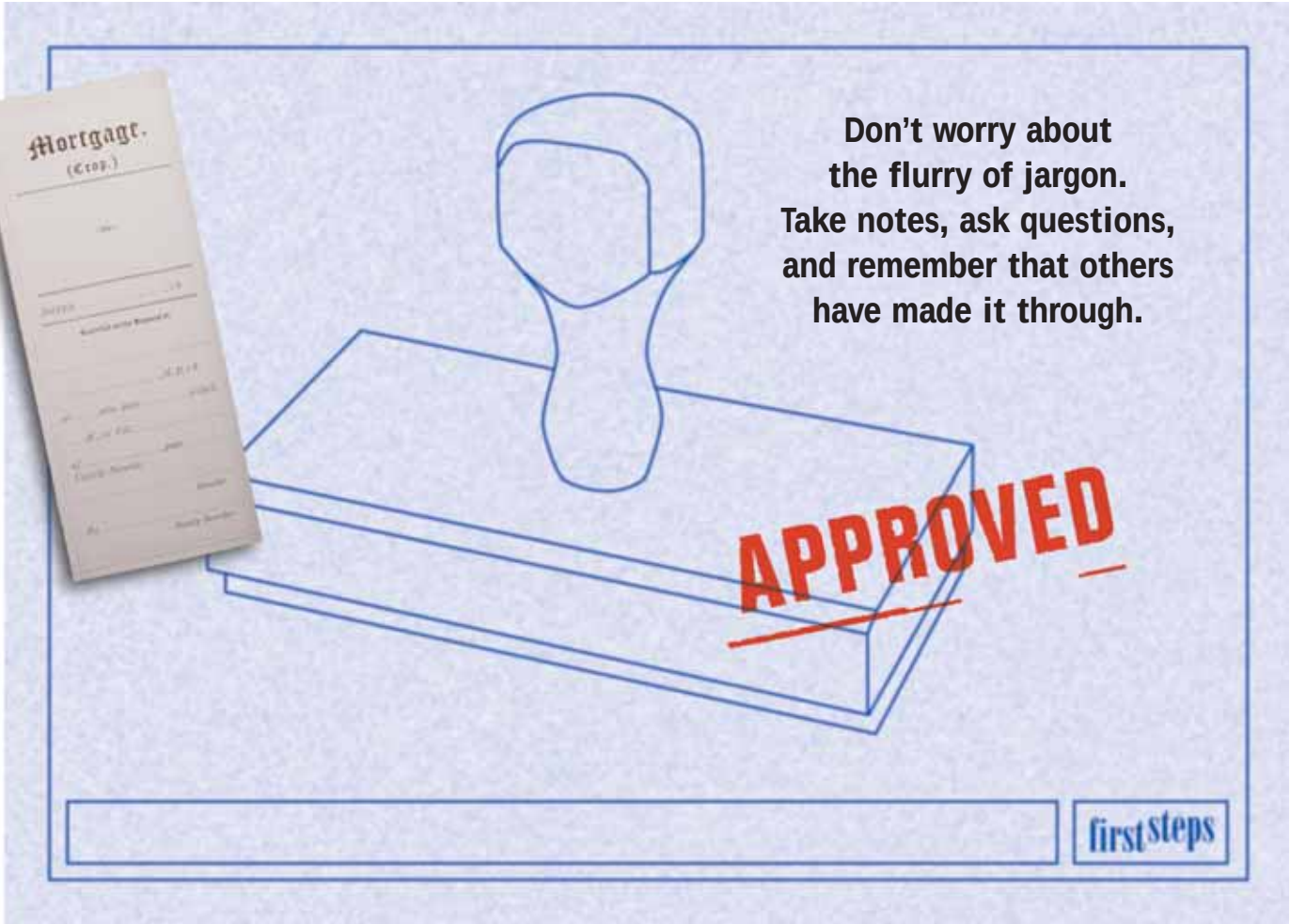
STEP 7 get financed

Find the right mortgage for you.

Owning a home can be one of the most rewarding experiences of your financial life. Because it affords you the opportunity to build equity and hopefully turn a profit when you sell, homeownership is a great investment tool. It is also a major expense. Most new homeowners do not have the assets available to finance such an undertaking, requiring many to seek the help of a lending institution.

Choosing an institution to finance your new home won't be nearly as hard as choosing a builder. However, if it's your first home loan, you may feel lost in the flurry of banking jargon you encounter. Don't worry. As with the rest of the home-building process, remember that others have made it through, and you will too.



Don't worry about the flurry of jargon. Take notes, ask questions, and remember that others have made it through.

