Fundamentals of Home Ownership & Mortgages

Buying or renting a home is a big financial decision. And whether it's a condo, a townhouse, or a single family residence — new construction or a home with a history — this transaction will have a significant impact on your budget.

What do you need to know?

Understand the financial differences between renting and home ownership.

While owning a home may be beneficial for some, many people find renting to be a better option. There are plenty of examples that show how renting can save consumers a considerable amount of money. However, the decision to rent versus buying a home is purely a personal choice. Use this calculator to help determine which makes sense for you at this time. Also, read NCUA's Renting vs. Buying a Home for more detailed information.

Know what you can afford.

Review your monthly spending plan to estimate what you can afford to pay for a home, including the mortgage, property taxes, insurance, and monthly maintenance and utilities. Make sure you save for emergencies. Plan ahead to be sure you will be able to afford your monthly payments for several years. Check your credit report to make sure that the information in it is accurate. A higher credit score may help you get a lower interest rate on your mortgage.

Rent vs. Buy? Should You Rent or Buy Your Home?

Sure, there are some intangible advantages to owning your own home, like doing whatever you want to the back yard, or remodeling the kitchen, or painting the kid's room purple. There is the advantage of knowing that no one can make you move – as long as you can afford your monthly payments.

But a home is an investment too. When considering a home purchase, you should at least know the financial cost you are paying to own a home, or the benefits you could receive if the home appreciates.

When calculating your rent vs. buy decision, don't forget to factor in some of these costs:

- Home Maintenance – You can spend a large amount of money in maintenance and updating a home. Home maintenance varies by area, and depends on how old your home is and how much work you choose to do by yourself. Some possible maintenance items may include pool maintenance, tree trimming, air conditioning/ heating maintenance, septic maintenance, home painting, landscaping, etc. If your home isn't new, you should also factor in replacement costs of appliances, roof, kitchens, bath, carpet, etc. For example, if you know you'll have to replace your refrigerator in 2 years, you should set aside $50 per month for that future expense.
- Taxes and Insurance – These are a little easier to track as most homeowners have these escrowed (included in the monthly mortgage payment and paid out by the mortgage company). But before purchasing a home, ask your real estate agent to give you past tax history on the home. Contact your insurance agent to determine how much a policy on the home will cost.
- Homeowner's Association fees – Some homes are in a homeowner's association which carries an extra monthly fee. Find out the monthly fee from your real estate agent.
- Selling costs – Unless you plan on staying in the home forever, you'll need to factor in costs to sell the property. Ask your real estate agent what the owner will be paying in closing costs when he sells the property to you. Closing costs for sellers can include attorney's fees, title insurance, and real estate commissions.

But now for the good news. Owning a home has some financial advantages that you can use to offset some of these costs.

- Appreciation – In most years, homes appreciate in value. Your real estate agent can help you determine how much homes in the area have increased in value in the past 5 or 10 years. Though real estate is cyclical, if you look at a longer time frame, you should be able to get a ballpark estimate as to how much your home may appreciate every year.
- Tax Savings – If you plan to have a mortgage on a property, you can deduct your interest from your taxes, in effect decreasing your monthly mortgage payment. Ask your accountant what your yearly savings will be. As a ballpark, you can multiply your yearly interest payment times .25 to get your yearly savings in taxes.
- Principal – remember that some of your payment is principal that you get back when you sell your home (if you sell it for more than your purchase price. Though the first few years are mostly interest payments, some is principal.

Shop around.

Shopping takes time and energy, but not shopping around can cost you thousands of dollars. To find the best loan, you have to shop around.

Understand loan prices and fees.

Many consumers accept the first loan offered and don't realize that they may be able to get a better loan. On any given day, lenders and brokers may offer different interest rates and fees to different consumers for the same loan, even when those consumers have the same loan qualifications. Keep in mind that lenders and brokers also consider the profit they receive if you agree to the terms of a loan with higher fees, higher points, or a higher interest rate. Shopping around is your best way to avoid more expensive loans.

Ask about down payments and private mortgage insurance.

Some lenders require 20 percent of the home's purchase price as a down payment. However, many lenders now offer loans that require less than 20 percent down — sometimes as little as 5 percent on conventional loans. If your down payment is less than 20 percent, lenders usually require the homebuyer to purchase private mortgage insurance (PMI) to protect the lender in case the homebuyer fails to pay.
When government-assisted programs like FHA (Federal Housing Administration), VA (Veterans Administration), or Rural Development Services are available, the down payment requirements may be substantially smaller.

- Ask about the lender's requirements for a down payment, including what you need to do to verify that funds for your down payment are available.
- Ask your lender about special programs it may offer.

If PMI is required for your loan

- Ask what the total cost of the insurance will be.
- Ask how much your monthly payment will be when the PMI premium is included.

Know the risks and benefits of loan options.

