The *Real World* Home Buyer's Guide

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The ***Real World*** Homebuyer's Guide© Updated 02/2010

The real estate and mortgage markets have changed tremendously over the last years. Not so long ago, buyers rushed to find the new listings, hoping to be the first to put in an offer. Everyone had stories about how much they had made by buying real estate. At the same time, mortgages were easier to get than they've ever been before. No money for a down payment? No problem. Bad credit? That wasn't a problem either. Maybe you didn't have the income to qualify, or maybe you didn't even have a job. There were mortgages for these buyers, too. Home prices were going up and it looked like the boom would never end.

Things have changed. Fear is in the air now and the boom has been replaced by gloom. The economy is scary and it has gone from being a strong seller's market to a true buyer's market. The mortgage market has tightened up, too. The 100% financing programs are gone (mostly), and you will need to prove your income in order to get a loan. **But it isn't all bad news. In fact, now could be the best time in years to buy a home.** The best time to buy is when people are anxious to sell, and couples and individuals who are ready to buy now, are getting great deals. Interest rates are at all time lows, and the government is helping first time home buyers to the tune of up to $8,000 as a tax credit ($6,500 for current home owners). **This is a great time to buy, but you need to know what you are doing.**

I have been a mortgage lender since 1992, and in that time I have helped thousands of families buy their own homes and change their lives. I have found that people are hungry for good credible information on the best way to buy a home. With that in mind, this guide will go into detail about everything you need to know to buy a home and get a mortgage in a way that meets all your needs, in today's market. My goal is to fully educate you about the whole process, from now to the closing, so you can comfortably navigate your way through the mortgage and home buying maze.

This report is long, because it is thorough. Some people read the whole report at once. Others scan through it and take note of those parts that apply most to their current situation. Either way, make sure you save it and use it while you look for a home and decide on a mortgage. It will make the process less intimidating, and save you money, if you do.

Good information is crucial throughout your search. It is my goal to make your experience as satisfying and rewarding as possible. Be sure to use my site, www.ptmortgage.com/blog as a resource. I blog regularly to keep up with changes in the markets and ways to help you make the right decision. If you have any questions, are ready to be pre-qualified, or if I can help in any way, give me a call or send me an e-mail. Let me know what I can do for you.

Peter Thompson

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Buying a home is one of the biggest financial transactions you will make in your lifetime. Home ownership is the best way to build equity and take control of your finances. You know that it makes sense to own, but the home buying and financing process can be complicated. With that in mind, this guide will go into detail about everything you need to know to buy a home and get a mortgage in a way that meets all your needs. My goal is to fully educate you about the whole process, from now to the closing, so you can comfortably navigate your way through the mortgage and home buying maze.

Why should you buy a home?

There are so many reasons for owning a home: the pride of having a place of your own, the need to establish roots, the joy of being able to have a place where you can express your own personality and style. There are also some very strong financial advantages to owning.

The three main financial benefits to homeownership are:

Principal reduction
Appreciation
Tax Advantages

Principal reduction:

First of all, a quick explanation. With most mortgages, each payment is divided into two portions, ***principal***, and ***interest***. Interest is the amount the lender charges for the use of their money over the time you hold the mortgage. Principal is the amount of the mortgage you are paying back each month.

Interest is charged on the outstanding loan balance each month, so at the beginning of the mortgage, most of the payment goes to pay off the interest portion. But with each payment you make, you pay off a little more of the principal, and the loan balance goes down a little more each month. Let me give you an example to help explain:

If you borrow $100,000 at 6.5% interest over 30 years, that means your mortgage payment each month is $632.07. On your first payment, about $542 will go to pay the interest, and a little over $90 will go toward the principal. That means after one payment, your loan has been reduced by $90 to $99,910. Each month a little more of the payment goes toward reducing your principal, and a little less goes to pay off the interest. If you stay in this house, and this mortgage, for the whole 30 years, you'll have paid off the entire mortgage and you'll own the home free and clear. But in the early years, you are paying off mostly interest, and chances are, you won't be in that same home 30 years from now. There are other, bigger, advantages to homeownership.

Appreciation:

Property appreciation is one of the great things about owning real estate. Up until recently, it was considered a given that home prices would rise. They have risen steadily over the years, but in the last few years, since the real estate bubble popped, home prices have fallen – sharply in some areas. If you bought a home in 2005 or 2006, chances are your home is worth a lot less than what you paid for it. But prices are determined by supply and demand. With the crash in prices, home builders have mostly stopped building new homes. As the economy improves, the extra supply on the market will gradually be absorbed, and supply and demand will balance out. At some point prices will start rising again. Appreciation isn't an automatic, but historically, home prices have risen at least at the rate of inflation. Now is also a buyer's market so I think appreciation will be a bigger factor again moving forward. When appreciation is positive, this is a great way to build wealth. Here's an example:

If you buy a home for $200,000, and the market appreciates, that is the property values increase, by 4% per year, at the end of 5 years your home will be worth $243,330. At the end of 10 years it would be worth $296,048.

In this example, you've increased your equity by nearly $100,000 while living in your own home. There's no guarantee of what home values will be in the future, but this illustrates what has happened in many communities in the past.

Let's take this a step further. Let's say you bought this same home for $200,000, but that you took out a mortgage for 95% of the price, or $190,000, over 30 years at 6.5% interest. At the end of the 10th year your mortgage balance will be paid down to $188, 239. If, through appreciation, the value has grown to $296,048, your equity is now worth $107,809. Not bad for an investment of only $10,000.

Appreciation is the reason so many people are able to move up to a larger house after owning for a period of time. Having the extra money to use as a down payment, gives you the buying power to buy a home for your growing family, or maybe the chance to move into your dream home. Appreciation is one of the key benefits of homeownership.

Tax Benefits:

The third key financial benefit to home ownership is the tax benefits it provides. When people own their own homes, they have a stronger tie to their community and to the nation. One of the strengths of the United States is that it is a nation of home owners. The Government understands this and encourages people to own their own homes. They do this in several ways, but the most important way is through deductible interest.

Real estate is treated differently than nearly every other purchase in this regard. If you were to get an auto loan to buy a new car, the interest would be treated strictly as an expense. The same goes with school loans or purchases on your credit cards. It's different when you get a mortgage. With a mortgage, all your interest, as well as your property tax, is tax deductible. (In some cases, the mortgage insurance is tax deductible, too.)

This means that you may be able to buy your own home for the same amount as you're paying in rent now. Let's say you're paying $1,200 in monthly rent. How much would that payment afford if you were to buy? The truth is, you can afford a much higher monthly payment when you look at it on an after tax basis. Here's how this works:

Let's say you were to buy a $180,000 home with a 5% down payment, on a 30 year fixed mortgage at 6.5% over 30 years. It would look like this:

$180,000 purchase price
$171,000 mortgage

$1,080	Principal and interest
300	Taxes
50	Insurance
111	Private Mortgage Insurance
$1,541	Total payment

Of your mortgage payment (principal and interest), $926 is the interest portion. Add that to the real estate taxes and you get $1,226. This is the amount that you base the tax deductions on. How much of a benefit you get, depends on your tax bracket. If you are in the 30% tax bracket, it looks like this.

$1,226 Interest + Taxes
x30% Tax Bracket
$368 Tax Savings

Now subtract the tax savings from your full mortgage payment.
$1,541 Total monthly payment

-$368 Tax Savings
$1,173 Effective Rent

In other words, a rent payment of $1,200 is equal to a mortgage payment of over $1,500. This is a great benefit, but there are ways to stretch your buying power even more. We'll go over them later in this guide.

First Time Home Buyer Tax Credit

This is another big benefit of buying a home, but this benefit is only buyers who buy this year. As part of the Recovery and Reinvestment Act – the economic stimulus package – a federal tax credit has been put in place for first time home buyers. The credit was originally only for first time home buyers, but has now been extended to some current home owners who buy a new home. This credit has been extended to cover purchases under contract by April 30th 2010 and you have until June 30th to get your financing together and close.

Here is how it will work:

1. **The credit is for 10% of the purchase price up to a maximum of $8,000.** This means that if your purchase is $80,000 or more, the credit will be $8,000.
2. **It is available for first time home buyers and some current home owners who buy a new home.** By their definition, a first time home buyer is anyone who hasn't owned a home in the last 3 years. For home buyers who have owned a home, they must have owned a home for 5 out of the last 8 years.
3. **The home has to be for your primary residence.** Second homes and investment properties don't qualify.

4. **This is a true tax credit.** This new version makes it a true credit as long as you stay in the home at least 3 years. If you sell before 3 years is up, you may need to pay the credit back.
5. **If your tax liability is less than the $8,000 credit, you will get the difference as a check back to you.** If you have already filed your taxes, you can file an amended tax return right after closing on your home and you will get the credit back as a check to you. Depending on the backlog, this may take some time, so be patient.
6. **Income caps apply.** They have increased the income caps so more home buyers will now qualify. A single buyer qualifies with earnings up to $125,000 per year and couples are maxed out at $225,000 per year. Higher earning borrowers may get a partial credit, but the amount decreases as their income rises.
7. **This credit applies for purchases under contract by April 30th 2010 and closed by the end of June.**

There was a move to make this credit available upfront so borrowers could use it as part of their down payment on an FHA mortgage. Unfortunately, this plan was derailed, so you will need to come up with the 3.5% down payment first and you can then get the credit after closing. With an FHA mortgage all the money needed to close can come as a gift, so if you have a willing parent or other well to do relative, this is one way to raise the money for the down payment. Another way you can raise money for the down payment is by adjusting your W9 form so you increase your deductions and reduce (or eliminate) your withholding taxes. This means you will have more money now and can kick your savings for your down payment into overdrive. You will owe the taxes that would normally be withheld, but these will be covered by the $8,000 tax credit. Be sure to change the exemptions again after closing.

The Home Buying Process

You know that it makes sense to buy a home, but how do you go about it? There are so many things to consider. What type of house do you want? What's the best area to buy in, and what's the best way to find a home? How do you negotiate the contract? What happens between the time you agree to buy the property and the closing? These are all good questions that you'll need to make decisions on, but before you do anything else, you need to know how much of a house you can afford.

Pre-qualification and pre-approval:
To find out what you qualify for you need to be **pre-qualified**, or **pre-approved**. Both terms are different levels of the same thing. With both, you are sharing your financial information with a mortgage loan officer, and they are helping you figure out how much of a home you can afford to buy, and what the best program is for your needs.

How much of a mortgage you can afford, and the type of mortgage you qualify for, go a long way toward determining what kind of home you will buy. The good news is that there are lots of mortgage options, and it may be much easier to qualify for a loan than you think. My job is to go over your situation, and find the program that works best for your own personal goals and needs. Choosing the right financing can save you thousands of dollars over the time you have the loan.

The difference between the two programs is that with pre-qualification you are telling the loan officer what your situation is, and they base their decision on what you tell them. Pre-approval takes it a step farther and verifies, or proves, that all the information you told us is correct. This means you are providing all the needed documentation upfront, and we are going through the documents and determining what is acceptable according to the program guidelines, and then running your credit report and putting the whole file through an automated underwriting system to give you an approval. This will make sure there aren't any unwanted surprises at the end – it will also help save you money when you go to negotiate your contract. Years ago, it could take a week or more to get a pre-approval. Now I can usually do it with a single phone call, and have it together within 24 hours.

To get pre-approved we'll need some documentation. Depending on your situation and the loan program, we may need more, but typically we'll need to see at least the following:

- W2s for the last 2 years (full tax returns if you are self employed or on commission income).
- Your pay stubs for the last 30 days.

- Full bank statements for the last 2 months, along with statements from any retirement or stock accounts.
- A copy of your drivers license or other photo ID.

What lenders are looking for

When qualifying someone for a mortgage, I look at it as a game of twenty questions. I need to get as much information about you and your finances as possible to make sure we find the best loan program for you. A good loan officer should be a trusted advisor who takes more into account than just how much of a loan you can qualify for. The mortgage you choose has to fit your life style and future goals, as well as your current financial situation.