The basics

Long before choosing a lender to work with, make sure your credit is in order; most experts suggest you do this at least six months before you apply for a loan. This means trimming down to one credit card, paying off as many debts as you can, and saving as much money as possible for a down payment. Lenders are wary of those who use credit like cash, so make sure you give them every reason to trust your money management skills.

To start looking for a lender, remind yourself of something your grade school teacher used to say: There are no stupid questions. No one expects you to be an expert at financing or building a home, especially if it's your first, so ask questions. Approach family members, friends and colleagues who have already gone through the process, and gather the names of lenders they recommend. Taking these steps may help you avoid costly mistakes.

Take notes. Write down the meanings of terms that are new to you, or that you want explained further at a later time. Many banks even offer handouts explaining the language of financing. If they don't, ask for one; chances are good that loan officers have something they can photocopy from a resource book they themselves use.

The next step in financing your home is determining how much you can afford. The rule of thumb is that your mortgage should be no more than 2 to 2.5 times your annual salary. Another standard dictates that homeowners spend about 38 percent of their annual salaries (after taxes)

on total housing costs—including mortgage, insurance and utilities. Remember to take into account your changing financial circumstances over the life of the loan (up to 30 years). Do you expect your income level to remain stable, increase or decrease? Do you have young children, or will your family expand in the future? Will education costs affect your family over the course of the loan? A good loan officer will review all these factors with you.

Finding the right lender

Be smart when choosing a loan officer. If you don't feel comfortable with one from the start, move on. You have to feel you can trust the person with whom you will share your private financial information. Also, shop around for a good deal. Create a worksheet comparing the options available from each lender you consider, and remember that not all offers are as good as they look. In particular, ask for and compare each one's Annual Percentage Rate (APR), which should include not only the interest rate on your mortgage, but also the costs associated with applying for and securing the loan you want.

For example, most lenders tack on several up-front costs for processing your application and running credit reports, in addition to closing costs that charge you points relating to your mortgage rate. (A point equals one percent of the amount borrowed. Lenders often charge points to increase the yield on a mortgage and to cover closing costs. In general, the higher the rate offered, the lower the number of points you'll be charged.) Even though one lender may offer a lower interest rate than the rest, the hidden additional costs may dramatically increase your overall mortgage payments in the long run.

The loan officer you choose will ask to see certain financial documents that indicate your net worth, as well as your ability to repay debts on time. This documentation, in addition to a loan application and a check for the application fee, are what lenders will use to begin the process of evaluating your appeal for a loan (see the table in this article). Once the ball is rolling, you should keep abreast of your application's progress, as well as the weekly mortgage rates. Call your loan officer regularly to check in, ask questions and provide additional information, not to mention make sure he or she is reviewing your application while the rates are low so you get the best deal possible.

Types of mortgages

It's likely that, once your application is approved, you'll end up with one of two conventional mortgages. Perhaps the most common in the past has been the 30-year fixed-rate mortgage (FRM), which carries the same interest rate and the same monthly payments throughout the life of the loan. Though equity builds more slowly under this type of mortgage, it can be a great investment when interest rates are low. FRMs are also available in 15-year terms. The 15-year mortgage carries a higher monthly rate, but the amount you pay in interest is lower over the life of the mortgage. This type of mortgage is ideal for middle-aged and older homeowners who are able to afford higher monthly payments.

An increasingly common type of home financing is the adjustable-rate mortgage (ARM), so called because the interest rate adjusts periodically throughout the life of the loan. Many lenders advertise ARM interest rates that are much lower than those for fixed-rate mortgages. Those rates often last for a short time and, after that initial period, the rates are adjusted on a regular basis. The time between rate changes—called the adjustment period—is usually one year. Three- and five-year adjustment periods are also available. This type of mortgage suits young or first-time home buyers who anticipate their income increasing in future years, as well as for those planning to move within four years.

An ARM allows you to take advantage of low initial rates. If interest rates drop over the life of the loan, you could also save money over an FRM. However, if interest rates rise, you could end up owing more than you would have under an FRM. Before assuming an ARM, evaluate how your finances will change in upcoming years. Can you afford monthly payments that could be higher than those you started with? A federally mandated cap on ARMs may help, but you should still work with your loan officer to find the type of mortgage that's of most benefit to you.

Another loan that is especially appealing to first-time buyers is the 5/25 or 7/23 mortgage. These mortgages allow you to take out a 30-year loan under a rate that is fixed for the first five or seven years. After that initial period, the rate is adjusted (usually to a higher rate) for the remaining 25 or 23 years. Some lenders offer the option of converting this

Loan Checklist. Be sure to bring the items on this list to show your lender.

