Shopping and Qualifying for a Mortgage

Overview

Information on how to shop for a mortgage, what you need to qualify, and how much you can afford to pay each month.

- How much cash do you need up front?
- What if you don't have that much cash?
- How much can you afford to pay every month?
- How much money can you borrow?
- How much money *should* you borrow?
- How to choose a lender
- How to choose a mortgage
- How to qualify for a mortgage
- What if you've had credit problems in the past?
- Prequalification and preapproval
- Getting help and advice

Whether you're buying a house, an apartment, or a condominium, the purchase is probably the biggest you've ever made. And the mortgage is probably the largest amount you've ever borrowed. You may wonder right up to the signing whether you've made the right deal. But if you shop carefully for a mortgage, you'll feel confident that you have made the right decision. Luckily, there is a lot of information available to help you shop for a mortgage.

How much cash do you need up front?

Here are some of the main up-front costs you will need to plan for when buying a home:

- *Down payment.* For most regular mortgages, you will need a down payment of 5 to 20 percent of the price of the home. For low-down-payment loans, you will need 3.5 percent. For example, if you are buying a $50,000 house or condominium, a 20-percent down payment would be $10,000; a 5-percent down payment would be $2,500; a 3-5 percent (low) down payment would be $1,750. A home loan from the VA (Department of Veterans Affairs), if you're eligible, allows for zero-down-payment mortgages, but experts suggest that you put some percentage down so that you're not 100-percent financed.
- *Points.* Some loans include extra money up front in return for a lower interest rate. You pay some percentage of the loan amount, and each percent is called a "point." For example, if you take out a $50,000 mortgage and agree to pay two points, that's 2 percent of $50,000, or $1,000.
- *Origination fee*. An origination fee, or activation fee, is a fee charged by a lender upon entering into a loan agreement to cover the cost of processing the loan. This is usually equal to 1 percent of the loan amount.
- *Closing costs*. There are a number of extra expenses you have to pay when you finally sign the papers and buy a home. Some of these are required by state and local laws, others are required by the bank lending you the money. Closing costs can add 3 or 4 percent to the cost of your home. They include:

  - escrow fees
  - pre-payment of property taxes
  - title insurance
  - appraisal
  - survey charges

- contract registration
- transfer tax
- deed recording
- water and sewer fees
- mortgage insurance for low-down-payment loans
- pre-payment of homeowner's insurance

Closing costs can add up, so you need to plan for them. Luckily, banks are required to tell you in advance, to the best of their ability, what your closing costs will be. This is called a "good faith estimate." To get a sense of what closing costs might be for a mortgage, check out the calculator at *http://calculators.aol.com/tools/aol/home09/tool.fcs*.

- *Inspection fees.* It costs $200 to $400 to have a home inspected before you buy it, and some lenders also require radon, lead, and termite tests. Inspection fees will vary with the type of home and number of rooms and will be higher for multifamily homes. In certain parts of the country, expect to pay $100 an hour for an inspection. It's very important to comparison-shop and to interview several inspectors to find out what kind of training they have, whether they are licensed, and what they charge. Unlicensed inspectors are perfectly legal but may not be as well trained. For help with finding a suitable home inspector, visit the website for the American Society of Home Inspectors at *www.ashi.org*.
- *Other costs.* If your new home needs repairs or if you plan to do work on it right away, you'll have to take that into account when you figure out how much money you'll need up front. Moving day can be expensive, and you may have to take some time off work, which can also cost you money. You may also have to pay deposits to start up new utilities, rent a moving van, and buy items to take care of your home, like garden tools or a lawnmower.

What if you don't have that much cash?

There are several ways to pay less cash up front:

- *Low-down-payment loans*. These loans require a down payment of as little as 3.5 percent of the cost of the house or condominium. However, to get this kind of loan, you'll also need to pay for mortgage insurance that protects the lender if you default on the loan. The mortgagee lender will outline the type and amount of mortgage insurance required for the mortgage loan you have agreed to. VA loans are the exception and do not require mortgage insurance. State and local housing finance agencies can also make mortgage money available with low down payments, between 3.5 and 5 percent if you qualify.

