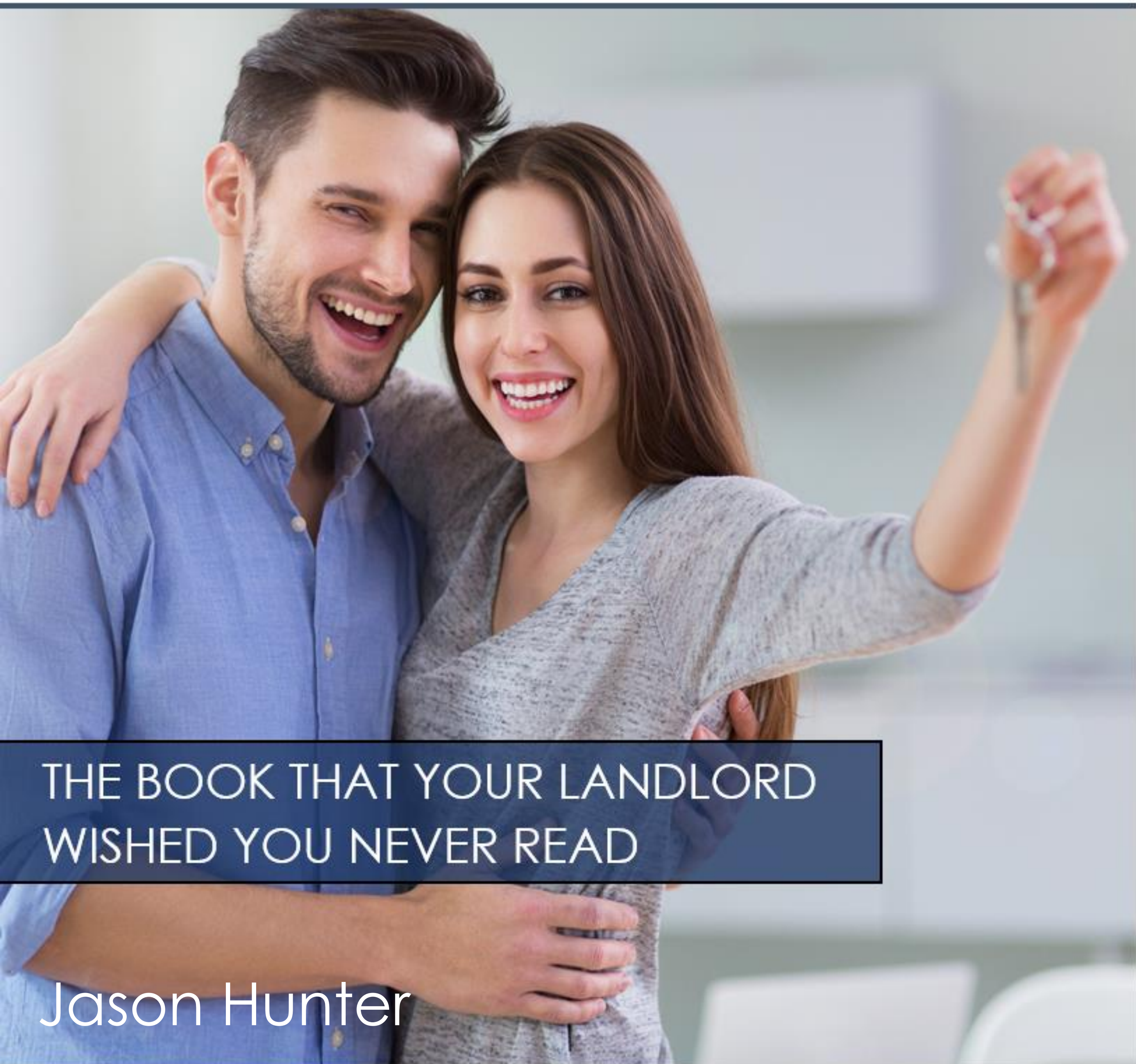
MILLENNIAL'S GUIDE TO BUYING A HOME

STRAIGHT OUT OF COLLEGE



THE BOOK THAT YOUR LANDLORD WISHED YOU NEVER READ

Jason Hunter

Hi [ProspectFirstName],

Thank you for requesting my book, "Millennials Guide to Buying a Home Straight Out of College."