The whole idea behind the qualifying process is to measure the risk, that is, to figure out how likely it is that a borrower will pay back the money they're borrowing. I ask a lot of questions, but the qualifying issues all revolve around 3 areas:

Credit
Income
Assets

Your history in these 3 areas determines what type of loan you can get, how much you can afford, and what your payments will be.

Credit Qualifying:

Our whole society is run on credit. How well you manage your accounts, and how you've made your payment in the past are key factors in getting an approval. That doesn't mean you're out of luck if you've had a few late payments in the past. We look at your overall credit pattern, not just isolated incidents. And even if you have had serious problems in the past, this doesn't mean you won't be able to buy a home in the future.

Risk Based Pricing - One big change in the mortgage market is the new Risk Based Pricing. This is the idea that those borrowers with the best credit scores and higher down payment will be able to get mortgages at the best rates, and those with lower credit scores and lower down payments will have to pay more. (The best conventional rates are now for borrowers with scores of 740 or above). The people affected by this change are borrowers with credit scores good enough to qualify for Fannie Mae and Freddie Mac based conventional financing. (FHA does have credit based pricing, but the cut off is at 680 with a minimum credit scores of 620).

This concept has been talked about for years, but it is only now with the real estate market soft and foreclosures rising that it is going into effect. Or more to the point, it's only going into effect now when the big mortgage players are taking it on the chin for all the bad loans they wrote when credit was easy. Those with lower scores and not much equity (first time home buyers?) will be hit hardest.

This means that **good credit is more important now than ever before**. The best thing you can do is review your credit early and address any problems now**.**

Our Credit System

Your credit record is compiled by 3 companies, Equifax, Experian and Trans Union. They are called credit repositories. The credit report from each repository can come out slightly different. When we run a credit report for your mortgage we pull a merged report which draws from all 3 repositories.

Your credit report is a record of all the credit you've built up over your lifetime. It gives a list of all the accounts you currently have, as well as accounts that you have closed. It shows the balance of the accounts, the credit limit on each account, the payment history showing late payments as 30, 60, 90 or over 90 days past due, and any past due balance. It also has a record of any bankruptcies, judgments, and foreclosures you may have had (these will eventually drop off the report in either 7 or 10 years, depending on the type, but you can usually buy a home long before they've dropped off).

FICO Scores

There is a tremendous amount of information on your credit report, but what most lenders focus on now is what's called the **FICO** score (Actually, there are 3 FICO scores, one from each repository. We generally use the middle score). The FICO score is a computer model that weighs the overall risk in your credit profile. The idea behind scoring is that they measure the likelihood of a customer's defaulting on a loan. This, for the most part, takes the human out of the approval process and makes the system more automatic. There are some big advantages to this. It's through the use of this system that you can go into Best Buy, apply for a credit card and be automatically approved for financing. It works the same way with mortgages. This is why we can offer full pre-approvals in just a few hours.

The scores can range from a low of 350 to a high of 850, but it's rare to see scores at either extreme. Most people's scores are in the 600s and 700s. Approval depends on other factors besides credit, but a high credit score will go a long way toward helping your situation. For conventional loans, if your score is 740 or above, it's considered excellent credit. There are options for borrowers with lower credit scores, but pricing hits are added. But even if your credit scores are much lower there are still options. If your credit score is lower though, it means that you may have a harder time getting approved, and the interest rate will be higher than if your credit score were higher. This is one reason it's important to check your credit early in the process, before you're ready to start looking for a home. This way if there are mistakes or problems, you have time to work on the credit and improve your scores. With time and some effort, there are ways you can raise your scores.

There are five factors that comprise the credit score. These are listed below in order of importance, just as an underwriter will look at the score:

- **Payment History: 35% impact.** Paying your bills on time and in full has a positive impact. Late payments, judgments and charge-offs have a negative impact. Missing a high payment has a more severe impact than missing a low payment. Delinquencies that have occurred in the last two years carry more weight than older items.
- **Outstanding Credit Balances: 30% impact.** What they're looking for here, is how many accounts do you have open, and what the balances are on the accounts. If you owe a lot of money on a lot of accounts, this is a risk that, in the future, you're more likely to make payments late, or not at all. The amount of your outstanding balance compared to your available credit limit is important here. If you are near your max, it hurts your score. The less available credit you use the better. It helps your score if you spread your debt around several cards, using no more than 30% of your available credit limit.
- **Credit History: 15% impact.** How long have you had credit, how long has it been since you've established each particular account, and how long

has it been since you've used the credit line? A seasoned borrower with well established credit is stronger in this area.

- **Type of Credit: 10% impact.** A mix of auto loans, credit cards, and a mortgage is ideal, and reflects better than if all of your debt is from credit cards only.
- **Inquiries: 10% impact.** Every time you apply for credit, it shows as an inquiry in the credit repository. Inquiries can lower your score because applying for more credit means you may be taking on new debt. This takes into account the number of inquiries that have been made on your credit history within the last six months. Each inquiry can cost from 2 to 50 points on a credit score. If your credit score is high, the inquiry won't affect you much. But if your credit score is lower, new credit is looked at as a big problem, and can bring your score down by as much as 50 points. Also, if you're about to buy a car or apply for a mortgage and have your credit run several times, make sure you do it all at once. It only counts as one inquiry if they're all done in a 14 day period.

Remember, these scores are calculated by a computer that's not taking any personal factors into consideration. When a credit report is generated, it's simply a snapshot of your credit profile for that day. Scores change, sometimes by large amounts in a short period of time. You just need to be aware of what you're doing, and make sure you don't go on a spending spree before applying for a loan. Again, to make sure you don't have a problem when you're ready to buy, it's important to have a loan officer review your credit and make sure you are on the right track.

Tips for credit use:
Here are some things you can do to put your best foot forward and improve your score:

- Pay your bills on time. If you have had problems, get current and stay current.
- Dispute any inaccuracies – you can contact your creditor and negotiate with them about how they report, and if that doesn't help, you can write to the repositories and dispute items directly with them.
- Be aware that paying off an old collection account won't remove it from your report, and because it shows as new activity, will most likely lower your score.

• If possible, keep your credit card balances low, compared to your credit limit.
• Don't close unused credit cards to increase your score. In the short term it takes away history and reduces your available amount of credit, so it can actually make your score drop.
• Apply for and open new credit only when you need to.
• Keep in mind that closing an account doesn't make it go a way. A closed account will still show up on your credit report, and will be factored in your score.
• Don't open a lot of accounts too quickly. New accounts will lower your average account age, and that hurts your score.
• If you've had problems in the past, re-establish your credit history. In this case opening new accounts and paying them off on time will help in the long term.

Dealing with credit problems:
So what happens if your credit isn't the best? If you've had major credit problems in the past, this may affect your ability to buy. Your situation depends on what the problem was, and how long ago it occurred. If the problem was from years ago, you might be surprised at what we can do. But even if it's a more current problem, there are options.

FHA, a government program, is more lenient of past credit mistakes, and can be a great option for many situations. We'll discuss this more later. It also depends on the specific circumstances of your situation. Many people think that after a bankruptcy, for example, they won't be able to buy for years. But depending on the causes, you may be able to buy, at good rates, as soon as a year or two after the discharge, if you have reestablished your credit.

Another option is to take steps to improve your credit report. Mistakes on credit reports are all too common. Because of this, a process has been put in place, by law, for consumers to contest incorrect items on their credit report, and have them removed. First you need to get a copy of your credit report and decide which items you want to dispute. Next write the credit repository (Trans Union, Equifax or Experian, this can be done on their websites. Here are the links to their dispute pages: Trans Union Equifax Experian). Tell them that the information is incorrect, and that they need to investigate the information and remove it from your report. If you have any documentation to help your case, include it with your letter, but you are not required to show proof. Once the credit repository gets this, they are required to investigate it within a reasonable amount of time (60 days), and if they can't prove that the information is correct, they have to remove it from your report.

To do this, they send a form to your original creditor. At this point a few things can happen. If the creditor fills out the form and sends it back stating that the information is correct, the credit repository will reject your dispute, and the item will remain on your report. If they agree with you that the item is incorrect, it will obviously be removed. But in many cases they simply don't respond. If they don't respond by sending the form back within the 60 day period, the credit repository is required, by law, to remove this item from your credit report. They are also required to notify the other repositories that the item is incorrect, and they too are required to delete it from their files.

It's possible to clean up problem spots on your credit using this approach, but you will need to be very disciplined about following through, and it may take several attempts before you see any progress. There are companies that specialize in cleaning up people's credit, using the same methods, and some claim they can guarantee results. But watch out. Some charge huge upfront fees, and if you don't know who you're dealing with, you could spend a lot of money and end up with no change in your credit. However you do it, the best thing to do is to address this situation early. If your credit score is a concern, give me a call. I can consult with you, and help you to find the plan that's right for you.

Income Qualifying

The second area we look at is your income. Again, we're measuring risk here. In this case we want to make sure that your income is high enough to comfortably make the payments on your new mortgage. To do this, we look at two things: income stability, and ratios. I'll go over both.

Income stability: When people are trying to figure out how much they can afford, this is one area where it's easy to get bad information. First we need to determine how much you make each month. We use gross income, not your take home pay. If you're in a job where you get the same amount of pay each month, it's pretty simple. But if you have a job where your income fluctuates from month to month, like commissioned sales or construction, or if part of your pay comes from bonuses, it gets more complicated. In these cases we need to go back and look at the history of your income over the last two years and make sure that this income is likely to continue.

In any event, lenders look more favorably on someone who has been in the same (or similar) line of work for at least 2 years. If you haven't been working steadily for the last two years, we need to know why. There are many acceptable reasons, including:

- You recently finished school, vocational training, or left the military.
- Your work is typically seasonal and gaps in employment are normal in the industry.
- You have been laid off from your job.
- Frequent employment changes are normal in your line of work (some types of sales, for example), but you have been consistently employed and maintained a consistent level of income over the past 2 years.

In addition to income from your job, other sources of income are also acceptable. These can include alimony or child support, pension or disability payments, investment income, trust income, and so on. We can also use income from part time jobs, but you need to show a history of keeping two jobs. Again, in order to use the income to qualify, we need to be able to show that the income is likely to continue.

Housing and Debt Ratios:

This is a big factor in how much you qualify for, but one that has changed a lot recently. There are actually 2 ratios we look at. The first, the ***housing ratio***, is a measure of your total housing cost compared to your monthly income. The housing figure includes all the normal monthly costs of owning a home: the principal and interest payment, the monthly taxes and insurance, mortgage insurance, and the association fee if it's a condo or townhouse (we'll get into this more, later). The second ratio is the ***total expense ratio***. This measure includes not only your housing expenses, but all your other monthly debts, too. So this takes into account all your minimum credit card payments, car payments, student loans, any alimony or child support, and the like. (There are some obligations that you are required to pay, things like car insurance and day care for children, that don't count in the ratio. You do, however, need to keep these items in mind when budgeting.)

For years, the maximum ratios were 28/36; that is, no more than 28% of your income could go toward your housing payment, and all your debts combined couldn't be above 36% of your income. This isn't the case anymore. As I mentioned before, credit scoring changed everything. Now most of our programs are run through an automatic underwriting system which analyzes the total risk. With good credit, it's now common to qualify for a much larger payment than you would have before.

What if you can't prove all the income you receive? This is another area where the underwriting guidelines have changed a lot. Not so long ago, there were lots of loans that didn't even ask about how much you made, or if they did, they didn't try to verify it in any way. These programs went under a variety of names such as, no income verification (NIV), no ratio loans, stated income and 'No Doc' loans. These loans opened the system to a lot of abuse. Some people bought houses they had no hope of making the payments for, and foreclosures in these loans skyrocketed.

