



Factors that Affect Your Interest Rate:

A Closer Look

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Below is a list of some of the major factors that may affect your interest rate. In the industry, we call these factors “add-ons”. Each of these add-ons has a cost associated to it that would be added to your base loan pricing. After an attempt to include the cost for each of these add-ons, I realized the variance by lender is so great that it would be impossible. Most borrowers are looking to get the lowest interest rate they possibly can on their loans. The best way to accomplish this is to work with a professional that understands each of these factors and can advise you on how to maximize your borrowing potential and then shop on your behalf for the lender that will offer you the best pricing in your particular situation.

- 1. Amortization** – Amortization is the death or pay down of your principle balance. There are three basic types of amortization: full, none, or negative. Generally, the more principle a borrower pays monthly the less your add-ons will be; and the less principle paid, the more the add-ons will be.
- 2. Bankruptcy or Foreclosure in Past** – As you can imagine, the lender prices their loans in a “risk versus reward” manner. If the lender believes they are taking on a higher risk that the borrower will not pay their monthly payments, they will charge a premium for this. Clearly, a bankruptcy or foreclosure in the past indicates a higher likelihood of future similar behavior than a financial package that does not.
- 3. Cash Reserves** – Lenders like to see that should a borrower run into some income or expense hardships, they have some cash reserves to continue making their mortgage payments with. For owner occupied property they typically like to see 2 – 4 months principle, interest, taxes and insurance in liquid funds. For non-owner occupied, they prefer 6 months of these reserves.
- 4. Loan to Value** – This is where your own personal “skin in the game” comes in to play. If a borrower has little or no equity (the difference between the value of the property and what you owe) in your property the ramifications to them in terms of loss of net worth is miniscule. This makes it very easier for a person in hard times to just stop paying their mortgage payments and not care significantly if their house is foreclosed on. On the other hand, if a borrower has hundreds of thousands of dollars in equity in their property, they will fight much harder to stay in control of the property and make their mortgage payments. Based on this, the lenders will charge more the less equity in the property.
- 5. Debt to Income Ratio** – Your Debt to Income Ratio (DTI) is a very important percentage when you are looking to finance 1 – 4 unit properties. In order to ensure that a borrower is able to make their monthly mortgage payments



lenders do not like to see the monthly liabilities and housing expense exceed 38% - 55% of the gross monthly income. The higher the Debt to Income Ratio is the higher the premium the lender will charge for the loan.

6. **Documentation Type** – This is another significant factor. There are many, many ways to document your loan package. What I mean by “document your loan package” is support the statements made on your Loan Application. If every statement on your Loan Application is proven with the appropriate and sometimes necessary documentation, the borrower will get cheaper pricing than if they cannot. The key here is not that there is a methodology by which to defraud the lender (not having to support statements on the Loan Application), but rather that sometimes the “appropriate and necessary documentation” is just not available, even when the statements are true. This often times is the case for self-employed borrowers.
7. **FICO Score** – Fair Isaacs has developed a credit scoring engine that attempts to determine the likelihood that a borrower will have a 90 day mortgage late. After much statistical analysis they have become very good at this and lenders have come to depend on the FICO score as a tool for them to measure the risk of someone being late paying their mortgage payments. The lower the FICO score, the higher the premium will be.
8. **Financing Type** - There are 4 major categories of financing types: Purchase, Rate & Term Refinance, Cash-Out Refinance, and Debt Consolidation Refinance. Lenders have determined that borrowers pulling cash out of their properties and/or using equity to pay off debt typically have a higher likelihood of being late on a mortgage payment. This is because many people live beyond their means and are living off of the equity in their properties instead of their job or business income. Eventually this catches up to them and they are unable to continue making their mortgage payment, which are increasing each time they refinance.
9. **First Time Home Buyer** – A first time home buyer has no history of paying a mortgage payment. Based on this, the first lender to “test” the borrower’s financial stewardship with a mortgage is taking on more risk than the lender who lends to borrowers that have a proven track record of paying mortgages on time.
10. **Impounds** – An impound account is an escrow account that a borrower pays a pro-rated monthly Property Tax and Hazard Insurance amounts into with their mortgage payment. The lender then uses this escrow account to pay the Property Taxes and Hazard Insurance for the borrower. It is like a forced budget system and ensures to the lender that the Property Taxes and Hazard Insurance on their collateral is being kept current.
11. **Lien Position** – A lien position simple means what order of priority the lien holders are entitled to get restituted for a loan should a borrower default. Obviously, most lenders prefer to be in 1st position. A lender in 2nd position, 3rd position and so forth would require additional compensation for this additional risk of not being the first to be paid back.