This book is a useful guide to help take the mystery out of purchasing your first home so that you'll feel confident and excited about the process, rather than scared of the unknown. This is not a book full of platitudes and feel-good stories about the pride of homeownership. Rather, it's a practical guide to pin a spotlight on the homebuying process.

One thing I don't want to do is to convey that purchasing a home is for everyone. This book isn't a rah-rah speech about virtues homeownership. I only want to highlight the process, give you the facts and let you make an educated decision if homeownership is right for you at this stage in your life.

After reading this book, most readers are surprised that the home buying process and qualifications needed are more straightforward and easier than they were led to believe.

Enjoy and feel free to reach out if you have any questions.

Thank you,

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I just graduated! I'm ready to start enjoying my life…why should I buy a house now?

This is a reasonable question. Buying a home is a large commitment. It is also one that will be likely to keep you in one place for quite some time. If you are thinking about a series of job transfers, or significant changes in your lifestyle over the next few years, you should think carefully about taking on that large responsibility.

Look at the real cost of owning a home compared to renting a similar one. To do this, we should start with a few assumptions:

1. You plan to stay put for at least a few years. While selling a home that no longer meets your needs or life's situation is not difficult, it does take some time to accomplish. If your job were to call for a transfer, you'd be faced with the choice of selling the home or of keeping it as an investment. Either choice is possible, but this is a matter worth careful consideration to before buying.

2. Your income is reasonably secure. If you are at the beginning of your career, you should feel confident that your job will continue for the foreseeable future.

3. The real monthly cost of ownership is not a financial burden.

The first consideration in comparing renting and owning is the cash needed to buy. It is true that there are many loan programs available requiring a small down payment—3½% or less—but you will have to pay additional money for closing costs. We'll cover that thorny issue later in this book, but for now, be aware that you will likely have to come up with more money than the down payment. You should have an idea in advance of how much cash you will need to buy the kind of home you'll be satisfied with, and where the money will come from.

Next, be aware of the tax aspects of home ownership. A detailed explanation of how tax deductions work is beyond the scope of this book, but you should be mindful of the fact that you may be able to reduce your income tax liability substantially when you deduct items such as mortgage interest and property tax. You should consult a tax professional early in your decision process to get an idea of what those savings will be. This is an important thing to know; if your tax consultant tells you that you may save $2,400 a year by deducting mortgage interest and property taxes, a $2,000 total mortgage payment becomes the equivalent of $1,800 because of the tax savings. Your tax consultant will show you how to increase the exemptions on your W-4 to increase your take-home pay rather than having to wait for a tax refund at the end of the year.

Next, determine how much of your monthly mortgage payment goes to reducing your principal balance. If you have a $200,000 loan at 4.5%, for example, your monthly payment will be $1,013. In your first year, you will pay down the balance to $196,773, or $3,226. You should think of this part of your payment as a sort of "forced savings" account. Although the amount of interest you'll pay decreases each year as you pay down the balance, we can use the first-year figure for our simple comparison. The monthly mortgage payment (not including taxes and insurance) is $1,013, but $269 each month goes to your "forced savings" account. You should consider the remaining $744—the interest on your mortgage—to be like the "rent" on the money you borrowed to buy your house.

You will also pay taxes and insurance when you own your home. Your landlord pays those items, too, but that is part of the rent you pay. For this example, we'll assume that your taxes and insurance amount to $1,400 per month.

You can begin your rent-vs-own comparison by looking at the difference between the rent you would pay now with the tax-adjusted mortgage payment. We'll assume that you can rent a house like the one you can buy for $1,200 per month. Although the expense of owning initially seems to be $200 higher each month, that difference may disappear when we account for the tax advantages. The real cost of owning a home decreases, even more, when we consider the part of each payment that reduces the principal balance.

