Mortgages: What You Need To Know

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Buying Your First Home
And Getting Your First Mortgage

Owning a home is one of the main ways that many Americans build wealth. Instead of renting each month, and having nothing to show for it, you can buy a home and build equity.

Equity is the difference between what a home is worth and what is owed on it. There are two ways to create equity in your home. First, your home's value may rise just because housing values in your area are rising. Secondly, as you pay off the loan, the difference between what the house is worth and what you owe gets larger.

Building equity can give you flexibility. You may be able to borrow against it, take it out as cash when you sell the home, or even leave the home to your heirs as an inheritance.

In addition, a good portion of your home mortgage payment each month will go toward paying interest — especially in the early years. That interest is usually tax-deductible, which may mean more money in your pocket each month than if you were making a similar rent payment before.

Buying your first home can be intimidating, but you shouldn't let it be! Today, there are thousands of different loan programs designed to allow people to get a loan that fits their needs. Whether your challenge is saving money for a down payment, or a damaged credit rating, there are loans that can help. At the same time, you want to be financially prepared to own your own home – so you'll be able to afford to keep it!

How Much Can I Afford?

The most general rule of thumb is that you can afford a home of about 2 – 3 times your annual income. So if you earn $30,000 a year, you can "afford" a home of about $60,000 -- $90,000. Lenders, however, have much more specific guidelines which we'll describe next.

Tip: Be very careful about stretching yourself too thin and buying the most expensive house you can afford. Unexpected repairs, a spouse who decides to stay home to take care of children or aging parents, a lay off, or any other financial challenge can make it difficult to keep up the house payments.

Qualifying Ratios

Lenders use something called "qualifying ratios" to decide how much house you can afford. There are two ratios used here: the housing ratio (or "front end" ratio) and the debt ratio (or "back end" ratio).

Housing Ratio

Your housing ratio shows how much of your income will go toward making your house payment. Your house payment includes the payment required on the loan, which is made up of principal and interest. It also includes your property taxes and homeowner's insurance. Together, these are called "PITI" – for principal, interest, taxes and insurance. If you have to pay Private Mortgage Insurance (PMI) because you put too little down on your house, it will be included in your PITI.

The rule of thumb is that your monthly PITI should not be more than 28% of your total monthly income. To calculate how much monthly payment you can afford:

Take your total monthly income (before taxes, health insurance or retirement plan contributions are taken out).
$____________
x ___.28________
=____________

Example: Monthly income of $2500 x .28 = $700.

What price house will that payment buy? That depends upon what current interest rate you'll qualify for, and how much your

taxes and insurance on the property will be. Ask a loan officer to calculate this for you, based on current interest rates and typical taxes and insurance rates in your area.

Debt Ratio

Your debt ratio tells how much of your monthly income is going toward all your debts, including your housing payment. To figure your debt ratio, list your monthly debt payments. Don't include any debts that will be paid off in the next 6 months:

Expected PITI:

____

Credit cards (minimum payments only):

____

Auto loans or leases:

____

Student loans:

____

Other personal loans:

____

Child support or alimony (you pay):

____

Total monthly payments on all loans:

____

Now take your total monthly income and multiply it by .36.
$_______________
x_______.36______
=_______________

Example: Total monthly income of $2500 x .36 = $900

The figure you get is the maximum total monthly debt payment you'll be allowed under many conventional loan programs. Ideally, your monthly debts should be lower than that amount. But again, it's not a hard and fast rule – consumers do sometimes get mortgages even though they have higher debt ratios.

Co-signers
If a spouse, relative or anyone else will be purchasing the home with you, then you can include their income and debts in the calculations. If you qualify, however, you can buy the house yourself. Generally you cannot have someone cosign for the home loan unless they will be living in it as an owner with you.

What if your debts are too high? First, talk with your loan officer or mortgage broker to see if there are other programs that can help. But if you are still having trouble qualifying because you have too much debt, contact credit counseling agency for help in working out a repayment plan to pay back your debts.

Plan for Other Expenses
Owning your own home can be expensive! All the repairs you previously left for your landlord to worry about now become yours. Plus most people want to fix up their new home to suit their tastes. Keep a cushion for all those expenses that may crop up. Here are some examples:

Expenses	Amount Budgeted
Moving Expenses	$
New utility service deposits/connection charges	$
Painting	$
Flooring: carpet cleaning or replacing, etc.	$
Landscaping and lawn maintenance (also lawnmower and tools)	$
Pest control	$
Alarm system	$
Smoke and CO_2 detectors, fire extinguisher	$
New furnishings	$
Window coverings	$
Repairs	$
Appliance replacement or repair	$

Coming Up With A Down Payment

When you buy a home, you'll need money for the down payment and for closing costs. While it used to be that you had to have 20% of the price of a home for a down payment, those days are long gone. Now you can get loans for 90 to 100% of the home's price!

