Financing Your First Home

A Guide for Homebuyers

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4/1/2014

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The Basics of Underwriting

There are four main requirements to getting a loan, which are referred to as "The 4 C's of Underwriting." Lenders will be looking at these facets in their underwriting decision.

The 4 C's of Underwriting:

Capacity: What is your capacity to pay back the loan? To determine this, what lenders are really looking at is your qualifying ratio, also called your Debt-to-Income (DTI) ratio. This ratio takes your total proposed housing payment, plus any monthly payment liabilities per your credit report (car loans, student loans, credit cards) divided by your monthly gross income, and that ratio is deemed acceptable or unacceptable. Ratio requirements depend on the type of loan you are applying for, but should typically be no more than between 40.0-45.0%. See "Qualifying" section for an in-depth example of a DTI ratio.

Capital (or Cash): Where are the funds for the down payment and closing costs coming from? Besides factoring these assets for down payment and closing costs, the underwriter will look at what is remaining in your accounts for reserves: i.e. if you were to lose your job, this is how many months you have in assets that would cover your total housing payment obligation.

Collateral: Since the loan is secured by the home you are buying, the property (collateral) must be in acceptable shape in the lender's eyes. This is determined by an appraisal, not just for value, but for condition, safety and habitability of the home.

Credit: Your credit history and score is a huge factor in getting a loan, and your interest rate will be based on this as well.

Getting preapproved is an important first step when considering buying a home because you will know where you stand on each of these items (pending the collateral); so if you are weak in any area, we can discuss the steps you should take or what needs to happen to strengthen those specific areas.

Basic Requirements for Getting a Loan

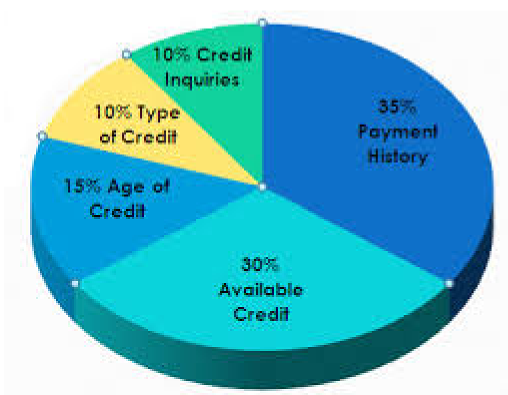
Here are some basic, additional items an underwriter is looking for:

- A FICO score of 620 or greater
- A 2-year consistent history of employment, income, credit and residence in the United States
- All income and assets fully documented
- A history of credit with minimum required “trade lines” (credit cards, car loans). The minimum is usually 3-4
- A qualifying ratio of 45% or below (although a lower ratio may be required on Jumbo loans)
- U.S. citizenship or acceptable visa status

Credit Scores 101: What You Need to Know

Credit scores range from 350-850. The lowest acceptable credit score to get a home loan is currently 620, but those at this score will be paying a higher interest rate than if their credit score were higher. Since your credit score is a major factor to getting a good loan, I like to share information on what goes into the score determination so that if you’re lacking in one place or another and do not have optimal credit, you will know where to concentrate your efforts.

How your credit score breaks down:



Payment History (35% of credit score’s weight)

- ✓ Make timely payments. The fewer late payments, judgments, liens or collections, the better
- ✓ Recent derogatory items will hurt your score much more than older ones
- ✓ The longer a payment is past due, the more it will negatively impact your score (i.e. being 60 days past due on an account is worse than being 30 days past due)

Amounts Owed (30% of credit score's weight)

- ✓ Keep balances low on many credit cards as opposed to high balances on 1 or 2 credit cards. The rule of thumb is that you should attempt to have no more than 30% of your credit limit as a balance on your credit card (so if your limit is $10k, keep your balance at $3k or less)

Length of Credit History (15% of credit score's weight)

- ✓ The longer you've had an account open with good, timely payments, the higher your credit score will be. The idea behind this is that your past payment habits will reflect your future payment habits.
- ✓ Closing old, seasoned accounts will actually negatively impact your score (that credit card you got on your 18th birthday can serve you extremely well)

Types of Credit in Use (10% of credit score's weight)

- ✓ I know they can be attractive, but stay away from finance company accounts (such as direct retailers like Macy's, Banana Republic, Home Depot, etc.). In terms of credit scoring, it is interpreted that you cannot qualify for other types of credit.