- ❑ **Social Security number(s)**
- ❑ **Purchase contract for the house or contractor bids**
- ❑ **Your bank account numbers and branch addresses**
- ❑ **Recent (past 2–3 months) bank and securities (CDs, IRAs, stocks, bonds, etc.) statements**
- ❑ **Recent (past 2–3 months) paycheck stubs showing year-to-date earnings**
- ❑ **Your employer information and W-2 forms (If self-employed, bring business tax returns and balance sheets from the past 2–3 years.)**
- ❑ **Any and all information about monthly debts, including loans and credit cards**
- ❑ **Addresses of previous residences and landlords from the past 2–3 years**
- ❑ **Information about real estate you currently own, including the market value**
- ❑ **Mortgage or rental payment receipts**
- ❑ **(If applying for a VA loan) a Certificate of Eligibility from the Veteran's Administration**

Sources: Firstar.com; Fannie Mae, Inc.; Homestore.com; idiotsguides.com; The Complete Idiot's Guide to Managing Your Money, *Robert K. Heady and Christy Heady.*

If you're thinking about an ARM, be sure you will be able to make your payments if interest rates go up.

remaining loan to an ARM. In either case, you'll spend less money up front, with the idea that you'll be able to afford higher payments in the future.

Government-insured loans provide a way for low- or middle-income families to secure a home loan for a lower-priced home. Federal Housing Administration (FHA) loans are not so much a loan as they are a guarantee from the government that you will pay less on your down payment and on your monthly payments than you would with a conventional loan. The drawback is that these loans have a lower credit limit on how much money you can borrow—around $200,000 in most areas. Veteran's Administration (VA) loans function in much the same way, but without requiring a down payment, and they are available only to borrowers with current or previous military service.

Finalizing your loan

Because interest rates fluctuate from week to week and even from day to day, the rate a lender quotes when you are shopping around could be very different from the rate available when you finalize. Those rates can also increase after you apply for the loan, but before finalization. A few percentage points can dramatically increase (or decrease) the total interest you pay over the life of the loan.

Many lenders offer a lock-in on a quoted interest rate and sometimes on the number of points quoted. The lock-in ensures that if interest rates increase before finalization, the borrower can still secure the loan at the terms previously discussed. Lenders often charge a fee for the lock-in, which lasts for a pre-determined time—usually between 30 and 60 days. If you choose to lock-in on a rate, do so immediately if the rates are rising, but stall as long as possible if the rates are dropping. This will help you get the best rate.

Of course, if you've got money to burn, you may not need to employ these mortgage tips! But if you're like most home buyers, the proper financing is absolutely essential to securing the home of your dreams.

glossary of mortgage terms

Adjustable-rate mortgage (ARM): A mortgage in which the interest rate changes during the life of the loan; also referred to as an Adjustable Mortgage Loan or a Variable-Rate Mortgage.

Amortization: When monthly payments are large enough to pay the interest and also reduce the principal on a mortgage. Negative amortization occurs when monthly payments do not cover interest costs, so the balance due increases.

Annual percentage rate (APR): A measure of the cost of credit, expressed as a yearly rate, including interest, as well as other charges. This rate provides a good basis for comparing costs of loans.

Cap: A limit on how much the interest rate or the monthly payment can change, either at each adjustment or during the life of a mortgage.

Conversion clause: A provision in some ARMs that allows you to change the ARM to a fixed-rate loan at some point during the term, usually allowed at the end of the first adjustment period.

Equity: A buyer's initial and increasing ownership rights in a house as he/she pays off the mortgage. The buyer has 100 percent equity when the mortgage is paid in full.

Farmers Home Administration loan: A government loan available to citizens with limited incomes in rural communities.

Federal Housing Authority (FHA): Insures loans made by banks and other lenders; sets a maximum mortgage limit and usually requires a lower down payment than a traditional loan.

Fixed-rate mortgage (FRM): A mortgage in which the interest rate stays the same throughout the life of the loan; usually paid over 15- or 30-year terms.

Index: The measure of interest rates.

Loan-to-value (LTV): A percentage ratio that indicates how much of a mortgage remains due. (For example, if you make a down payment of 10 percent, and finance 90 percent of your mortgage, it is called a 90 percent LTV loan.)

Lock-in: A lender's promise to hold a certain interest rate and a certain number of points for the borrower, usually for a specific amount of time; also called a rate-lock or a rate commitment.

Margin: The percentage points the lender adds to the index rate to calculate the ARM interest rate at each adjustment.

Points: One percent of the principal amount of a mortgage; lenders often charge points to increase the yield on a mortgage and to cover loan closing costs. The home buyer, seller or both can assume this cost, usually due at closing.

Veterans Administration (VA): Insures loans made by lenders for eligible veterans and their spouses. Encourages lenders to write loans for people with lower incomes.