Because of these problems, lenders have pulled these loans off the table. Still, if you are self employed, or if you know that you'll be able to make the payments, but there's income that we can't use for qualifying, and you have good credit, there may still be options available. If you have questions about whether we can use all of your income to qualify, give me a call and I can see what works best for your circumstances.

Assets Qualifying:
This is the third major area we look at, and here we mostly want to make sure you have enough money for your down payment and closing costs, and in some cases, money in reserve. Again, we get back to the idea of risk. The lender as a rule wants you to have your own money invested in the property you're buying. The thought behind this is that if you have your own money at stake, you're more likely to take care of the property and make sure you make your payments on time. It used to be that in order to get a mortgage, you needed to have 20% of the purchase price as a down payment.   That's not the case anymore. There are loan programs that let you buy with low down payments, or in some cases no money out of your own pocket at all Still, how ever much you are putting down, we need to verify it, know where it's coming from and be able to prove that you have enough to close.

In order to check for assets, we look at the statements from your bank and other accounts (we'll usually need your last 2 months of statements). If there are any large deposits (not counting your normal payroll checks) we need to show proof of where the money came from. Depending on the loan program, the money to close can come from your savings, the sale of stocks or other investments, a loan against your 401K, a gift from a family member, selling other assets (an extra car, a boat or having a garage sale), and a number of other sources. Where it ***can't*** come form is another loan.

To make things as smooth as possible, it's important to know where your down payment money is coming from, and be able to show it before getting final approval. It's best not to transfer money from account to account, if possible, but if you have to, make sure you keep records so we can trace the flow of funds. If you have any questions about your down payment, and whether it will be acceptable, discuss it with your loan officer before you are ready to make an offer, to make sure you can structure it correctly.

Gifts for your down payment:
Gifts are a special case, and if you are expecting that some of your money will be from a gift, a little planning ahead of time will make your experience much easier. First of all, gifts aren't allowed on every program. With some conventional programs, unless you are putting at least 20% down, 5% of the down payment needs to be from your own funds. All the rest can come from a gift. With FHA loans all your cash can come from gift.

Gifts also have to be documented in a particular way. We have to be able to show that this truly is a gift, not a loan. To show this, we use what is called a gift letter. This is a form that is filled out by you and the person giving the gift. It states how much the gift will be, what your relationship is to the person (it has to be a family member of some kind), and that this is a gift and won't need to be repaid.

Then we need to prove that the donor (the person giving the gift) has enough money to give the gift. For this we will need an account statement or a letter from the donor's institution stating that they have the funds available. The last step is that we need to show the transfer of funds from their account to yours. The easiest way to prove this is for them to give you a certified check showing them as the donor and you as the payee. Make a copy of the check and show the deposit into your account, and we're done. If they give you the gift as a personal check, you will need to allow extra time because then we'll have to see the canceled check. This whole process is clumsy and redundant, but following each step will make things much smoother in the long run.

One other note, this letter and the documentation are only used for approving the loan. None of the information will be shared with the IRS, or any other government agency.

Some things to avoid before closing:
Once you've been pre-approved, you are ready to buy as long as there are no major changes in your financial situation. These are some things you need to avoid before you've closed on your new home.

Don't buy or lease a car - Unless you have to, it's better to put off any big purchases until after you've closed on your new home. A large increase in your debt-to-income ratio could be a problem. It's a good idea to call your loan officer before making any major purchase.

Don't move assets from one bank account to another - If you do, we will need to have a paper trail to document the source of funds for each new account or large deposit. If you want to consolidate accounts, it's better to wait until after you have closed. Either way, call myself or your loan officer before you do transfer funds.

Don't change jobs - Sometimes this is unavoidable, but many new jobs have a probation period, that is, a time before you are considered a permanent employee. This must be satisfied before we can count your income from the new job.

Don't apply for new credit - This counts as an inquiry on your credit report, and it may affect your credit score. If you open new accounts we will hit you with the new payment.

Don't try to consolidate bills before speaking with your lender - Moving loan balances around can affect your credit score. Talk with your lender before you do anything major.

The Home Search

Once you have a range of what you can qualify to buy, you are ready to start looking for a home. But this can be confusing too. There are so many options out there; the internet, ads in the paper, yard signs, real estate magazines, open houses. How do you go about finding the right house for you? Prices can differ tremendously from town to town, and even neighborhood to neighborhood. You have to decide what type of home you want and what amenities are important to you. You have to learn about the school districts, and see what areas have done best with resale value. You need to sort through all the houses available on the market, and narrow your choices down until you know exactly what kind of house is the perfect house for you. In a way, you need to educate yourself on all these different options so that you can make the right choice. But what's the best way to go about this?

Realtors: Most people turn to Realtors when they begin their search for a home. A key benefit of working with a Realtor, is that they have full access to the computerized ***Multiple Listings Service*** (**MLS**). This means that your agent can view every property listed in the market, and show you new home listings as they become available. They will usually put you on an automatic email search, and they can also give you access on their websites so you can do a lot of the searching yourself.

But good Realtors do much more than just show you properties; they can act as your advocate and guide, steering you away from costly mistakes and helping you make the right decision. A good Realtor provides valuable guidance from your search, through negotiations, inspections and closing. They are experts in the areas they specialize in, and can help you determine trends in a neighborhood's property values, demographics and the quality of schools. An experienced agent will also have a good feel for a home's true market value.

A common misconception is that it costs a lot of money to work with a Realtor. The opposite is true. First of all, the Realtor's commission comes from the seller – the buyer doesn't pay a thing. One mistake many buyers make, is to try and save money by buying properties that are for sale by owner. Sometimes these can be a deal, but more often the seller is selling by himself in order to get top dollar for the property. It's easy to overpay if you don't know the market. A good Realtor will help you avoid mistakes as well as find the home that works best for you. If the home is for sale by owner, they can often negotiate directly with the owner. Their knowledge of property values, and their ability to negotiate, can usually save you money.

Agency: One thing you need to be aware of right from the beginning is who your Realtor is working for. The commission is almost always paid by the seller. If you call off of a sign or ad, you will be dealing with the ***Listing Agent***. The listing agent works for the seller, and her job is to sell the property at the best price and terms for the seller. Listing agents do work with buyers, and they can be quite helpful and informative, but their duty is always to the seller. Unless arrangements are made beforehand, any other agent showing you houses is also considered a subagent for the seller. That means that they too are legally representing the seller's interest.

This isn't necessarily a bad thing. If you're working closely with your agent, you often develop a personal relationship with each other. She knows your needs and what you're looking for. As you work together she starts to think of you as her client. Also, if she does a good job working with you, you're likely to refer friends and relatives to her, bringing more income down the road. She has no such relationship with the seller. So on an emotional level, your Realtor is likely to be working in your interest. But legally she is working for the seller.

There is another option. ***Buyer's Agency*** means that the Realtor represents you, not the seller. That means that she will be able to negotiate the transaction for your best interest. The important thing is to discuss your options with your Realtor upfront. This way you know exactly what to expect as you go along.

Finding the right Realtor:

A good Realtor can help you a lot. But how do you find the right Realtor for you. Most people know someone who sells real estate. For a lot of people it's a side job where they can make good income while working part time (in good times, anyway). But buying a home is one of the biggest decisions you will make in your life. It's important to find a professional agent who will work well with you, negotiate effectively and be able to handle all the details all the way through the closing. Here are some questions you need to keep in mind when choosing an agent:

How long have they been selling real estate?
Is this their full time job?
How familiar are they with the area you are looking in?
How many transactions have they had over the last year?
Do they mostly work with buyers, or sellers?
How do they approach negotiations?
What professional designations have they earned?
Do they sell many homes in your price range?

The best way to find an agent who will work well with you, is through referral, either from someone you know who was pleased with their performance, or from someone in a related business who has direct experience and knows who the quality agents are. Another way is on the internet. More and more buyers are finding their agents online. If you find an agent with a blog, this can be a way to get to know them before you have any contact with them at all. By reading their posts, you can get an idea of their experience level, personality and what areas they cover. This is becoming a great source of finding agents you might not have heard of otherwise.

Once you find someone you are thinking of working with, another consideration is how comfortable do you feel with them as a person? Until you close on your new home, this will be a close relationship. You need to be able to trust and get along with your Realtor or it will cause friction. You need to know that they are on your side and working toward your goals.

When you first start looking for a property, you are in an education phase. You need to learn about the prices, the types of homes, the advantages of one neighborhood over another, and all the other details, before you're comfortable making an offer. This education phase is a normal part of the home buying process, and it can take from a month, to over a year before you are ready to buy.

When first starting their search, many buyers will stop by open houses, or call any ad or sign for a property that sounds interesting to them. They're just gathering information at this point. A recent study found that the average buyer talked with between 14 – 17 agents before buying a new home. You are better off finding one good real estate agent and sticking with them. Through their access to the MLS they can find the answers to any of your questions and they can also put you on a service that automatically sends you all the new listings that fit your criteria. While you are researching the market they can help you gather all the information you need to narrow down your choices. Then, when you are ready to start looking at the insides of homes, you will have a better idea of what is important to you. I can refer some excellent agents to you when you are ready.

A few last points on your home search:

A few other notes to keep in mind as you look for a home. School districts are important, even if you don't have kids, because a good school district means strong property values. Also, you should look at the house you're going to need, not necessarily the house you need right now. Some people try to keep their payment down by buying a house smaller than their needs, but over time most people get used to their payments, no matter how scary they may seem at first. If you can afford it, it's not a bad idea to give yourself some room to grow. That way you won't feel like you need to move again, sooner than you'd like. On the other hand, you shouldn't buy the biggest home you can afford. If you are house poor and all your income is going toward your mortgage payment, it can add to your stress level and cramp your lifestyle and put you at risk. It is important to plan a budget so you can comfortably make the payments on your new mortgage.

Making an offer, and negotiating the contract:

Once you've found the perfect home for you, it's time to make an offer. Before you commit to anything, make sure this is really the house that you want. Contracts are binding, so once you've committed, it's too late to change your mind. It's important to know what houses in the area with comparable amenities have sold for. The better you know your market, the better prepared you'll be for negotiating. A lot of times people will want to start the bidding by coming in with a "low ball" offer. If the sellers are highly motivated to sell, this may work, but more often, a better strategy is to make a realistic first offer. What you offer and what the seller will accept depends on the strength of the market and the circumstances of the seller. Your Realtor can help advise you on how much to offer by showing you what comparable homes have recently sold for.

In real estate, your offer has to be in writing, which means you'll be using a real estate contract. Most likely you'll be using a standardized contract that's used by all the real estate professionals in the entire MLS area, which is almost all of the Chicago area. Because it is standardized, most of the legal details are spelled out in the body of the contract, and aren't considered negotiable items. You've probably been told never to sign anything until it's been looked at by an attorney. That's usually good advice, but with a standardized real estate contract, one of the clauses gives you several days after signing during which your attorney can review the contract and make any legal changes. (Keep in mind, your attorney can modify legal issues, but can't change the terms of the contract.) This allows you to move fast when you're ready to buy, yet still make sure you are fully protected.

Most of the legal matters of the contract are already spelled out, but there are blank spaces where you fill in details specific to this home, and this offer. This will include the address of the property, your names and the seller's names, as well as all the negotiable items. Some of the items that are considered negotiable are:

The price of the home: This is the detail most people focus on, and it is important. But sometimes you are better off if you are more flexible with the price, and work other terms to your advantage.

The amount of earnest money: This is your "Good Faith deposit". In order for the contract to be binding, you need to offer something of value upfront. The more money you put up, the more seriously the seller will view the offer, but you can make this whatever amount you choose. This money will be applied toward your costs at closing, and if the sale falls through for reasons outside of your control, you'll most likely get it back.

Items to be included in the sale: You're buying the real estate, but you want to be sure you are getting what you think you are. Items that are built in are considered fixtures and will stay with the house. But things like window treatments, playground equipment, refrigerators, and washers and driers are considered personal property. If they aren't listed as part of the sale, they may not be included. If you choose, you can make these items, or anything else, part of your offer.