Those loans, however, may be more expensive because you may have to pay Private Mortgage Insurance (PMI). PMI protects the lender, not you, if you can't make your house payment and go into foreclosure. It can add anywhere from $25 -- $150 or more to your monthly payment. It's important to know that PMI is purchased by the lender, the cost may be influenced by your credit rating, and it is not tax deductible.

Down payment assistance organizations can help some people. These nonprofit organizations offer programs that allow you to buy a home with no money down. The seller of the house you're buying must participate and some will when they learn how this can help them sell their home faster. For more information, including links to companies that provide these services, visit www.downpaymentalliance.org You don't have to be a first-time buyer to take advantage of one of these programs.

First Time Homebuyer Credit

The American Recovery and Reinvestment Act of 2009 (Recovery Act) provides for as much as an $8,000 tax credit to qualified first time homebuyers. This credit may be used as part of the homeowner's down payment. Basic information on how the first time homebuyer tax credit works, including the eligibility requirements for the tax credit, the amount of the tax credit that a first-time homebuyer may be eligible to receive, and how a homebuyer may claim the tax credit is available on the IRS website at http://www.irs.gov/newsroom/article/0,,id=204671,00.html?portlet7

Closing Costs

If you've never obtained a mortgage, the variety of closing costs that

may be charged may seem bewildering! Closing costs, also called "settlement costs" can usually account for about 4% of the loan amount, sometimes more. If you don't have a lot of cash, it can be helpful to negotiate to have the seller pay part of your closing costs. Depending on the loan program, they may be able to contribute 3 – 6% of closing costs. Again, ask your loan professional.

Three days after you apply for a mortgage, you'll get what's called a Good Faith Estimate of these closing costs. Review it carefully and ask your loan professional about any fees you don't understand. You can also keep a copy to compare with your closing statement. Some items that were estimated will change.

When your loan goes to closing, you'll get a copy of what's called the HUD-1 Settlement Statement. These costs may be listed on that statement. The numbers listed below refer to the section of the statement where you'll see them appear:

800. Items Payable in Connection with Loan: These are the fees that lenders charge to process, approve and make the mortgage loan.

801. Loan Origination: This fee is usually known as a loan origination fee but sometimes is called a "point" or "points." It covers the lender's administrative costs in processing the loan. Often expressed as a percentage of the loan, the fee will vary among lenders.

802. Loan Discount: Also often called "points" or "discount points," a loan discount is a one-time charge imposed by the lender or broker to lower the rate at which the lender or broker would otherwise offer the loan to you. Each "point" is equal to one percent of the mortgage amount. For example, if a lender charges two points on an $80,000 loan this amounts to a charge of $1,600.

803. Appraisal Fee: This charge pays for an appraisal report made by an appraiser. The lender will require that the appraiser

be on its approved list. An appraisal is not a substitute for a good home inspection.

804. Credit Report Fee: This fee covers the cost of a credit report, which shows your credit history. In some states, lenders are not allowed to charge more than the actual cost they pay for a credit report. In others, it may be marked up.

805. Lender's Inspection Fee: Lenders usually require inspections of newly constructed housing. (Pest or other inspections made by companies other than the lender are discussed later.) It is still however, a good idea for you to pay for your own inspection.

806. Mortgage Insurance Application Fee: This fee covers the processing of an application for mortgage insurance.

807. Assumption Fee: This is a fee which is charged when a buyer "assumes" or takes over the duty to pay the seller's existing mortgage loan. Most conventional loans these days are not assumable, while VA and FHA loans are.

808. Mortgage Broker Fee: Fees paid to mortgage brokers would be listed here. You may see additional fees listed in this section, such as courier fees, loan processing fees, underwriting fees, etc. Some fees may be negotiable, and the seller may pay some.

Section 900. Items Required by Lender to Be Paid in Advance

901. Interest: Lenders usually require borrowers to pay the interest that accrues from the date of settlement to the first monthly payment.

902. Mortgage Insurance Premium: The lender may require you to pay your first year's mortgage insurance premium or a lump sum premium that covers the life of the loan, in advance, at the settlement.

