

# Home Buyer's Handbook

## Introduction

The idea of purchasing a home, whether it be your first or last, is bound to bring many questions to mind. This is a natural reaction, as it is one of the biggest decisions you will ever make. Rest assured, my team and I are here to assist you in understanding the loan process with our goal being to make your experience a pleasant one.

This book covers the basics about buying a home. It is designed to answer commonly asked questions and provide clear definitions of terms you may be unfamiliar with, even if you have been through the home-buying process before.

## Rate Shopping



Shopping for the best interest rate possible has always been the consumer's primary objective when borrowing money. As well it should be! The challenge with this strategy is that there is much misleading information released on the subject by various media. Internet web sites and email marketing, along with other media such as radio, television and billboard advertising, have brought the importance of interest rates to the forefront of consumers' minds.

The problem for the consumer with this type of marketing is that it is designed to make the lender's phone ring. Often, the advertiser offers a ridiculously low interest rate, with the intent of using a "bait-and-switch" technique once the client is reeled in. This is often done through short pricing. Short pricing is a term that is used when a lender offers an extremely attractive interest rate, but that rate is only locked-in for a very brief period of time.

The average consumer enters into a purchase contract to buy a home for at least 30 days. Pricing on an interest rate locked in for a 7-day period is of no use to most prospective home buyers. It simply isn't enough time to complete the transaction. While the billboard advertising or Internet banner ad may boast a terrific rate, the lock-in period is often not realistic in terms of providing enough time to negotiate a purchase contract and close the deal. Be very careful when shopping for interest rates. Make sure that when you are quoted a rate, you are asking the broker what the lock duration is. Make sure that lock period allows you enough time to complete your purchase transaction.

Another common marketing ploy that makes interest rates appear attractive is geared around the manner in which fees are presented. All lenders are required by law to state the real cost of the financing through the Annual Percentage Rate (APR) each time an interest rate is quoted in advertising. APR takes many of the fees associated with the loan into consideration, and it is usually listed in fine print as a disclaimer.

Advertisers often list a low interest rate in large bold type, but the higher APR indicates in fine print that several points are being charged to get that rate.

While APR can be helpful in comparing rates seen in advertising, it is important for consumers to know that lenders use different methods to calculate APR. Hence it is not an entirely failsafe method for comparing interest rates.

Additionally, the consumer must take into consideration that the interest rate is not the only important factor in obtaining financing. Another equally important question to answer is, "How long do you need to borrow this money?"



The length of time you need to borrow the money has a profound impact on whether or not you should be paying upfront fees (points), and likewise has bearing on your loan program selection.

Statistically, homeowners move every 7 to 10 years. One of the common mistakes made by home buyers is automatically selecting a 30-year fixed rate loan program for financing instead of evaluating other options. The chance of needing the financing for 30 years is actually slim-to-none. If the buyer is somewhat transient in their job or is planning a family in the near future, the home may not really meet their long-term needs.

Buyers are often solicited with programs that are contingent upon 30-year financing. The interest rates that are offered, regardless of how low they might be, are often irrelevant as rates are dependent upon several factors, including down payment and credit score.

If a buyer has at least 5% for a down payment, an interest rate that is fixed for three, five or seven years may be a much more realistic option. This allows the buyer to capitalize on a low introductory rate and save a significant amount of money, which can then go toward the down payment on their next home. It is of utmost importance to work with an experienced loan consultant that understands some of the practical aspects of financial planning. A well-versed consultant will ask you many questions about your short- and long-term goals, and assist you in choosing a loan program that is truly suited to those goals.

### The Nuances of Your Contract



The process of purchasing a home is often much more complex than the average individual expects it to be. Items involved in your purchase contract can have a significant impact not only on the success of your purchase transaction, but

on your stress level as well. We have listed out some of the important items you should be aware of, that require you to make decisions as a buyer entering into a purchase contract.

#### **Loan or Financing Contingency**

Loan contingency is the period of time the seller is giving you to obtain full, formal loan approval. It is important to include a financing contingency in your offer, as it makes the transaction dependent on you receiving the mortgage you've applied for. It specifies your cancellation rights if you are unable to obtain financing.

