The First-Time Homebuyer's Guide to Homebuying Success

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Shopping around for your first home is an exciting prospect, but it can be intimidating. There are many factors that go into a decision of this magnitude, and first-time homebuyers will want to get their ducks in a row so they don't fall in love with their dream home only to realize they're not ready to buy.

Just like a little bit of research ensures prospective buyers know what to look for in a property, brushing up on the financial facets of the homebuying process will prepare shoppers to make informed decisions that set them up for long-term success.

Obstacles to Ownership

You're probably not going to pay for your new home with a briefcase full of cash, so you'll need a mortgage. While a mortgage allows you to borrow the money you need to purchase a home and then pay it back over an extended time period, you'll still need to make a down payment.

Unless you're a veteran and qualify for a zero-down VA loan, most lenders will require you to put down a minimum of 3 percent. It might not sound like much, but if you're buying a $200,000 home, that means you'll pay a minimum of $6,000. Saving for a down payment is one of the biggest factors of buying your first home. It takes time and preparation — but the more you save to put down, the better your terms will be when you take out a mortgage.

Because banks are taking a risk by loaning a large sum of money, they'll base the terms of the loan on your credit score. Your credit score is a three-digit number based on how much you've borrowed in the past and how responsible you've been in terms of paying your bills. For example, regularly making late payments can negatively affect your credit score.

Lenders will also look at how much of your available credit you use. People who consistently max out their credit cards are a riskier investment, so it's recommended to use less than 30 percent of your available credit on your credit cards if you want to be approved for the most money possible for your loan. Each of the three major credit reporting agencies (Equifax, Experian, and TransUnion) will allow you to get one free copy of your credit report per year, so make sure you're checking your score consistently to see where you stand. Visit AnnualCreditReport.com or call 1-877-322-8228 for more information.

To supercharge your credit score (and, therefore, be approved for the most money possible for your loan), use less than 30 percent of your available credit on your credit cards.

When it comes to borrowing money, any outstanding loans you have (such as student loans or car loans) can also have an impact. Lenders will calculate two ratios to determine how much money they're willing to lend you.

The first compares your monthly income to the monthly payments (including principal, interest, and applicable insurance costs) necessary for a loan. The second compares your monthly income to payments for all your monthly debts. Even if you have a monthly income of, say, $3,000, if you're paying $1,000 per month to cover your debt payments, a bank might not approve you for as much of a loan as you want.

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Terminology (and Translations)

The homebuying process occurs in stages. Along the way, you'll run into all kinds of financial jargon. Most of these terms are actually pretty simple, but we've translated some of the most common ones into plain English to help you keep up.

Mortgage

"Home loan" and "mortgage" are often used interchangeably, but "mortgage" is the legal term for the specific document used by a borrower to pledge his or her property as security in order to obtain a loan. In some areas, people refer to a mortgage as a "deed of trust."

Principal

The principal is the actual balance of a mortgage loan excluding interest. It also refers to the amount of the monthly mortgage payment that's applied to the actual balance.

Interest

Banks are undertaking a risk by lending you money. In return for the bank lending you the capital you need to buy a house, you'll pay back the balance you borrow plus an additional amount calculated based on the interest rate.

P&I

This is the monthly principal and interest payment that's required when repaying a mortgage.

Escrow

Generally, an escrow account refers to the funds a borrower pays to the lender along with his or her monthly principal and interest payments for the payment of real estate taxes and hazard insurance. This is also referred to as "impounds." The lender holds the money to make payments when they are due. An escrow can also refer to funds that are held by a third party to ensure the completion of repairs or improvements that are not completed prior to closing.

PMI or Mortgage Insurance

If the loan-to-value (LTV) ratio is greater than 80 percent, lenders will usually require mortgage insurance that's provided by a private company to protect the lender against losses in the event that a loan defaults. The borrower typically pays for the cost of the insurance until the loan amount falls below the 80 percent LTV mark. At that point, the insurance is no longer required. Sometimes referred to as "private mortgage insurance," it's simply a way for the lender to mitigate the extra risk of some loans.

Earnest Money

Think of this as a down payment to the seller. This is a sum of cash paid to a seller by a buyer that shows he or she is serious about buying the home and is willing to make a firm offer. The amount can vary and is sometimes as low as $500, but it can be several thousand dollars depending on the purchase price and how serious the buyer is about the purchase. If the offer is accepted, the earnest money is deducted from the purchase price at closing and is merely an immediate payment instead of an additional cost. If the offer is declined by the seller, the earnest money is returned to the buyer. However, if the offer is accepted and the buyer backs out of the deal before the closing, the seller keeps the earnest money. Earnest money is sometimes referred to as a "binder deposit."

