

First-Time Homebuyers Guide



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Introduction

The purpose of this guide is to provide straightforward information on the steps involved in buying a house. Homeownership is not for everyone and by the time you complete this guide you will be able to determine what is best for you. Homeownership is a major undertaking that can lead to financial security, however it takes preparation and knowledge to fully understand the process and potential pitfalls associated with owning a home. Protect yourself and financial well being by understanding the process.

Objectives

- Describe the positive and negative attributes of renting versus owning a home.
- Identify the steps required to buy a home.
- Develop a list of questions that will be helpful to determine your readiness to buy a home.
- Identify and understand basic terms used in a mortgage transaction.
- Understand the advantages and disadvantages of different mortgage options.



Renting Versus Owning a Home

Let's begin by looking at the advantages and disadvantages of renting and owning a home. Depending on your circumstances, lifestyle, and preferences renting is not a bad option. For some people owning a home is not practical and renting has become a preferred choice. There are several advantages to renting.

Some advantages of renting include the following:

- Property maintenance is typically the responsibility of the landlord unless you rent a house then you may be responsible for maintaining the yard.
- Rental contracts vary from month-to-month to a year or more providing options for moving easily, if you wish to do so.
- You don't have to deal with the additional costs of homeownership such as property taxes or homeowner's insurance.
- Renting requires less financial commitment up-front. Instead of a 10 to 20 percent down payment of the purchase price you only need to come up with deposit money.

Note: Even though you don't have to carry homeowner's insurance it is a good idea to consider renter's insurance, even though it isn't required. Renter's insurance protects your personal property and assists in case there is a theft or fire in the home or apartment you are renting. Other types of coverage may also be available. Renter's insurance is typically less expensive than homeowner's insurance.

Some disadvantages of renting include the following:

- When you rent you are responsible, financially, for any damages you may cause to the home.
- Your rent could increase when your lease is up.
- The owner may not renew your rental contract causing you to find a new place to live.
- If you live in a complex with other renters you may have noise and parking issues.
- Can't make major changes to the property without approval such as painting the interior.

For many Americans owning a home has been part of the American dream because there are many benefits to homeownership.

Benefits of owning a home include:

- Pride of ownership is a big part of owning a home.
- You can build equity in your home. Equity refers to the value of the home minus the debt you owe on it. As time progresses your principal is paid down and the value of your home increases thus building equity.
- As you build equity you can borrow against that equity for many purposes.
- Since the value of homes tends to increase over time it makes it a safe place to invest your money.
- Once you pay your mortgage in full the home is yours.
- Homeownership has tax advantages as well and may reduce the amount of income tax you owe, since property taxes and mortgage interest are deductible.
- You can do what you want with the home such as remodeling.
- You can pass your home to your family.



Now that we have looked at a few of the advantages of homeownership lets take a quick look at the costs.

Costs and disadvantages of owning a home:

- Homeowners' insurance.
- Real estate taxes.
- Association fees.
- When you own a home the property maintenance and upkeep are your responsibility. If the furnace breaks you pay to fix it.
- Less mobility. If you need to move for some reason it takes time to market and sell your home. In some real estate markets this can be extremely difficult.

- It is also important to note that you can lose your home, investment in your home, and equity if you fail to make your mortgage payments on time.

Steps in Buying a Home

In order to adequately explain the home buying process we are going to break it down into five steps:

- Step 1 – Determine your readiness in buying a home.
- Step 2 – Determine how much home, mortgage, you can afford.
- Step 3 – Determine the best mortgage option for you.
- Step 4 – Qualify for the loan.
- Step 5 – Go through settlement and closing.

Am I Ready to Buy a Home?

We are going to start off this section of the guide with a story to aid in the understanding of the home buying process. In this story we will follow Zac through his experience of buying a home for the first time.

The story begins...

“After completing his college degree, Zac got a full-time job in the medical field making \$49,200 a year, or \$4,100 a month. Till this point Zac has been living with his parents and has decided to move out on his own. Considering his situation he has decided that buying a home is something that appeals to him.”