New Credit (10% of credit score's weight)

- ✓ Looking for new credit can indicate higher risk
- ✓ Inquiries into your credit report can also negatively impact your credit score

There are three credit bureaus that will give you three scores. Lenders will take the middle of the three scores and use this for determining your interest rate. If you are purchasing the home with someone else that will be on the loan, then the lower middle score will be used.

Example:

Husband		**Wife**	
Experian:	743	Experian:	805
Transunion:	722	Transunion:	781
Equifax:	737	Equifax:	790

In this scenario, even though the wife's credit scores are excellent (a 790 middle FICO), the interest rate would be based on the husband's middle FICO of 737 because it is the lower of the two middle scores.

TIP: You will get the best interest rates with a middle FICO score of 740 or greater.

Qualifying

The very first question people ask in buying their first home tends to be: “How much can I qualify for?” Your Qualifying Ratio, also referred to as your Debt-to-Income (DTI) ratio, is calculated the following way:

- Take your total housing payment (mortgage, property taxes, homeowners insurance, HOA Dues, Mortgage Insurance…) plus the minimum monthly payments due on anything that will show up on your credit report (i.e. car loans, student loans, credit cards etc.), and this is your debt.
- Then divide the total debt by your monthly gross income, and that result is your qualifying ratio.

Lenders want to see a DTI ratio of 45.0% or below on conforming and high-balance loan amounts, and a ratio of 41.0% or below on Jumbo loan amounts.

What Goes into a Housing Payment

Your payment responsibilities as a homeowner are:

1. Mortgage Payment
2. Mortgage Insurance (if you are putting less than 20% down)
3. Property Taxes
4. Homeowners Insurance (single-family home) or HOA Dues (condo or townhouse)

Other potential responsibilities:

a. If you are purchasing a condo or townhouse and the HOA dues do not cover insurance for the interior of your unit, then you will be required to get an “HO-6” (interior) insurance policy.
b. If you are buying a property in a flood zone, then flood insurance will also be required.

So here is an example of the Debt-to-Income ratio in action. Let’s assume a $625,000 purchase of a single family home with 20% down payment. The loan amount would be $500,000. For illustration purposes, we will assume an interest rate of 4.75% (this is not a rate quote).

Housing Payment:
Mortgage: $2608.24
Property Taxes: $651.04
Homeowners Insurance: est. $100.00
TOTAL: $3359.28

Monthly payments per credit report:
Car loan: $450
Credit card debt: $100

TOTAL DEBT: $3909.28

TOTAL GROSS MONTHLY INCOME: $10,000 ($120k annual salary)

3909.28 ÷ 10,000 = 39.1% qualifying ratio.

This is below the 45% requirement and therefore this individual would qualify for the loan.

Employment Requirements and Calculating Income

Documenting a two-year history of employment and income (in the same line of work) is very important to underwriters. It shows stability and consistency. How we calculate income depends on your type of employment. Here's a brief synopsis of different types of income and how they are calculated:

- Salaried Employee: Current annual gross base income divided by 12 months
- Self-Employed Individual: Your net income (not gross) from your most recent 2 years' filed tax returns, divided by 24 months (in some cases, we can add in depreciation and expenses for the business use of your home).
- Hourly Employee: Averaged over 24 months
- Overtime: Averaged over 24 months
- Child Support or Alimony: Must be able to document receipt over the past few months, and prove that it will continue for a minimum of 3 years

To document income, you will be asked for paystubs, W2s, tax returns, and in some cases a written "Verification of Employment" form from your employer if we need to break down any hourly, bonus or overtime income received.

**Bonus income can be used if it has been received for the most recent 2-year period from the same company, and if it has remained the same or has increased.*

Your Down Payment and Closing Costs

You need to plan for and be prepared to document the funds you have for both the down payment and closing costs. You will be asked for all pages of your most recent 2 months' asset statements (bank/brokerage/retirement). The underwriter will not just review your current balances, but all deposits in your accounts. If there are any non-payroll large deposits, you will be asked to "source" them. What constitutes a "large" deposit can vary among lenders' guidelines, but it is typically any deposits that are 25% or more than your gross base salary in a given month.

The reason you are asked to source deposits is firstly because there are acceptable and unacceptable sources of funds, and secondly, because lenders are required (or encouraged) by the government to monitor for money laundering.