Property Taxes

These are taxes based on the assessed value of the home. The homeowner pays these costs for community services such as schools, public works, and other costs of local government, sometimes as a part of the monthly mortgage payment.

Origination Fee

Borrowers are often required to pay an origination fee to the lender. This fee covers the time and services rendered in preparing the loan. Some lenders use the origination fee as a blanket term that includes an application fee, an appraisal fee, fees for any follow-up work, and other costs associated with the loan. However, The Callaway Bank typically separates these fees for increased transparency.

Title Insurance

Because the lender is using the home as collateral for the mortgage transaction, it needs to be certain that the title of the property is clear of any liens that could jeopardize the loan. Therefore, lenders require borrowers to get title insurance on the property, which provides research to ensure the home is unencumbered and acts as an insurance policy in case something was missed.

Loan Estimate

The lender will provide an estimate of the closing costs for the loan. The Callaway Bank provides this within three days of receiving a completed application. It's not an exact amount, but it's a way for buyers to get an idea of how much they will need at the time of closing.

Prequalification Letter

A lender prepares this letter informing the realtor, seller, and seller's agent that the lender has run a credit report, has calculated debt-to-income ratios, and has knowledge of the borrower's liquid assets that are available for down payments. While the letter doesn't fully commit to approving the borrower, it indicates that the bank feels confident that it will approve the loan. This helps the borrower when it comes to negotiating an offer.

Preapproval Letter

This letter is prepared by a lender and informs the principals in a pending transaction that a credit report has been run, the lender has formally verified income and assets, and the borrowers are approved subject to an acceptable appraisal. It's a step up from the prequalification letter.

Home Inspection

This is an inspection of the subject property that is performed by a licensed inspector. Typically, the inspector will investigate the condition of the HVAC system, foundation, roof, windows, plumbing, siding, etc. The home inspection will reveal the overall condition of the property and outline any necessary repairs or problem areas. It doesn't address value — an appraisal will do that.

Appraisal

This is an analysis of the subject property from a market valuation perspective. An appraiser analyzes and inspects the property and compares it to at least three other properties that are similar in size, style of construction, and proximity to the subject property that sold within the past year in roughly the same price range.

Loan Commitment Letter

This is a letter that is often (but not always) used to inform borrowers that their loan is fully approved and cleared to close.

Closing Costs

A variety of fees that come at the end or closing of a home loan. Some of these are related to the loan, but most of them are third-party fees tied to the home purchase. While the bank origination fee is part of the closing costs, the bulk of the fees usually include the property appraisal, title insurance, property taxes, recording fees, and homeowners association (HOA) dues. Another large portion can be the first year of homeowners property insurance.

Final Closing Disclosure

This document is provided to the borrowers no less than three business days before the closing date. It will detail the amount of the loan; the loan term; the interest rate; all the closing costs/settlement charges; and all the transaction principals including the lender, loan officer, realtors, and title company or settlement agent. It also discloses the details of the loan itself, such as the percentage of interest paid over the life of the loan, any prepayment penalties, rate changes, balloon features, etc.

The Complications of Construction

If you've looked around for a while and no homes have piqued your interest, you might be tempted to buy exactly what you want by having a new home constructed. This option can be viable in certain situations, but it's often difficult for first-time buyers to come up with the necessary equity to finance new construction.

At The Callaway Bank, we can sometimes lend as much as 100 percent of certain loan types. For construction loans, however, we generally cap our lending at 80 percent of the appraised value of the finished property. Because first-time buyers haven't built up equity in another home, they generally have limited options. They either have cash on hand or build the home themselves and gain "sweat equity" by saving on labor costs.

Even experienced homeowners generally underestimate the hassle of buying a new construction. There are important decisions to be made at every turn, and it's not uncommon for the final cost to exceed the initial budget. Another important factor is the relationship between buyer and builder. If problems arise in the middle of construction, it's particularly bad for the buyer who's left holding the loan (or multiple loans) without a property to show for it.

