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Read the fine print on those mortgage rate lock offers

Pioneer lenders are thinking outside the box and advertising rate lock programs that begin before you even find your dream home. (Ted Shaffrey/AP)

The recent rise in mortgage rates has created a head-scratching dilemma for both buyers and sellers. For buyers, higher rates mean higher monthly mortgage payments. For sellers, higher rates equate to a smaller pool of buyers who can afford to purchase their property at the desired sale price.

So how do buyers and sellers navigate the rising tide and protect themselves financially in this changing real estate market?

Fortunately, there are mechanisms for buyers to protect themselves against increased mortgage rates. Most lenders offer a "rate lock" option, whereby a buyer can lock into the current rate as a way to immunize themselves from changes in the market.

Before selecting a rate lock program, it is crucial to understand what a rate lock is.

A rate lock provides the opportunity to secure today's mortgage rate before it goes up. Lenders compete to provide the best rate lock program, hoping to entice you to work with them.

There are many options for locking rates, and alternative rate lock programs are being introduced to the market at a fast pace.

Historically, banks have locked in a rate at the time of contract ratification. Most banks still do that today. But pioneer lenders are thinking outside the box and advertising rate lock programs that begin before you even find your dream home.

"Some lenders are challenging this long-established rule," said Kenneth Sonner, chairman of the Mortgage Bankers Association of Metropolitan Washington and senior vice president of Old Line Bank in Bowie, Md. "They are changing previous practices, just like Costco and Apple and Amazon did to their industries."

A few lenders are advertising programs in which borrowers can lock in a rate for 90 days while searching for a home. The programs promise that if rates go up, the borrower's rate will remain steady. If rates drop, they say, the rate will, too.

As with any claim or offer, I recommend that you read the fine print. One says: "Acceptance of this offer constitutes the acceptance of these terms and conditions, which are subject to change" at the lender's sole discretion. In other words, nothing is guaranteed.

Sonner said that these early rate locks could be padded with extra fees to hedge against the higher risk to the lender. "Rate locks have always been tied to the property and not to the borrower. There is less risk to the lender to have all the transaction details."

The reason for the decreased risk is that if the buyer defaults on the loan, the lender will sell the property to recoup its money. Therefore, lenders are concerned about the value of the property.

The higher the risk on value, the higher the rate. Thus, they prefer to wait until a buyer is under contract on a home. Of course, they also evaluate how likely you are to repay the loan when determining mortgage rate.

Higher rates also can be difficult for the seller.

"We have definitely seen lower offers due to rate increases," said Brandon KeKich, a licensed real estate broker with The KeKich Team in Northville, Mich. "We use rates to negotiate and it's one of the things that we calculate and spell out when we are presenting a lower offer."

In my own work as a real estate broker, I have experienced firsthand how increasing mortgage rates can completely alter and, in some cases, checkmate contract negotiations, frustrating both the buyer and seller.

For the past two months, my client buyer and the seller of a property in New York City have been volleying back and forth on price and terms of a contract. During that time, the mortgage rate for my buyer increased three-quarters of 1 percent (0.75) above the original rate quote, adding up to a $100 per month increase in the mortgage payment. This increase has made a significant difference in my client's purchase affordability.

In the most recent round of negotiations, my buyer had no choice but to stay firm on his last offer price. Negotiations have now reached a stalemate. He has become despondent about his ability to buy the type of property he originally hoped to purchase.

My client sent this text to me: "Do you think the deal is pretty much dead at this point?"

"It has a dangerously slow pulse," I answered. "But I am trying to keep it alive."

The light at the end of the tunnel for my buyer is that the seller is coming to terms with the fact that increased rates have affected property values, particularly in the lower price ranges where every dollar counts to a buyer. The listing agent has advised the seller to accept our last offer or postpone selling until the market is more in her favor. It remains to be seen how our negotiations will end, but my buyer has some renewed hope for buying his target property. In the meantime, we continue touring other listings. Every day that goes by is another day that potentially lowers his chances to buy what he wants.

Mortgage rates are not the only reason for changing property values. Inventory, state and local tax policies and caps on deductibility of mortgage interest affect property values. But mortgage rates are precisely tied to a buyer's monthly outflow of cash. Lenders look at monthly outgoing cash versus monthly incoming cash to determine how much a buyer can afford. Thus, mortgage rates and buying power are closely connected.

So how does a buyer determine which rate lock program is best? That is not an easy question to answer, unfortunately. There are many factors to consider when choosing a program, and you will need a sharp pencil to do some back-of-the-envelope calculations.

Almost all rate locks come with a fee and, if you need to extend the rate lock because of delays in settlement, there may be an additional fee. If a lender claims there is no fee, the truth is that it is baked into the mortgage rate offered.

Is it worth paying the fee to lock? You need a crystal ball for this one. You can pay the fee, or gamble that rates will not increase before you settle on a property.

Below is a calculation in favor of the cost to lock a rate:

Consider a $300,000 home financed for 30 years at 4.5 percent, with a 20 percent down payment. Just a quarter point (0.25 percent) rise in mortgage rates to 4.75 percent will kick your payments up $36 a month, from $1,216 to $1,252 (not including taxes and insurance). If you stay in your home for five years, that adds up to about $2,160.

By comparison, a 0.25 percent fee to lock in the 4.5 percent rate would be $692.

What would happen if rates drop below your locked mortgage rate? Many lenders will honor a lower rate if the rate drops during the transaction process up until settlement. Be sure that your lender does offer this benefit.

If you are in the market to purchase a home, some experts are advising buyers to get in before rates go up further, while others warn against moving too fast.

So should a buyer rush to enter the market before rates go higher? If you have found your dream home, get in while rates are low. Otherwise, don't buy with the singular goal of getting a low rate.

For sellers, keep in mind that as rates go up, buyer affordability and, subsequently, property values go down.