This contingency is typically between 15 and 30 days depending on what has been negotiated in the contract. The earnest money deposit you make at the time the offer is accepted will be put in jeopardy once the contingency for the loan has expired. In fact, pursuant to the terms of the contract, if the loan contingency has expired and you fail to close the purchase transaction, you could lose your earnest money deposit and not have the failure of obtaining loan approval to lean on as an excuse. Written pre-approval will help to eliminate problems in this area. Please note: pre-approval is not the same as pre-qualification.

#### **Pre-Approval**

Seeking pre-approval for financing prior to making an offer on a property is a sound strategy that can help you get the best deal possible, especially if you plan to make a minimal down payment. The seller is often leery of the stability and reliability of the buyer if the buyer is only capable of making a down payment of 10% or less. This can cause the buyer to lose a significant amount of negotiating ability, by being perceived as a weak buyer rather than a strong one. This is why it is very important to get full loan credit approval in advance and provide a written confirmation of the loan approval when an offer is made. This shows it is a done deal and you are perceived to be a cash buyer.

#### **Contract Period**

The contract period is the period of time in which all due diligence must be completed, including obtaining loan approval, property appraisal, home inspection reports, termite inspection, etc. Give yourself enough time for all due diligence to be completed for this very important purchase you are about to make. Typically, purchase contracts are drawn up for a period of 30, 45 or 60 days. However, it is really not uncommon for a purchase contract to be written with terms in excess of 60 days if the parties involved need that long of a period to complete all aspects of due diligence.

#### **Home Inspection Contingency**

As part of the negotiation in your purchase contract you and the seller will mutually agree upon the amount of time needed to complete all the home inspection procedures that are required. Utilizing an outside third party service to complete these inspections is highly recommended.

You will be provided with a report by the home inspection company that you should review very thoroughly to make sure there are no material defects in the property that you were not aware of, and which could subsequently have an impact on the value of the property. Once your home inspection contingency has expired, you no longer have the leverage to go back and renegotiate with the seller to resolve any issues revealed by the home inspection. If there are material defects, you and your real estate agent should renegotiate either a reduction in the purchase price to offset the cost of any necessary repairs or having the seller make the repairs prior to the close of the transaction. Buyers with limited cash reserves should most likely negotiate to have the repairs made prior to closing.



#### **Termite Inspection**

A termite inspection is required by the lender if it is listed in the purchase contract. The lender may also require an inspection if the appraisal states there is evidence of termite damage. On

FHA loans inspection is required only under the following circumstances: when there is evidence of active infestation, if mandated by the state or local jurisdiction, if customary to the area, or at the lender's discretion.

If termites are present it is up to both parties to determine who will be responsible for the remedy of the problem. When you negotiate your contract make sure you state up front whether you want the property checked for termites.

#### **Seller Rent Back**

It is often the case that when the buyer and seller are unable to agree upon a specified closing date for the transaction, the real estate agents will negotiate a "rent back" period. This means the transaction closes, the loan funds and ownership of the property is transferred into the buyer's name, but the buyer does not take occupancy of the property until several days later. In this scenario, the buyer sets up a rental agreement, in which the property is leased back to the seller.

An important footnote to this somewhat common strategy is to make sure the seller is not occupying the property in a lease agreement for more than 30 days after the close of the purchase transaction. This would constitute a non-owner occupied purchase in the lender's eyes, and would cause the terms of the loan to change radically.

### **Seller Contributions**

Depending on the seller's eagerness to close the transaction, the seller of a property will often become aggressive and offer to pay some or all of the closing costs, origination points and/or pre-paid items (interest, hazard insurance, tax escrows) associated with the purchase on the buyer's behalf. This common strategy can be very beneficial to the buyer, particularly if the buyer is short on funds to close. It can also be the vehicle that effectively drives the interest rate down and provides the buyer with a more affordable monthly payment.