Acceptable Funds for Down Payment

- Current savings/checking, stock and brokerage accounts
- Withdrawals from your retirement account(s)
- Inheritance funds (must be sourced/documented)
- IRS/State Tax Refund
- Gift Funds (check with me on current rules though; in most cases, there is a minimum contribution that you as the borrower must make, and then gift funds on top of that contribution are acceptable)
- Funds from Down-Payment Assistance programs

Acceptable Funds for Closing Costs

- Any of the above items is acceptable
- Seller Credit for closing costs
- Lender Credit for closing costs

Unacceptable Funds

- Credit card loan
- Any other loans or notes you must pay back
- “Mattress money” or “cash on hand”

TIP: Document all transactions and activity. Banks have even rejected funds from garage sales because it was too difficult to source the cash. If you are in a similar situation, then we can have those unacceptable funds “season” in your account for 2 months and then apply for a loan.

Financing Options

Conventional Conforming Loans

Conventional loans are the most common types of financing. They are any loan that is not insured by the Federal Housing Administration (FHA) nor guaranteed by the U.S. Department of Veterans Affairs (VA).

Benefits of conventional loans:

- ✓ Excellent credit is not required; however, the interest rate is very sensitive to credit score, down payment and property type
- ✓ No Private Mortgage Insurance if you put down 20% or more
- ✓ For 1-unit properties, as little as 5% down payment if your loan amount does not exceed $417,000

- ✓ For 1-unit properties, as little as 10% down payment if your loan amount is greater than $417,000 and up to the "conforming high-balance" loan limit for the county you are purchasing in
- ✓ Options to avoid paying Private Mortgage Insurance with split financing (1st & 2nd mortgage structure); 10% down payment needed
- ✓ Either 0 or 2 months reserves required

The conforming high-balance loan limit throughout the Bay Area is $625,500, which is the maximum nationwide. Other counties have lower limits, so contact me to look for your county's limit specifically.

Conventional Jumbo Loans

A jumbo loan is any loan amount that exceeds the county's high-balance loan limit. Basic underwriting guidelines include:

- ✓ Higher interest rate than conforming or conforming high-balance loans
- ✓ 20% down payment required (in some cases and up to a certain purchase price, 10% down may be acceptable)
- ✓ Higher FICO scores required
- ✓ More restrictive qualifying ratio (41.0% usually; some lenders may consider up to 43.0%)
- ✓ Reserve requirements are usually 12 months' worth of a housing payment remaining in your asset accounts after the down payment and closing costs

FHA

An FHA loan is a government-insured loan. What this means is that if you default on your mortgage, the government insures payment to the lender.

Basic FHA guidelines:

- ✓ 3.5% minimum down payment
- ✓ Down payment can come from 100% gift funds
- ✓ Financing up to the conforming high-balance loan limit for county you are purchasing in
- ✓ Competitive rates for low FICO scores
- ✓ Upfront Mortgage Insurance Premium of 1.75% charged in addition to monthly Mortgage Insurance
- ✓ Mortgage Insurance charged regardless of down payment amount
- ✓ If purchasing a condo, the condo development must be FHA-approved

Fannie Mae Homepath

Fannie Mae Homepath is a financing program for properties foreclosed upon directly by Fannie Mae.

You can search for available Fannie Mae Homepath homes on its website: homepath.com

- ✓ Minimum 5% down payment
- ✓ No Mortgage Insurance (MI)
- ✓ Closing cost assistance specials are often offered
- ✓ Higher interest rate than traditional financing, but when you have little down, payment savings from no MI usually offsets the higher rate
- ✓ No appraisal report is necessary
- ✓ Properties are often move-in ready, unlike other foreclosed homes

Economic Opportunity Mortgage

Eligibility for this program depends on one of two things: (1) If your income is below 120% of HUD's Median Family Income limits for the county you are purchasing in, and (2) if you are purchasing a home that is located in a targeted census tract. Highlights of the Economic Opportunity Mortgage program include:

- ✓ 5% minimum down payment
- ✓ No Mortgage Insurance
- ✓ Loan amount up to conforming high-balance loan limit
- ✓ Interest rate not dependent on FICO score, as long as FICO is 620 or greater
- ✓ Interest rate reduction for purchase in certain counties

VA

VA loans are for our veteran heroes. The loan is guaranteed (up to a certain amount) by the U.S. Department of Veterans Affairs. Some VA loan highlights:

