Independent Investor

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# Doing Your Homework: What You Need to Know About Home Mortgages

Buying your first home can be a learning experience, especially when it comes to getting a mortgage. The myriad financing options can leave you wondering if owning a home is really worth the trouble. But finding the best solution for your needs is not so hard if you know some of the basics.

## Put Your Own Financial House in Order

Before you go house shopping, you should evaluate your own financial situation and assess your ability to take on a mortgage. Most lenders will prequalify you to borrow up to a certain amount. Prequalification allows you to focus in on a realistic price range and makes you a more attractive buyer. Whether or not you want to prequalify, eventually you'll be required to complete a loan application and it may take some time to gather and assemble the required information.

It's also a good idea to review your credit status. You can request a free copy of your credit report from each of the three major national credit bureaus -- Equifax, Experian and TransUnion -- once every 12 months, as well as under certain other circumstances, such as if you've been denied credit. To order your free annual report, go to: http://www.AnnualCreditReport.com or call toll-free (877)-322-8228.

Review your report to ensure that all information is correct. If your report indicates past credit problems, don't lose hope. Be prepared to present a rationale for each incident with your prospective lender, and demonstrate an improvement in your ability to pay bills on time.

## How Much Mortgage Can You Afford?

Your next step is to get specific about how much mortgage you can afford. The Federal National Mortgage Association (Fannie Mae) is a government-sponsored organization that purchases mortgages from lenders and sells them to investors. Fannie Mae has established two standard requirements for conventional mortgages. The first is that monthly mortgage principal and interest payments (P&I), plus homeowners insurance and property taxes, cannot exceed 28% of the buyer's gross monthly income (some exceptions may apply to increase this limit to 33%). The second requirement limits total monthly debt payments (housing, credit cards, car payments, etc.) to 36% of gross monthly income. In addition to these requirements, you may have to pay 20% down on the total purchase price to qualify for a conventional mortgage.

To help you get a better idea of what your own situation might look like, try "running some numbers" with one of the many mortgage calculators that are prevalent online, especially on real-estate- and consumer-finance-focused websites.

## Types of Mortgages

Aside from your income, the other key variables affecting how much house you can afford are the term and interest rate of your mortgage. The term is the length of time (usually 15 or 30 years) over which payments will be paid. The rate can be fixed (meaning it doesn't change over the loan's term) or adjustable (it fluctuates with market conditions). Thirty-year, fixed-rate mortgages remain the most popular. The longer term lowers the monthly payment, while the fixed rate provides stability over the life of the loan. Given relatively low interest rates, these mortgages are attractive to buyers planning to stay at least six or seven years in their new home.

The drawbacks are low principal payments in the early years, and the risk that interest rates will decline over the term. However, if your credit history is sound and you have sufficient income, you can usually refinance your mortgage when rates decline.

A 15-year term lowers the interest rate, reduces total interest payments, and increases principal payments. But it also increases monthly payments. If you can't afford the higher payments now, you might opt for a 30-year mortgage. If there are no prepayment penalties, you can make additional principal payments as your income increases. Making just one extra monthly payment a year will pay off a 30-year mortgage in less than 22 years and can save tens of thousands of dollars in interest costs.

If you plan to stay in a home no more than three years, you might consider an adjustable-rate mortgage (ARM). ARMs offer initial rates that are lower than fixed mortgage rates. At some point, usually after the first year, rates are tied to market conditions and are subject to potential rate increases. Most ARMs include a cap on rate increases in any given year, as well as over the life of the loan. Some ARMs offer initial rates at least 2% below fixed rates and limit increases to 1% annually and 5% to 6% over the life of the loan. Many home buyers are attracted by the affordability of an ARM during the initial period. However, you should be confident that your future income will be sufficient if both interest rates and your monthly payments increase.

## Three Steps to Finding the Right Mortgage

1. Estimate how long you expect to live in the house. If the answer is less than three to five years, consider an ARM, which typically starts out with a lower rate. If you plan to live in your new home longer than five years, a fixed-rate mortgage offers protection against rising interest rates.

2. Shop around for mortgage rates. Banks, credit unions, and mortgage companies all offer mortgages. Compare several different lenders in your area.

3. Add up all the costs for each lender. Include fees, points, closing costs, etc., to arrive at the total mortgage cost for each lender.

## Alternatives Are Available

If you can't afford a conventional mortgage, there are a variety of alternatives to consider. The Federal Housing Administration (FHA) -- a government agency responsible for insuring affordable housing mortgages—may offer loan down payments as low as 3%, but may require the buyer to purchase mortgage insurance. The Veterans Administration (VA) offers no-money-down mortgages to qualified veterans of the U.S. military. Finally, there are local affordable housing advocates that offer low-cost, low down-payment loan alternatives. For further information, contact these agencies directly or your local mortgage lender or real estate broker.

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