Seller Contributions: This is one of the **best-kept secrets** in the home-buying process. Most loan programs will allow at least 3% of the sale price as a seller contribution (Right now it is 6% for FHA, but as of April 1st 2010 it will also be 3%). This means that you can ask the seller to pay for your closing costs. For most first time buyers, the biggest obstacle to a sale is having enough cash to close. This tool allows you to use the cash that you do have most effectively, and many times can be the difference between buying, or not. Contributions have to be negotiated upfront, and you may need to trade off on the price in order to make it work. Give me a call and I can show how this can work for you.

Finance contingencies: A contract is usually written with a contingency for your getting fully approved for a mortgage. That means that if you aren't able to get approved by the date set in the contract, you can void the contract and get your earnest money deposit refunded. (If you haven't been able to get your financing together by the contingency date, you must request an extension, or else you risk losing your earnest money. Your attorney will be able to handle that.) Sellers have more of a risk until the contingency date has passed, so they will usually want as fast a contingency as possible. Extremely well qualified buyers can waive the contingency, effectively coming in as a cash buyer. This can be appealing to the seller, but it carries a risk to you if for some reason you can't get your mortgage. Make sure you talk with your loan officer before writing the contract, and put in a contingency that is realistic.

Other items you'll need to include in your offer are when you want to close and a contingency for a home inspection.

Counter Offers:

Once you've presented your offer, three things can happen: one, it will be accepted as it is, two, it will be rejected outright, or three, you will receive a counter offer. If you receive a counter offer, that means the sellers are seriously considering selling to you, but they aren't satisfied with your price or terms.

You will usually sit down with your Realtor when you are first making your offer, but the counter offers will often be made in back to back phone calls. This is when things can get stressful. It's hard not to get emotional when negotiating, but it will serve you well if you can keep calm and look at the big picture. Remember, everything is negotiable. You need to look at each point and determine how important it is to you. Some things may not be that important to you; other items can be deal-breakers. Give in on the things you can do without, and concentrate on the points that are truly important to you.

A good deal is good for both the buyer and the seller. There may come a point where the deal no longer makes sense, and you need to walk away, but don't do it for ego reasons because you feel that you have to win. Try not to look at it as a contest, but more of a process that allows you to get the home you want.

Buyer's remorse: After you've come to an agreement, it's normal to feel that you acted too fast, and paid too much. This is a common reaction. If you do experience this feeling, try to think back to all the houses you looked at before coming to your decision. You made an offer on this home because something about it stood out when compared to all the other properties you could have bought. Usually you'll find you made the right decision.

Buying foreclosures and short sales. In this market, special mention needs to be made be made about distressed homes, where first time home buyers often start their search. Foreclosures are bank owned properties, homes that are owned by the lender because the home owner couldn't make their mortgage payments. Short sales are pre-foreclosure properties where the home owners owe the bank more than the value of their home. Foreclosures in the Chicago area used to be a tiny percentage of the homes sold. But over the last few years with the down turn in the housing market and the economy, the percentage has grown and foreclosures have exploded. There are a lot of bank owned properties on the market, but short sales are the fastest growing segment. It is a sad sign of the times that these homes are the most active part of the market. It is a real tragedy when a family loses their home (though a good percentage of the foreclosures are investments and speculations gone bad). It is also bad news for the community and a real problem for the bank that holds the mortgage or owns the home. **But if you are in the market for a new home, buying a foreclosed property or a short sale can mean big bargains.**

With a foreclosure, the bank is the owner of the property and you negotiate directly (through the Realtors) with them. This can be more bureaucratic, but they are looking at the property sale as a business decision and their goal is to sell the property quickly for the best price they can obtain. Another thing to keep in mind with foreclosures is that the bank has a bottom line idea of what they need to close. The bottom line is what is important, not how the transaction is structured. This means you can ask for the seller to pay closing costs, just like you would with a private seller. The biggest issue with foreclosed homes is often their condition. It's common for the foreclosed former owner to take out their frustrations on the home, and some homes are left in rough condition. Another problem is that many banks are overwhelmed with all the properties on their books, so they are slow to handle even routine maintenance. There are a lot of properties which weren't winterized in time, so they now have plumbing problems, mold or other issues. As a rule, the bank wants to sell as is and they won't handle repairs if they are needed. For properties with larger problems this means that an FHA 203k rehab loan is the only way to buy. But often, the problems are fairly minor. Many times the buyers are handling the repairs themselves, before closing, as this is the only way to get the deal completed. Buying a foreclosure is usually a straightforward process, but make sure you allow enough time to close, as the bank who owns the home may insist on penalties if the closing takes longer than the negotiated close date.

On the other hand, short sales are a two step process. A short sale is a property which is being sold by an owner who is selling for less than what they owe on the mortgage. This means that you not only have to get the seller to agree to your price and terms (the easy part), but also the bank (or banks) which carry the mortgage. A year or two back when short sales first became a major factor in the market, a lot of contracts were being negotiated, but the chances of their closing were pretty iffy. Banks would sit on the contracts for months at a time. Meanwhile the homeowners would get further and further behind and the home buyer would often lose interest in waiting and move on to another property. That situation has changed, and many short sales are getting done in a reasonable length of time, but there are still a fair amount of obstacles with short sales. Banks have gotten more realistic about the market and have gotten much more aggressive in responding to short sale offers. But a lot of it comes down to what stage they are at with the seller. If the seller is already working with the bank and has a case manager assigned, the transaction can come together quickly. If the bank is starting from scratch, be prepared for a long, drawn out wait. A bank needs to do their own due diligence to show that accepting the offer for the short sale is in their best interest. This means they need to have an idea of what the current value is on the property and run an assessment to see if it makes sense to take the offer now or to go through the time and expense of foreclosing and then remarketing the home.

Short sales can be a win-win-win. They are usually good for the bank that holds the mortgage, good for the seller having trouble paying for the mortgage, and good for the new buyer. From the bank's perspective, the worst thing that can happen is when they have to foreclose on a home and take possession. Banks make their money by collecting mortgage payments, and a foreclosure means that they own a property that they don't want, and aren't equipped to take care of. It also means big legal fees, extra time lost, and lots and lots of expenses for a property that is worth less than what they originally made the mortgage for. Their motivation is to get rid of this problem as quickly and with as little cost as possible. A short sale means that they take a one time loss and they know exactly how much it will cost them. This avoids having to take the time and effort of going through the foreclosure process, less legal fees, and gets a bad loan off the books in a quicker time period. This is a win for the bank. For the seller it's a win too. A short sale is going to be a bad mark on their credit, but not nearly as bad as a foreclosure. A short sale stops the pain and brings a bad stage in their life to an early end. They can then work on rebuilding their credit and getting their lives back to normal. The advantage for you, the buyer, is that you have a chance to strike a real bargain with the bank and buy for less than other comparable homes. The price and terms are negotiable, and the bank's feelings won't be hurt if you come in low. So this can be a big win for the buyer. Short sales are done a little different than with a normal contract between a buyer and a seller. The buyer first negotiates the price and terms with the home owner, but then the contract must be approved by the bank that holds the mortgage. They can come back accepting the contract as it is, or they may make a counter offer.

When making an offer for a short sale you may want to put in a time limit for a response. Banks by nature are not nimble, and often take too long in responding. Another problem comes in when the seller has more than one mortgage on the property. This means you have to negotiate terms with both mortgage holders, and s the second lien is likely to get nothing out of the sale, they have no real incentive for negotiating. If you are looking to close quickly, short sales may not be the way to go.

Property Types

It used to be that all property types were looked at in a similar way. Now properties are adjusted for risk. This means that the requirements are tighter and the pricing will be more expensive if you are buying a **condominium** or a multi unit (2, 3 or 4 flat) building. With condos, the minimum down payment for most buyers using conventional financing will be 10% (we do have 5% down condo loans available, but they are only for the most qualified borrowers) and you will pay more unless you have at least a 25% down payment. All condo projects will need to fit into the guidelines for both the end lender (Usually Fannie Mae and Freddie Mac guidelines, the industry standards) and if you have less than a 20% down payment you will need to conform to the mortgage insurance guidelines, too. FHA may be a good way to get around these new tighter guidelines. I have more information on FHA condo approvals later in this guide.

Once you have a contract

You've been pre-approved, you've found a property and have a contract. What now? You'll have lots to keep you busy in the days after you get the contract together. It's a smart idea to have a real estate lawyer review your contract. They will look it over and make sure you are protected legally. They'll also attend the closing and will review all the closing documents before you sign. Nine times out of ten everything will be just the way it's supposed to be. But if there is a problem, it helps to have a good attorney on your side. Real estate is a specialty, and you need someone who concentrates on it, not a generalist who does family law and personal injuries as well as real estate closings. If you need a recommendation, let me know.

This is also the time to have your home inspection. Every home has little things that are wrong with it, but if a house has major structural problems, or if the roof or plumbing system is shot, it could cost you a fortune. A home inspector knows the things to look for. After he finishes his inspection, he'll give you a written report. If there are any serious problems, make sure that your attorney gets a copy of the report. At this point you can ask the seller to either fix the problems or give you a credit to fix it yourself after the close. Or, if it is too big a problem, you can get out of the contract and get your earnest money back. Make sure you do everything within the home inspection contingency period.

You will also need to buy a ***home owner's insurance policy*** before closing. This policy protects you and the lender from loss due to fire, accidents and other circumstances outside your control. You will need to purchase a full year's coverage, and you can buy it from whichever agent you choose. Your insurance agent will need to contact your lender to make sure they have the right terms and wording on the policy.

Types of mortgages:
This is also the time to get your mortgage finalized. You may have gone over this when you were pre-approved, if not, you need to decide what type of mortgage is best for you. There are a lot of mortgages available but most of them are variations of a few types, and most will break down into one of two categories: fixed rates, or adjustables.

Fixed rate mortgages: This is probably the first type of mortgage you'll look at. These are the simplest and safest mortgages overall, because you know that your payment will stay the same from your first payment to the last.

A fixed rate means that the interest rate and the monthly payment are fixed at closing, and never change. The most common mortgage is a 30 year fixed, but you can also get fixed rates that run for 40, 25, 20, 15 and 10 years. In each case, if you stay in the mortgage for the whole time period, you'll pay off the mortgage and own your home free and clear at the end of the term. The shorter the period you're borrowing for (say a 15 year instead of a 30) the more of each payment will go toward principal, so your loan pays off faster. The difference in payment between a 30 year and a 25 isn't that much. If you can afford it, you may want to go this way and pay your mortgage off quicker. But before you do, take a look at your overall financial situation. One major mistake people make is to pay off their mortgage quickly, while maintaining balances on their credit cards. You're better off if you take a longer term mortgage, and use the difference in payments to pay down your debt or build your savings. If your goal is to build up equity quicker, there are other ways to do that, as we will see.

In recent years many people have chosen to go with a fixed rate, because interest rates have been so low. This has been a safe choice, but it's not always the best choice. Most people, especially first time home buyers, don't stay in their home, or their mortgage, for anywhere close to 30, or even 15 years. Most first time home buyers stay in their home for 5-7 years. With a fixed rate you know your interest rate will never change, but if you don't think you'll stay in the home, or the loan, that long, it may pay to consider an adjustable rate. Sometimes there can be a big difference in the rates (usually when rates are moving higher).

Adjustable rate mortgages (ARMs):
This is a scary concept for many home buyers, but you might want to consider an ARM if this isn't going to be the house you want to spend the rest of your life in, or if you feel that your income will be increasing over the next few years and you are willing to accept a little more risk. With an ARM, your interest rate is lower in the beginning, in some cases a lot lower, than it would be with a fixed rate. There's a tradeoff here. You're getting the benefits of a lower interest rate, but you're taking on more risk if the interest rates go up, and you stay in the house longer than you had expected to.