Note that there are limitations on how much the seller is permitted to contribute, depending on the loan-to-value ratio. The typical seller contribution is from 3% to 9% of the purchase price, based on the size of the down payment. Seller contributions may sometimes be isolated to non-recurring closing costs and/or origination points only. The lender will not permit the seller to contribute funds back to the seller after the close of the transaction to accommodate repairs to the property. Items such as roof leakage or new carpet cannot be covered by any seller contribution clause.

### **Origination Points**

Origination points are often misunderstood. Points are nothing other than interest paid at the time of closing to obtain a lower interest rate on a loan. One point is equivalent to 1% of the loan amount. If you are going to borrow \$300,000 on your loan, one point would equal \$3,000. This generally generates 1/8 to 3/8 of a percent lower interest rate, depending upon the loan program.



When does it make sense to pay points? Paying points is a prudent financial move, if you are planning to be in the loan for a long period of time. Again, one of the most important questions to address when you borrow money is, "How

long do you need to borrow this money?" This will answer the two all-prevailing questions you will have, which are 1) Should I pay points? And 2) What loan program is best for me? Notice that the question is not geared to, "How long do I plan to live in the home?" but more appropriately, "How long am I likely to be in this loan?"

How long you will be in the loan is not only affected by the tenure that you own the home, but also the probability of seeking a refinance at some point in the future. As a general rule of thumb, you will need to be able to recuperate the total cost of the points in a period of time that is less than the amount of time you will need to borrow the money.

Here's an example. Let's say you are going to borrow \$300,000 for your mortgage, and choose to pay one point, which equates to an initial up front cost of \$3,000. If paying one point up front saves you \$100 a month, this means it will take you 30 months or 2.5 years, to recuperate the cost of the point that you paid. If you refinance the home anytime before that 30-month mark, or decide to sell the home, you will have effectively wasted money. However, if you keep that loan for longer than a 30-month period of time, it is a prudent financial move.

When deciding whether or not you should pay points, take into consideration where interest rates are at when you seek financing, and compare that to historical market trends.

When interest rates are at historical lows, it makes much more sense to pay points, especially if you think you will live in the property for an extended period of time. Historically low rates, combined with the fact that you know you do not intend to move would indicate you will have longevity in the loan. It is unlikely rates will go down, giving you incentive to refinance.

Rates are cyclical. When interest rates are off of their historical lows, and higher than they generally are, we know that there is a strong likelihood rates will eventually come down. This is certainly no time to pay points. The chances of refinancing at some point in the future are extremely high, and therefore, you would not need to be in this loan for a long period of time.

### **Credit Scoring**

Your credit score is a major factor that will be considered by the lender when they review your loan application. They want to know what your credit history is, and whether you have the ability to pay back the loan you are requesting. In short, good credit translates into lower rates for the home buyer and less risk to the lender.



Credit scores can range between a low score of 300 and a high of 850. The higher the client's score is, the less likely they are to default on their loan. We will run a credit report to determine what your credit score is, and if necessary, we can point out some simple ways to help you improve your credit score without enlisting the help of a credit repair service.

Once you fill out a loan application and enter into the loan process, you should not run up your charge cards or make any major purchases! You also should not apply for any other type of new credit, as this could negatively impact your credit scores.

Today, many programs limit your borrowing ability if you have a low credit score. If you do have a low credit score you may still be able to obtain financing, just be prepared for both a higher interest rate and higher down payment requirements. While you may not get the interest rate you had hoped for, it is an opportunity to start building up your credit again. Once you begin making mortgage payments on time and in full, your credit standing will improve and we can seek to refinance you at a lower rate as soon as the opportunity arises.

Sometimes we may determine the need to refer you to a credit repair specialist. In some cases, borrowers have seen significant improvement in their credit scores in as little as 3 to 6 months, allowing them to qualify for the mortgage they desire.

### Pre-Payment Penalties

Lenders attach pre-payment penalties to loans to ensure that the loan will be profitable for them. As a general rule of thumb, we do not suggest that you accept a pre-payment penalty as a part of your loan structure. One of the most important aspects of financial planning is to have options with your money. Restrictive clauses such as a pre-payment penalty can prohibit you from maneuvering when it is necessary or when other opportunities arise.