- *HUD homes*. If you buy a home from the U.S. Department of Housing and Urban Development (HUD), HUD will sometimes pay some of your closing costs, up to 6 percent of the cost of the home.
- *Seller-paid points*. Sometimes the seller will pay your points or part of your closing costs in exchange for a higher purchase price. That way, you pay less cash up front, but your monthly payments will be higher.
- *Low- or no-point loans*. Shop around and you may find a lender willing to give you a mortgage with no points. These loans may have higher interest rates, so again, you may be trading lower up-front costs for higher monthly payments.

How much can you afford to pay every month?

Mortgage lenders want to lend you their money, but they don't want you to get into debt over your head. They know if that happens, they probably won't get their loan back. Here are two guidelines that lenders use to see how big a mortgage you can afford:

- *What percentage of your monthly gross income would be spent on housing costs?* Gross income is your income before taxes are taken out. Housing costs, usually paid all together in one monthly payment, include the mortgage principal (the money you borrowed), the interest you are paying on the principal, 1/12 of your real estate taxes, and 1/12 of your homeowner's insurance.
- *What percentage of your monthly gross income would be spent on housing costs plus monthly long-term debt payments*, such as car payments, college loan payments, and personal bank loans? Any expense that extends 11 months or more into the future is considered a long-term debt.

These two percentages are called "qualifying ratios." What percentage actually qualifies you for a loan depends on what kind of loan it is:

- *Conventional bank loan*. Monthly housing costs should be no more than 28 percent of your gross monthly income. For example, if your gross income is $4,000 a month, 28 percent of that is $1,120. So if you would be paying $1,000 a month for housing costs, that's within the limit. But if the housing costs worked out to $1,300 a month, that would be too much. Monthly housing costs plus long-term debt payments should be no more than 36 percent of your gross monthly income. But 36 percent of $4,000 is $1,440. So monthly housing costs of $1,300 might be acceptable with a $4,000 monthly gross income, but only if you have no more than $140 a month of other long-term monthly debt payments.
- *Government-insured (Federal Housing Administration) loan*. The two qualifying ratios (monthly housing costs and monthly housing costs plus long-term debt payments) are 31 percent and 43 percent.

- *Loans for low- and moderate-income first-time homebuyers*. These are loans for people who meet certain eligibility guidelines established by either the state or federal government. For these loans, the qualifying ratios are generally 33 percent and 38 percent.

  Now take a look at the chart on the next page. Find your gross annual or gross monthly income in the first or second column. Then you can see what lenders would consider your maximum affordable total housing costs for these three types of loans.

Chart 1: How much money can an individual pay each month?

Annual gross income	**Monthly gross income**	**Bank mortgage** (28% of monthly gross income)	**Government-insured mortgage** (31% of monthly gross income)	**Loans for low- and moderate-income first-time homebuyers** (33% of monthly gross income)
$14,000	$1,167	$327	$362	$385
$15,000	$1,250	$350	$388	$413
$16,000	$1,333	$373	$413	$440
$17,000	$1,417	$397	$439	$468
$18,000	$1,500	$420	$465	$495
$19,000	$1,583	$443	$491	$522
$20,000	$1,667	$467	$517	$550
$21,000	$1,750	$490	$543	$578
$22,000	$1,833	$513	$568	$605
$23,000	$1,917	$537	$594	$633
$24,000	$2,000	$560	$620	$660
$25,000	$2,083	$583	$646	$687
$26,000	$2,167	$607	$672	$715
$28,000	$2,333	$653	$723	$770
$30,000	$2,500	$700	$775	$825
$32,000	$2,667	$747	$827	$880
$35,000	$2,917	$817	$904	$963

How much money can you borrow?

Once you find out from Chart 1 how much the bank thinks you can afford to pay each month for total housing costs, you can use Chart 2 to see how much money you would be able to borrow.

Chart 2: How much money can an individual borrow?

Amount borrowed	Fixed interest rate on a 30-year mortgage						
	4%	4.5%	5%	5.5%	6%	6.5%	7%
$25,000	$120	$126	$134	$142	$150	$158	$166
$30,000	$143	$152	$161	$170	$180	$190	$200
$40,000	$190	$202	$215	$227	$240	$253	$266
$50,000	$238	$253	$268	$284	$300	$316	$332
$60,000	$286	$304	$322	$340	$360	$379	$399
$70,000	$334	$355	$376	$397	$420	$442	$466
$80,000	$381	$405	$429	$454	$480	$506	$532
$90,000	$430	$456	$483	$511	$540	$569	$599
$100,000	$477	$507	$536	$568	$600	$632	$665
$110,000	$525	$557	$590	$624	$660	$695	$732
$120,000	$573	$608	$644	$681	$720	$758	$798
$130,000	$620	$658	$698	$738	$780	$822	$865
$140,000	$668	$709	$751	$795	$840	$885	$931
$150,000	$716	$760	$805	$851	$900	$948	$998

Say, for example, that your monthly gross income is $1,850. Looking at Chart 1, you can see that for a regular bank mortgage, your monthly housing costs should not be more than $513. (For a government-insured loan, they should not be more than $568.)