When buying a home, remember to shop around, to compare costs and terms, and to negotiate for the best deal. Mortgages have many features, including:

- fixed interest rates or adjustable interest rates;
- payment adjustments;
- some you pay only the interest on the loan for a while and then you pay down the principal (the loan amount);
- some charge you a penalty for paying the loan off early; and
- some have a large payment due at the end of the loan (a balloon payment).

Consider all mortgage features

the APR (annual percentage rate), and the settlement costs. Ask your lender to calculate how much your monthly payments could be a year from now, and 5 or 10 years from now.

This mortgage shopping worksheet may also help you. Take it with you when you speak to each lender or broker and write down the information you obtain. Don't be afraid to make lenders and brokers compete with each other for your business by letting them know that you are shopping for the best deal. Most lenders should provide initial amortization schedules for the life of the loan based on the features of the loan product.

Once you are ready to buy a home, consult your credit union about competitive interest rates and to find out about your mortgage options, including the term of the loan and the conditions.

Read the fine print. Disclosure statements are legal documents.

A disclosure details all material facts relevant to a transaction. Federal or state laws require financial institutions to provide disclosures containing information about terms to their customers. Reading disclosures can seem like deciphering a bunch of mumbo jumbo. But, disclosure statements contain the critical information you need to make an informed decision about which financial institution, and its products and services, to choose.
To understand your legal rights and responsibilities as well as the rights and responsibilities of the credit union, read the documents you receive from the financial institution. Read the entire disclosure document. Don't be shy about asking for explanations, clarifications, and answers to your questions before you open an account or take out a loan.
You should understand the disclosure statements prior to signing any documents.

Get advice from trusted sources.

Buying a home is the largest investment most Americans will make. A mortgage loan is also one of the most complex, most expensive financial commitments you may ever assume, and it's okay to ask for help. Talk with a trusted housing counselor or a real estate attorney that you hire to review your documents before you sign them. You can find a list of counseling resources at NeighborWorks and on the U.S. Department of Housing and Urban Development's (HUD) website or by calling (800) 569-4287.

Know the different types of mortgage products.

Fixed rate and adjustable rate mortgages are the two main types of mortgages, but there is a wide variety of other mortgage products available. Below are pros and cons of just a few of the mortgage products you may want to consider.

COMMON TYPES OF HOME MORTGAGES

Type of Mortgage	Pros	Cons
Fixed-rate mortgage	No surprises. The interest rate stays the same over the entire term, usually 15, 20 or 30 years.	If interest rates fall, you could be stuck paying a higher rate.
Adjustable-rate (ARM) or variable-rate mortgage	Usually offers a lower initial rate of interest than fixed-rate loans.	After an initial period, rates fluctuate over the life of the loan When interest rates rise, generally so do your loan payments.
FHA (Federal Housing Administration) loan	Allows buyers who may not otherwise qualify for a home loan because of less-than-perfect credit to obtain one with a low down payment.	The size of your loan may be limited.
VA loan	Guaranteed loans for eligible veterans, active duty personnel and surviving spouses Offers competitive rates, low or no down payments.	The size of your loan may be limited.
Balloon mortgage	Usually a fixed rate loan with relatively low payments for a fixed period.	After an initial period, the entire balance of the loan is due immediately This type of loan may be risky for some borrowers.
Interest-only	Borrower pays only the interest on the loan, in monthly payments, for a fixed term.	After an initial period, the balance of the loan is due. This could mean much higher payments, paying a lump sum or refinancing.
Reverse mortgage	Allows seniors (62 or older) to convert equity in their homes to cash; you don't have to pay back the loan and interest as long as you live in the house.	Subject to aggressive lending practices and false advertising promises, particularly by lenders that prey on seniors. Check to make sure the loan is federally insured.

Fair Lending Is Required by Law

The Equal Credit Opportunity Act prohibits lenders from discriminating against credit applicants in any aspect of a credit transaction on the basis of race, color, religion, national origin, sex, marital status, age, whether all or part of the applicant's income comes from a public assistance program, or whether the applicant has in good faith exercised a right under the Consumer Credit Protection Act.

The Fair Housing Act prohibits discrimination in residential real estate transactions on the basis of race, color, religion, sex, handicap, familial status, or national origin. Under these laws, a consumer may not be refused a loan based on these characteristics nor be charged more for a loan or offered less-favorable terms based on such characteristics.

Income Requirements to Buy a Home

It's not all about the take-home pay when buying a home. Banks look at both your INCOME and DEBT when deciding whether you qualify. They rely on two ratios, often called the "front-end" debt-to-income (DTI) ratio and the "back-end" debt-to-income ratio. You can calculate these ratios yourself and determine how much home payment you can afford and the home payment the banks say you can afford.