The first step to homeownership is first determining if you are ready to buy a home. To do this, ask yourself the following questions:

- Do I have a steady source of income, ie. full-time job?
- Have I held employment on a regular basis for 2-3 years?
- Is my income reliable?



- Do I have a credit history?
- Do I have a good record of paying my bills on time?
- Will I be able to afford to pay my bills and other debt?
- Do I have the ability to make the monthly mortgage payment in addition to the taxes, insurance, and maintenance?
- Do I have money saved for a down payment and closing costs?

These are just a few questions that need to be asked and some need additional information to be able to answer. For example; in order to know if you can afford the mortgage payment you need to know how much money you will need to borrow, better yet how much you can afford to pay. Some additional questions that are helpful in determining if you are ready to buy are:

- Where do you want to live?
- Do you have a particular neighborhood you want to live in?
- If you have children, what types of schools are in the area?
- How much space do you need?
- Do you have any special needs that require attention?

When it comes to determining how much home you can afford it depends on how much home you want. Generally, the down payment for a home is 20% of the purchase price. For example, 20 percent of a \$200,000 home is \$40,000. However, there are several programs that you can participate in that require less of a down payment or even no down payment at all. Some states offer first-time homebuyer assistance programs. Remember, the more money you are able to put down on the home upfront the less you will have to borrow.

With what we have just read, if we return to our story about Zac do you think that he is ready to buy a home?

For starters we know that he has a good job making a reliable income. But he has not been working long so he might encounter problems getting a mortgage loan. Another aspect Zac will have to examine is whether or not he will be able to handle a mortgage payment on top of his other bills and expenses. Zac also realizes that he doesn't have much money saved for a down payment. A good place to go when you have questions and need to learn more is a local bank to see if there are programs available that may help.

If you've answered, "yes" to these questions, it may be the right time for you to buy your first home. If there were any questions that you answered, "no" to, consider strengthening those areas. A good place to do that is to attend homebuyer education classes in your area. These types of classes are a good source of information and will help prepare you for home ownership.

Before we discuss step 2 let's take a minute to look at homebuyer assistance programs and what they are.

Homebuyer Assistance Programs

There are a several different programs available for first-time homebuyers. The best way to find out what types are available to you is to ask your lender or local government about the homebuyer assistance programs they offer. Local real estate agents may also be a good source of information.

Characteristics of Government Programs

Government loan programs are generally geared toward individuals and families with a modest income and will have one or more of the following characteristics:

- Zero or low down payment requirements.
- Flexible underwriting standards. This could mean that the lender will take into account non-traditional forms of credit history, such as utility payments or rent, and higher ratios of debt to income.
- Longer payment terms than the average mortgage loan. In this case your monthly payment would be lower but it would take longer to repay.
- You may be required to take a homeowner education class where they educate on topics such as; budgeting, finding the right home, how to get a loan, and home maintenance.
- Government program restrictions might include purchase price limitations, service charges, and higher loan origination fees.

We are going to look at one more thing before we determine how much home you can afford and that is what makes up a monthly mortgage payment.

Your mortgage payment will consist of the following costs:

1. Principal – the outstanding balance of the loan.
2. Interest - the cost of borrowing the money (APR).
3. Taxes – equal 1/12th of the estimated annual real estate taxes on the home.
4. Insurance – equals 1/12th of the annual homeowner’s insurance premium.
5. Private mortgage insurance (if required).

You will most likely pay the insurance and taxes along with your principal and interest to the lender monthly.

How Much Mortgage can You Afford?

When buying a home whether it is your first home or 10th it is always important to keep in mind that banks compete. By shopping and comparing home mortgage options from several lending institutions you will be able to get the best deal possible and potentially save thousands of dollars.

Before we discuss how much mortgage you can afford lets take a look at one very important item. That is the Fair Housing Act. The Fair Housing Act prohibits discrimination on the basis of race, color, religion, sex, national origin, family status, or handicap in housing related transactions. This law will protect you from discrimination throughout the loan process.

Loan Decision Making Factors

Lenders typically use four factors to qualify you for a loan, also know as the Four Cs of Loan Decision-Making.