This comparison may seem overly simplistic, and in one sense, it is. We have not considered the cash needed to buy the home. Getting together a 20% down payment plus a few thousands more for a closing costs is not a trivial undertaking—and it is a major challenge for a great many people.

Solving the down payment problem

There is no such thing as a "normal 20% down payment," even though you may have been led to believe there is. Lenders view a borrower's initial investment as one way for them to manage risk. They consider a loan for 80% of a property's value to be comparatively low risk. This does not mean they won't make a loan with a smaller down payment; they will. Lenders manage their risk for borrowers making smaller down payments by requiring some form of mortgage insurance. We will talk about mortgage insurance in a later section.

Tweaking the comparison

Our earlier rent-vs-own comparison used a $250,000 property with a 20% down payment. Since $50,000 cash is out of reach for many people, let's assume a smaller down payment: $25,000 (10%). The loan amount is now $225,000—and the monthly payment is higher. Including mortgage insurance, the monthly payment is now $1,550.

If we adjust the house payment as before, with $200 per month for tax savings and $3,600 payment to the principal balance ($300 a month), our adjusted house payment is now $1,050 ($1,550 – 200 – 300 = 1,050).

Taking the cash into account

If we are going to do a proper comparison of rent-vs-own, we should consider how money works. If we have enough cash available for a down payment and closing costs, we must consider the "opportunity cost" of the money. This means that by putting money into one investment, such as a house, you are unable to invest it somewhere else to earn a rate of return.

For our simple comparison, let's assume that we can invest our cash to earn 5% per year. If the total investment is $35,000, for example (down payment plus closing costs), you will give up the opportunity of earning $1,750 per year ($35,000 x 5% = $1,750), or $145 per month. Put another way, if you didn't invest your $35,000 cash in a home, you'd be able to put the money to work elsewhere, earning you $145 a month.

Considering opportunity cost, we can now adjust the cost of home ownership once again, to $1,195. Compare this number to the rent you would pay for a similar house. If the adjusted cost to own is higher, you may choose to look at it as a monthly investment you make, hoping that the home will appreciate over time. You could also think of a higher monthly cost as the price you pay for pride of ownership.

The area where you choose to live will have different numbers—but following this method will allow you to make a rational, objective financial comparison between renting your home and owning it.

There are two additional factors we have not covered: rent increases and appreciation.

You may have been paying a very low rate to your landlord for some time, but you shouldn't assume you'll have that advantage forever. There always comes a time when rents increase as the market allows for it. At a minimum, a property owner wants to cover rising costs of doing business: insurance, maintenance, replacements and whatever utilities they might cover as part of your rent. If the general inflation rate is 2%, that means that rent of $1,000 should go to $1,020 after a year, then $1,040 after two years, and so forth. Landlords tend not to raise rents every year, but sooner or later, the rents will increase to reflect a rising market. Home ownership is not subject to the same kinds of cost increases; the payment on your fixed-rate mortgage will never change.

The second factor we have essentially ignored thus far is appreciation: the increase in the property's market value over time. If the general appreciation rate in your area is 3%, a property selling for $250,000 today is likely to be worth $257,500 at the same time next year.

We are disregarding appreciation for this comparison because it seems to many as "pie-in-the-sky." Since no one can accurately predict how much any property will increase in value, we suggest using an appreciation rate of zero for the rent-vs-own comparison.

Solving the cash problem

You may decide that being a homeowner fits your lifestyle, but can't see where you'll be able to save up enough money to buy. We used a $250,000 home as an example earlier, but many areas of the country are much more expensive. You may find that, even for lower prices, the down payment and closing costs are too high a barrier.

