Guide to Buying a House

Buying a home is a large undertaking with several steps. Understanding all that goes into securing a mortgage to buy your home can make the process easier to experience and allow you to look out for items, fees, and conversations that just don't seem right.

Homebuyers Checklist

1. Monitor your credit score and history
2. Pay down debt
3. Save up for a down payment
4. Gather your financial documents (tax returns, pay stubs for the last two months, etc.)
5. Compare potential lenders
6. Get pre-approved for a mortgage with the lender
7. Find and work with a real estate agent
8. Identify a home and make an offer
9. Close on the home

Our Guide to Buying a House will review the following:

1. Mortgage Qualification Factors
2. Types of Mortgages
3. Choosing a Lender
4. Types of Lenders
5. Searching for a Home

Mortgage Qualification Factors

There are multiple variables that go into qualifying for a mortgage and they include: credit, income, assets, debt, down payment and loan-to-value (LTV).

Credit Score and History

The first is your credit score and history. A poor credit score indicates you cannot handle debt which severely limits a lender's willingness to give you hundreds of thousands of dollars to buy a home. Managing your credit score well from a young age gives you a distinctive advantage as you grow toward home ownership.

After your credit score, the remaining variables all play together to build a case to support your ability to afford the home.

Debt

High amounts of debt in relation to your income indicate to lenders that you aren't capable of effectively managing your finances and available credit. The higher your debt-to-income ratio is the greater the risk the lender perceives there to be in your ability to repay the mortgage they provide. If you have too much debt, you might want to consider strategically paying off the debts that will most improve your debt-to-income ratio.

Income History

A strong income history also goes a long way in justifying to the lender that you will be able to repay the loan not just today, but in the coming years as well. Your past credit history doesn't do you any good if you don't have an income to pay the mortgage once you buy the home.

Assets

Strong financial assets such as bank accounts, retirement accounts, and other investments give the lender collateral to take in the event you cannot repay your mortgage.

Down Payment and Loan-to-Value

Buyers with enough documented funds to put a 20% down payment on the home they plan to purchase will greatly increase the odds of qualifying for the mortgage they want. This provides the lender a healthy 80% Loan-to-Value on the mortgage. While the housing bust in 2007-2008 and ensuing financial crisis has limited the number of options available to buyers with limited funds for down payment, there are a few loan programs that allow for very low or no down payments. It is important to note that those loan programs require buyers to meet other qualifying factors first.

Pre-Qualification vs. Pre-Approval

There's a big difference between pre-qualifying for a mortgage and getting pre-approved for a mortgage.

Pre-qualification is where a lender looks at the basics: your income, your assets, and your debts. The lender gives you a general idea of what amount you could get for a mortgage, but it is a very rough estimate.

With pre-approval you typically pay an application fee and the lender digs into your financial background by looking at all of the above factors. You are then given a pre-approval letter with the amount the lender is willing to let you borrow. Almost anyone can be pre-qualified for some sort of mortgage amount. Pre-approval is what you want so you know exactly how much home you can afford to buy.

Types of Mortgages

The next big factor in your home-buying decision is the type and length of mortgage to get.

Fixed-Rate Mortgages

A fixed-rate mortgage is the gold standard of the mortgage industry. Both the term length and interest rate for the loan are set and will never change. This allows buyers to easily budget for the mortgage amount each month. There are multiple term lengths available depending on the lender you use. The most common are 30-year and 15-year mortgages.

Interest-Only Mortgages

An interest-only loan is exactly what it sounds like: a loan where you don't pay any money toward the principal of the loan. This type of loan only works in very limited situations and is more difficult to find after the Great Recession.

Adjustable Rate Mortgages (ARM)

ARMs are more complicated than fixed-rate mortgages due to one main factor. The interest rate changes over a period of time. This causes your payment amount to fluctuate; that fluctuation could be significant compared to a fixed-rate mortgage.

Instead of locking in a set payment for the next 30 years an ARM allows you to have a set interest rate (and thus payment) for 1, 3, 5, 7, or 10 years. At the end of the time period the lender provides you a new rate based on the available interest rates in the market. In a dropping interest rate environment this can lead to lower payments for you – a win. On the other hand if rates are rising your rate rises as well, and could rise above what you can afford to pay. (There is typically a cap on how much the rate can increase; this helps borrowers do the math on what the maximum they might pay is.)

FHA Mortgages

The Federal Housing Administration provides insurance to certain qualified buyers that allow the borrower to bring a smaller down payment to the table. Depending on your qualifications you could put down as little as 3.5% of the home's value as a down payment. (Other FHA borrowers put down 10%.)

What is confusing about FHA loans is the FHA doesn't actually lend out funds to borrowers. Instead they run an insurance program that entices lenders to work with less qualified borrowers.

To pay for this insurance program, FHA borrowers pay two types of premiums to the FHA. The first is an upfront premium of 1.75% of the loan's value. (A $150,000 home would need $2,625 to be paid up front.)

Additionally there is an annual premium based on the length of your mortgage and how much you brought to closing as a down payment. This ranges from 0.45% for 15-year mortgages with a 10% down payment to 0.85% for a 30-year mortgage with 3.5% down payment.

VA Mortgages

VA Loans are run through the Veteran's Administration. The program is similar to the FHA program in that the VA doesn't lend any money to borrowers. Instead, they guarantee a portion of the loan. The program doesn't require a down payment nor private mortgage insurance.

If needed, the VA steps in to assist lenders who have a borrower that cannot pay their mortgage.