Let's back up a little. An ARM is usually amortized, or paid off, over 30 years, but the loan is divided into two time periods; the beginning, where the rate is fixed, and after that when the interest rate and payment can change. The time where the rate is fixed can last from as short as one month to as long as 10 years. The shorter the fixed period is, the lower the rate will be. Most people try to pick an ARM length that matches up to how long they expect to be in their home. So, for example, if you think you'll be living in this house for 5 years, you would pick a 5 year ARM. This is how it might compare with a 30 year fixed:

$100,000 loan
30 year fixed at 6.5%
Principal and interest -- $632 per month

5% year ARM at 5.75%
Principal and interest -- $583 per month

That comes to a savings of $48 per month on a $100,000 loan with the ARM, and you would save $2,905 over the first 5 years of the loan.

You can see that the ARM has some strong benefits in the early years, but for many people, the fear is, what happens if they're still in the home after the fixed period is over? The thought that rates could rise and send payments through the roof is enough to keep them up at night. It's true that you are taking more risk with an ARM, but there are some features built in which make them much safer than most people realize. In order to see this, we need to break down exactly how an ARM works.

What happens if the rates go up? – Anatomy of an ARM:

After the fixed portion of an ARM expires, the mortgage will adjust, or change, on a regular basis. When and how it will change depends on what type it is. Most ARMs are set up to change yearly after the fixed period is over, though some will adjust every six months, and others every month. (You will hear people talk about 3-1 or 5-1 ARMs; this means they are fixed for 3 or 5 years at the beginning, and then change every year after that.)

The ARM changes are based on two things that are set up at the beginning: the ***index,*** and the ***margin***. The first part, the index, refers to the financial indicator the rate is based on. There are a number of indexes that are used: the One Year US Treasury Index, the LIBOR (London Inter Bank Rate) and several different Cost of Funds indexes are the most common. In each case, the index is a measure independent from and out of the control of the company making the mortgage. They are all posted weekly in financial papers. The index will go up and down over the lifetime of your loan, based on what happens with interest rates overall. Some indexes are more volatile, that is they move faster when rates change, while others move much more slowly. If you would like to compare the history of different indexes, let me know.

The second part of an ARM loan is the margin. While the index will change on a regular basis, the margin is set at the time of closing, and it always stays the same. To see how the ARM will change, you add the margin to the index. We refer to this as the ***fully indexed rate***.

So let's say you have an ARM where the index is at 3% and the margin is at 2.75. To get your interest rate, you add them together and the fully indexed rate is 5.75%. But this doesn't necessarily give you your rate. There's one more step.

It's normal for rates to move over time. And because the ARM is starting out at a lower level than you would be if you were in a fixed rate, some movement upward is just taking away part of the gain that you locked-in in the early years of the loan. But if the rate spikes up sharply, it could increase your payment so much that you might have trouble making the payments. To protect you from this, most ARMS have ***caps*** built in to them. A cap is a maximum amount that the rate can increase in any single year, and over the entire lifetime of the loan. Typical caps are 2% per year, and no more than 6% over the lifetime of the loan.

So this is how it would work. Let's take the same 5-1 ARM at an interest rate of 5.75% with caps of 2% per year and 6% for the lifetime. That means that the rate will be fixed at 5.75% for the first five years. Then, starting with the sixth year, the rate will readjust every year. If rates skyrocketed, the highest it could be on the sixth year would be 7.75%, and in a worst case scenario, the highest it could ever go would be 11.75%. This sounds scary, but let's look at this situation a little closer. First of all, rates usually don't go straight up, or straight down. They rise and fall based on what is happening in the economy. Usually, if interest rates rise too much, that puts a brake on the economy, and it begins a cycle where rates will come back down. Several academic studies have compared ARMs to fixed rates, and ARMs have come out ahead over almost every time period. Going back to our example of the $100,000 loan, we know that the ARM (5.75%) saved $2,905 over the fixed (6.5%) in the first 5 years. If the rates went up and the ARM went to its full cap, it would be at 7.75% in the sixth year, and the payment would be $701 per month (the mortgage has paid down some, so the new balance would be $92,762). That's almost $69 higher than the fixed rate would have been, but at the end of the year you are still ahead by over $2,000. The next year, if the rate goes up the max again, the rate would be at 9.75%, with the payment at $823 per month. That's $191 more than you would be with the fixed, but it takes another ten months before you have paid more than you would have with the fixed rate. So in a worst case scenario, you would have close to 7 years of lower costs before breaking even with the fixed rate.

Even if you stay in your home longer than you expect to, it's not likely to be a disaster. If rates are going up, chances are your income will be increasing too. Your income seven years from now may be much higher than it is now. So even if the payment does go up, you will be in a better position to adjust to it.

The bottom line is that you have to feel comfortable with the loan you choose. For many people the low rates on the ARMs are a great benefit and worth the risk. For other people the fear that their rate might go up is enough to keep them up at night. You need to decide which program works for you, emotionally as well as financially.

Interest only loans: A loan that was very popular over the last few years is the ***Interest Only*** loan. These are available as both fixed rates, and as ARMs. The ARMs come with the same features as other ARMS, that is they can be fixed for a period before they start to adjust, and they have caps built in for safety. But with these programs, you pay only the interest portion of the payment, and no principal. This drops your payment down even more, and allows you to qualify for a larger mortgage, or use your cash for other purposes. These programs give you more flexibility with the loan, and they are great if you are looking for the lowest monthly payment upfront; but at some point you will have to start paying the principal back, too. The risk here is that if rates rise at the same time you have to start repaying the principal, the combination can make your monthly payment go up more than you are expecting.

The fixed rate interest/only loan is a safer option. This works like all other fixed rates in that your rate is set at the beginning and never changes. With the interest only feature, you have the option of paying only the interest for the first 10 years of the loan. After that, the loan will re-amortize into a 20 year fixed loan at the same interest rate. These can be a great option, especially if a big part of your income comes from bonuses or other non regular sources, or if you expect your income to increase over time, but make sure you understand exactly what you are getting into.

Low down payment options:

For most people the biggest obstacle to owning a home, is finding the down payment, and having the cash to close. Lenders have pulled back here, but there are still options. If you have enough saved for at least a 5% down payment, there are conventional options. If you have 3.5% of the purchase price FHA is a great way to buy.

Most of these low or no down payment programs use ***private mortgage insurance (PMI).*** When you buy insurance for your house or car, the insurance protects you from major losses. PMI is a different type of insurance. If a borrower doesn't make the payments on their home, the PMI protects the lender from taking a loss. But because the PMI company is willing to take that risk, it allows the lender to make you a loan with less than the 20% down payment that was once traditional. The PMI payment can be made in several ways, but it's usually paid out monthly as part of your mortgage payment. The rates vary based on how much you have put down – the less you put down, the greater the PMI payment. When you look at 5% down programs, the PMI can be a substantial part of your total payment. Still, it sometimes is the best option, and paying the PMI allows you to buy now, instead of waiting until you have saved a large down payment.

You can get rid of the PMI, though. After you have been in the house for a while, with appreciation and from paying down the mortgage, you will build up equity. When you think your mortgage is down to 80% of the balance of the loan, you can petition your lender to have the PMI removed. In order to do this, you will need to request it in writing, and your lender will require an appraisal on the property to make sure the value is there. If they agree, and you have been current on your mortgage payments, they will remove the PMI. Another option is to refinance.

Piggyback mortgages: Another option may be by breaking your mortgage into 2 parts. These aren't as common as they used to be, but 80/10/10s or combo mortgages are still available through a few lenders. These loans are a combination of a regular first mortgage, with a second mortgage or home equity loan added on. For example, an 80/10/10 is an 80% first mortgage with a 10% down payment and a 10% second mortgage. With these programs you are borrowing the same amount as you would in a more traditional loan, but by structuring it this way you are making two payments, to two different lenders.

Because lenders have pulled back on the second mortgages, the biggest use of these loans now is in specific situations and not for general use.

100% programs:
This was one of the fastest growing areas in lending in recent years, but now most lenders want to see at least some down payment. Recently the mortgage insurance companies withdrew coverage for 100% financing

programs. In response, Fannie Mae and Freddie Mac, the organizations that buy up most of the loans in the aftermarket, changed the guidelines on their programs. This means that even the programs designed for low and moderate income buyers, like **My Community** and **Home Possible,** now require at least a 5% down payment, and if you are buying a condo expect to put down at least 10% for a conventional mortgage.

Another option is through **Government Loans:** There are two government insured programs geared toward low and no down payment borrowers, FHA and VA.

FHA: This was the original low down payment option. FHA is a government backed program that's designed to allow more people to buy their own homes. FHA has recently updated its guidelines, and is now one of the most attractive loan programs available for many buyers. It requires a 3.5% down payment, but all of that can be a gift, so the money doesn't have to come from your savings. FHA is more forgiving for people with credit problems then many other programs, and the qualifying standards are designed to get more people into their own home.

FHA loans are federally insured mortgages targeted toward increasing home ownership for people with moderate incomes. The FHA max mortgage is determined on a county wide basis based on the areas median home values. In higher priced areas (mostly California) the max limit extends up to a high of $729,750. The floor in counties where higher limits don't apply, is $271,050.

Here are the FHA maximum loan amounts for the Chicago Metro Area:

1 unit $410,000

2 unit $524,850

3 Unit $634,450

4 Unit $788,450

These loan limits are now close to the conventional limits, so you can use minimum down payment FHA financing for a purchase of up to about $425,000.

The biggest difference between FHA and conventional is how FHA handles mortgage insurance. FHA splits the mortgage into 2 parts, a monthly premium (.55% of the loan amount divided by 12 paid each month) which is lower than private mortgage insurance, and an upfront premium which is added into the amount financed. The monthly insurance can be taken off after you have had the loan for 5 years and your loan is down to 78% of your home's value. The Up-Front MIP is 2.25% of the loan amount, and this is usually added onto the loan and financed. Here is how this would work:

Purchase price	$200,000
-3.5% down payment	- 7,000
Loan amount	$193,000
+2.25% Up Front MIP	+4,342
Total loan amount	$197,342

The mortgage payment is based on the total loan amount. If you rates come down and you refinance with an FHA streamlined refinance, you will get a portion of this premium credited back for the first 3 years. Otherwise this is just a cost of doing the loan.

More people will qualify with FHA than with any other program. The rates are comparable to conventional rates, and better for many home buyers. FHA is the only option for many people, but even if you qualify for conventional financing, FHA may be the better way to go. Some of the reasons FHA may be right for you include:

A common sense approach to credit - FHA doesn't require perfect credit. If you have had problems in your past, they will want to know what happened and what you have done to correct the problems. A few isolated late pays are no problem. If it is something bigger, they usually require a twelve months of good credit history.

Low and in some cases, no down payment - Conventional loans require a minimum of a 5% down payment. FHA only requires 3.5%, but this can be structured so you are not using any of your own money at all. One way to do this is through a gift from a family member.

Lower Risk Based Pricing adjustments - Risk Based Financing is the idea that those borrowers with the best credit scores will be able to get the best mortgages rates**,** and those with lower credit scores will have to pay more. Fannie Mae and Freddie Mac, the two big buyers of mortgage loans in the mortgage aftermarket, recently changed their guidelines in a way that meant all but the very best borrowers will pay more for a loan. Now buyers with credit scores under 740 and with down payments under 20% are getting hit on their pricing. With FHA there are minor hits to the price if your credit score is below 660, and they will go down to credit scores as low as 620. For borrowers with credit scores under 700 FHA is often the better alternative, even if you do have more than the minimum down payment.

Past bankruptcies are OK - If you are looking at conventional loans, they will require that you wait at least 3 years after a bankruptcy was discharged. FHA allows a new loan after 2 years, one year if you can show that the circumstances that led to the bankruptcy were beyond your control (medical problems, loss of job or similar situations). You will have to re-establish credit, and show that you can afford the new payment. If you are in a chapter 13 bankruptcy where you are paying off all your debts, you can qualify for an FHA mortgage before the bankruptcy is discharged. You will need to get the courts approval of the new payment.

