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Advancing Fairness in the Marketplace for All

Guide for Homebuyers

Tips for Getting a Safe Mortgage You Can Afford

QUICK SUMMARY

- Figure out what you can afford.
- Contact at least 3 different lenders or brokers.
- When you call, say: "I'm buying a (*house or condo*) to live in. I'd like to apply for a no-cost, 30-year, fixed-rate, fully-amortizing mortgage for $ (*insert sale price*). I want a loan that doesn't have a prepayment penalty."
- After you get 3 quotes, check that they meet your terms and then choose the one with the lowest APR. Next, ask for a "rate lock."
- Want an even lower rate? Call the lenders with the 2 best offers and ask them to do better.

Introduction

This guide gives you advice for getting a safe, affordable mortgage. If you're a financial whiz, there may be other ways you can save money. But this guide emphasizes *safety* and *affordability*.

You might think it's OK to sign up for a mortgage that will not be affordable over the long term, because you can sell your home or refinance the loan before you run into trouble. But that's a big risk. If you can't refinance or sell when the monthly payments go up or your income goes down, you could lose your home to foreclosure. We think the best deal is a mortgage you can afford over the long term, without worrying about whether you can refinance or sell later.

There are a number of steps to getting a mortgage:

1. Decide what you can afford
2. Choosing the right loan terms and loan program
3. Shop for a loan
4. Negotiate for a better deal
5. Get ready to sign.

A First-time Homebuyer Class Could Save You Money

Qualified housing counselors are specially trained to help you assess your financial situation and prepare for buying a home. They can teach you what to look for when you shop for a house and how to pick a good loan. They may also be able to tell you about special loan programs that could save you money.

Unlike a real estate agent, mortgage broker, or a lender, a housing counselor's job is to give you independent advice. And, because they are nonprofit agencies, their services often cost little or nothing. To find a housing counselor approved by the U.S. Dept. of Housing & Urban Development, call 1-888-995-4673 or go to the Consumer Financial Protection Bureau's website.[1]

[1] consumerfinance.gov/find-a-housing-counselor.

Step 1: What Can You Afford?

The first step is to figure out what you can afford. You should do this before you shop for a house. Otherwise, if you get your heart set on a house that's too expensive, you'll feel pressured to sign a mortgage you can't afford.

Budgeting If you don't know where your money goes each month, you're not ready for a mortgage. You must have a realistic budget before shopping for a house. Even if you already know your budget, ☑ **we strongly recommend going to a first-time homebuyer class**.

Your budget should show how much you can afford for the total cost of homeownership. That means paying for:

- utilities
- maintenance
- your mortgage payment
- any homeowner's association or condo fees
- property taxes (and maybe school or other local taxes)
- homeowner insurance and
- flood or wind insurance (depending on where you live).

To get an idea of what you can afford, first figure out what you spend now. Homeownership will probably be more expensive than renting because you will be responsible for taxes, insurance, repairs, and other expenses that you might not be paying when you rent. Your budget should also include enough money for unanticipated expenses. Every house will need maintenance every month. Plus there will be occasional repairs that could be very expensive (such as patching your roof or replacing a broken refrigerator). So plan to save money each month to cover big expenses. (Don't forget food, closing, transportation expenses, and all your other living expenses, too!)

Your Credit Report Get a copy of your credit report and credit score. You may be eligible to get a free credit report from annualcreditreport.com. To get your credit score, you may need to pay a small fee. For more information about credit reports and scores, see the National Consumer Law Center (NCLC) website.[2] Then, talk about any problems you see with your housing counselor or credit counselor.

Moving expenses You'll need enough money to pay moving expenses. To plan a safe and affordable move, visit usa.gov/moving.

What Is Pre-Qualification?

Applying for a loan starts with submitting a loan application. If the lender agrees to give you a loan, that lender is "approving" your application. But what if you're not ready to officially apply for a loan? What if you just want to get an idea of how big a loan you can get and what it would cost? That's a good question to ask before you start house shopping.

To get that information, ask a lender to "pre-qualify" you for a loan. To get pre-qualified, the lender will need to look at your credit report, proof of income, and possibly other supporting documents. The important thing to remember is that a pre-qualification is not a guarantee. All the details (such as the interest rate and closing costs) can change. The lender will need to review everything again once you pick a house. If you need a guarantee from the lender, ask for a Loan Estimate (see Step 3).