Although we used a 10% down payment in our example, there are other ways to buy when you don't have a lot of cash. There are conventional loans available for as little as 3% down, for example. Also, all 50 states offer some form of assistance for first-time buyers. This assistance may include low- or zero-interest loans, "sleeping" loans that require no monthly payment, grants (which don't have to be repaid) and tax incentives for home ownership. You can search for programs available in your area by going to DownPayment Resource.

About closing costs

We've been talking about additional money needed besides the down payment. These are the "closing costs." Let's talk about what they are, and how to handle them.

When you buy a home, there are certain costs and fees that will always be present. The first category of costs is the "non-recurring closing costs" because they happen only once.

There will always be a policy of title insurance. The lender will require this to protect their security interest in the property. Most people will also purchase an owner's policy as well, although it is not generally required. This protects you, the buyer, in case there are any irregularities ("clouds") in the chain of title. Your owner's policy is good for as long as you own the property.

You will also use the services of an escrow company, sometimes called a "settlement service." The job of escrow is to act as a neutral third party who coordinates all the components of your transaction and makes sure everyone gets what they agreed to in writing. Depending on your state, there may be lawyers involved at the closing, as well.

There will be an appraisal to document the property's value. This is important because the property is the lender's security for the loan they're about to give you. Then if the appraised value turns out to be lower than the agreed purchase price, the lender will base its loan on the lower figure. If it's higher, they'll use the purchase price.

Other non-recurring costs include fees for underwriting, document preparation, the wiring of funds, notary and recording.

There is another category of costs called "pro-rations and prepaids." Most of these are expenses you'll pay for as long as you own the property. Among these are your first year's hazard insurance policy and prorated interest.

When you make a mortgage payment, you're paying interest for the previous month. If you close escrow on the 15th of September, your first payment will be due on November 1. That payment will cover interest for the month of October. The lender will charge you prorated interest from September 15 to the end of the month, so you'll pay 15 days' interest at close of escrow.

You may also have an "escrow account" for taxes and insurance. Your lender will collect 1/12 of the annual taxes and 1/12 of the insurance renewal with your regular payment. This money will go into a special account, from which they'll pay the taxes and insurance at the appropriate times.

If the loan is more than 80% of the home's value, the lender will require an escrow account. At 80% or lower, the account is optional, although most buyers choose to have the account because it's convenient—they don't have to worry about setting money aside for taxes and insurance.

You will deposit money into the escrow account to "fund" it at the beginning. The lender will determine how much has to go into it, depending on your state's tax calendar. They may require as few as two months or as many as 9 months' taxes.

In some cases, the total closing costs can be as much as the down payment—so be prepared.

How to handle closing costs

You have three choices—and you can combine any of the following:

- Pay them out of pocket. If you have the cash available, this is the obvious choice.
- Ask the seller to pay them for you. In a highly competitive housing market, this can be a tough sell, although it is not impossible. When a seller agrees to pay some or all of a buyer's closing costs, they are including those costs into the price of the home.
- Get a rebate from your lender. Yes, you can get money from the lender to help with your closing costs. You do this by choosing a slightly higher interest rate. You can expect a rebate of about 1% of the loan amount for each ¼% you increase the rate.

Solving the mystery of the FICO score

You already know that lenders look at a three-digit number, called a "FICO score," or just, "credit score," when reviewing your loan application. There are a few things to know about your credit scores.

Most people have three FICO scores—one from each of the three national credit bureaus. The number ranges from 300 (terrible) to 850 (awesome). The scores are generally different for each of the three credit bureaus. Lenders throw out the high and low scores and use the one in the middle. It's called, appropriately, the mid-score.

You may have heard that lenders' credit standards are impossibly high and that they are approving only those buyers with nearly perfect credit. This is false. The fact is that a credit score as low as 580 will work for an FHA loan (3½% down payment) or 620 for a conventional loan (as low as 3% down payment). A borrower with a lower score will pay a higher rate, however, so it's worth paying attention to your credit profile.