903. Hazard Insurance Premium: Hazard insurance (homeowner's insurance) protects you and the lender against loss due to fire, windstorm, and natural hazards. Lenders often require the borrower to bring to the settlement a paid-up first year's policy or to pay for the first year's premium at settlement. You can shop around to find the best policy for your needs.

Tip: A free brochure with tips on shopping for homeowner's insurance is available from the National Association of Insurance Commissioners at www.naic.org.

904. Flood Insurance: If the home is in an area considered at risk for flooding, the lender will require you to purchase flood insurance.

Section 1100: Title Charges: Title companies and/or real estate attorneys process the paperwork for the mortgage closing, conduct searches of the title, facilitate the transfer of funds, and make sure the proper documents are recorded with the city, county and/or state. Title charges can vary in different parts of the country, and whether the buyer or seller pays them is also often based on the custom in that area.

1101. Settlement or Closing Fee: This fee is paid to the settlement agent or escrow holder. Responsibility for payment of this fee should be negotiated between the seller and the buyer.

1102-1104. Abstract of Title Search, Title Examination, And Title Insurance Binder: A title search will be conducted to make sure there are no problems that could hold up the legal transfer of the title to the property. The charges on these lines cover the costs of the title search and examination.

1105. Document Preparation: This is a separate fee that some lenders or title companies charge to cover their costs of preparation of final legal papers, such as a mortgage, deed of trust, note or deed.

1106. Notary Fee: This fee is charged for the cost of having a person who is licensed as a notary public swear to the fact that the persons named in the documents did, in fact, sign them.

1107. Attorney's Fees: You may be required to pay for legal services provided to the lender, such as an examination of the title binder. Occasionally, the seller will agree to pay part of this fee. The cost of your attorney and/or the seller's attorney may also appear here.

1108. Title Insurance: The total cost of owner's and lender's title insurance is shown here.

1109. Lender's Title Insurance: The cost of the lender's policy is shown here.

1110. Owner's (Buyer's) Title Insurance: The cost of the owner's policy is shown here.

Tip: The lender's title insurance policy will not protect you if there is a problem with the title. It is always a good idea to pay the extra amount for an owner's policy to protect you as long as you own the property.

1200. Government Recording and Transfer Charges: There are various taxes and fees required by cities, states, counties and municipalities when you buy or sell a property. These may include fees for legally recording the new deed and mortgage; transfer taxes that are assessed by state and/or local governments; and city, county and/or state tax "stamps" which must be purchased as well. These fees – which can really add up -- may be paid by you or by the seller, depending upon your agreement.

1300. Additional Settlement Charges

1301. Survey: The lender may require that a surveyor conduct a property survey. This is a protection to the buyer as well. Usually the buyer pays the surveyor's fee, but sometimes the seller pays it.

1302. Pest and Other Inspections: This fee is to cover inspections for termites or other pest infestation of your home. It is required in some areas of the country.

1303-1305. Lead-Based Paint Inspections: This fee is to cover inspections or evaluations for lead-based paint hazard risk assessments and may be on any blank line in the 1300 series.

Protect Your Purchase

A home is a significant purchase. Whether you are buying a brand new home, or one that's years old, it is always a good idea for you to hire a professional home inspector to inspect the home for problems and defects. This may cost $200 – $300, but it is money well spent if something is uncovered.

Don't rely on the seller's assurances that the home is fine, and choose an inspector who is well qualified and works for you. Visit www.ashi.com for a referral to a qualified inspector in your area.

If possible, accompany the inspector when he inspects the home so he can answer any questions you may have. If problems are discovered, you may be able to negotiate with the seller to have them fixed before you buy.

Types of Loans

Fixed Rate Loans: A fixed-rate loan keeps the same interest rate for the life of the loan. The most popular fixed-rate loans are 15-year and 30-year loans, though there are some 10, 25 and even 40-year loans available.

The benefits of a fixed rate are:

- Your monthly payment will remain the same throughout the loan, which makes it easier to budget.
- If you get a relatively low interest rate when you get the loan, it will remain that way – even if interest rates in the economy go up.

Should I Choose a 15-Year Fixed or 30-Year Fixed Loan? Your payment will be higher on a 15-year fixed rate loan than it will be on a 30-year loan. Your interest rate will be a little lower, though. Obviously the biggest advantage is that you'll own your home free and clear in 15 years if you pay it off as agreed.