1. Capacity – do you have the ability (present and future) to meet your payment obligations including your bills and other debts.
2. Capital – refers to the value of your assets and your net worth.
3. Character – defers, partly, to your credit report to determine your willingness to repay your debts. Do you pay on time?
4. Collateral – refers to property or assets offered to secure a loan.

Pre-Qualification

As you begin the home mortgage process you will become very familiar with what is known as the “pre-qualification”. Pre-qualification is an informal method of determining a ballpark figure of how much mortgage you can obtain. In order to get a no obligation quote you will be required to provide the following information:



- Employment
- Income
- Down payment information
- Outstanding debt

Pre-Approval

Another term you will hear when discussing mortgages is “pre-approval”. Pre-approval is a commitment from the lending institution to lend you the money needed to make your home purchase. The pre-approval process allows you to determine how much money you can borrow and indicates to the sellers you are prepared and serious about buying a home.

In order to obtain pre-approval, you will need to gather financial records and fill out a loan application. You will usually require the following:

- Pay stubs from your current job for the past several months.
- W-2 forms for the last 2 years.
- Tax returns for the past 2 years.
- Information concerning your assets and long-term debts.
- Recent bank statements.
- Proof of any additional income that you may be receiving such as; child support, alimony, etc. If you don't want additional income considered when applying for the loan then you are not obligated to provide this information.

Lets put thing into perspective and run through a quick exercise. Generally, most individuals are capable of affording a mortgage two to three times their household income. If we were to look at Zac's income from the previous example, his annual income was \$49,200. He might be able to afford a mortgage of \$98,400 to \$147,600.

$$\begin{aligned} \$49,200 \times 2 &= \$98,400 \\ \$49,200 \times 2.5 &= \$123,000 \\ \$49,200 \times 3 &= \$147,600 \end{aligned}$$

It is important to remember that just because you qualify for that amount does not necessarily mean you afford or be comfortable with the monthly payments. Taking your circumstances, future financial needs and goals into consideration is extremely important.

Mortgage lenders examine the debt-to-income ratios when reviewing an application or pre-qualification for a home loan. This ratio is your monthly expenses compared to your monthly gross income.

Lenders consider monthly housing expenses as a percentage of income and total monthly debt as a percentage of income. When determining whether or not to make the loan, both ratios are a factor to lenders.

Generally speaking, lenders require the principal, interest, taxes, and insurance (PITI) or your housing expenses to be less than or equal to 25% to 28% of your monthly gross income. This is called the front-end ratio. In other words, since Zac's gross monthly income is \$4,100 his mortgage payment including escrow should \$1,148 or lower.

$$\mathbf{\$4,100 \times 28\% = \$1,148 \text{ (maximum monthly housing costs)}}$$

Lender will also look at the long-term debt you have as well. They typically require that the housing expenses plus long-term debt be less than or equal to 33% to 36% of your monthly gross income. This is known as the back-end ratio. Since Zac's gross monthly income is \$4,100, the combination of his mortgage, \$1,148, and his other long-term debt should not exceed \$1,476.

$$\mathbf{\$4,100 \times 36\% = \$1,476 \text{ (maximum total debt)}}$$

What is Zac's maximum amount of other debts (credit cards, student loan, car payment etc..)?

$$\mathbf{\$1,476 \text{ (max total debt)} - \$1,148 \text{ (max housing costs)} = \$328}$$

Zac’s monthly debt cannot exceed \$328. Long-term debt is outstanding debt with a remaining term of more than 10 or 11 months. It can include items such as:

- Credit card bills
- Car loans
- Student loan payments
- Other bank loans

If your debt-to-income ratio exceeds these ratios, talk to your lender about options that may be available to you.

Additional Factors

There are two additional factors that affect how much you can borrow to buy a new home.

1. The length (term) of the mortgage loan.
2. The type of interest rate associated with the loan (variable or fixed).

Mortgage loans range from 10-year to 50-year terms, however a mortgage is typically 15-year to 30-year terms. The tables below show some of the positive and negative of each term.

