payment. In the initial months, most of each payment is allocated toward interest; in the later years, most of the payment goes to reduce principal. An amortization schedule is provided to the borrower showing the exact breakdown for each payment.
- **Appraisal:** A professional assessment of the value of a home at a specific point in time. In-person appraisals include a physical inspection of the property; digital appraisals skip the inspection, using an automatic valuation methodology (AVM) instead to approximate a home's value by factoring in recent sales data for similar homes.
- **APR vs. Interest Rate:** A loan's Annual Percentage Rate (APR) is the annual cost of a loan to a borrower, expressed as a percentage. It includes the amount and timing of interest paid on the loan, as well as other charges or fees (such as mortgage insurance, certain closing costs, discount points and loan origination fees) to reflect the total cost of the loan. In contrast, a loan's interest rate refers more narrowly to the actual interest on borrowed funds; it does not include additional closing costs. To evaluate loan options objectively, always compare APRs.
- **Closing:** Also called a settlement, closing refers to the transaction at the end of the loan process in which property ownership and loan funds change hands and legal documents (e.g., deed and mortgage) are signed and filed in the public record. At least 3 days before closing, lenders are required to provide a Closing Disclosure (CD), which includes important details such as loan amount, interest rate, estimated monthly payment and closing costs. Usually, closing costs are between 2% and 6% of the mortgage amount, and they can include a loan origination charge, discount points, appraisal fee, title search and insurance, survey, taxes, deed recording fee, credit report charge and other costs, and are also detailed on the CD.
- **Credit score:** A numerical summary of a person's overall creditworthiness, ranging between 300 and 850, distilled from data on their past credit behavior. A FICO® (Fair, Isaac Corp.) score is the most common type of credit score. Financial institutions use a person's credit score and other data to determine whether, and at what rate, to lend money.
- **Credit utilization:** The percentage of available credit currently in use. If the borrower has available credit lines that total $50,000 and has used $5,000 of it, their credit utilization is 10%. Lower utilization suggests a responsible equilibrium between income and expenses; higher utilization may suggest overdependence on credit.
- **Discount points:** Fees paid to the lender at closing to lower (or "buy down") the interest rate on a mortgage. Also called mortgage points. One point is 1% the of amount borrowed. Although discount points may reduce the interest rate, they may also raise the APR.
- **Debt-to-income (DTI) ratio:** The percentage of an individual's gross monthly income allocated to monthly debt payments. DTI is calculated by adding the recurring monthly payments of accounts like credit cards, auto or student loans, and housing (rent or mortgage) divided by the gross monthly income. DTI is one factor lenders use to evaluate a borrower's ability to use credit (and therefore to repay a loan) responsibly.
- **Escrow account:** An account, set up by a lender, in which funds are deposited (usually monthly) to pay for future real estate taxes and homeowners insurance as part of the borrower's monthly mortgage payment. The lender disburses these funds when they are due on behalf of the borrower.
- **Fixed-rate mortgage:** A home loan with an interest rate that typically does not change for the entire term of the loan.
- **FHA:** Federal Housing Administration, an agency of the U.S. Department of Housing and Urban Development, that provides mortgage insurance for certain residential mortgages. FHA loans are principally designed for low- to moderate-income borrowers and typically require lower minimum down payments and credit scores than many conventional loans.
- **Gift letter:** A document establishing when a cash gift is received. Cash gifts, when used as part of a borrower's down payment, must typically be in the borrower's account for a period of several months in order to qualify as a valid source of down payment funding. Gift policies vary by lender.

- **Income verification:** The process of documenting that a borrower earns the income they claim to earn. Borrowers can submit W-2, 1099 and other federal forms to document income.
- **Loan-to-value (LTV) ratio:** The percentage of a home's purchase price that is mortgaged. For a $240,000 mortgage on a home valued at $300,000, the LTV would be 80%. If LTV is above 80%, private mortgage insurance (PMI) may be required.
- **MIP:** The mortgage insurance premium is the monthly assessment for FHA insurance, and it protects the lender.
- **PITI:** An acronym for the four components of a typical monthly mortgage payment: Principal, Interest, Taxes and Insurance.
- **PMI:** Private mortgage insurance, which may be required when the down payment on a conventional loan is less than 20% of the purchase price (i.e., when the LTV exceeds 80%). PMI protects the lender against default. As equity rises above 20% of fair market value, PMI can be eliminated.
- **Pre-Approval:** The process of verifying your financial situation with a lender. This is typically accomplished by providing your lender with documentation that validates your employment, income and (for purchase) assets, and includes authorization for the lender to obtain your credit report.

  Once verification is complete, you will learn the loan amount you are qualified to borrow for the purchase or refinance of your home.
- **Preliminary Pre-Approval:** Similar to a pre-approval, without the submission of the validation documents. A preliminary pre-approval helps you to understand the loan amount you may be eligible to borrow based upon your stated responses to questions around income, employment and assets. In most cases, a credit report authorization is also required.
- **VA:** A type of mortgage that is guaranteed by the U.S. Department of Veterans Affairs (VA) for eligible veterans, reservists, National Guard or certain surviving spouses.

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1 Borrower must satisfy pre-approval conditions outlined in commitment letter. Final loan approval and amount are subject to verification of loan data, property appraisal and underwriting conditions.

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