There are two FICO components you should be especially aware of: your payment history and your credit card balances. The first is obvious; keep your obligations current. The second one, credit card balances, is nearly as important where your credit score is concerned.

When the balance on a credit card (referred to as "revolving credit") goes over 30% of the limit, your score starts to suffer. A credit card with a $600 limit and a $500 balance could cost you 20 points on your score. You should be especially aware of store cards that promise you, "60 days, same as cash!" You get a great deal on a $2,500 refrigerator with no interest or payments for 60 days or more. You may see this as a great deal—but this can cost you dearly on your credit report. It will appear as a revolving account with a limit of $2,500 and a balance of $2,500. It looks exactly like a maxed-out credit card—so beware; it could cost you thousands when you apply for a mortgage.

How the lender approves your loan

Most of the lender's decision process is driven by simple math—specifically two ratios. These are the "Debt to Income Ratio" (DTI) and the "Loan to Value Ratio" (LTV).

The DTI tells the lender how much of your gross income (before taxes) will go to your house payment and other debt payments. To calculate this number, the lender adds up your total house payment, including taxes, insurance and mortgage insurance, if any. This is called "housing expense." They add all monthly payments appearing on your credit report. This will include obligations like car payments, student loans, and credit card minimum payments. They can exclude any obligations with less than 10 months remaining, however.

Adding all these numbers to the proposed house payment gives "total debt." When they divide that number by your gross monthly income, they get the DTI. If your house payment will be $2,000 and your $400 in other debt, and your gross income is $6,000 per month, your DTI is 40% (2,400 / 6,000 = 40%). Lenders can generally go as high as 50% DTI. You should make your own decision about your maximum payment, however.

On the subject of Debt-to-Income ratio: you can see how debt obligations affect the amount of loan you can qualify for. Each additional $100 of payment reduces the price of the house you can qualify for by about $17,000.

You may be starting your career, straight out of college. With a nice starting salary, you decide that you can eat a lot more steak and a lot less ramen. There is nothing wrong with that—you've earned that pleasure. But you may also decide that it's time to dump the old "beater" car you drove while you were going to school and finally get a new car; after all—the dealership is offering 0% interest and a very small down payment.

Before you commit to your new ride, however, you should be mindful of how it can affect your purchasing power. Taking on an additional $600 per month in a car payment—even if the interest rate is zero—will drop the amount of house you can qualify for by over $100,000.

The second important ratio, the LTV, will determine whether you will have to pay mortgage insurance, and if so, how much it will cost you.

Lenders require mortgage insurance for an LTV higher than 80% – in other words, where the buyer puts less than 20% down. Mortgage insurance limits the lender's risk in case the borrower fails to make the payments.

The monthly mortgage insurance premium depends on a combination of the LTV and your credit score. A borrower making a 10% down payment will pay .31% if they have a 760 score, up to 1.1% for a 620 score, the minimum for a conventional loan. The cost goes up for smaller down payments: a high-scoring borrower (760) putting 3% down can expect to pay typically .69% for monthly mortgage insurance. With a 620 score, the cost goes up to 2.37%. Credit scores matter, obviously.

Another choice for a small down payment

The Federal Housing Administration (FHA) is a government agency under the Department of Housing and Urban Development (HUD). FHA has been insuring loans with low down payments since 1934. FHA loans require a down payment of just 3½% and are insured by HUD.

FHA can be a good choice if you have a lower credit score; there are fewer adjustments to the interest rate for lower scores, and no adjustments to the cost of mortgage insurance at all. Every borrower getting an FHA loan with 3½% down will pay the same rate for monthly mortgage insurance: currently .85%. FHA also requires an initial premium, currently 1.75% of the loan amount. It is added to the base loan amount, so it is not an out-of-pocket cost.

Next steps

Now that you have read to this point, you should have a good understanding of how mortgage financing works. If you've decided that home ownership is for you, read on.

Your first step in the home buying process is to get your financing arranged. The fact is that most home purchases depend on financing; if that part doesn't happen, the deal doesn't happen.