- ✓ No down payment required
- ✓ No Mortgage Insurance
- ✓ Up to 6 months reserves required for loan amounts above $417k
- ✓ A Funding Fee is charged. Fee depends on down payment and type of veteran (regular military versus reserves/national guard)
- ✓ Unmarried surviving spouses of veterans who died as a result of service or service-connected causes are also eligible for a VA loan

CalHFA

The California Housing Finance Agency (CalHFA) helps buyers by providing down payment assistance and low interest rates. Things to know about CalHFA:

- ✓ There are specific credit score and income limit requirements for each CalHFA program
- ✓ You must take a homebuyer education course
- ✓ Typically only used when you need down payment assistance; otherwise, you will usually get a better interest rate through other financing options
- ✓ There are often max purchase price limitations
- ✓ CalHFA offers down payment assistance programs with certain eligibility requirements

Down Payment Assistance Programs

These programs can provide you with the funds to put money down on a home if you have not saved enough on your own yet. They are called "silent" second mortgages because you do not have to make any payments on them until you sell, refinance or pay off your mortgage in full.

- ✓ Typically combined with CalHFA financing, but not always
- ✓ There are income and/or sales price limitations on these programs
- ✓ You are required to take a homebuyer education course
- ✓ Some of them are based on an "equity share" program, which means when you sell your home, you are to share the home's appreciation with the institution that lent you the funds
- ✓ Funding the assistance may depend on state funds available, so your chances of getting assistance are higher in the beginning of the program's fiscal year rather than at the end

Loan Program Options

You may be limited to certain loan programs depending on your down payment amount and financing program, but here are some general loan program options:

- Fixed Rate Mortgages
    - o Offered in fixed terms of 10, 15, 20 or 30 years
    - o Interest rate and payment is fixed for the life of the loan with no adjustment
- Adjustable Rate Mortgages (ARMs)
    - o Hybrid product with an initial fixed term before entering an adjustable period based on the market
    - o The initial fixed term options are for 3, 5, 7 or 10 years
    - o Loan term is for a 30 year period, so a "5/1" ARM is fixed for 5 years, then adjustable the remaining 25

- The shorter the initial fixed term, the lower the interest rate since you are assuming the risk for what will happen at the time of adjustment
- Interest-Only ARMs
  - Operate like a fully-amortizing ARM (above), but you pay interest-only (no principal reduction payments) during the fixed term of the loan
  - This is not a common loan program anymore because of its inherent risks, and very few lenders offer it
  - Strict qualifying and down payment requirements
- 2nd mortgages
  - Can be offered in conjunction with a 1st mortgage, as necessary
  - Fixed Rate 2nd mortgage or Home Equity Line of Credit (HELOC)

Mortgage Insurance

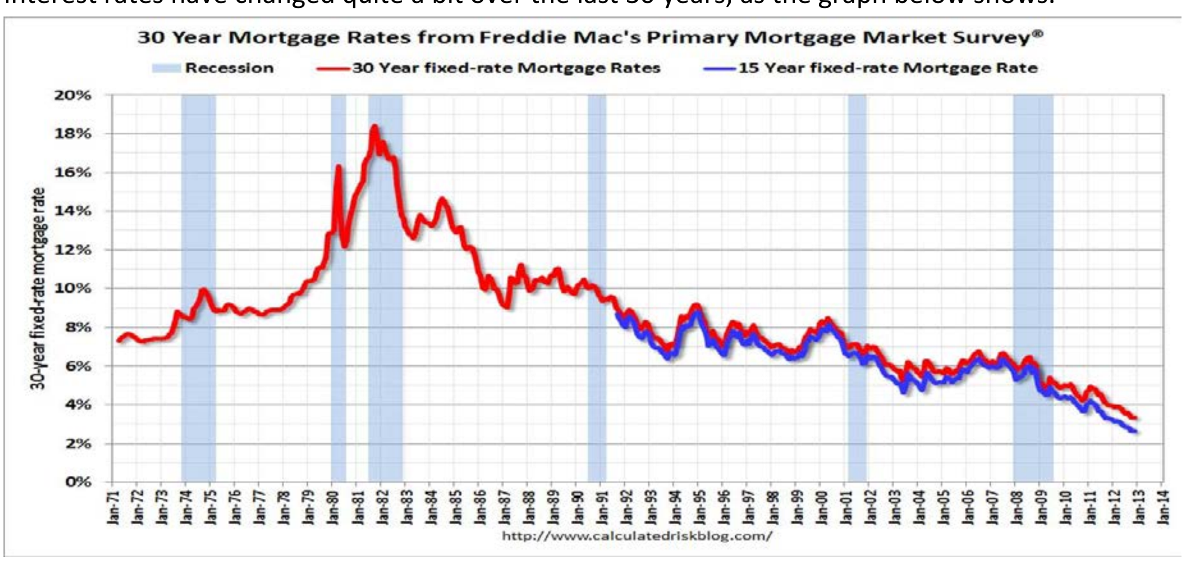
Mortgage Insurance (MI) is a premium you pay when you either have less than a 20% down payment on a Conventional loan, or if you require FHA financing, regardless of down payment percentage. It serves to protect the lender against you defaulting on your mortgage.