DTI ratios change by Fannie Mae and FHA decree, so it's important to contact your lender to determine what DTI ratios are required for your type of loan and your financial situation, but a DTI front-end ratio of 31% and back-end ratio of 43% is a good place to start.

The front-end debt-to-income ratio is the amount of your monthly house payment divided by your gross (before taxes) monthly income. To calculate your monthly house payment, add up the interest and principle payments, taxes and homeowner's association dues. Here's an example:

Principal and interest:	$800
Monthly property tax:	$50
Home Owners Assoc: HOA Fees	$50
Total payment:	$900
Monthly Income:	$3000
Front end ratio: $900 / $3000	30%

At a front end ratio requirement of 31%, the above scenario would work. Note that conventional loans may not have a front end ratio requirement.

The back-end ratio is where many borrowers get tripped up. To calculate the back end ratio, you'll add up all your debt, including the housing debt you used in the front-end ratio and any credit card payments, car payments, and student loans, along with most other installment loans you currently pay. If your total monthly debt, including your proposed house payment, is $1200, and your monthly income is $3000, your back-end ratio is $1200/$3000 = .4, or 40%. Many lenders require a back-end ratio of no more than 45%, though some loan products offer higher back-end ratios, especially if your credit score is good.

Prequalify for a Home Loan Before You Start Home Shopping

Why get pre-qualified by a lender before looking for your next home? Based on my first hand experience with clients, I have found several compelling reasons for home buyers to get pre-qualified for a loan.

1) You'll uncover credit problems.

In the ideal world, you'd contact your lender 6-9 months in advance to see what issues on your credit will need to be resolved. If you have any errors that may have caused a negative credit score or that disqualify you from the prime lending rates, you'll have an opportunity to fix them before you need to get a home loan. I've had first time home buyers with practically no credit discover that their lack of borrowing can actually hurt their ability to get a loan at a good rate. I've advised them to get a credit card or a car loan and make sure it is paid on time every month.

2) You'll know how much house you can afford.

Nothing is more difficult for a home buyer than to start looking for a larger or nicer home and find out later that the payments for that home will be too high. Once you have to downsize your price range, it is difficult to downsize your expectations as well. That is why good real estate agents only show you homes in your price range, and you can help by determining what that price range is by getting pre-qualified for a home loan.

3) Prequalification may be required when you purchase a home.

In the state in which I work, Arizona, real estate agents are required to submit a prequalification form, signed by the lender, with the purchase contract. In addition, a pre-qualified buyer is a strong buyer in the seller's eyes, and that matters when it comes to markets where multiple buyers are bidding for the same property, or you want to present a low offer on a home.

Locking in the Mortgage Rate

Just when you think you know how much your monthly payment will be, you find a perfect home, write the contract, qualify for the loan and wham! The mortgage interest rates go up.

Most lenders will not allow you to lock an interest rate until you have a signed contract for the home, but after that you usually have the option to lock in the current interest rate. Why do this? Because, as the well known idiom describes, “better the devil you know than the devil you don’t.” Interest rates could go down during your escrow period, but they could go up too, and sometimes dramatically so.

Interest rate locks have a time period of usually 30-45 days. Ask your lender what happens if you don’t close after the rate lock expires and determine with your real estate agent the likelihood of your closing date occurring past the rate lock expiration date.

Some lenders have a Float Down Rate Lock, which allows your interest rate to decrease if the index rates decrease, but it won’t increase above the rate lock amount. The catch is that you may have to pay for this privilege, but it might be worthwhile if current rates are varying greatly.

Need a Lower Down Payment? Check out FHA Loans

If you don’t have a 20% down payment for a loan, an FHA loan may be for you. FHA stands for “Federal Housing Administration.” If you’ve guessed that the government is involved in an FHA loan, you are right. The federal government pays the lender if a homeowner using an FHA loan goes to foreclosure. Because of this government insurance, lenders are willing to extend these loans with a low down payment – only 3 ½ percent of the purchase price ($3500 for a home with a purchase price of $100,000). FHA borrowers may be able to get the loan even if with credit that isn’t perfect. FHA loans also allow the seller to pay closing costs, which decreases the out-of-pocket expenses you’ll need to buy a home.

Most lenders can issue FHA loans these days as they are very popular. But before you decide on an FHA loan, make sure you know the negatives:

You’ll pay mortgage insurance, and lots of it. Plan for 1 ½% at closing and then another .5% that will be built into your monthly loan payment (these numbers may change, so check with your lender).

You won’t have much of a buffer if housing prices decline and you have to sell. Ask any homeowner who bought a home in 2006 and had to sell in 2008. It doesn’t feel good to come to the closing table with cash when you have to sell a home that is worth less than the loan amount. For many homeowners, the only choice was a credit-wrecking foreclosure or short sale. Make sure you have a good cash buffer when you buy a home. The typical advice for a 3 month salary buffer may not be enough.