Because of the perceived difficulty of getting a mortgage—one real estate pundit who should know better called it "insanely difficult"—sellers and their agents are highly averse to even considering any offer from a prospective buyer who doesn't have some sort of written document from a lender confirming that he has at least begun the process and has been approved on a preliminary basis.

Preapproval

The preapproval process is easier than many people believe. You begin by supplying your loan officer with some essential documents. These will be, at a minimum:

- A recent pay stub showing your rate of pay and year-to-date earnings
- A bank statement or statements showing the source of funds needed to complete the purchase
  - If there are any large deposits (greater than 10% of the annual income), you'll have to document their source
  - If you are relying on gift funds from a relative, you'll provide a gift letter and one bank statement from the donor showing the source of their funds
- If you own a business or rental property, or if you get significant income from investments, you'll provide two years' tax returns with all schedules
- A copy of government-issued photo ID, such as a valid driver's license or passport.

Help from your loan officer

The loan officer will help you prepare your loan application and documents for preapproval. He or she will get a credit report and merge all the information into your loan application.

Some lenders issue a "pre-approval." This involves gathering your documents, completing a loan application and submitting it to the automated underwriting system (AUS). This is all done online, so it's a quick process. The AUS should return a result of "Approve/Eligible" or "Accept," which means that your application has been approved as it was submitted.

What's better than a preapproval?

A more thorough—and more convincing—approach is to get what is called a "TBD approval." This means that your lender has submitted your loan package to the underwriter (not just the automated system) for review and approval, even though the actual property is To Be Determined (TBD). When the underwriter approves your application, he or she will do so conditioned upon the purchase agreement and appraisal, along with some other routine conditions. This type of approval is much more attractive to any seller because it increases the likelihood in their mind that your deal will go through if they select your offer over any others they may be considering. Multiple offers are common today, so the TBD approach can maximize the chances of getting your offer accepted.

All set to make an offer!

Now that you have your financing arranged, you can make an offer on a home. You will have met with your Realtor® to decide on area, amenities and a price range. It is always a good idea to make your own list of what you want in a home. You should prioritize those items that are essential above those that would be simply nice to have.

When you have found a home that meets your criteria, you and your Realtor® will prepare your offer to the seller. You will write a check, usually to the title company or settlement agent, to show the seller that you're serious. This check is called, appropriately, the "earnest money deposit." Although technically no specific amount is required to have a binding contract, it is always advisable to make as large a deposit as you can. You do not risk a single penny of this money; if the seller doesn't accept your offer, the check will be returned to you. Your Realtor® will send your offer to the seller's agent, who will present it to the seller.

This competitive market

A word about making offers: the real estate market is highly competitive in many areas, and multiple offers—several people making an offer on the same house—are common. Sadly, you may not get the first home you make an offer. Don't give up! Your perfect house is out there.

The three choices

When you make an offer on a home, the seller has three choices: accept it as written (hooray!), reject it (boo!) or issue a counter-offer (huh?). In the third case, the seller says, "I won't sell it to you for that amount of money, but I will take this amount, instead." Any change that the seller makes to your offer, no matter how trivial, is considered a counter-offer.

Your turn for choices

Now you have the same three choices the seller had. If you can live with the price and terms on the counteroffer, you'll sign the form, and you are now "in contract." You can also choose to reject the seller's counter-offer, and you'll get your earnest money deposit back. You may also continue negotiations by making your own counter-proposal to the seller. This continues until you, and the seller have a "meeting of the minds," or until you give up and go home.

"In contract…" and what's an escrow, anyway?

Once you are "in contract," your Realtor® will open escrow. He or she will deliver the signed contract to the company handling the escrow along with your deposit check. It will be deposited in the escrow holder's trust account at that time.

The term "escrow" means a neutral third party who makes sure that everyone gets what they've agreed upon. They can only act on written instructions from you, the seller and the lender. All those written instructions must agree so that nobody can pull a fast one at the last minute.

