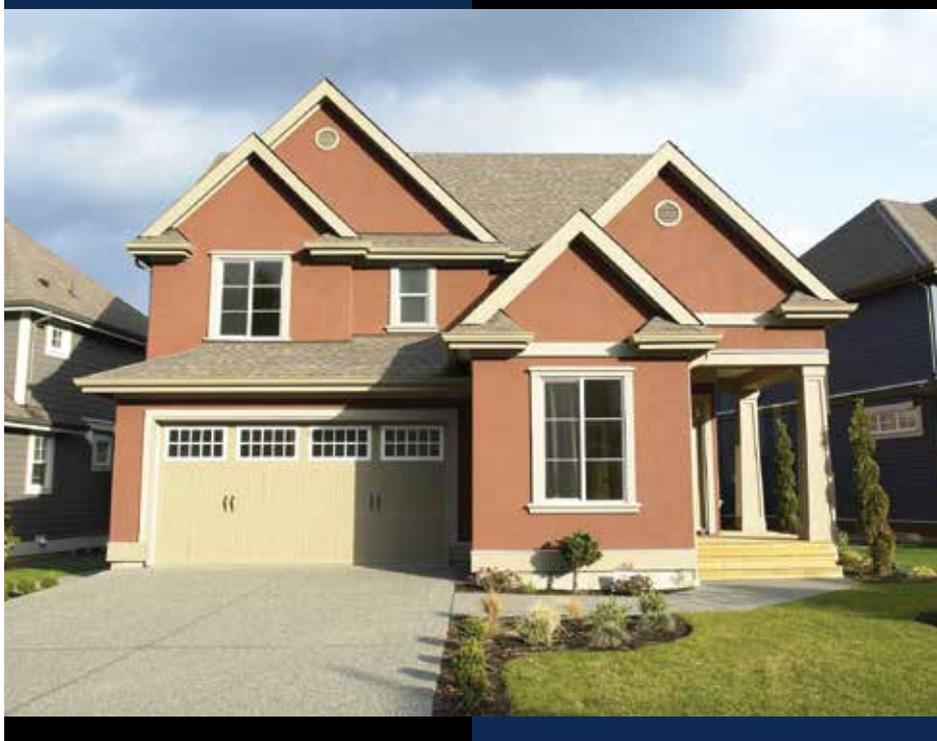


# MORTGAGES

What You Need To Know



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## Why Buy a Home and Get a 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. Second, 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 could 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 you receive a tax break as you pay off your mortgage that you don't get from paying rent.

Buying your first home can be intimidating, but you can change that by being prepared!

Today, there is a wide array of loan programs that 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. That way, you can 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

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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 home you can afford. Unexpected repairs, a spouse who decides to stay at home to take care of children or aging parents, a layoff, or any other financial challenge can make it difficult to keep up with 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 typically includes property taxes and homeowner’s insurance. Together, these are called “PITI” – for principal, interest, taxes, and insurance. If you must pay private mortgage insurance (PMI) because you put less than 20% down on your house, it will also be included in your monthly payment.

The rule of thumb is that your monthly payment should not exceed more than 31% of your total monthly income. To calculate how much you can afford, calculate your total gross monthly income (before taxes, health insurance, or retirement contributions are taken out).

Then, multiply that by .31 and you will get the total monthly payment you can reasonably afford.

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Example: Monthly income of \$2,500 x .31 = \$775.

What price house should you be shopping for? That depends on what interest rate you'll qualify for and how much your taxes and insurance on the property will be. You can ask a loan officer or a housing counselor to calculate this for you based on current interest rates, typical taxes, and insurance rates in your area.

## Debt Ratio

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

Expected mortgage payment:

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 .41.

Example: Total monthly income of \$2,500 x .41 = \$1,025.

The figure you get is the maximum total monthly debt payment you'll be allowed under many conventional loan programs. Ideally, your total monthly debt payments 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.

## Cosigners

If a spouse, relative, or anyone else will be purchasing the home with you, then you should 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.