15-Year Mortgage	30-Year Mortgage
Borrow less money Build equity in the home faster Less interest to pay Larger monthly payment Lower interest rate	Borrow more money Build equity slower Can deduct more interest from income tax Lower monthly payment Higher interest rate
<i>For example: If you borrowed \$75,000 for 15 years at 7.5%, your monthly principal and interest payment would be \$695</i>	<i>For example: If you borrowed \$75,000 for 30 years at 8%, your monthly principal and interest payment would be \$550</i>

Now that you understand how the length of the loan affects your monthly payment lets take a quick look at how a fixed versus variable rate will affect your mortgage payment.

Fixed-Rate Mortgage	Adjustable-Rate Mortgage
<p>Interest rate remains the same for the term of the mortgage loan.</p> <p>Your payments are predictable and not affected by fluctuations of interest rates.</p> <p>Interest rates could go down while you are locked into your mortgage at a higher than market rate.</p>	<p>Interest rate can increase or decrease during the term of the loan.</p> <p>You might have a low rate for an initial period of 1, 3, 5, 7, or 10 years.</p> <p>Monthly payments can be lower than fixed-rate loans.</p> <p>The interest rate and your payment can increase significantly throughout the life of the loan.</p>

Determine the Best Mortgage Option for You

There are several types of mortgage options available. They are traditional mortgage, interest-only mortgage, and biweekly payment mortgage.

Up till this point we have been looking at what a traditional or conventional mortgage looks like. Now we will take a look at interest-only mortgages and biweekly payment mortgages.

Interest-Only Mortgage

Unlike the traditional or conventional mortgages, interest-only mortgage loans are mortgages in which only the interest is paid in the initial monthly payments, not the principal. After a specified period you will be required to pay the entire principal balance in a lump sum or you may be required to start paying regular mortgage payments that include principal.

Interest-only mortgages have a lower monthly payment, so borrowers can purchase a home they might otherwise not be able to afford. However it is important to be very careful and read the fine print. The mortgage payment may increase over time if the interest rate is adjustable.

Biweekly Payment Mortgage

With a biweekly payment mortgage borrowers can pay down their mortgage faster because every year, they pay 26 smaller biweekly payments instead of 12 monthly payments. Biweekly payment mortgages are typically fixed-rate conventional mortgages. The same can be done with a conventional mortgage, however you need to make sure there isn't a penalty for paying your mortgage off early.

Qualify for a Loan - Getting the Best Deal Possible

There are 3 things to remember in order to get the best mortgage deal possible; shop, compare, and negotiate. Once you have made up your mind on the type of mortgage that meets your needs best you need to take several more steps in order to get the best price possible.

1. On the same day contact several different lenders to get compare quotes.
2. Checking interest rates on the Internet or local newspaper is a good starting point but keep in mind that rates change frequently so you may not get the published rate.
3. Let lenders compete for your business by making it public knowledge that you are shopping for the best mortgage deal.
4. From each lender you talk to it is important to get the costs of the loan in writing.
5. Don't forget to negotiate for the best deal possible. Don't be afraid to ask the lender for better terms than originally quoted. Ask the lender to waive or reduce one or more of the fees.
6. Use the APR and good faith estimate of closing costs to compare all costs.

Good Faith Estimate

Be certain to obtain a good faith estimate of settlement service charges you will probably have to pay. By law the mortgage company or broker is required to provide this information but not until you have applied for a home loan.

Keep in mind that the amounts outlined on the good faith estimate are just that, estimates. Actual costs may vary. Changes in market conditions can and most likely will affect prices.

Hold on to your good faith estimate so you can compare it with the final settlement costs and ask the lender questions about any changes.

Mortgage Shopping Worksheet

The mortgage shopping worksheet is a great tool to help compare mortgage offers side by side and the costs associated with each. To compare terms before you fill out the mortgage application ask the lender for the information listed on the worksheet.