Now, let's say the current mortgage interest rate is 4 percent. Looking at the 4 percent interest rate column on Chart 2, you'll see that if monthly costs are to be no more than $513, the amount borrowed must be just under $110,000. (A bank's mortgage officer would be able to give you an exact number.)

Bear in mind that you may need to borrow more than $150,000 (or possibly get an interest rate even lower than 4 percent). To get an idea of your mortgage payment, use the mortgage calculators on *www.lifeworks.com*. Search for "financial calculators."

How much money *should* you borrow?

You and the bank have one thing in common: Neither wants to see you go broke. The point of the mortgage process is to figure out how big a monthly payment you can afford to take on without getting in over your head. The bank has a lot of financing experience, but you are the one who knows your own particular situation.

Surprising as it may sound, your lender is likely to offer you more than you can afford. Banks look into some of your expenses, but not all of them. For example, they do not take into account the money you may have to spend every month on child care, on medical care for special conditions, on travel to visit your relatives, on an expensive hobby, on repairs to your aging car -- not to mention your monthly expenses for food, gas, and utilities.

Following is a worksheet that will help you figure out how much you can actually afford to spend on housing. You can also find worksheets like this on the Fannie Mae website at *www.fanniemae.com*. (Fannie Mae is a private, for-profit company, chartered by Congress, which works to make more mortgage money available to people trying to buy homes.)

Step 1: Determine net monthly income

Gross monthly income

Gross base pay (all wages and salaries other than overtime)	$_____
Net profit (from any business)	+$_____
Interest and dividends	+$_____
Other income	+$_____
Total gross monthly income (add)	=$_____

Deductions

Income tax (federal, state, and local)	$_____
Social Security tax/retirement contributions	+$_____
Insurance premiums (life, health, property)	+$_____
Other (charities, etc.)	+$_____
Total deductions (add)	=$_____

Step 1: Total monthly take home pay $_____
(subtract deductions from income)

Step 2: Determine long-term monthly obligations

Car loans (per month)	$_____
College loans (per month)	+$_____
Installment payments on furniture, etc. (per month)	+$_____
Other debt, over 11 months (per month)	+$_____
Total long-term monthly debt (add)	=$_____
Step 2: Subtract long-term monthly debt from total take-home pay (Step 1)	$_____

Step 3: Determine monthly non-housing expenses

Food, beverages (home and eating out)	$_____
Transportation, all auto expenses	+$_____
Education	+$_____
Medical, dental, vision care (out of pocket)	+$_____
Clothing and grooming	+$_____
Insurance (life and health) beyond what's deducted from payroll	+$_____
Child care	+$_____
Entertainment, vacation, and recreation	+$_____
Gifts and charity	+$_____
Savings	+$_____
Other (pets, licenses, gym, lottery, allowances)	+$_____
Total monthly non-housing expenses (add)	=$_____
Step 3: Subtract monthly non-housing expenses from total of Step 2	$_____

Step 4: Estimate monthly housing expenses

Proposed mortgage payment	$_____
Allowance for mortgage insurance (if applicable)	+$_____
Allowance for utilities (heat, water, phone, electricity)	+$_____
Allowance for maintenance, emergency repairs, furnishings	+$_____
Allowance for homeowner's/property insurance	+$_____
Step 4: Total estimated monthly housing expenses (add)	=$_____

Step 5: Compare

Compare estimated monthly housing expenses (Step 4) with available income (Step 3)

Total from Step 3: $_____

Total from Step 4: $_____

If your available income is less than your estimated monthly housing expenses, then you must rethink your plans. You need to spend less on a house, spend less on other expenses, or find a way to earn more money.

How to choose a lender

It's easy to feel intimidated when you're buying a home. You hope someone will lend you the money, and you hope you can keep your promise to pay it back. But you need to remember that banks and other lenders are eager for your business.