12. Loan Amounts – The major loan amount ranges that affect your add-ons here involve whether or not your loan amount is a Conforming Loan Amount. When a loan is a Conforming Loan Amount, this means it conforms to Fannie Mae and Freddie Mac's underwriting guidelines. This allows lenders to get a guarantee from these government backed agencies that they will purchase their loan package. In order to understand why this is so important, you will want to request our FREE Report called "Understanding Mortgage Banking: An Overview". Conforming Loan Amounts are updated every year. For Year 2005, they are as follows:

1 unit - \$359,650
2 units - \$460,500
3 units - \$556,500
4 units - \$691,600

These maximum loan limits apply to all states in the U.S. except Alaska and Hawaii which have higher limits.

13. Loan Program – This is where a great Real Estate Finance Consultant is worth their weight in gold. Often times, borrowers pay additional compensation to lenders for loan programs that offer far above and beyond the necessary securities a borrower needs. By choosing the appropriate loan program for the borrowers needs, they can save tens of thousands of dollars and sometimes more. One example of this is in regards to the fixed interest rate. If you require a 30 year fixed interest rate the lender is taking on the risk that the market interest rates rise and now they have their capital tied up at below market cash flow returns in your mortgage. They charge substantially for this risk. There is far too much detail under just this one topic to cover here, but suffice it to say that when you are choosing a loan program make sure you consider all your options.

14. Loan Term – Most lenders are cash flow investors. This means that they are looking to receive the highest monthly payments each month and not necessarily the highest interest on a monthly basis. Why? Because they are able to sell financial packages on the secondary market with higher streams of payments for substantially more money than financial packages with lower streams of payments. Therefore, if a borrower accepts a 15 year loan term as opposed to a 30 year loan term and their monthly payments are substantially higher, the lender will discount the interest rate.

15. Location – Believe it or not, lenders do know that real estate prices appreciate over time and that this is largely due to appreciating incomes. They also know that some locations appreciate better than others. Because the property is the collateral for their loan, they will charge more for properties located in areas where the income and appreciation growth is not as strong or stable.

16. Occupancy – If you own investment property currently, you understand that often times tenants do not take care of property as well as owners take care of their properties. Also, if an investor got into financial trouble, which



mortgage do you think they would stop paying first? Their home mortgage or investment property mortgage? You see the point here, I'm sure. Lenders understand this and therefore, once more, charge a premium for taking on the risk of a non-owner occupied property.

- 17. Pre-Payment Penalty** – Again, lenders are cash flow investors. They do not make most of their money from the upfront fees on a loan, but rather on the monthly cash flow over time. One of the most expensive parts of financing for a lender is the turnover cost. A good rule of thumb to not be looked at negatively by lenders when applying for financing is to not pay off your mortgages within 4 - 6 months from the time you got the mortgage. To make sure that they have enough money to recoup their costs, lenders will offer a discount if you accept a pre-payment penalty. They are covering themselves with higher costs up front if you do not take a pre-payment penalty, or by a pre-payment penalty that ensures they get paid for their costs if you pay off the loan early.
- 18. Private Mortgage Insurance** – Private Mortgage Insurance insures the lender for any loss they take should the borrower default on the loan. Lenders will require PMI for any loans they make in excess of 80% Loan to Value. Sometimes rather than the borrower paying for PMI, the lender will pay the PMI premium, but will charge higher interest cost in order to cover the cost of the PMI.
- 19. Property Type** – There are varying add-ons for each type of property a borrower asks the lender to finance. For example, a high rise condo is a higher risk for the lender than a single family residence (the chances that a person in another condo would start a fire and burn your unit down with theirs is more likely than if you had a separate home). The same is true for attached versus detached single family residences.
- 20. Rate Lock Period** – A rate lock is simply a way that you can ensure in the future a current interest rate. The longer you want to lock in the current rate the higher premium you pay for that rate lock. The lender is taking on the risk that interest rates rise and they have guaranteed you a below market interest rate. Typically rate lock periods range from 15 – 180 days.

Above are some of the most common factors that affect interest rates, but on top of these an underwriter can add-on additional premium to any loan based on just about anything they feel is reasonable. This is often called "exception pricing". When a loan package does not fit perfectly into the lender's underwriting guidelines, they may still do the loan; but often times they will charge exception pricing for each item that does not fit inside the guidelines.