There are several sections associated with the worksheet:

- Section A – Basic loan information
- Section B – Fees
- Section C – Closing costs
- Section D – Totals sections A, B, and C
- Section E – Other questions and considerations about the loan

MORTGAGE LENDING WORKSHEET

	Lender 1		Lender 2	
	<i>Name of Lender</i>			
	<i>Name of Contact</i>			
	<i>Date of Contact</i>			
<i>Mortgage Amount</i>				
A. Basic Information about the loan	Mortgage 1	Mortgage 2	Mortgage 1	Mortgage 2
① Type of Loan: Fixed rate, variable rate, conventional, FHA, other?				
① Minimum down payment requirement				
① Loan term (length of loan)				
① Contract interest rate				
① Annual Percentage Rate (APR)				
① Points (may be called discount points)				
① Monthly PMI payments (mortgage insurance)				
① How long must you keep PMI?				
① Estimated monthly escrow for taxes and insurance				
① Estimated monthly payment (Principal, Interest, Taxes, Insurance, PMI)				
B. FEES – different banks have different names for similar fees. Listed below are some of the typical fees you may see on loan docs				
① Application or loan processing fee				
① Origination or underwriting fee				
① Lender fee or funding fee				
① Appraisal fee				
① Attorney fees				
① Document preparation and recording fees				
① Broker fees (may be quoted as points, origination fees, or interest rate add-on)				
① Credit report fee				
① Other fees				
C. Other Costs at Closing/Settlement				
① Title Search/Title Insurance For Lender For You				
① Estimated prepaid amounts for interest, taxes, hazard insurance, payments for escrow				
① State and local taxes, stamp taxes, transfer taxes				
① Flood determination				
① Prepaid PMI				
① Surveys and home inspections				
D. Total Fees and other closing/settlement cost estimates				

MORTGAGE LENDING WORKSHEET (Continued)

<i>Name of Lender</i>	Lender 1		Lender 2	
	Mortgage	Mortgage	Mortgage	Mortgage
	1	2	1	2
E. Other Questions and Considerations about the loan				
❶ Can any of the fees or costs be waived?				
Prepayment Penalties				
❶ Is there a prepayment penalty?				
❶ If so, how much is it?				
❶ How long does the penalty period last? (3 yrs? 5yrs?)				
❶ Are extra principal payments allowed?				
Lock-ins				
❶ Is the lock-in agreement in writing?				
❶ Is there a fee to lock-in?				
❶ When does the lock-in occur – at application, approval or another time?				
❶ How long will the lock-in last?				
❶ When the rate drops before closing, can you lock-in at a lower rate?				
If the loan is an adjustable rate mortgage:				
❶ What is the initial rate?				
❶ What is the maximum the rate could be next year?				
❶ What are the rate and payment caps each year and over the life of the loan?				
❶ What is the frequency of rate change and any changes to the monthly payment?				
❶ What is the index the lender will use?				
❶ What margin will the lender add to the index?				
Credit Life Insurance				
❶ Does the monthly amount quoted to you include a charge for credit life insurance?				
❶ If so, does the lender require credit life insurance as a condition of the loan?				
❶ How much does the credit life insurance cost?				
❶ How much lower would your monthly payment be without the credit life insurance?				
❶ If the lender does not require credit life insurance, and you still want to buy it, what rates can you get from other insurance providers?				

Settlement and Closing

After you have obtained financing and your offer on a home has been accepted you will need to go through the settlement and closing process.



Settlement occurs when you (the borrower) meets with the seller and other representatives to sign the documents that will finalize the home sale and mortgage financing. Be sure to compare the mortgage documents with the good faith estimate for discrepancies and if you find some be sure to inquire to why.

There is a lot of paper work at closing and it is easy to get overwhelmed. Take your time and don't sign anything you don't understand.

Congratulations You are Now a Homeowner!!

Glossary

Adjustable-Rate Mortgage (ARM)

An adjustable-rate mortgage has an interest rate that might change during any period of the loan as written in the contract (loan agreement).

Annual Percentage Rate (APR)

The APR is a measure of the cost of your loan expressed as a yearly percentage rate, such as 10 percent or 11 percent.

Asset

An asset is anything owned by a person or organization having monetary value.

Balloon Mortgage

A balloon mortgage is a large payment at the end of your loan term. This is often after a series of low monthly payments. A balloon mortgage generally offers very low rates for an initial period of time (usually 5, 7, or 10 years). After the period ends, the entire balance is due. Many borrowers pay the balance by refinancing their mortgage.