FHA financing is available for Permanent Resident Aliens – With FHA you don't need to be a U.S. citizen and you don't need to have your green card. You will need to have a social security number, established credit and proof that you are able to work in the United Sates.

No cash reserves are required – This is another way that FHA differs from conventional financing. Saving up for a down payment is the biggest obstacle to buying for most first time home buyers. With conventional loans you need to have saved not only the amount for the down payment, but also have some money left over in reserve. With FHA they only require enough cash to close and you don't need money in reserves.

No income limits – Many of the low down payment conventional loans are set up to help low and moderate income home buyers. This isn't the case with FHA. The goal of FHA is to help more people buy homes and there are no caps on how much you can make.

Non traditional credit is accepted – Most conventional loans require that you have a credit score and an established credit history. But not every one uses credit. With FHA we can build up a credit history from other payments you have mad. This would include your rent and utility payments, and any other non-traditional credit you have used.

You can buy a 2-4 unit building with only 3.5% down – Conventional financing isn't even close here, and rental income is looked at in a way that makes it much easier to qualify. With a 2-4 unit you will need 3 months of reserves, though.

FHA loans are assumable – This means that when you go to sell your home, the new buyer can take over the payments on your loan (if they qualify) at the same terms. This could be a big advantage if rates go up down the road (and I would bet that they will). If you have a below market interest rate, this makes your home more attractive (and worth more) than a property where the buyer would have to pay more for the financing.

FHA condo financing

One of the biggest uses for FHA is when buying a condo. Conventional guidelines have tightened so much with condos to the point that most borrowers won't qualify, and if they do (unless they are putting down a 25% down payment) they will be paying more. This is a niche that FHA covers which will save you a lot of money if the condo fits the criteria. Because it doesn't have the price hits that conventional now does, the mortgage rates are often better and you can buy with the minimum FHA down payment. Anyone who is putting less than 20% down should compare both options and see which loan is better for them. Like conventional, we will need to approve both the borrower and the condominium project.

There are two ways that a condo can be FHA approved. The first way is if the developer or home owner's association applied for and was granted a project approval. This means that FHA has already done all the checking and the project is ready to go. Here is a link to the site which tells whether a project is approved, or not:

FHA Condo Search Tool

This tool is just a starting point. You can search a number of different ways, but the results aren't always up to date, and if you don't have the search exactly right you might not find it, even if the property is approved. But it is a good starting point.

One problem with FHA approvals is that much of what you will find are older properties. When the market was booming, FHA was looked at as too old school, and there were conventional options with no down payment where the borrowers (and the developer) didn't have to go through the extra paperwork that FHA required. So many of the approvals will be older, more established (and usually without the amenities most buyers are looking for) buildings which went through the process some time back, or newer properties that have just gone through it. The good thing is that this is changing because of the second option, the FHA DELRAP approval.

The DELRAP approval allows an FHA delegated mortgage company to approve the condo complex at the same time they are approving your loan. This is similar to the old spot approval process, but on steroids. Once one unit is approved, the entire project will be listed in the FHA data base as eligible for FHA financing. If you are looking at a condo that isn't on the FHA approved list, your loan officer will need to send over a condo questionnaire and review the projects budget. If the condo project appears to meet the guidelines, we will then gather up all the documentation for the building and make sure that we cover all the bases so that it meets all the FHA requirements. This adds one more step to the approval process, but it doesn't have to add a lot of time. The key is to get cooperation from the condo association and management company. Under this new program many properties which weren't able to get FHA financing before, are now eligible. This is only available through FHA direct endorsement lenders (Full Eagle) and not through mortgage brokers or other lenders. Some companies are also charging extra fees for approval. Make sure you know exactly how this will be handled before you start.

FHA 203k Rehab Loans

With all the foreclosures on the market, the FHA 203K loan has become a popular option. The FHA 203K is designed so you include the cost of repairs and improvements into a purchase price and wrap it all into one loan. FHA divides the program into two sections, the full 203k and the FHA 203K streamline, or Mini K. The full program is for major projects and with this you can do anything from a major remodel to a full gut rehab. But the full 203K can be a complicated and expensive loan. You will need to hire an

FHA 203K consultant to advise you and help with the paperwork, and getting it all done can be a big commitment. This is the right choice for big projects, but for most home buyers, the better choice is the FHA 203K Streamline.

The Streamline 203k is meant for more manageable projects, and the cap on spending is now set at $35,000. The reality is that you can get an awful lot accomplished with $35,000. This program also fits the reality of the current market. Most of the properties out there don't need gut rehabs, they need specific work done in order to be eligible for financing, or to improve the livability of the home. You can't change anything structural with a Streamline 203k, but other than that you can tackle almost anything the budget allows.

Here is how the FHA 203k project works:

First step, get pre-approved for an FHA mortgage – This program is different in how it treats the property, but your credit approval will be the same as with any other FHA approval. This means a down payment of only 3.5% (based on the purchase price plus the repairs), credit scores of 620 and above, and all the other first time home buyer friendly features that FHA is known for. You need to know how much of a loan you can afford and how much cash you will need to close on the loan. One of the great features of FHA is it allows the seller to pay your closing costs (when negotiated in your contract, currently up to 6% of the selling price, but will be moved down to 3% by the beginning of this summer). Knowing how much cash you will need up-front helps when it comes time to structure your purchase in a way that works for you.

Find the house you want to buy – This sounds like the easy part, but that's not always the case. If you are looking at distressed properties this means the bank that holds the mortgage has to approve the contract. This can take some time, and some banks are more responsive than others. Either way, when putting the contract together, make it subject to approval as an FHA 203K loan. Decide what work needs to be done, and get a rough idea of what it will cost before you finalize the contract.

Find a contractor that will do the work, and get the bid in writing – Getting the bid is the crucial step. You need a contractor who will put in a detailed bid showing exactly what work will be performed and with specifications and cost break downs for everything, including both materials and labor. We aren't able to order the appraisal until the contractors order is in. The appraiser will use this bid to determine what work will be done, and what the value of the home will be once all the work is completed. Along with the bid, we will need to approve the contractor.,This means your contractor will need to furnish us with a package showing his business licenses, a resume showing similar work done, and proof of insurance.

Apply for the mortgage and get the appraisal – This is the biggest difference between an FHA 203k and a normal FHA mortgage. We order the appraisal through one of our FHA approved appraisers. They are actually doing two appraisals at the same time. The first part of the appraisal is based on what the property's value is now, in its present condition. The second part values the property as it will be once all the work has been completed. The appraiser will take the detailed contractor bid and incorporate this into the appraisal. After the close, the work will have to be completed as laid out in the appraisal.

Underwriting and closing – Once we have the full file with the completed appraisal, the loan is underwritten like any other FHA loan. There is more paperwork on our end, and we need to make sure that everything conforms to the guidelines and all the pieces of the puzzle fit right. This loan has more moving parts, and if your bid changes at all, this will cause all the numbers to change. Once we have a clear to close approval, the loan is ready to close. The closing of a 203K is similar to any other closing. One thing to keep in mind, though, is you won't get the money for the rehab at the closing.

After the close – It takes around 30 days before the loan is set up in the system. At this point you will get a check, made out to you and the contractor (or each contractor if you are using more than one) for half of the rehab amount. This is to cover the materials and to get the work started. You will also get a check list which tells you exactly what needs to be done from that point on. Once the work is completed an inspector comes in to confirm that everything was done according to the original bid, and once you have the sign off you get the rest of the money to pay the final bills. If the work comes in under the budget, the balance will be used as a principal pay down on your loan. All the work has to be completed within 6 months.

The FHA 203k rehab loan is a great way to take a rough home that you can buy for a bargain price, and turn it into a finished gem. This loan is a way that many buyers are using to add value to their home and gain instant equity. This is obviously a simplified rundown for the FHA 203k and if you don't do things exactly right, there are a lot of little obstacles that can trip you up. But if you have a good experienced loan officer as your guide, the process is easier than you might think, and the best way to improve a home while keeping your investment and payments low.

There are many other advantages of FHA financing. Let me know if you would like to see how this would help you in your situation.

VA loans: This is the original, and last surviving 100% loan. Since the end of World War II, VA loans have allowed qualified veterans to get a piece of the American Dream and buy a home of their own with out a down payment and with easier qualifying standards than with conventional mortgages. This loan is now more important than it has been in years. As more and more veterans separate from the service after action in Iraq and Afghanistan, this will be a great way to take advantage of the lower home prices and buy a home at terms they can afford. **Some of the features of the loan are:**

- **Can be used for a single family home, town home or an approved condominium.**
- **0 down payment** - The VA loan offers 100% up to the maximum benefit of $417,000. You can use the VA benefit for loans above this amount with a lower down payment than you would need for conventional financing.
- **No mortgage insurance** – There is no mortgage insurance with a VA loan. They do have a one time funding fee (2.125% for the first use) which can be added into the loan and financed over the course of the loan. This funding fee varies according to your service and whether you have used your benefit before.
- **Competitive interest rates** – The rates for VA loans are not set by the VA, but by the bank making the loan. This means that the rates move up and down with normal market fluctuations and are competitive from one lender to another. The rates for a VA mortgage are similar to FHA rates. Considering that these loans are with no down payment and with no mortgage insurance, they are the best bargains available.

- **Low closing costs** – Closing costs for VA loans are similar to other loans and . As part of your purchase negotiation, you can also ask for a credit from the seller to pay for all the closing costs associated with purchasing the home.
- **Easier qualifying standards than with conventional financing** – VA loan guidelines are focused on making sure that the veteran is able to make the payment and isn't going to get themselves in trouble or over their head. But they do allow for more lenience in credit. They don't go by credit scores (They do allow automatic underwriting approvals) but want to see a history of the veteran meeting their obligations. It is okay if the borrower has had credit problems in the past, but they want to see no major problems in the past year. VA is also flexible with debt ratios and how much of a payment the veteran can afford.
- **VA loans are assumable** – This can be a real benefit if you are going to sell when rates are higher. The new buyer can take on the existing loan at the existing interest rate, which could be a real advantage for you down the road. VA loans also have no pre-payment penalty, so it won't cost you more if you need to sell or refinance.

Qualifying for a VA loan is similar to qualifying for any other type of mortgage. We will look at your credit, your income and debts, your job history and the expectations for your continued employment. We also need to verify your military service and your eligibility for VA financing. We do that through a VA Certificate of Eligibility, which we can get as part of the loan process. In order to get a VA approval you will need at least these items:

- A copy of your DD 214 discharge papers.
- Certificate of eligibility (or we will get it as part of the loan process).
- Past 2 years W2s and tax returns.
- Current pay stubs for the past month.
- Current bank statements for the previous 2 months.
- Other items depending on your own personal situation.

There are a few things to watch out for with VA financing:

If you are buying a condominium, the condo needs to be on the VA approved list. An FHA approval doesn't work and there is no spot approval process. This can put a real limit on what you can look at, as most of the VA approved condos are older properties. If you want to see what condos are available in your area, let me know and I will send you a list.

Only veterans and their spouses are eligible. If you are buying with someone other than a spouse, and they aren't a veteran, you can qualify only with your income and close only in your name.

Residual income. VA loans have only one ratio, 41% of your income for your housing payment and any debt. You can stretch quite a bit beyond that ratio, but you will need to show that you have enough money budgeted to pay for all expected expenses. The VA has a formula for these expense and you will need to meet the residual income requirement in order for your loan to be approved.

Bond and CRA Programs: ***Free Money from the Government***

Most of the bond programs have disappeared, but there are still a couple of great programs left.

MCCs or mortgage credit certificates, also called the **I-Loan** or **Tax Saver**, is a tax credit that can be added on to whatever mortgage option you choose **(** as long as it isn't already an IHDA loan). It allows first-time homebuyers to take a dollar for dollar reduction in their federal income taxes for 25 percent of their mortgage interest. This reduction is in addition to their standard income tax deduction. You can take up to the maximum $2,000 per year, and the benefit continues as long as you stay in your home. If you refinance, the MCC can be redone on the new loan.