## 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 financial 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 replacement, etc.	\$
Landscaping and lawn maintenance (also lawnmower and tools)	\$
Pest control	\$
Alarm system	\$
Smoke and CO2 detectors, fire extinguisher	\$
New furnishings	\$
Window coverings	\$
Repairs	\$
Appliance replacement or repair	\$
Other	\$
Other	\$
Other	\$
<b>Total</b>	<b>\$</b>

Save this total and set it aside as a fund for home expenses.

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## 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 up to nearly 98% of the home's price!

However, those loans could be more expensive because of Private Mortgage Insurance (PMI). If you put anything less than 20% down, will be required to pay PMI until you pay off 20% of the home's value.

PMI protects the lender (not you) if you can't make your house payment and go into foreclosure. It can add anywhere from \$25 to \$150 or more to your monthly payment. It's important to know that since PMI is purchased by the lender, the cost may be influenced by your credit rating and it is not tax deductible.



If you're having trouble generating the funds you need, down payment assistance organizations may be able to help. These nonprofit organizations offer programs that allow you to buy a home with no money down on your part.

The seller of the house must participate. Many sellers will want to participate once 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](http://www.downpaymentalliance.org). You don't have to be a first-time homebuyer to take advantage of one of these programs.

## Closing Costs

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

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may seem bewildering. Closing costs, also called “settlement costs,” usually account for about 4% of the loan amount – sometimes more. If you don’t have a lot of cash, you can 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 to your closing statement.

Some estimated items will change. When your loan goes to closing, you’ll get a copy of 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 they 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 the 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 1% 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.

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**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 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. However, 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 the first year's premium at settlement. You can shop

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around to find the best policy for your needs.

**Tip:** A free brochure with tips on homeowner's insurance is available from the National Association of Insurance Commissioners at [www.naic.org](http://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 proper documents are recorded with the city, county, and/or state.

Title charges 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, Title Insurance Binder:** A title search will be conducted to make sure there are no problems, such as property liens, 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

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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.

**1119. 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 the seller, depending on your agreement.

### **Section 1300. Additional Settlement Charges**

**1301. Survey:** The lender may require that a surveyor conduct a property survey. This is a protection for 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 infestations in your home. It is required in some areas of the country.

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**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

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 or more, 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](http://www.ashi.com) for a referral to a qualified inspector in your area.

If possible, accompany the inspector when they inspect the home so they 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 your 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 go up because of a change in the economy.

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## Should I Choose a 15-Year Fixed or 30-Year Fixed Loan?

Your payment will be higher on a 15-year fixed 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 payments when you can afford them.

The downside of a fixed-rate loan is that if interest rates go down you will have to refinance your loan (and pay the 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 3 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

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San Francisco office of the Federal Home Loan Bank. Another is the LIBOR, or the London Interbank 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 worst-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 down payments on loans, and closing costs can be wrapped into the loan. You can finance the loan with as little as 3.5% down. 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 U.S. 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;

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and an 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 HUD-approved lender, who can help you find the right program. There are several 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, Service Members and Reserve Members to purchase, refinance, or improve homes. You can borrow up to 100% 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 of 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 to 3%, with an average of 2%.

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

## **First-Time Homebuyer Programs**

Today, the first-time homebuyer has a variety of loan programs

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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](http://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 few 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. Below 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 canceled deposit money check

## Income and Assets

- Recent paystubs (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 employed
- Tax returns for the last two years, if self-employed

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- \_\_\_ 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)
  - \_\_\_ Proof of other income, such as interest/dividends, retirement income
  - \_\_\_ Court papers and copies of canceled 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 canceled 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

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major credit bureaus: Equifax, Experian, and TransUnion. It will also include your credit score for 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 credit bureaus as soon as you start shopping for a home. You'll usually need at least 30-60 days to fix mistakes or problems you may find.

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

- Missed payments on loans or credit cards that you cosigned for another person
- Payments on joint accounts assigned to your ex-spouse in a divorce that have been missed by more than 30 days
- Medical bills 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

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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 sale price.
- Any necessary inspections (such as 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 your loan proceeds smoothly:

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- 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 the loan professional time to work on your file.