If you want to accept a pre-payment penalty clause in your loan, it is much more advisable to go with a "soft pre-pay." This only penalizes you in the event of a refinance, but not if you decide to sell the home.

Interest rates have dropped significantly many times over the last 15 years. Many homeowners have not been able to take advantage of lowered rates by refinancing, because their hands have been tied by a daunting pre-payment penalty. Pre-payment penalties will generally provide you with a slightly lower interest rate in exchange for the pre-payment penalty clause. Mortgage professionals will sometimes push the benefits of a pre-payment penalty so they can beef up their commission. Be very leery of this type of sales pitch!

### Junk Fees



A junk fee is a derogatory term defining extra fees, which are charged as a dollar figure rather than a percentage of the loan amount. It is important to know that you can often negotiate these fees down or have them removed if they have not been properly disclosed to you. The lender is required to provide you with a Good Faith Estimate disclosing their fees within three days of your application.

Fees associated with the following are NOT considered junk fees: appraisal, credit report, escrow or attorney, title search, title insurance, document recording, notary, tax service, flood certification, title endorsements and survey. These are legitimate fees charged by third parties and are necessary to complete the trans-action.

### Glossary of Terms

#### **Adjustable Rate Mortgage (ARM)**

A mortgage in which the interest rate is adjusted periodically based on a pre-selected index and margin, also referred to as the renegotiable rate mortgage.



#### **Amortization**

Means of loan payment by equal periodic payments calculated to pay off the debt at the end of a fixed period, including accrued interest on the outstanding balance.

#### **Annual Percentage Rate (APR)**

The interest rate that reflects the cost of a mortgage as a yearly rate. This rate is likely to be higher than the stated note rate or advertised rate on the mortgage, because it takes into account points and other credit costs. The APR allows home buyers to compare different types of mortgages based on the annual cost for each loan, however not all lenders calculate APR the same way.

#### **Broker**

This person assists in arranging funding or negotiating contracts for a client. Brokers usually charge a fee or receive a commission for their services.



#### **Buydown**

This is when the lender and/or home builder subsidizes the mortgage by lowering the interest rate during the first few years of the loan. While the payments are initially low, they increase when the subsidy expires.

#### **Construction Loan**

This is a short-term interim loan for financing the cost of construction. The lender advances funds to the builder at periodic intervals as the work progresses.

#### **Discount Points**

Prepaid interest assessed at closing by the lender. Each point is equal to 1% of the loan amount, i.e., two points on a \$100,000 mortgage would equal \$2,000. Discount points are charged to reduce the interest rate.

#### **Down Payment Assistance Program (DPA)**

Down Payment Assistance Programs are funds given to buyers to assist with the purchase of a home. Buyers do not have to repay these funds. There are two types of DPAs: those involving seller contributions and those provided by the government which are usually local programs.

#### **Earnest Money**

Money given by a buyer to a seller as part of the purchase price to bind a transaction or assure payment.

#### **FHA Loan**

A loan insured by the Federal Housing Administration open to all qualified home purchasers. While there are limits to the size of FHA loans, they are generous enough to handle moderately-priced homes almost anywhere in the country.

#### **FHA Mortgage Insurance**

All types of Mortgage Insurance protect the lender in the event of default. There are two types of FHA Mortgage Insurance Up-front Mortgage Insurance (MIP), paid at closing and Monthly Mortgage Insurance, paid monthly with the mortgage payment. Upfront premiums range from 1.25% to 2.25% of the loan amount and monthly premiums range from 0.50% to 0.55%, depending on the borrower's credit score and the loan-to-value.

**First Time Home Buyer Program**

Mortgage loans with special qualifying terms for those who have never owned real estate or have not in the previous 3 years. Although the programs and terms vary by state, they often offer down payment and closing cost assistance.