Choosing a Lender

Mortgages are a commodity and thus interest rates are similar between lenders. When comparing lenders you'll want to pay attention to their service level and responsiveness to you through the application process. If the lender will retain and continue to service your loan (collect your monthly payments), then you'll want to evaluate the available ways you can make your payments and the ease of making payments.

Retail Direct

A retail direct lender cuts out the middleman and lends directly to borrowers. Home mortgages can be just one line of business for the lender who may also put out commercial and other loans as well.

Wholesale Lender

A wholesale lender works with a third-party lender such as a credit union or bank in order to provide the funds for the mortgage. Typically the third-party lender has the relationship with the customer, but uses the wholesale lender to actually write the mortgage loan. The wholesale lender's name goes on the loan documents, and the third-party gets a fee for acting as an agent to bring the borrower and wholesale lender together.

Mortgage Broker

A mortgage broker acts as an agent to bring a borrower together with a lender. The broker does no actual lending, but shops around for the borrower to find the best deal. A broker typically works with multiple other lenders to secure the best deal and adds a fee on top of the rate to generate a profit.

Correspondent Lender

A correspondent lender wants to hold the mortgage for a very short period of time before flipping it to a sponsor.
The sponsor, such as Freddie Mac and Fannie Mae, agrees to buy loans originated from the sponsor to take on the risk of the default of the loan. The correspondent lender generates a point or two (1%-2% of the loan's value) in origination before flipping the loan.

Mortgage Banker

Most lenders are a mortgage banker, which indicates they borrow the funds needed to issue the mortgage for a short-term, get the loan originated, and sell the loan to an investor through Freddie Mac or Fannie Mae. In short, the lender isn't lending its own money – it is lending borrowed money.

Portfolio Lenders

In contrast to mortgage bankers, a portfolio lender is lending out its own funds to the borrower. The goal is to hold the mortgage in the portfolio of loans until it is repaid; this generates consistent income for the lender. Portfolio lenders often target niche needs in the market such as investment property or borrowers with strong cash-flow but poor credit history.

Searching for a Home

Buying a home is a monumental financial and emotional decision. Home is where you lay down roots, be part of a community, and have a place to lay your head. Finding the right home in the right neighborhood is a task you shouldn't take lightly. Consider the following items as your narrow down your list of potential places to live.

Neighborhood Selection

Picking a home means picking neighbors, too. Do you want to be spaced out with large yards in-between homes? Or is less spacing but closer to downtown more your style? Factor these items into your selection.

Besides the actual size of the home and yards in a neighborhood there are two main factors to consider when appraising neighborhoods: real estate taxes and whether the neighborhood has a homeowner's association (HOA).

For most municipalities the main driver of real estate taxes is whether you are within a city limits or just within a county. The swing between the two can be several thousand dollars per year.

HOA's are divisive. Some people love living in neighborhoods with set architectural styles and rules to make sure none of the homes fall into disrepair or have abandoned cars in the yard. Others feel the myriad of rules is suffocating and cumbersome. Moving into an HOA neighborhood means giving an elected board authority over your home and lawn. It also means that you'll have the additional expense of an annual membership fee that typically starts at several hundred dollars per year.

Existing Home Inventory vs New Construction Homes

Homes are full of systems that require maintenance and have a limited lifespan. Asphalt roofs and HVAC systems need to be replaced every 15-20 years while water heaters typically last 8-12 years. A new construction home comes with systems that are brand new, often with warranties included, that provide peace of mind for the buyer.

However, many new construction neighborhoods are in the suburbs where developers can buy a larger quantity of land at a lower price than what is available closer to city centers. If you want to live closer in to the city your new construction options will be limited.

New construction homes are more likely to be in "cookie cutter" neighborhoods where there is a rotation of 5-10 home types that are repeated throughout the neighborhood. Many developers level large swaths of land to build these neighborhoods then provide each home with some foliage and trees that develop over time. Existing homes are more likely to be in established neighborhoods with extensive trees and shade cover; yet with dated home systems that need replacing before a new construction's systems will.

Selecting an Agent

Home purchases are typically the biggest purchase you will make in your entire life. Not many of your transactions come with 6 digits before the decimal. Flying solo into a decision of this magnitude is unwise.

Yes, real estate agents do charge 6% of the sales price to represent both buyer and seller (3% if they are just your buying agent). This can easily run the cost of using one up into the five-figure range. Yet unless you are well-versed in real estate law and can access the MLS, using an agent is a virtual requirement in most real estate markets.

Foreclosures and Fixer Uppers

Want to keep your initial costs low and have the aptitude and elbow grease to work on homes that need some TLC? Foreclosures and fixer uppers can be a great solution to meet the goal of keeping costs down, but you must know what you are doing. The multitude of television shows about flipping foreclosures can misconstrue the issues that pop up, the challenges overcome, and the abilities brought to bear on the project.

There are real estate professionals and investors in every city that snap up quality foreclosures and fixer uppers on a monthly basis. If they have passed on the home you're looking at – which may have been on the market for months – proceed with caution.

Nonetheless, being able to see the potential in a property that others cannot is still a great way to save money. A thorough inspection that really digs in to all of the potential pitfalls of the property allows you to make an informed decision.

House Values

A home is only worth what someone will pay for it. The tax assessor in your county can undervalue or overvalue a property. The tax assessment value alone should never be used as justification to purchase a home; the assessor can always come back and raise the assessment in the future. (Likewise you can request a reassessment if you think your property is overvalued and you are paying too much in real estate tax.)

A closer fit on the value of your home is tied to dollar per square foot (or $/sq. ft.). This allows for variation in prices due to the size of homes while giving a general figure to target for your purchase. You have to mentally add in a valuation for the lot that home sits on, but it is an easy indication of value.