Banks, credit unions, mortgage lenders, and savings and loan companies all offer mortgages. You can look in the newspaper or the yellow pages to see who your local lenders are. You may see their rates listed in the paper, but remember that these rates change all the time. Bankrate.com (*www.bankrate.com*) also offers a list of mortgage lenders who offer loans in your area.

There are also mortgage brokers, who do not make loans themselves but can shop around and find a lender for you. It's important to remember that a mortgage broker is not necessarily working to get you the best deal. They may be trying to promote mortgages where they earn the highest commissions. You can ask the broker to show you loan comparisons and to advise you as to which deal is best for you.

You can't always tell when you are dealing with a broker. Some banks act both as lenders and as brokers. Make sure you know whether there's a broker involved in any deal, because you may find that you owe a broker's fee as well as the lender's fees.

It is very important to visit a few lenders and see what kinds of mortgages they can offer you. Be sure to see what your own bank (where you have your checking and savings accounts) has to offer. Comparison-shopping is a good idea since banks sometimes have special offers.

When you've seen what several lenders are offering you, it's time to negotiate for the best deal you can get. Mortgage officers often have some leeway to sweeten their offer to you, much as car salespeople do. For example, sometimes they can waive or reduce some of the closing costs or reduce the number of points you need to pay. It doesn't hurt to ask for what you want -- you might get it.

How to choose a mortgage

Two of the most common types of mortgages are:

- *Fixed-rate mortgage*. You pay the same interest rate throughout the life of a fixed-rate mortgage. Most fixed-rate mortgages are for 30 years, although some can be as long as 40 years or as short as 10, 15, or 20 years. With this kind of loan, your monthly payment stays pretty much the same month after month, year after year. The only changes to your payment would be to the property tax and home insurance portions of your payment, should either of those amounts change. This type of loan makes sense if you plan to own your home for many years.
- *Adjustable-rate mortgage (ARM)*. An ARM starts with an interest rate that is lower than the going rate for fixed-rate mortgages -- often 3 percentage points lower -- but is then adjusted every so often, rising to match the current interest rate. ARMs do have a cap, though, meaning they can only rise so high, and no higher. Nowadays there are many ARM packages to choose from, ranging from one-year to ten-year ARMs. When you consider an ARM, have your lender calculate how high your monthly payment could possibly go (the cap). This is the worst-case scenario, and you need to be able to afford it if it happens. Also, bear in mind that fixed-rate mortgages are currently very inexpensive and have a fixed rate for the life of the loan. Often, fixed-rate loans aren't much more expensive than an ARM -- and they carry no risk of interest rate changes.

When you shop for a mortgage, the more questions you ask, the better. Take notes and compare the answers you get from different lenders. Don't be afraid to call back and ask what something means or ask a question you forgot to ask the first time.

Here are questions worth asking each lender you speak with:

- What are the current mortgage interest rates, and which are the lowest at the moment?
- Is the rate fixed or adjustable?
- For an adjustable rate, how will my rate and loan payment vary? If rates go down, will my payment go down?
- What is the loan's annual percentage rate (APR)? (This is a good figure for comparing different loans.)
- What do the points amount to in dollars?
- What is each fee and closing cost actually for?
- What do I need to show the bank to prove that I have the money for the down payment?

- Are you offering any special programs?
- If I need mortgage insurance, what will the monthly payment be?
- How long will I need to keep paying the mortgage insurance?

While the down payment and closing costs seem big at the time, it's the principal, interest, and possibly the mortgage insurance that you're going to be paying month after month. (Real estate taxes, too, but you generally can't negotiate those.) It's worth making every effort not to overestimate what you can afford, and then to shop and negotiate for every break you can get.

How to qualify for a mortgage

Two things are important to lenders:

- *Your ability to pay*. Lenders look at the size and stability of your income. They like to see that you have worked at the same place for at least two years or have, at least, been in the same line of work for a few years.
- *Your willingness to pay*. Lenders want to see if you have a history of paying your debts and your monthly bills on time, late, or not at all.

To qualify for a loan, you will need to show that you have:

- enough income to make your monthly payments
- enough cash for the down payment, closing costs, and so on
- a good credit history
- an appraisal of the home, showing that its value is at least equal to the price you are paying for it

Some banks also want to be sure you have enough reserve cash for two months of mortgage payments (in case you lose your job, can't work due to an injury, etc.).