There are income and property value limits, and this is available only through mortgage bankers like myself, not brokers. Let me know if you would like more information or to see if you qualify.

CRA Programs: Another option is with CRA financing. CRA grants are offered by certain lenders in specific zip codes in order to meet federal fair lending requirements. What this can mean to you, is that, if you are buying in one of these often disadvantaged areas, you may be able to get a better deal. There are sometime income restrictions, but not always. As a mortgage banker I have access to a number of different CRA programs.

No closing costs

Many people think that if they buy with a low down payment they won't need any cash other cash to close. But buying a home is an expensive proposition. Keep in mind that you will also need money for closing costs, escrows and reserves. (We will cover these later.) There are a couple of ways to buy with no money out of your pocket, but you need to plan ahead.

One way is to ask the seller to pay for your closing costs through a seller concession. You need to do this as part of your initial negotiation. Most loan programs allow the seller to contribute up to 3% of the value toward the buyer's costs. Once you know how much it is going to cost you to close, you can ask that the seller pay that amount at the closing. From the seller's standpoint, this is part of the price. Any money that he pays out is deducted from the sale price. If the contract for the home is $300,000 and they are paying $2,000 for closing costs, the true offer to them is $298,000. You need to ask for seller contributions when you first present the contract, and it is important to phrase it so that the seller credit will be "toward closing costs and pre-paids" to make sure you get the full benefit. This is one more item that can be negotiated, so it never hurts to ask. Once you have a signed contract it is too late.

Another way to pay for closing costs is through a lender credit. As a mortgage banker, I can offer loans in a variety of price and cost variations. For people who are strapped for cash, it is possible to offer a slightly higher interest rate, but use some of the premium to pay for the loan costs. This is very common in refinances, but it can be used for purchases, too.

Shopping for your loan:

Once you have decided on the type of loan that will best meet your needs, it is time to compare rates and prices to make sure you are getting the deal that is right for you. Ads for mortgages are everywhere: on the internet, over the TV and radio, and in the newspaper. The focus of most of these ads is that they can get you the lowest rate. Many people think of loans as a commodity, and that one lender is the same as another, so the decision should be made strictly based on who has the best rate. This can be a big mistake. While it is true that many lenders may have the same loan programs, there are other factors you need to compare to make sure you are getting exactly what you think you are. Besides the rate, you need to compare a company's fees, the terms, the quality of their service, and the company's reputation. Getting a good rate is important. But if the company you choose is not able to close on time, or doesn't deliver at the terms you expected, a low rate is no bargain.

In order to know how to compare loan offers, it helps to understand how the mortgage market operates. The truth is, nearly everyone borrows money from the same sources. Outside of government loans and loans for higher priced homes (currently loans of more than $417,000), the majority of loans end up in the portfolio of one of two organizations, FNMA or FHLMC, often called Fanny Mae and Freddy Mac. These organizations are government sponsored corporations (now controlled by the government) that are charged with buying up mortgages in the aftermarket, packaging them into investments that are sold on Wall Street, and making sure there is always money available to lend for mortgages.

These companies set the standard for qualifying, and they also establish a base for the prices that all of the end lenders charge. Lenders price their loans with the expectation that they will be selling their loan, and eventually delivering it to one of these organizations.

What all this means to you is that the true rates on mortgages are usually going to be close to the same from one lender to the next. The range in rates for the same product is typically going to be only 1/8 to 1/4 point difference among most lenders. But if you are looking at the newspapers, or searching the internet, you may see advertised rates that are much lower. These look attractive, but you need to know exactly what you are getting. What makes this complicated is the way that lenders show their prices to their customers. Because most consumers are looking for the lowest rate, it's easy for unscrupulous companies to manipulate the fees and the terms in order to appear to offer a rate lower than it actually is. When comparing mortgages, you need to compare apples to apples. Too often, you think you are comparing apples, but you are really getting baloney.

Borrower Beware! What to watch out for

The number one complaint regulatory agencies receive regarding mortgages, is that the terms they ended up with weren't what they were promised. There are lenders who will promise whatever it takes to get the customer in the door, but don't deliver on that promise. Here are some of the areas you need to watch to make sure you are not being quoted an artificially low rate.

Locking In – When you find a property and apply for a mortgage, you have a choice between ***locking in*** or ***floating*** the rate. Locking in means that you are guaranteed that the rate you choose will be good for a certain period of time. If you choose this option, make sure that the period you lock in for is long enough to approve the loan, and that it extends through the closing date in your contract. Floating means that you are taking a chance. If the rates go down, you will get the lower rate; if rates go up, you will end up with a higher rate than you had planned on. Interest rates go up and down based on what's happening in the financial markets. The markets tend to overreact to both good and bad news, so lenders try to price according to the market, which means they can change every day – sometimes more than once a day. Because the market is so volatile, rates are priced based on how long they are guaranteed for – the shorter the time period, the lower the rate.

Some lenders take advantage of this system in several ways. One way is to quote a very short-term lock period, which means a lower interest rate. But it doesn't help you to lock into a 15-day rate guarantee if you aren't closing for 45 days. Another twist on this is to quote you based on the short-term rate but then to encourage you to float. Or they claim that you can't lock in until after you have been fully approved, or right before closing. These techniques are unfair because all the risk is put on you. If rates go up, you are stuck with the higher rate. Floating is always an option, but it should be your decision, not something that is forced on you.

A more sinister version of this is when the lender tells you that you are locked into a rate, but doesn't lock you in with an investor. If rates stay the same or go down, you will close at the rate that was quoted and never know that you hadn't been locked in. If rates go up, however, you may find that you are rejected for a mortgage at the last minute, or are forced to take a higher rate in order to close your loan. This is not only unethical, it's illegal. But it happens. Every time that interest rates move up sharply, there are businesses that close their doors for good because they couldn't honor their lock commitments, leaving their customers without the financing they had relied on.

Hidden Fees: There is a relationship between the rate that is quoted, and the amount of fees that are charged. The lower the rate is, the more money you will have to pay to get it. It costs a certain amount of money to process and fund a mortgage. Mortgage companies are in business to make a profit, so they know that they need to bring in enough income to pay all their expenses and earn a reasonable profit. There are two ways to do this. First through the rates – the investors pay lenders for bringing them loans. The second way is through fees that are charged to you, the borrower. Either way is fine, as long as you know exactly what you are getting. Where it gets tricky is when the lender hides fees in order to make the rate seem better than it is.

There are a number of fees that are normally paid as part of getting a mortgage (I'll go into more on this later). But sometimes the fees can get excessive. Look for things like origination fees, warehouse fees, document preparation, administrative fees and the like. Ask what each of the fees goes for. Chances are there will be no specific service linked to it. Again, there's always a trade off between rates and fees. But if you are paying thousands of dollars in fees upfront, it will take you years before you've broken even by getting the lower rate.

Pre Payment penalties: Another thing to watch out for is a pre-payment penalty. This is when the mortgage contains a clause that states that you will have to pay an extra penalty if you get out of the mortgage within a certain period of time, either through selling the home or refinancing. Some mortgages, usually those that are aimed at solving a specific situation like bruised and damaged credit, may have pre-payment penalties built in. But many more conventional loans offer the penalties as an option. That is, you can get a lower rate if you agree to take a pre-payment penalty. If you know that you won't be moving, and you're convinced that rates won't drop and give you an opportunity to refinance at a lower rate, this can be a fine decision. Where it becomes a problem is when you are quoted with a built-in pre-payment penalty in order to show the lower rate, but the terms are not disclosed to you. This can cut off your options, and cost you thousands of dollars in the long run.

How to protect yourself:
Knowing what to look for, and what questions to ask, puts you in a position where you can make an informed decision.

APR: The APR, or Annual Percentage Rate, is a measure used to compare different loan options. It is an attempt to express the total cost of credit over the life of the loan, taking into account the costs to take out the loan. It is required by law that any time a rate is advertised, the APR also has to be shown.

This concept is a step in the right direction; unfortunately it doesn't work nearly as well as it should. There are a couple of problems with it. First, there is no one precise formula for determining the APR. Some costs are included in the calculation, and others aren't, and there are some costs, such as application fees, that can be considered a cost under some circumstances, but not under others. This means that the same loan, with the same closing costs, can show different APRs with different lenders.

Another problem with the APR is that it balances the cost over the entire loan period. For example, the closing costs on a 30 year loan would be averaged over the entire 30 year period, even though all the costs are paid up front. In the real world, very few people stay in a loan for the entire time. Let's say you were comparing loans between two lenders and the closing cost on one was two thousand dollars higher than the other. Because you are averaging the costs over a 30 year period, the APRs would be very similar. But if you only stayed with that loan for seven years, it would turn out to be much more expensive than the lower cost loan.

The Good Faith Estimate: Many people focus on the loan's APR, but the best way to shop is to directly compare the costs of one loan against another. The way to do this used to be through the **GFE** or **Good Faith Estimate of Settlement charges**, but as of the beginning of 2010, the GFE form has changed, and as a consumer protection, the form became binding. This means that if any of the figures (not just the bank charges, but other fees including title charges and municipal transfer taxes) were off at closing, the lender is now responsible for paying the difference. This was meant to stop lender abuses and give the Good Faith Estimate some teeth, but with such large penalties for getting something wrong, the opposite is now happening. Most lenders won't give out a Good Faith until the borrower has committed to applying with them, and because of the risk of getting numbers wrong, all lenders are padding the estimate. There are still loop holes out there so unscrupulous lenders will still quote low and come up with a reason to switch before closing.

You do need to compare options and have the lender put everything in writing. When comparing lenders the focus is on the program, rate and bank fees. Make sure you are comparing similar scenarios. When choosing the lender make sure to compare the items they have control over, the bank fees, any discount or origination charges and the rates. You also need to have the rest of the closing costs broken down so you know how much to bring to closing and what your payment will be.

In order to know what to compare, you need to understand what closing costs are spent on, and what to expect. I will go into this more in a minute. Let me know if you want a breakdown of all the charges and costs to close.

Reputation: The last thing you should compare may be the most important. The reputation of the company, and loan officer you are dealing with, will go a long way toward predicting what kind of experience you will have. Does the company have a reputation for meeting its commitments and closing on time? Is the loan officer experienced and able to answer your questions? Does the company have the financial stability to stand behind its commitment? Do they have the resources to meet the deadlines in the contract? Do you feel comfortable with your loan officer? Does he get back to you quickly, and does he follow through when he says he will do something?

These are all questions that should be part of your decision. Until you close, you will rely heavily on your loan officer. If you have a loan officer who doesn't return phone calls, or one who doesn't provide information, or doesn't communicate well with you, getting your loan will be a frustrating experience. If someone is not responding during the process, can you be confident that you will close on time and with the right terms? Keep this in mind when choosing who you want to work with.

Closing costs:

You will need to understand what you are paying for not only so you can compare programs, but so that you will know how much money you will need to close. Buying a home is expensive, and the transaction costs are high. This why you need to plan on staying in your home for several years, at least. There are three different types of expenses: ***lender-related expenses***, ***title and non-lender-related expenses*** and ***pre-paids***.

Lender-related costs: Lender related expenses are charges that are either required for services needed to process the mortgage, or are part of that company's pricing model. At the beginning of the process, you will usually need to pay an ***application fee.*** This will usually cost around $350. This fee often includes two services that are required for the mortgage – the ***credit report***, and the ***appraisal***. These are usually the only charges that you will be required to pay upfront; everything else will be paid at the closing. The credit report is simply the cost for running your credit. The appraisal goes to pay for a licensed appraiser who investigates the house you are buying, compares it to similar properties, and makes sure that it's worth the amount you are paying for it.