**Impound/Escrow Account**

That portion of a borrower's monthly payments held by the lender or servicer to pay for taxes, hazard insurance, mortgage insurance, lease payments, and other items as they become due. Also known as reserves.

**Index**

A published interest rate against which lenders measure the difference between the current interest rate on an adjustable rate mortgage and that earned by other investments (such as one-year, three-year, and five-year US Treasury Security yields, the monthly average interest rate on loans closed by savings and loan institutions, and the monthly average Costs-of-Funds incurred by savings and loans) which is then used to adjust the interest rate on an adjustable mortgage up or down.

**Loan Level Price Adjustments (LLPAs)**

Loan-Level Price Adjustments are automatic, cumulative fees based on credit scores and the amount of your down payment. Fannie Mae (FNMA) and Freddie Mac (FHLMC) levy these fees on borrowers with credit scores below 720. They have nothing to do with the mortgage company or its various products and cannot be negotiated away.

**Margin**

The amount a lender adds to the index on an adjustable rate mortgage to establish the adjusted interest rate.

**Mortgage Insurance (MI)**

Money paid to insure the mortgage when the down payment is less than 20%. See Private Mortgage Insurance or FHA Mortgage Insurance.

**Negative Amortization**

Negative amortization occurs when the monthly payments are not large enough to pay all of the unpaid balance of the loan, therefore increasing the loan balance and going in a "negative" direction. In this particular scenario, a borrower can literally end up owing more money than they originally borrowed. The reason that this occurs is because on a negatively amortized loan, the borrower is given several different payment options.

**OPTION 1:** To pay what is known as the fully indexed payment. This is the margin plus index on the adjustable. This payment, which is typically the highest of the options, will prevent you from going negative.

**OPTION 2:** An interest only payment. You would not be going negative by making this payment either, but you would not be decreasing the principal balance on your loan. This is because you are paying only the interest portion and no additional principal to your loan.

**OPTION 3:** (And the one that most often gets people into trouble...) The negatively amortized payment.

This is a payment that not only does not cover the principal, but doesn't cover all of the interest owed on the monthly payment, therefore accruing negative equity as a result.

**Origination Fee**

Fee charged by a loan originator to provide the borrower with a lower interest rate. Usually charged as a percentage, each point is equal to 1% of the loan amount.

**PITI**

Also known as total monthly housing expense, this is an acronym for the principal, interest, taxes and insurance.

**Piggy Back Loan**

"Piggy Back Loan" is a slang term, which really is another way of describing 1st and 2nd mortgages that close concurrently. In today's mortgage lending environment, obtaining a piggy back loan can be very difficult if a borrower has less than 20% for a down payment. In such instances, obtaining one mortgage with Private Mortgage Insurance may be the only option. See Private Mortgage Insurance.

**Private Mortgage Insurance**

In the event that you do not have a 20% down payment, the lender may allow a smaller down payment, sometimes as low as 3%. However, with a smaller down payment, borrowers are usually required to carry private mortgage insurance on the loan. Private mortgage insurance comes in two forms: upfront, paid at closing, and monthly. A lender may require some combination of both upfront and monthly mortgage insurance. The amount required is determined based on program type, property type, credit score and loan-to-value.

**Title Insurance**

Title insurance protects a real estate owner or lender against any loss or damage they might experience because of liens, encumbrances, or defects in the title to the property, or the incorrectness of the related search.

It protects against claims from various defects such as another person claiming an ownership interest, improperly recorded documents, fraud, forgery, liens, encroachments, easements and other items that are specified in the actual policy.

**Underwriting**

Approves (or declines) funding to potential home buyers, based upon factors such as credit, employment, assets, etc., and matches approved risks with appropriate rates, terms and loan amounts.

**VA Loan**

Mortgage loans available to eligible US veterans. VA guaranteed loans are made by private lenders, such as banks or mortgage companies, for the purchase of a home for a buyer's own personal occupancy. These loans offer competitive rates and require little or no down payment.

*We hope this handout has been helpful for you. Please call us today to schedule your appointment to discuss how we can help make your home buying experience go smoothly.*

