



STEP-BY-STEP GUIDE 5 OF 7

Mortgage Basics: How a Home Loan Works

How mortgages work in plain language: principal, interest, taxes and insurance, fixed versus adjustable rates, APR, points, mortgage insurance, and how lenders decide what you can borrow.

43%

common debt-to-income guideline

78%

loan-to-value where PMI ends automatically

1 point

costs 1% of the loan amount

SUMMARY

Key takeaways

- 01

Most payments include principal, interest, property taxes and homeowners insurance, plus mortgage insurance when you put less than 20% down.
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- 02

Lenders size your loan from credit, debt-to-income ratio, income history and savings.
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- 03

Compare the rate, APR, points and lender credits on Loan Estimates from at least two or three lenders.
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- 04

Early payments are mostly interest; extra principal payments shorten the loan and cut total interest.

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01	Know what goes into your payment
02	Learn how lenders decide what you can borrow
03	Get pre-approved, not just pre-qualified
04	Choose a fixed or adjustable rate
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A mortgage is a loan secured by the home you buy. If you don't repay it, the lender can take the home through foreclosure. Everything else, including rates, points, mortgage insurance and escrow, is detail on top of that. This guide covers the terms you will see on every Loan Estimate, in the order you will run into them.

STEP 01 OF 08

Know what goes into your payment

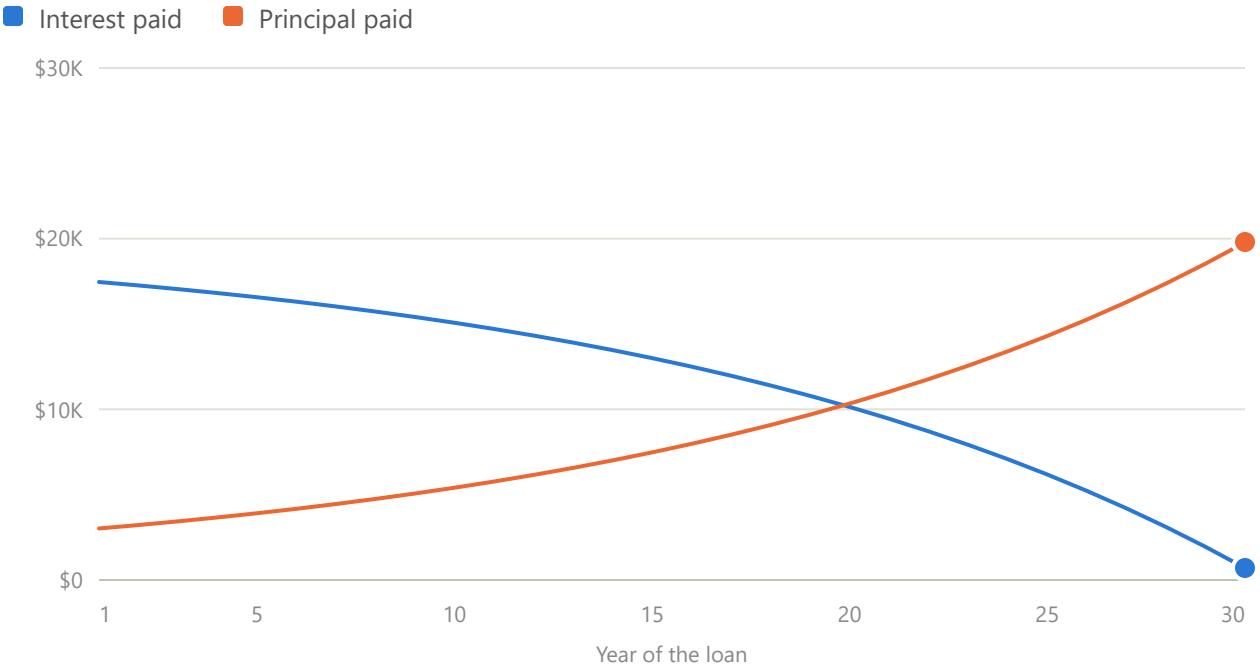
Most monthly payments have four parts, often shortened to **PITI**:

- **Principal.** Pays down what you borrowed.
- **Interest.** What the lender charges for the loan. Early payments are mostly interest, and the mix shifts toward principal over time. This is called amortization.
- **Taxes.** Property taxes, usually collected monthly and paid by the lender from an escrow account.
- **Insurance.** Homeowners insurance, usually paid from escrow the same way.

FIGURE 1

Where your payments go: interest vs. principal

Each year's payments on a \$270,000, 30-year fixed loan at 6.5%.



Source: HouseBuyerGuides.com calculations. Example loan. The monthly principal and interest payment stays the same; the split shifts toward principal over time. Taxes, insurance and mortgage insurance are not included.