Time is also a consideration. It generally takes about nine months for a builder to complete a new construction. In order to pay the builder, the homebuyer must take out a construction loan. Plus, if the weather doesn't cooperate, it could easily take longer. The traditional financing begins once the new house is built, but many buyers don't realize that two loans mean double the closing costs — including the origination fee for preparing the loan and/or application and appraisal fees as well as title work. To make things easier for the buyer, The Callaway Bank often reduces some of the fees associated with the permanent loan. We typically cut the origination fee in half, for example, and a full appraisal might not be necessary if the construction is completed within a year.

Weighing Your Loan Options

If you're interested in buying a home but don't have the financial credentials to qualify for a loan, don't panic — you still have a few options. In the meantime, the most important thing you can do is improve your credit score. Getting into the habit of making payments on time is vital, and this simple practice will have a tremendous impact on your score.

You'll also want to take steps to reduce your outstanding credit card balances relative to your credit limit. For example, if you have three credit cards with limits of $3,000, $4,000, and $5,000, your total credit limit is $12,000. That doesn't mean you should use that entire limit, though. For an ideal score, you'll want to stay below a 30 percent utilization rate for each individual card. Another practice that could help your score is paying off your balances twice a month instead of once; in addition to ensuring you never miss a payment, you'll also further limit the amount of credit that you use.

Aside from your credit, there are a few other things to consider when it's time to put together a down payment. Most importantly, avoid the temptation to pull money from retirement accounts such as your 401(k) or IRA. Early withdrawals can result in hefty penalties and additional taxes, so check with a financial advisor and weigh your options.

Conquering the Costs

In many cases, especially for first-time homebuyers, friends and family will want to "pitch in" to help with your down payment. These contributions are known as "gift money." In years past, many lenders would require you to put down at least 5 percent of your own money if your down payment was below the 20 percent threshold. In most cases today, however, your entire down payment can come from gift money. While many folks don't have a generous friend or favorite grandma to slide them a down payment, one specific loan type makes it easier to afford a down payment regardless.

Depending on your situation, you might qualify for an FHA loan. This type of loan is insured by the Federal Housing Administration, and it features lower down payment requirements designed to make purchasing a home feasible for more people. The Callaway Bank's mortgage lenders can help you determine whether you meet the qualifications. Either way, though, you'll need to determine how much of your income you can afford to budget for paying your mortgage.

To calculate your budget for a mortgage, start with your gross monthly income. Subtract what is already earmarked for other financial obligations such as car payments, student loans, and spending money. Don't expect to be able to devote the remaining balance to your mortgage, though. You'll want to save money in other ways, and you should always be prepared for the times when your finances are stretched by unexpected demands such as health issues, injuries, or a job loss.

How much home can you afford?

Gross monthly income
– Monthly costs and spending money

Maximum monthly payment

At The Callaway Bank, we'll look for a debt-to-income ratio (your total monthly debt payments divided by your gross monthly income) of 43 percent or less. That doesn't necessarily mean you should have a ratio that high — the higher your ratio, the more difficult it might be to make your mortgage payments.

What's your debt-to-income ratio?

Total monthly costs ÷ Gross monthly income =
Debt-to-income ratio

Another rule of thumb is that your house shouldn't cost more than three times your annual salary. You can also base your mortgage budget on your experience paying rent each month. If you're constantly scrambling to pay rent, you might want to consider a mortgage with lower monthly payments.

Financing Your Future

Now that you're acquainted with the basics of buying a home, let's look at some of the ways The Callaway Bank can help you finance your purchase.

You'll want to start by saving as much as you reasonably can for a down payment. It's a common misconception that a down payment must be 20 percent of the purchase price of a home. There are many advantages to coming up with that much money upfront, but you don't necessarily need to put 20 percent down.

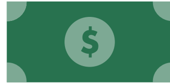
The larger the down payment, the less money you have to borrow. And let's face it: Less debt is always a good thing. A greater down payment also means you'll pay less per month because you're borrowing less, which reduces your principal and interest payments.

When you put less than 20 percent down, you'll typically have to purchase private mortgage insurance (PMI), which is an extra cost bundled into your monthly payment. Banks require PMI because buyers who contribute less than 20 percent of the purchase are more likely to default on their loan than those who put more money down upfront.

If you're finding the money for a down payment hard to come by, you're not alone. Fortunately, there are certain loans that can help. Not everyone will be eligible for these types of loans, but it's a good idea to explore a few of the following options.