On the other hand, if funds get tight, you may be stuck with a payment that you can't afford and be forced to sell your house. If you don't have a lot of cash reserves, you may want to consider getting a 30-year loan and paying it off like a 15-year loan. Check to make sure your loan allows for extra prepayments. If so, you can make additional early payments when you can afford them.

On the downside, if interest rates go down you will have to refinance your loan (and pay new closing costs) to get a lower interest rate.

Adjustable Rate Mortgages (ARMs): With an ARM, the payments and interest rate can change based on interest rates in the economy. The rate and payment are set for an initial period (which can be as short as a month or as long as 10 years or more). After that, it can change.

For example, a 3/1 ARM will have a fixed rate and payment for the first three years, and then change every year after that. A 5/1 ARM will have a fixed rate and payment for the first five years, and then change every year after that.
The interest rate on an ARM is based on an index rate – a widely available interest rate. For example, a popular index is the COFI, or the Eleventh District Cost of Funds Index published by the San Francisco office of the Federal Home Loan Bank. Another is the LIBOR, or London Interback Offer Rate, which is the rate international banks charge each other for loans.

The lender will add a margin to the index. For example, the interest rate could be the COFI + 3%. If the COFI is at 2%, your rate will be 2% + 3% or a total of 5%.

Because the interest rate on an ARM can go up (and so can your payments) it's important to understand any caps that may protect you. Periodic caps protect you each time the rate is adjusted. For example, a periodic cap of 2% would mean the rate could not rise more than 2% in one adjustment period. A lifetime cap of say 8%, would mean that the interest rate cannot rise more than a total of 8% over the life of the loan.
The main attraction of ARMs is a lower interest rate and payment – at least in the beginning. However, since rates (and payments) can rise, you may put yourself at risk if you can't continue to make the higher payments. ARMs can also be confusing, so evaluate this option carefully and be sure to get answers to anything you don't understand. Always ask your loan professional to calculate a worse-case scenario for you. If a low initial payment is the only way you can afford to buy a home, you may want to save up first until you have more of a financial cushion.

FHA Loans: FHA loans offer low and no down payment loans, and closing costs can be wrapped into the loan. This makes these attractive to consumers without a lot of cash to put down on a house. These programs typically offer flexible credit and income requirements as well.

They are insured by the Department of Housing And Urban Development (HUD), which means you'll pay an upfront mortgage premium of 1.5% of the loan, which can be financed; and a mortgage insurance premium of .5% which will be tacked onto the loan each month. These loans may be a little more expensive than other conventional options, but again are popular for consumers looking for low down payment loans.

You'll need to work with a local HUD-approved lender, who can help you find the right program. There are a number of HUD-insured loan programs including loans to rehab properties in need of repair, loans for those with credit challenges, and special loans for teachers and police officers buying in neighborhood revitalization areas.

VA Loans: VA loans are made to qualifying veterans to purchase, refinance, or improve homes. You can borrow up to 100 percent of the VA-established reasonable value of the property.

The VA provides a guaranty on the loan that protects the lender against loss if the payments are not made. With the current maximum guaranty, a veteran who hasn't previously used the benefit may be able to obtain a VA loan up to $240,000 depending on the borrower's income level and the appraised value of the property. There is a nonrefundable funding fee of 1.25 – 3%, with an average of 2%.

Although the owner must occupy a VA-financed home, it is possible to purchase a 2-4 unit home and live in one of them. Veterans need a certificate of eligibility and a VA-assigned appraisal, but otherwise, it is not much different than buying a home through a conventional loan. You'll work with a lender that offers VA loans.

First Time Homebuyer: Today, the first time homebuyer has a variety of loan programs to choose from. If you've never owned a home before, talk with a mortgage professional to find out what type of program you may qualify for. There may also be local programs offered by community or government agencies available to you. Visit www.HUD.gov for information on local housing agencies that may be able to help.

Getting the Loan: There are many ways to get a loan to buy a home. You can see what your local bank, credit union or savings & loan has to offer. Or you may want to work with a mortgage broker who has access to a number of different lenders. Either way, it's important that you feel comfortable asking – and getting answers – to your questions.

Paperwork, paperwork

The paperwork involved in getting a mortgage can seem endless! Now is the time to start getting organized, before you are ready to buy. Here are some of the documents you may need.