[2]Credit reports: nclc.org/images/pdf/older_consumers/consumer_facts/cf_what_you_should_know_about_credit_report.pdf; Credit scores: nclc.org/images/pdf/older_consumers/consumer_concerns/cc_understanding_credit_scores.pdf.

Step 1: **What Can You Afford?** CONTINUED

Down payment You may also need money for a down payment. The minimum down payment required can be as low as $0 and as high as 20% of the purchase price of the house. VA loans (loans guaranteed by the U.S. Dept. of Veterans Affairs), loans through the U.S. Dept. of Agriculture's Rural Development program, and some other special loan programs do not require a down payment. FHA loans (loans insured by the Federal Housing Administration) allow small down payments (as low as 3.5%). Conventional mortgages (meaning everything else) usually require down payments of 3% to 20%.

Closing costs You'll also need money for closing costs. "Closing costs" are charges for making a loan. They include fees charged by your local government and charges by the lender and brokers. They can add up to thousands of dollars. Closing costs are *in addition to* the amount you will pay for the home. So you may need enough cash for closing costs *plus* a down payment.

Housing counselors can give you advice about how big a down payment you need, what loan programs you qualify for, and whether you qualify for any special programs to help with your down payment or closing-costs.

Step 2: **Getting the Right Loan**

There are two key parts to choosing the right loan:

- Choosing the right loan program
- Choosing the right loan terms

Loan programs There are two broad categories of loan programs:

Special programs insured or guaranteed by a government program or a non-profit agency. These are sometimes called "agency loans."

Everything else. These are called "conventional mortgages."

Special programs: The federal government, some states and cities, Native American tribes, some employers, and some nonprofit groups offer loans that are designed to help people buy homes. Most of these programs have special restrictions. Some are limited to veterans. Others are limited to first-time homebuyers, people buying in a certain neighborhood, etc. If you are eligible, one of these loans might be good for a number of reasons:

- they often allow lower down payments
- they may be cheaper than conventional mortgages (but not always)
- they may have special protections.

Conventional mortgages: There are many, many different types of conventional mortgages. They are available from banks, credit unions, and non-bank mortgage companies. If you don't qualify for (or don't want) a loan from a special program, you will need a conventional mortgage.

The loan terms we recommend will minimize the financial risks of getting a mortgage.

Housing counselors specialize in helping you choose the right loan program.

Loan Terms The "loan terms" are the most important part of any loan. The loan terms determine what you will pay each month and other rules of the road. Choosing the right loan terms can be complicated. This guide recommends safer loan terms.

Nobody can predict the future. Will interest rates go up or down? Will you get a raise or a pay cut or lose your job in two years?

The loan terms we recommend will minimize the financial risks of getting a mortgage. A healthy savings account and careful budgeting are important, too. If you can tolerate more risk, you might want to consider other options.

Important Loan Terms:

- closing costs
- fixed or adjustable (variable) interest rate
- maturity (15 years, 30 years, or something else?)
- escrow account
- prepayment penalty
- balloon payment or fully-amortizing

Closing costs All mortgage loans include closing costs. For example, the lender may want to charge you for the cost of an appraisal (so the lender knows whether the home is worth what you are paying for it) or the cost of preparing the loan documents. You can pay these costs; the seller sometimes pays part of them; or you can ask the lender to pay them. The total closing costs should only be 2% to 3% of the amount of money you borrow. You can find the average closing costs for your state at bankrate.com.[3]

A **"no-cost loan"** is a loan where you pay the closing costs through the interest rate. Instead of paying cash up front for the closing costs, the lender will charge you a slightly higher interest rate on your loan. In truth, there's no such thing as a "no-cost" loan because you pay one way or another. But that's what some lenders call it. A no-cost loan can be good for two reasons: 1) you can use your savings for the down payment or other expenses; and 2) research shows that no-cost loans can be cheaper. When you are paying the closing costs in cash, lenders have an incentive to overcharge you. But when they're paying the closing costs, they're less likely to overcharge.

☑ **We recommend asking for a no-cost loan.**

Fixed or Adjustable Interest Rate The interest rate on your loan has a major effect on the size of your monthly payment. Do you want an interest rate and payment that stays the same or changes? A fixed-rate loan will stay the same so your payment will stay the same (but be sure to read about Escrow Accounts on page 5). The interest rate and your payment on an adjustable-rate mortgage (sometimes called a variable rate mortgage or an ARM) may go up or down—nobody knows how much.