When you meet with a lender, you may need to bring such information as:

- a purchase contract for the house, apartment, or condominium you intend to buy (if you have one)
- bank account numbers and addresses of the banks where you have accounts, along with recent checking and savings account statements
- pay stubs, W2 forms, and tax returns for the last two years or some other proof of your employment and your income
- divorce settlement papers if you are divorced
- current credit card bills and recent canceled checks for rent or utility payments

- documentation for car loans, furniture loans, student loans, and credit cards
- balance sheets and tax returns if you are self-employed
- Gift letters. If a relative or organization is willing to help you with the down payment and/or closing costs, a gift letter states that you are not required to repay the money -- that is, that it won't become another long-term debt.

Remember that there are no absolute rules. You may not look so good in one category, but if you look good in the others, the lender may be happy to grant you a mortgage. Many people go into a lender's office worried about credit card bills that have gotten out of hand or a school loan payment they missed. But plenty of people who've had credit problems get home loans, as long as the problems they've had aren't repeated year after year.

What if you've had credit problems in the past?

Don't assume that past or present credit problems doom you to a high-interest mortgage. If there were understandable reasons for your credit problems and good reasons why the same thing won't happen again, be sure to explain that to the lender.

If you can't "explain away" your credit problems, ask what effect they are having on the price of your loan and what you would have to do to get a better price. For example, your lender might give you a better price if you could pay off a long-overdue credit card debt or if you could show that you've made your college loan payments on time for six months in a row.

It's always a good idea to find out what your credit history is before you apply for any loans. There might be mistakes in your credit record. Annual Credit Report .com (*www.annualcreditreport.com)* will provide you with one free credit report per year from each of the three national credit agencies (Equifax, Experian, and TransUnion). You can also contact these organizations yourself and order a copy of your credit report for a fee (which is what the bank will do):

- Equifax (*www.equifax.com)*: 800-685-1111
- Experian (*www.experian.com)*: 888-397-3742
- TransUnion (*www.transunion.com)*: 800-916-8800

Prequalification and preapproval

Once you've chosen a lender and gotten a general idea of what size mortgage you can afford, it's a good idea to get either prequalification or preapproval:

- *Prequalification* is a good idea if you think it will be at least six months before you actually buy a house. You give your lender some information about your financial status, and he or she gives you an estimate of the loan you could expect. It is very

informal (no one checks the information you give), and it is free. You can even go through this process over the phone. Getting prequalified does not imply any commitment, whatsoever, on the part of the bank.

- *Preapproval* is a good idea if you're going to buy a home within six months. For preapproval, you go through almost the whole loan approval process -- your information is checked and verified, and your credit record is looked up. You may have to pay a fee, but when you find a home, the appraisal of its value is all that is needed for final approval. Also, preapproval often gives you some clout with the seller because it tells the seller that you're a feasible buyer.

  Once you've met with your lender and officially applied for your mortgage, you should know if you are qualified (approved) for a loan within 30 to 60 days, or sometimes a good deal sooner than that. If you are not qualified, the lender is required to explain to you why not and will usually discuss other options with you.

  Once approved for a mortgage, there is often another decision you have to make, whether to "lock in" the interest rate. A typical lock period is for 30 days, and if you think rates may go down you may want to delay locking in a rate until nearer to the closing date. If you think interest rates will go up, you will want to lock in the approved rate right away. No one has a crystal ball to know what interest rates will do in a short period of time, and if you feel the lender has approved you for a good interest rate, then consider locking it in and moving ahead with the other aspects of your home purchase.

Getting help and advice

- *Many communities and organizations offer homebuyer counseling courses*, especially for people buying a home for the first time. These courses explain different kinds of real estate agents and brokers, mortgages and lenders, home inspectors, real estate lawyers, closing costs, and much more. Sometimes, people who take these classes can qualify for lower-interest loans.

- *The Fannie Mae website* (*www.fanniemae.com*) *can guide you to homebuyer counselors in your area*. You can also call their consumer resource center at *800-7-FANNIE (800-732-6643)*.
- *There are many books, pamphlets, websites, and hotlines with information about buying a home*.

Some of the information in this tip sheet is adapted from *How to Buy a Home With a Low Down Payment,* a brochure published by Mortgage Insurance Companies of America in cooperation with the Extension Service of the U.S. Department of Agriculture, and *The HUD Home Buying Guide*, published by the U.S. Department of Housing and Urban Development.

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