Appraisal and inspections

Next, the loan officer will order the appraisal. Most lenders require that you pay for it in advance. The typical cost is $450-$550. Appraisals generally take five days to a week to complete.

If your offer calls for inspection reports, such as pest control (termite), roof and a comprehensive home inspection, your Realtor® will order them now. You may have to pay for these at the time they are performed, depending on the contractor's policy.

Contingencies protect you

Your offer to the seller will contain clauses known as "contingencies." These are conditions that must be satisfied before you continue with the sale. One common example is an "inspection contingency." This clause states that you must be satisfied with any inspection reports before proceeding with the purchase. If a home inspection report finds a defective dishwasher, for example, you could tell the seller (in writing), "I'll continue with my purchase only if you replace the dishwasher." If the seller refuses, you have the right to cancel the transaction—and you'll get your deposit back.

Loan and appraisal contingencies

There are two other important contingencies, involving the loan and the appraisal. The loan contingency states that if for some reason your loan doesn't go through within a specified time, you're allowed to walk away from the sale, and you'll get your deposit back. The appraisal contingency states that if the appraisal's value is lower than the price you've agreed on with the seller, you can cancel the sale and get your deposit back. In practice, a low appraisal may mean that you and the seller renegotiate the price. Sellers are often willing to do this, rather than place the home back on the market and take their chances on finding another buyer. Keep in mind that the seller is under no obligation to sell the property at the lower price.

Verifications

While you're waiting for the appraisal and inspection reports to arrive, your lender will gather other documents and verifications. They'll get a written verification of employment, which often can be done through an automated service, such as The Work Number (Equifax). They may order a transcript of your income taxes from the IRS for one or two years to ensure that those numbers are consistent with the documentation you've supplied for your application.

Your initial loan approval will have some conditions that you and your loan officer will satisfy before you can sign loan documents. Most of these tend to be routine and easily handled—you may be asked to update bank balances or provide an updated pay stub, for example.

"Clear to close:" almost ready to sign!

Once the underwriter has signed off the conditions, your loan will be in a condition known as "clear to close." This means that the lender can draw loan documents for you to sign. They'll send those documents to the closing agent (often a title company) and the signing package will be prepared.

Before you can sign loan documents, you must receive a "Closing Disclosure" (CD). This five-page form contains the best estimate of the cost of your loan, close to the date of closing. You will wait three business days from the time you receive it before you can sign loan documents.

Signing all those papers

You'll go to the title company or some other convenient location to sign the documents. There are mobile signing services all over the country, so many people sign documents in their home or office. Some of the documents must be notarized. This means that a licensed and bonded person watches you sign, then attests that, to the best of their knowledge and belief, you are the person you claim to be.

"Funding" ...and CLOSING!

After you sign your name at least 8,000 times—it may feel like that—the escrow officer will send some of the signed documents to the lender for review. If everything is in order, the lender will "fund" your loan, which means they'll wire the money to the escrow holder's account.

Once the loan has funded, the escrow officer will perform a final audit of the file to make sure all the numbers are accurate. She tells the appropriate personnel to record several documents with the county where you live, and your escrow is closed. You are now a homeowner—congratulations!

How long?

In these days of automation, the loan process is faster than it used to be. There may be things that delay the process, however, such as an employer who doesn't respond promptly to the verification of employment request, or questions about the appraisal.

Most real estate transactions today tend to specify 30-day escrow periods. Ideally, your lender should be able to get everything done ahead of time, so no one has to scramble at the end to close your escrow.

Finally…

As you set out on your journey to home ownership, know that there are many people working for you: your Realtor® and your loan officer, are on the front lines with you; but there are also many people behind the scenes helping you: the escrow officer and her staff, your Realtor's staff, and dozens of people working for the lender, approving your loan, sending you important disclosures, preparing documents and wiring money from the loan into the escrow to complete your transaction.

As you set out on this exciting and important journey, we wish you the very best.

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