Your payment may also include **mortgage insurance** (PMI on conventional loans, MIP on FHA loans), **HOA dues** if you pay them through the lender, and **flood insurance** in flood zones. When you compare homes, compare the full payment, not just principal and interest. Taxes and insurance can vary a lot from one house to the next.

STEP 02 OF 08

Learn how lenders decide what you can borrow

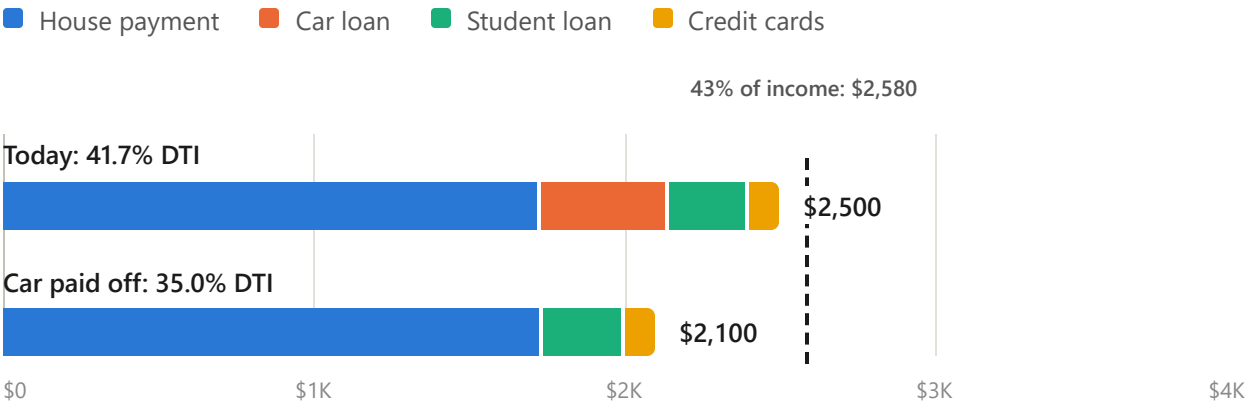
Lenders look at four main things:

- 1. **Credit score and history.** Minimums vary by loan type: about 580 for FHA with 3.5% down and 620 for most conventional loans. Higher scores get better prices.
- 2. **Debt-to-income ratio (DTI).** Total monthly debt payments, including the new house payment, divided by gross monthly income. Many lenders look for 43% or less, though some programs allow more with strong credit or savings. Example: \$6,000 gross monthly income and \$2,400 in debts plus the new payment gives a 40% DTI.
- 3. **Income and employment.** Usually two years of steady history, verified with pay stubs, W-2s or tax returns.
- 4. **Assets.** Enough for the down payment and closing costs, and sometimes a few months of payments left over as reserves.

FIGURE 2

Debt-to-income ratio: before and after paying off a car

Monthly debts for a buyer earning \$6,000 a month, including a \$1,750 house payment.



Source: HouseBuyerGuides.com calculations. Example only. Many lenders look for total debts at or below about 43% of gross monthly income; some loans allow more with strong credit or savings.

The amount a lender approves is the most you can borrow, not what you should borrow. Set your own monthly limit first.

STEP 03 OF 08

Get pre-approved, not just pre-qualified

- **Pre-qualification** is a quick estimate based on what you tell the lender. It is useful for planning but carries little weight with sellers.
- **Pre-approval** is based on your credit report and income and asset documents. It is what sellers expect to see with an offer.

A pre-approval is not a final approval. The loan still goes through underwriting and an appraisal after you are under contract. [Start a pre-approval](#).

STEP 04 OF 08

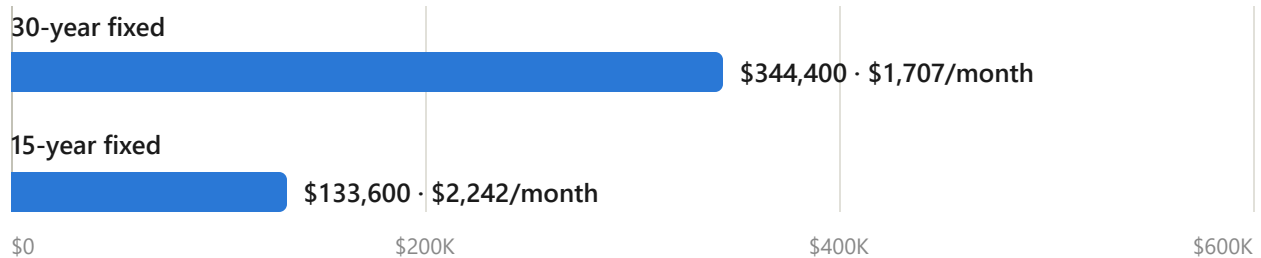
Choose a fixed or adjustable rate

- **Fixed-rate mortgage.** The interest rate never changes, so principal and interest stay the same for the life of the loan. Terms are usually 30 or 15 years. A 15-year loan has a higher payment, a lower rate and much less total interest.
- **Adjustable-rate mortgage (ARM).** The rate is fixed for an initial period, such as 5, 7 or 10 years, then adjusts on a schedule based on an index plus a margin. Caps limit how much it can rise. An ARM can make sense if you expect to move or refinance before the first adjustment, but plan for the payment at the highest rate the caps allow.