Not all may be required, but it will be helpful to have the items on the following list on hand when the application is filled out:

____ Sales contract, once an offer has been accepted on a home
____ Copy of the cancelled deposit money check

Income and Assets:

____ Recent pay stubs (usually two)
____ Names, addresses and phone numbers for employers, past two years
____ W-2 forms for the last two years, if employed
____ Tax returns for the last two years, if self-employed
____ Business tax returns for two years, if a business owner (own 5% or more)
____ Most recent three months' of banking statements (all pages, from all financial institutions where you have accounts)
____ Most recent three months of banking statements from all accounts if self-employed
____ Year to date income statement if self-employed
____ Proof of other income, such as interest/dividends, retirement income
____ Court papers and copies of cancelled checks for child support or alimony payments you receive
____ Copies of most recent three statements from investment/ savings accounts, including retirement accounts

Debts:

____ List of current lenders, addresses, monthly payment, and amounts owed
____ Bankruptcy discharge papers if you filed bankruptcy in the past seven years
____ Copies of one year of cancelled rent payment checks, if you've been renting

Other:

____ A copy of your driver's license or passport may be required to comply with the Patriot Act

____ Recorded copy of divorce decree/separation agreement if applicable
____ List of other properties you own, lender and loan balance, and copies of signed leases if rented

Your Credit Report

Your lender will likely purchase a Residential Mortgage Credit Report which includes your credit information from all three major credit bureaus: Equifax, Experian and TransUnion. It will also include your credit score from each agency. This information will play a key role in what type of loan you get, as well as the interest rate you may pay. So it's very important that you make sure it is accurate and up to date!

Although the lender will get your credit report, it's a very good idea for you to order your own copy of your report from each of the three major bureaus as soon as you starting shopping for a home. You'll usually need at least 30 – 60 days to fix mistakes or problems.

Surprises that pop up when you review your credit report may include:

- Loans for which you cosigned that have been late.
- Joint accounts assigned to your ex in a divorce that have been late.
- Medical bills that you thought should have been paid by your insurance company but were turned over to collections.
- Utility or cable bills that were due after you moved, but you didn't realize were outstanding -- or you disputed.
- Information belonging to someone with a similar name.
- Fraudulent accounts, in particular those related to identity theft.

The Mortgage Process

A lot of work must be done to ensure your loan is completed on time, especially when you buy a home and have a deadline written into the sales contract. The more you understand the process and are willing to work with your real estate and loan professionals, the quicker and smoother it can go.

After you sign a contract to buy a home, you'll submit a mortgage application.

- The loan officer will gather your documentation and begin to assemble the loan package.
- The appraisal will be ordered immediately to ensure your house is worth the sales price.
- Any necessary inspections (such as a pest inspection) will be ordered.
- Your employment information will be verified.
- Your credit report will be ordered and reviewed.
- Your bank account balances, loan history on your current mortgage, or other information may be verified directly with the source.
- You will need to shop for your homeowner's insurance policy, and order your own inspection if you are planning to get one.
- A title company or attorney will conduct a title search to make sure there are no other claims to the title.
- A survey may be ordered to verify the property boundaries and to make sure there are no unacceptable encroachments or easements that could affect the property's value.

When all the paperwork is completed, the closing will be scheduled. At the closing you'll sign all the documents, funds will be transferred and you'll be given the keys to your new home!

Don't Sabotage Your Loan

There are some important things you can do to make sure you loan proceeds smoothly:

- Return your real estate and loan professionals' calls quickly, and provide them with any documents or information they need right away.

- Don’t lie on your application. The information may be verified, and could cause the loan to be turned down.
- Don’t quit your job before the loan closes. Your employment may be verified the day you close!
- Avoid making any major financial moves until the loan closes. That includes taking out new loans or adding to your debt. (Wait until after closing to buy that new car!)
- Check in periodically if you haven’t heard anything about your loan, but also give your loan professional time to work on your file.

If You Have Damaged Credit

There are so many loan programs available today that you may be surprised by what’s available to consumers with less than perfect credit. Brian Sacks, author of “Yes! You Can Get A Mortgage” says that consumers with credit problems, even bankruptcy, can get a mortgage with low down payments and reasonable interest rates. If you’re in this situation, look for a loan professional with experience in working with consumers with previous credit problems.

If high debt is keeping you from getting a loan, you may want to work with an experienced credit counselor who can help you work out a repayment plan with your creditors. Credit counseling agencies help consumers get out of debt. Credit counseling also can have a positive impact on your credit by reducing your debt ratio, and because most creditors will remove recent late payments once you’ve made three consecutive on-time payments to the counseling agency.

Notes

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