A ***flood certification fee*** is paid to make sure you are not in a flood plain. If you are, you will need to get an extra insurance policy to cover yourself and your lender from possible flood damage down the road. There are other lender-related fees like ***underwriting fees***, that some consider junk fees, or fees that don't go for a particular function, but may actually be charged by a third party investor. Most of the other lender-related charges are going to be things like warehouse fees, administrative fees and the like. No matter what name they go by, they are really part of the lender's pricing strategy, not necessarily fees that the lender will be charged for. Most lenders will have some of these fees built in to their closing costs. Typical fees for lender related costs can run as low as $500 and as high as several thousand. When a lender quotes you on a rate, they are doing so based on the fees that they charge. You may be able to get some of these fees removed, but doing that may change the pricing on the loan.

There is one other lender-related cost, ***discount points***, which in most cases should be an option, not a requirement. A point is one percent of the loan amount. So if you were borrowing $100,000, 1 point would be $1,000. A point is really interest paid in advance, so by paying the point up front, you should receive a lower interest rate. It depends on the product, and what is happening in the market, but typically one point paid up front will reduce your interest rate by about ¼ percent over the lifetime of the loan. So if your rate was at 6.5% without the point, it would be 6.25% if you paid the point. On the $100,000 loan this comes out to a difference of $16.35 per month.

Whether it makes sense to pay an extra $1,000 to save $16 depends on a lot of things. One way to look at it, is to determine how long it will take before you break even, that is how long before the $16 you are saving equals the $1,000 you paid up front. To do this you divide the cost by the savings, and that tells you how many months it will take to break even. In this case you would break even in 61 months, or just over 5 years.

If you aren't planning on being in the house for a long time, it obviously doesn't make sense to pay points. But even if you do plan to stay long-term, you should consider this option carefully. First of all, is this the best way to use your money? In many cases you would be better off paying down your credit cards, using it to increase your down payment, or just put the money in your bank account and save it for a time when you may need it more. Also, what happens if interest rates drop down the line? If rates drop enough, you will be able to refinance your mortgage at a lower rate. That means the points you paid up front would be wasted.

Title and other non-lender related charges: These are the charges that are part of your closing costs, but will not change based on which lender you choose. The biggest items here are title charges. ***Title Insurance*** insures both you and the lender against any defects in the title. To do this, the title company searches the public records and pulls a history of who has owned the property and determines if there are any unsatisfied liens or judgments which are still owed against the property. If they do their job right, there will be no need to pay any claims down the road. Title companies also provide the ***closing agent***, who makes sure that all the papers are signed correctly and the title transfers at the right time. For this service they charge a ***closing fee***. The title company also collects the ***recording fee***, which is the cost to record the documents with the county courthouse, showing you are the new owner. Title charges can differ depending on the loan amount, but you should figure that these fees will run several hundred dollars.

Besides the title costs, there are some other fees you need to be aware of. Your attorney will tell you how much their fee will be when you first meet. In most cases this will be paid at the closing, too. Depending on where you buy, you may also have to pay ***transfer taxes***. This is a tax on the real estate transaction, and each community has their own policy. Some charge the seller, some charge the buyer, and others have no tax at all. Ask your real estate attorney about the details for your transaction. The transfer tax in the city of Chicago, for example, is .75% on the sale price. That means a $200,000 purchase would have a tax of $1,500. If you are not expecting it, this can be a rude surprise.

Escrows and Pre-paids: In most cases you will need to establish an ***escrow account***. This is money that your lender holds to pay for your tax and insurance payments when they come due. Though you are paying the money upfront, it's still your money. Down the road, when you sell or refinance, you will be refunded whatever money is left in your account. With home owners insurance, you will need to buy a policy before closing that will pay for the first year's insurance. After that, bills come due every year. As part of your mortgage payment you will pay 1/12 of the real estate tax and insurance bills each month. When the payment comes due, the lender will automatically pay it from your escrow account.

Insurance is paid once a year, but property taxes come due in two installments. The first payment in Cook County is due in March and the second is due in September. In Dupage and the other collar counties, the due dates are in June and September. The tax escrow system actually works to your advantage when you are buying a home. That is because in Illinois taxes are paid in arrears, or after the fact. That means that when you pay your tax bill you are really paying for the prior year. The seller needs to give you a credit for all taxes from the previous year and up to the date of closing for the current year. Your lender will set up the escrow account to make sure there is enough money to pay the taxes when they come due, plus a cushion in case the taxes go up. But whatever is left over in the account goes directly to you and depending on the time of year, this can be substantial. This reduces the money you will need to bring to closing.

The other item is ***pre-paid interest***. This is really just a bookkeeping expense. The mortgage takes effect the day that you close, but you skip a month before the payments start (That means that if you close in March, you will skip your April payment and your first payment comes due May 1st.). To make up for the time between the day you close and the end of the month, you will be charged pre-paid interest for each day. Some people think that you save money by closing at the end of the month, but that is not really true. If you close on the last day of the month you will only pay 1 day of pre-paid interest at closing, but after you skip the next month's payment, your first payment will be due in 31 days (if the month is 30 days). If you close at the beginning of the month you will pay all the interest until the end of the month, figure 30 days, but after skipping the payment, you won't have to make another payment for 60 days. So it works out the same, no matter what day of the month you close.

What happens when – Getting to the closing
The first week after you get your contract together you will feel like you are constantly running around and there is so much going on that it is hard to keep track. The first week you are finalizing your mortgage, getting the home inspection, and talking with your lawyer to make sure all those issues are resolved. At first the pace is hectic, but then it seems like everything comes to a stop. But the process is still moving, and the other pieces of the transaction are coming together.

On the mortgage side, your loan will be in processing. (If you were pre-approved, it already is.) All the details of the transaction will be double checked to make sure that everything is covered. If any documentation is missing, you will need to provide it at this time. Two things of special importance to the loan happen during this time: the appraisal, and the final underwriting.

The appraisal: One of the first things your lender will do is order the appraisal for the property. An appraisal is an estimate of value for the home you are buying, put together by a licensed appraiser. To get this value, the appraiser compares your home to other homes in the area with similar features, which have sold recently. This protects both you and the lender by making sure that the price you are paying, and the loan you are taking out, are based on the real market value.

A question many people ask, is what happens if the property doesn't appraise out for enough? This doesn't happen very often, especially if you are working with an experienced Realtor. But if it does, you should be protected under the mortgage contingency clause and would be able to get out of the contract if you choose to. It is best to consult your attorney for details. At this point you would have two choices. One, you could get out of the contract, collect your earnest money and move on. Or, two, if you still want the house, you could use the lower appraisal as a basis to renegotiate a lower price. Even if the sellers would not budge on their price while negotiating, when faced with a lower appraisal they may be much more realistic.

Underwriting: Once the appraisal is in and all the details of your loan have been verified, the loan package goes to the underwriter. The underwriter is the person who reviews all the details and makes the final decision on your loan. Underwriters are trained to look for the smallest details, and make sure that everything conforms to the guidelines of the program you chose. Most loan officers won't even submit your loan to the underwriter unless they are sure they have everything together and you will be approved.

Once a loan is submitted, it can have 3 possible decisions: Approved, suspended or denied. If it is approved, it may have conditions, or items that must be satisfied before you can close the loan. These conditions can be ***closing conditions***, meaning they have to be taken care of before you can close, or ***prior to close conditions*** where the conditions must be met before you can even schedule a closing. Some examples of possible conditions could be things like receiving gift money needed for the down payment, or being required to pay off an open collection account.

If your loan is suspended, this means that the underwriter is not comfortable with the loan as it is structured, but thinks that if certain things are done, it may be able to be approved. In this case the underwriter's findings will tell you the things you need to do to turn the decision around and get an approval. A denial is much more serious. This means that the underwriter has determined that the loan doesn't meet the product guidelines, and cannot be approved. There are however, still some options. Maybe the underwriter was not given all the information upfront, and, if the right documentation is presented, it could be enough to change her mind. Other times the transaction cannot be approved as it is, but with some changes, it may meet the requirements and be approved. Or maybe the loan can be switched over to a new program or a new investor. Sometimes a denial is just an obstacle on the way to your final approval. It's up to your loan officer to go over the situation and let you know what your options are.

The closing:

Once your loan is all set, and the title is in, you are ready for the closing. The closing is where everything comes together and the ownership transfers from the seller to you. The date of closing will be written into the contract, but it is actually set by agreement of the buyer's and seller's attorneys, based on their schedules, and what time slots are available at the title company. (Closings are almost always set during normal business hours, so if getting off work is a problem, make sure your attorney knows your schedule, and you put in for the time off as soon as you know when it will be.) At the closing, you will be in the same room with the sellers, both attorneys and the title agent. Though I try to attend closings when my schedule allows, there is no reason that the lender has to be there.

Lenders send their figures in before the closing, and the closing agent runs the closing according to the lender's closing instructions. The closing agent will take the lender's figures, along with the figures provided by the selling attorney, and put together the ***Closing Statement.*** (This is also called the **RESPA**, or **HUD1**.) This document shows all the costs and credits for each party, and lays out the bottom line of how much cash you will need to bring with you to closing. This is usually not put together until the day before the closing, so you won't have the final figures until then.

You should bring three things to the closing: a cashier's check (the money to close has to be certified funds, not a personal check) made out to yourselves for the amount needed to close, your driver's license or other picture ID, and a checkbook to pay for any incidental expenses you will need to take care of. Make sure you allow time to get to the bank before the closing to pick up the cashiers check.

At the closing, the closing agent will handle all the paperwork, making sure that all the documents are signed correctly and in the right order. Your attorney will review the documents and explain what you are signing. When everything has been signed, the closing agent faxes over the closing statement to the lender, the lender releases the funds, and it becomes official.

Congratulations! You now own your own home.

After the closing: If I've done my job right, the closing won't be the end of our relationship, but the beginning of a new phase. Your home is your single biggest investment, and the mortgage is your largest debt. If managed correctly, it can go a long way toward helping you meet your long term financial goals. Going forward, I will be watching the trends in interest rates.

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If rates drop, you may have an opportunity to refinance your mortgage, allowing you to lower your rate and payment. In many situations I can refinance with no closing costs, so you save money right away. I watch for these opportunities, and I'll try and contact you as soon as the timing makes sense. If your goal is to build equity in the property, or to use your equity as a basis for investment, I can help you there, too. As time goes on and your needs change, I want to be a resource for you, an advisor to help you manage your debt, and make the best use of your equity.

What's next? I hope you have found this guide interesting and informative. I've tried to give you a realistic account of what happens when people shop for a home and a mortgage in the real world – both the good and the bad. I know that the information is valuable, and if you use it, it will help you to understand your options, and save you money. But now the next step is up to you. If you are serious about owning your own home, you need to take action. I would like the opportunity to work with you. I'm committed to providing the best service throughout the transaction, and a rewarding experience dealing with a knowledgeable professional who cares about your needs.

My company is a mortgage banker, not a broker. This means that we act as a correspondent for dozens of lenders, so I can shop around to get you the best rates and programs available, but we will handle all the processing and underwriting and we will close in our own name and with our own money. The advantage to this is that I have control over the entire loan process, which means faster approvals and faster closings, and because of our size we can keep our rates and fees low. In a sense, we offer the best of both worlds.

Be sure to use www.ptmortgage.com and my blog, Illinois Mortgage Rates and News as a resource. We have calculators to help you figure out different payment scenarios and help you find out how much you can afford, and how a new mortgage will affect you. When you are ready, click the ***FREE*** pre-approval button for a safe, secure pre-approval with a credit report, on-line with no cost and no obligation. It's the easiest way to get things started.

If you are on any FaceBook, please stop by my fan page. I'm also on LinkedIn and Twitter. I post regularly about changes in the mortgage rates market and information related to first time home buyers, mortgages and real estate in general.

You can also contact me directly and we will set up a convenient time for an over the phone consultation. At this point we will go over your needs and goals and, together, form a plan to move forward.

Thank you in advance. I look forward to working with you.

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