A fixed-rate loan is the safest choice. It's predictable and easy to build a budget around a fixed-rate loan. The risk of an ARM is that your payment might go up even when your income doesn't. During the Great Rescission, people with ARMs were more likely to end-up in foreclosure than people with fixed-rate loans. Some people say "Oh, if I can't afford the payments, I'll just refinance." But there is no guarantee that you will be able to refinance or that refinancing will save you money.

☑ **We recommend asking for a fixed-rate loan.**

[3] bankrate.com/finance/mortgages/closing-costs/closing-costs-by-state.aspx. This list does not include some important charges, such as: title insurance, title search, taxes, other government fees, escrow fees and discount points.

How to Use the APR (Lower is Better)

The annual percentage rate (APR) is a tool for comparison shopping. When looking at two loans, the one with the lowest APR will be cheaper. Just make sure the loans have similar terms. For example, you can't compare a fixed-rate mortgage with an adjustable-rate mortgage.

The APR is a shortcut for measuring the price of a loan. Some people compare loans by looking for the lowest monthly payment or the lowest interest rate. But those numbers don't give you enough information. The cost of a loan depends on the interest rate, the closing costs, how much you borrow, how long the loan will be, and other details. The APR crunches all those numbers into one, making it easier to compare loans.

Comparing the APR on loans is better than comparing interest rates because the interest rate doesn't include any closing costs. The APR does. Imagine that you have two loan offers with the same interest rate. But one has lower closing costs and the other is for 15 years rather than 30. Can you do the math to see which loan costs less? If not, look at the APR instead. It's an easy shortcut.

Has someone told you the APR is no good? Was it a mortgage broker or loan officer? Remember that they make more money if you choose an expensive loan. So they don't want you to shop around. The APR is not perfect. But for most borrowers, it is safer and easier to go with the APR. If you are sure that you will refinance or sell your house in a few years, or if you are good with math and can analyze the cost of different financing terms, then there may be better ways to find the most affordable loan. Otherwise, use the APR.

Maturity The "maturity" of a mortgage is the number of years before it will be paid off. The standard mortgage is for 30 years. But you can get loans for 15 years too.

If you compare a 15-year and 30-year mortgage for the same house, the 15-year loan will usually have a lower interest rate but higher monthly payments. Over the life of the loan (all 15 years added together), a 15-year loan will usually be cheaper because you pay less interest.

If you get a 30-year loan, you can still pay extra each month and pay your loan off early. That will save you money on interest, but it will give you the flexibility to pay the regular 30-year payment if you want. This can be a little more expensive, but safer.

☑ **We recommend asking for a 30-year loan. But a 15-year loan is a good idea if you can afford it.**

Many lenders offer good loans without prepayment penalties. Shop around and you'll find one.

Escrow account An "escrow account" is like a savings account for taxes and insurance. If you have an escrow account, the payment you make towards it is in addition to your regular mortgage payment. Each month, you will be required to make a mortgage payment. If you have an escrow account, When you make your total monthly payment, your mortgage servicer will set aside the escrow part of it. your payment in the escrow account each month. Then, when your taxes and insurance are due, the mortgage servicer will pay them from your escrow account. The amount required for your escrow payment may go up or down each year if your taxes or insurance change.[4]

An escrow account is a great budgeting tool. Whether you have one or not, you will still be required to pay property taxes and insurance on your house. If you don't have one and you can't come up with all the insurance or tax money at once, you could lose your house. Many of the people who lost their homes to foreclosure in the Great Recession didn't have escrow accounts.

Most mortgage lenders require escrow accounts (unless you make a down payment of 20% or more), but you should check to make sure.

Important reminder: Whenever a lender tells you what your mortgage payment will be, ask if that includes escrow.

☑ **We recommend asking for a mortgage with an escrow account.**

Prepayment penalty If your mortgage has a prepayment penalty clause, you will be charged extra for paying off your mortgage early. For example, a prepayment penalty in a 30-year loan might require you to pay a penalty of several thousand dollars if you pay off your mortgage in the first two or three years. Selling your house or refinancing your mortgage before the prepenalty time expires can be very expensive.

Some lenders will offer a lower rate or other discounts if you agree to a prepayment penalty. The penalty usually applies if you pay your loan off within a certain period of time.