- Mortgage insurance rates vary by company, credit score, loan amount (conforming or conforming high-balance), and property type
- There may be options to pay MI monthly, or to select “Lender-Paid Mortgage Insurance,” where it is absorbed into the interest rate

Typically, MI can be eliminated once you reach 20% equity, but regardless of when you reach this equity level, you are asked to continue to pay it for a minimum of 2 years (Conventional financing); or with FHA, it is either 11 years or the entire loan term, depending on your initial down payment percentage

Mortgage Interest Rates

Interest rates have changed quite a bit over the last 30 years, as the graph below shows.



- Interest rates vary daily, sometimes multiple times within one day depending on market conditions
- Mortgage rates are dependent on mortgage bonds and how they are selling and trading. So the activity you see in the stock market happens similarly to the mortgage bond market. Many factors go into how mortgage bonds trade, but economic reports tend to be the primary drivers.
- There are ten factors that go into a rate quote:
  - Loan amount (conforming, conforming high-balance or Jumbo)
  - FICO score
  - Purchase price to determine Loan-to-Value ratio
  - Property Type (single family home, condo, townhouse, manufactured home, 2-4plex)
  - Loan Program (Fixed or Adjustable; Conventional or FHA)
  - Loan Term (10, 15, 20 or 30 years)
  - Purpose of the loan (purchase; refinance; cash-out refinance)
  - Occupancy purpose (primary residence, vacation home or investment property)
  - Impound Account
  - Lock Term

So where do you start?

GET PREAPPROVED

Getting preapproved means you go through the loan process and you have a written commitment letter from a lender backing up any offer you make. Real estate agents and sellers will want to see a preapproval letter to make sure you are approved to buy the home.

The typical documents needed to get preapproved are:

- ✓ Loan application and signed general disclosures
- ✓ 1 month most recent paystubs
- ✓ Most recent 2 years' W2s
- ✓ Most recent 2 years' federal tax returns, all schedules
- ✓ 2 months' most recent asset statements (bank/brokerage/retirement), all pages
- ✓ Copy of your driver's license(s)
- ✓ If not a U.S. citizen(s), copy of your visa(s), front and back

(There may be additional documents required upon receipt of initial items)

About

Irene Moustakas has been in the mortgage business since 2001 and has served hundreds of clients through successful and smooth purchase and refinance transactions. Her strength is in arming people with the tools, strategies and knowledge necessary to make informed and educated decisions in their real estate investments. Irene understands that homeownership is not just a practical investment, but an emotional one as well, so her approach to assisting first time homebuyers is strong in both analysis and support.

Irene is a California-licensed Mortgage Broker and received her Master's degree in Business Administration from San Jose State University in 2011. She is closely connected to the housing and lending community in the Bay Area and is affiliated with a number of industry associations. She has maintained an active blog since 2008, providing valuable information, tips and insight about the real estate market, updates in lending regulations and housing in general. In her personal time, she enjoys spending family time with her husband and young son, reading, and appreciating the outdoors.

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Author's Note: *I hope this guide has been helpful to you in what may be the first step in an exciting and important decision in your life. Please feel free to contact me at any time if you have any questions about anything mentioned in this e-book, or if you would like to discuss your personal financing options. I am very fortunate to love what I do and helping people achieve their goals is a huge part of the satisfaction that drives me. You can email me at Irene@LoansByIrene.com or give me a call at 408.257.1681. Thank you.*

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