FIGURE 3

Total interest: 30-year vs. 15-year loan

On a \$270,000 loan, paid on schedule.



Source: HouseBuyerGuides.com calculations. Example rates: 6.50% for 30 years and 5.75% for 15 years. Fifteen-year loans usually carry lower rates but higher monthly payments.

Most first-time buyers choose a 30-year fixed loan, and most down payment assistance programs require a fixed-rate first mortgage.

STEP 05 OF 08

Read the rate, APR and points

- **Interest rate.** The yearly cost of borrowing the loan amount.
- **APR.** The rate plus certain lender fees, spread over the loan term. It is useful for comparing offers with different fees.
- **Discount points.** Money paid upfront to lower your rate. One point costs 1% of the loan amount. Points pay off only if you keep the loan long enough. Divide the cost by the monthly savings to find the break-even point in months.
- **Lender credits.** The opposite of points. You accept a slightly higher rate, and the lender pays part of your closing costs.
- **Rate lock.** A promise to hold a rate for a set number of days. Make sure it lasts past your closing date.

Compare the same items across Loan Estimates from at least two or three lenders. Each lender must send one within three business days of your application. The CFPB's [Loan Estimate explainer](#) goes through the form line by line.

STEP 06 OF 08

Understand mortgage insurance

Mortgage insurance protects the lender, not you, and it is what makes low down payment loans possible.

- **Conventional PMI.** Required with less than 20% down. The cost depends on your credit and down payment. You can ask to cancel it once your loan balance reaches 80% of the home's original value, and it ends automatically at 78% if you are current.
- **FHA MIP.** A 1.75% upfront premium plus an annual premium, usually 0.55% on a typical 30-year loan with less than 5% down. With less than 10% down it lasts for the life of the loan, and with 10% or more down it lasts 11 years.
- **VA funding fee and USDA guarantee fee.** Upfront and, for USDA, annual fees that take the place of mortgage insurance.

See [types of home loans](#) for the full comparison.

STEP 07 OF 08

Know what escrow does

An escrow account holds the part of your payment that goes to property taxes and insurance, and the lender pays those bills when they are due. At closing you put in an initial deposit to start the account. Once a year the lender reviews it. If taxes or insurance went up, your payment rises. If there is a surplus, you may get a refund.

STEP 08 OF 08

Plan for the life of the loan

- **Extra principal payments** shorten the loan and cut total interest. Check that your loan has no prepayment penalty. Most don't.
- **Refinancing** replaces your loan with a new one, usually to get a lower rate or drop mortgage insurance. It comes with new closing costs. If you have down payment assistance, find out first whether it must be repaid when you refinance.
- **If you can't pay**, call your servicer early and talk to a [HUD-approved housing counselor](#). Options are much better before you fall behind.

Frequently asked questions

What is included in a monthly mortgage payment?

Usually principal, interest, property taxes and homeowners insurance, often shortened to PITI. Many payments also include mortgage insurance and, where it applies, an HOA or flood insurance amount.

What is the difference between the interest rate and the APR?

The interest rate is the cost of borrowing the loan amount. The APR adds certain fees, such as points and lender charges, to show a fuller yearly cost. Compare both on each Loan Estimate.

What is a good debt-to-income ratio for a mortgage?

Lower is better. Many lenders look for total debt payments, including the new mortgage, at or below about 43% of gross monthly income, though some loan programs allow higher ratios with strong credit or savings.

Is pre-qualification the same as pre-approval?

No. A pre-qualification is usually based on what you tell the lender. A pre-approval is based on your credit report and income and asset documents, so sellers take it more seriously.

Sources

Checked October 22, 2026.

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About this report

Written by Tyler Thompson, licensed real estate agent, for HouseBuyerGuides.com. Figures were checked against the official sources listed above on October 22, 2026. Charts are illustrative examples built from the assumptions stated under each one.

This report is for education only and is not financial, legal or tax advice. Loan rules, fees and assistance programs change. Confirm the details with your lender and the program administrator before you make decisions.

NEXT STEP

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