Broker

A mortgage broker helps a prospective borrower shop around for the best rate and terms in obtaining mortgage financing. You pay the broker a fee for this work.

Caps

Caps are provisions of an adjustable rate mortgage, which limit how much the interest rate can change at each adjustment period or over the life of the loan. A payment cap limits how much the payment due on the loan can increase or decrease.

Closing Costs

Closing costs are various charges associated with the transfer of property. The lender must disclose these costs to you.

Compensating Factors

Compensating factors are favorable factors that might outweigh the negative factors. For example, a borrower has high ratios, but he or she balances this with a good credit history and extra cash in a savings account.

Condominium

A condominium is an apartment building or multiple-unit housing area in which the living units are owned individually.

Conventional Loan

A conventional loan is a mortgage that is not guaranteed, insured, or made by the Federal Government.

Debt-to-Income Ratio (DTI)

DTI is the ratio of monthly debt payments to monthly gross income. Lenders use DTI ratio to determine whether a borrower's income qualifies him or her for a mortgage.

Down Payment

The down payment is the portion of the home's purchase price the buyer pays in cash.

Duplex House

A duplex is a house divided into two living units.

Finance Charge

The finance charge is the dollar amount the credit will cost.

Fixed-Rate Loan

A fixed-rate loan has an interest rate and payment amount that stays the same throughout the term of the loan.

Good Faith Estimate (GFE)

When you apply for a loan, the Real Estate Settlement Procedures Act (RESPA) requires that the lender or mortgage broker give you a GFE of the settlement service charges you will likely have to pay.

Government Mortgages

A government mortgage is insured by the Department of Housing and Urban Development (HUD) (through the Federal Housing Administration) or guaranteed by the Department of Veterans Affairs or the Rural Housing Service.

HUD-1 Settlement Statement

A HUD-1 Settlement Statement is a summary of all the costs paid by the buyer and seller in a mortgage transaction.

Index

The index is a base interest rate used to calculate the interest rate that will be charged on a variable-rate loan. The rate you will pay on a variable rate loan is usually a set percentage above the base rate, or the index.

Individual Development Account (IDA)

An IDA is a matched savings account. When an account is matched, it means that another organization, such as a foundation, corporation, or government entity, agrees to add money to your account.

Interest

Interest is the charge for borrowing money.

Lien

A lien is a legal claim on the home that secures the promise to repay the debt.

Loan Origination Fees/Underwriting Fees

These are fees charged by the lender for processing or evaluating the loan application and are often expressed as a percentage of the loan amount.

Loan to Value (LTV)

LTV is the amount of money you borrow compared to the price of the property you are buying.

Mortgage

A mortgage is a legal document whereby the borrower pledges property to the lender to ensure payment of a loan.

Principal, Interest, Taxes, and Insurance (PITI)

PITI are the factors included in the standard mortgage payment.

Point

A point is the amount equal to 1 percent of the loan amount. It is a fee paid to the broker or lender for the loan, often linked to the interest rate.

Principal

The principal is the loan amount borrowed or still remaining on the loan.

Private Mortgage Insurance (PMI)

PMI is mortgage insurance issued by private insurers that protects the lender against loss in the event the borrower defaults on a mortgage with a low down payment.

Rate Lock

A rate lock is the time period, usually 30 to 60 days, that a mortgage lender agrees to hold the mortgage rate and points payable by the borrower to the rate quoted by the lender on a given day.

Real Estate Agent

A real estate professional that helps people buy and sell property.

Settlement Costs/Closing Costs

These are fees associated with the transfer of property to a purchaser and recording the mortgage lien on the property deed by the bank financing the transaction. They may include application fees, title examination, abstract of title, title insurance, and property survey fees; fees for preparing deeds, mortgages, and settlement documents; attorney's fees; recording fees; and notary, appraisal, and credit report fees.

Title

The title indicates the right of ownership in the property.

Title Insurance

Title insurance protects the buyer and lender against losses arising from disputes over the ownership of property.

Townhouse

A townhouse is one of a row of houses connected by common side walls.

Additional Resources:

<http://www.hud.gov>