This is usually a bad deal. If you need to sell or refinance before the penalty expires (such as if you lose your job, you have an ARM and the rate goes up, you get a divorce, or you need a bigger house for your family) you will be required to pay extra to the lender. If you can't afford the penalty, you won't be able to sell or refinance. Prepayment penalties are negotiable; ask to have it removed.

Many lenders offer good loans without prepayment penalties. Shop around and you'll find one.

☑ **We recommend saying *no* to prepayment penalties.**

[4] A traditional mortgage payment always includes principal and interest. If you have a fixed-rate loan, that amount will stay the same. If you have an escrow account, your total mortgage payment will include principal, interest, and escrow. The escrow part may change if your tax or insurance bill changes.

Balloon payment or fully-amortizing A "balloon payment" is a huge payment ($25,000, $50,000, or more) that you are required to make at the end of some loans. A "fully-amortizing" loan is one that you pay off with regular payments that are all about the same size.

Most mortgages are fully-amortizing. You make an affordable payment each month and, if you keep going long enough, one day the loan is gone.

Balloon payment loans are different. The payments may be affordable for a while but only up to the final payment. The final payment is huge — sometimes tens or even hundreds of thousands of dollars. If you can't pay the balloon payment, you will lose your house.

Some lenders will offer a lower regular monthly payment in exchange for your promise to make a balloon payment in the future. But this is risky. Will you have enough money to pay it? Are you sure you can sell or refinance before the balloon payment comes due? Will your house be worth enough to pay the balloon when you're ready to sell or refinance?

Unless you can predict the future, a balloon payment is probably too risky for most people. If you absolutely can't avoid one, at least make sure it's a long way off in the future.

☑ **We recommend saying *no* to balloon payments.**

Step 3: **Start Shopping**

Now that you know what type of loan you want and what you can afford, it's time to start shopping for a loan.

It's OK to start *looking* at houses so you know what's available in your price range. But don't sign a contract or make a deposit until you decide what you can afford and find a lender that will give you an affordable loan. Signing a contract to buy a house before you get pre-approved (see page 2: What Is a Pre-Qualification?) for a loan is asking for trouble. You could get stuck with an unaffordable loan or you could lose your deposit. It's always safer to find a lender and get pre-qualified before you sign a contract to buy a house.

Ask for a Loan Estimate as soon as you choose a house.

Getting a good loan is just like buying anything else — you have to shop. We recommend contacting at least three lenders.

First make a list of lenders to contact. Try credit unions, your current bank (if you like it), friends who have a mortgage they're happy with. Then ask people you trust about the names on your list, have they heard anything bad about them? You can check for complaints about lenders by searching the Internet. You can also ask for a loan officer or mortgage broker's "NMLS Number" so you can confirm that he or she is properly licensed.[5]

Take a look at a sample loan application[6] so you know what information lenders ask for. Fill one out so you're ready to talk to lenders. Lenders must give you a **binding** "Loan Estimate" once you give them these six pieces of information:

- your name,
- your income,
- your social security number,
- the address of the property you are buying or refinancing,
- an estimate of the value of the property, and
- the mortgage amount you're asking for.

[5] nmlsconsumeraccess.org.
[6] https://www.fanniemae.com/content/guide_form/1003irev.pdf.

Remember that nothing the lender says is binding unless it's written on an official Loan Estimate form.

Start contacting the lenders on your list. You can call them on the phone or apply over the Internet.

If you don't have a specific house in mind, ask for a written pre-qualification for the type of loan you want (we recommend a no-cost, fully-amortizing, 30-year, fixed-rate loan). But remember that the pre-qualification won't be binding. Ask for a Loan Estimate as soon as you choose a house. It's OK to give the address of a house you're interested in even if you haven't made an offer yet. Just remember that the information on a Loan Estimate is only valid for ten business days and the lender will have to re-do it if you buy a different house.

When you apply, tell the lender that you're shopping around so they know they have to give you a good offer to keep your business.

Lenders may only charge you for a credit report when you ask for a Loan Estimate. And the fee must be reasonable (around $15 to $30). They cannot charge you a full application fee until you decide you want to get a loan from them. If you're worried about the cost of applying to more than one lender, that's a sign that you might not be able to afford a house yet. The cost of shopping around is worth it. You'll save a lot more money by getting a good loan. And, no, applying to more than one lender within a short period of time (such as in the same month) won't hurt your credit score.

After you get the pre-approval or Loan Estimate, *read it* and make sure you understand what it says. Ask questions if you don't. Make sure it has the loan terms you want.