A Lesson in Loans

The **FHA loan** mentioned previously is insured by the Federal Housing Administration, and qualifying applicants can pay as little as 3.5 percent down. In addition, people with lower credit scores will have an easier time qualifying for this type of loan.



With an FHA loan, qualifying applicants can pay as little as 3.5 percent down.

You might be eligible for a **U.S. Department of Agriculture (USDA)** loan if you live in a rural area or a smaller city, and these loans can be 0 percent down and 100 percent financed. They're typically available to individuals with lower to moderate levels of income. Most mid-Missouri locations qualify for this loan, except for property within Columbia city limits.

VA loans require 0 percent and are available to U.S. veterans, active-duty military members, and members of the National Guard. VA loans are guaranteed by the U.S. Department of Veterans Affairs (meaning the bank is guaranteed repayment if the borrower defaults on the loan), but they are issued by a qualified lender such as The Callaway Bank.* Eligible borrowers can buy a new home with a VA loan, or they can refinance an existing mortgage because VA loans generally have a lower interest rate.

The government-backed loans mentioned above all have an additional funding fee tacked on by the government, which is a percentage of the loan. The fees vary based on the program and sometimes how much of a down payment is made. For instance, the FHA fee can be as high as 2 percent of the loan. You can add that fee into the loan and essentially finance it, though.

Working with a good lender will help you understand your options. While you might qualify for a specific loan, that doesn't mean it makes the most financial sense. Veterans often think a VA loan will be their best choice, but a different type of loan could save them a lot of money in certain situations.

Adjustable-rate mortgages (ARMs) are loans that start out with a set interest rate that lasts for a specified number of years. After the initial fixed period, the rates adjust with changing market conditions. For example, a 3/1 ARM will remain fixed for three years, after which the rate can fluctuate annually for the life of the loan (typically 30 years).

With a conventional, or often called a fixed-rate loan, the interest rate remains the same for the term of the mortgage (typically 15, 20, or 30 years). Interest rates for fixed-rate loans are starting to rise, but they remain at historic lows as of the time of this publication. While the initial rate for an ARM might be lower, locking in terms with a fixed-rate loan can give homebuyers additional peace of mind because they know the rates won't increase. That being said, it's generally more difficult to qualify for a fixed-rate loan — and subpar credit isn't always the reason. Occasionally, some homes have an atypical construction that disqualifies buyers from fixed-rate mortgages.

When it comes to paying off a fixed-rate loan, buyers who can afford to make higher monthly payments should consider paying off the mortgage in 15 or 20 years instead of 30. Shorter loans will be paid off more quickly, so these buyers will be charged a lower interest rate and will pay much less over the life of the loan.

*VA loans are made by The Callaway Bank, not by the VA or the U.S. government.

Unexpected Costs

There are often unexpected costs that pop up that have nothing to do with the loan or the house itself. One of the biggest costs that people forget about is the actual cost to move. Movers, packing supplies, temporary storage, and rental trucks add up. Even if you can talk your friends into helping you move, there will still be extra out-of-pocket expenses. You might also need to put a deposit down for your utilities or stay in a hotel for a few days during the move.

The Do's and Don'ts of Buying a Home

If you've found any of the above confusing, that's OK! Everyone has different needs, and our mortgage specialists will walk you through your options and help you decide what makes the most sense for your particular situation. However, no matter who you choose as a lender, pay close attention to the following do's and don'ts to ensure you're not making any potentially costly mistakes.

DO:

- ✓ Save all pay stubs throughout the loan process.
- ✓ Save all pages of every bank statement during the process.
- ✓ Label every scanned document with as much detail as possible.
- ✓ Remember that any cash to close, or funds needed at closing, will require a cashier's check rather than a personal check.

DON'T:

- ✗ Make any unusual withdrawals or deposits (it could affect your chances of securing a loan).
- ✗ Throw away any financial or related documents.
- ✗ Use computer screenshots for asset statements.
- ✗ Incur any overdraft charges on any accounts.
- ✗ Open or close any new credit accounts.
- ✗ Make any large purchases.
- ✗ Co-sign for anything during the loan process.
- ✗ Miss any scheduled payments.
- ✗ Buy a new car or trade up to a bigger lease.
- ✗ Make random undocumented cash deposits into your bank account (very important!).

It's a common misconception that all loans are created equal. In reality, there are lots of different types of loans, and that's a good thing – your personal financial situation is almost as unique as your fingerprint.

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