- Check to make sure the interest rate they have offered you is fair. You can do this by going to the Consumer Financial Protection Bureau's (CFPB) website Owning a Home;[7] to check what rates banks are offering in your state, click on Explore Interest Rates.[8]
- Look at the APR you were offered. Compare the APR on each Loan Estimate or preapproval you have received.
- The best loan will be the one with the lowest APR *and* the other terms you asked for.

[7] consumerfinance.gov/owning-a-home.
[8] consumerfinance.gov/owning-a-home/explore-rates.

Step 4: **Negotiate!**

You'll usually get a better deal if you ask for something better. You're allowed to ask lenders to change things you don't like. All the details we've talked about here are negotiable.

Remember: Lenders and brokers aren't required to give you the best interest rate or the best loan you qualify for. Instead, if they can, they will try to make money by giving you a more expensive loan. So to get a fair, affordable loan, you must be willing to negotiate.

If you don't get offered a price you can afford and the loan terms you asked for, you have three choices:

- Cancel your plan to buy or refinance, and wait until your credit and income improve.
- Apply somewhere else.
- Negotiate with the lenders you've already contacted.

Tips for Negotiating: Even if you're happy with at least one of the offers, you should still try to negotiate to get a better deal from the same lender. Negotiating is easier than it sounds. Just decide what you want and ask!

- First, focus on the type of loan you want. If you want a no-cost, fully-amortizing, 30-year, fixed-rate loan and the bank didn't offer you one, ask for it!
- Next, focus on the APR. If you want a lower APR, just ask. For example, you can say: "I applied to another bank and they offered me a 4% APR. Can you beat that?" Or you can simply say, "I was hoping for a lower APR. Is this the best you can do?"

Step 4: **Negotiate!** CONTINUED

- If you want a lower interest rate, you can ask for that too. Try saying: "According to the CFPB's website, other banks in (*my state*) are offering lower interest rates. Can you give me a lower rate?" or "What is the best interest rate/discount point combination that you have?"
- It never hurts to ask: "Is this the lowest rate that I qualify for?"

It never hurts to ask: "Is this the lowest rate that I qualify for?"

- If you don't like the way the bank treats you, go somewhere else. If they treat you badly when you're applying for a loan, they won't get any better later.

Step 5: **Get Ready to Sign**

Once you find a lender you like, go shopping for a house. Remember not to sign a contract until you have found a lender that you trust. When you find a house that you're ready to buy, tell your lender. He or she will give you a revised Loan Estimate based on the price of the house. Remember to *read it* to make sure everything is OK. If you got one before, the numbers on this one will likely be different. It's still a good idea to ask for a Loan Estimate from more than one lender. Remember, the cost will be worth it. The price of a few credit reports is tiny when compared to how much you can save on your mortgage.

When you get a Loan Estimate you like, ask the lender to lock the rate. This will prevent the interest rate from changing before your closing. Yes, rates might go down in the meantime. But they could go up too! Unless you're a gambler, don't take the risk. The details on the Loan Estimate will be binding for ten days, unless you tell the lender that you want to go ahead with the loan during that time. If you wait longer, the numbers may change again.

From this point, you're ready to go. Read the CFPB's Closing Checklist[9] to get ready for the big day. And if you still have any questions or problems, you can ask a housing counselor for advice.

[9] consumerfinance.gov/owning-a-home/resources/checklist_mortgage_closing.pdf.

What About Points?

There are two kinds of points, both of which are paid at closing:

Discount points: When you pay discount points, you are paying the lender to give you a lower interest rate. The more you pay in discount points, the lower the rate should be.

Origination points: These are fees the lender charges you for work the lender does to close the loan. The more you pay in origination points, the more expensive the loan is.

Should I Pay Points?

Origination points? Try to avoid paying origination points. If you see them on the Loan Estimate (sometimes just listed as "points"), tell your lender you don't want to pay them.

Discount points? This is complicated.

- For most people, the easiest thing to do is to ask for a lower APR and let the lender decide whether to achieve that by lowering the interest rate or charging discount points.
- If you're very good with numbers and have a lot of financial knowledge, the decision to pay discount points depends on how long you plan to keep the loan. If you will keep it a long time, discount points might be worth it. If you plan to refinance or sell in a short time, they may be wasted money. You'll need to do a spreadsheet or consult an accountant for a final answer.