

Basics of Buying a House

Instead of making you read this whole website just to get the general idea of how the process works, here's a short summary of everything that follows.

Should I buy or keep renting?

In most cases it's better to buy instead of rent, and to buy as soon as you can afford to do so. The only exceptions are for people who have very low rent, or who plan on moving in a few years. So the first thing you need to do is to figure out whether buying is even a good idea for your situation. My [rent vs. buy calculator](#) will help you do that very thing. Unlike many calculators of this type, I've already filled in all the blanks with sample values, all of it realistic. You need change only a few items (current rent, home price, and mortgage rate) to get a good idea of whether renting is better than buying.



Most people think the benefit in buying is to "stop throwing your money away on rent," but in fact the equity you build from buying is mostly offset by the money you will "throw way" on taxes, insurance, maintenance, and mortgage interest, which renters don't pay. The real benefit from buying is that you *freeze your monthly payment for 15 to 30 years*, and then you stop paying it altogether.

The Basics

You don't pay cash when you buy a home. If you had to do that then nobody could afford to buy a house. Instead you get a loan from a bank called a **mortgage**. You make payments on this loan every month for 15 or 30 years, and then you get to stop making payments.

Most homebuyers also make a cash down payment of 3 to 20% of the sale price. The higher the down payment you can make, the easier it is to get a loan, and the lower the interest rate is, and the lower the monthly payment is. But if you can't afford to make a down payment (or don't want to), banks are increasingly offering "zero-down" loans. In fact, 43% of first-time homebuyers put no money down. ([USA Today](#), 2006)

(If you're rich and don't need a loan, congratulations. You can skip every part of this guide relating to loans.)

What kind of home can I afford?

In general you can afford a home worth about three times your annual household income. If your combined income is \$50,000, you could afford a \$150,000 house.

If it looks like you can't afford a home then consider getting a bigger home than you need and renting out part of it. This is especially applicable to single people, where the smallest home they can find might be too big for their needs. Later as your income increases and you can afford to live without renters you can do so, and you'll come out ahead by having bought sooner rather than later. Anyway, here's how the costs compare when you rent out part of a home you buy:

House Size	Total Cost	Rent out...	Your Net Cost
2 bedroom	\$1200/mo.	1 room for \$400/mo.	\$800/mo. for 1 room
4 bedroom	\$1800/mo.	2 rooms for \$800/mo.	\$1000/mo. for 2 rooms
Duplex (2 rooms each side)	\$1800/mo.	One side for \$900/mo.	\$900/mo. for 2 rooms

In 2006 a friend of mine was paying \$600 to live in a tiny 1-bedroom apartment. She bought a 4-bedroom house that cost her \$1100/mo., and rented out two of the rooms for \$600/mo. total. So her net cost per month is only \$500. She's spending \$100/mo. less, and she has twice as much room, a yard for her dog, and she owns her own house.

Earlier I said you can afford a home worth three times your income. Here are factors that could allow you to buy a home worth more or less than that.

Increases your buying power	Decreases your buying power
No debt	Debt, esp. big debt
Large down payment	Small down payment
Good credit	Bad credit
Duplex where you can get rental income	Single-family home, no bedrooms rented out

On the next page you can use my [How Much Home Can I Afford Calculator](#) to see exactly how much you can afford.

How much a home costs

The median price for a home was \$225,000 in U.S. metro areas in late 2006. ([Natl. Assoc. of Realtors](#)) Of course the price varies according to the part of town, and even the state you're in. Homes in California cost lots more than homes in West Virginia and Arkansas. And naturally if the *median* (middle) price is

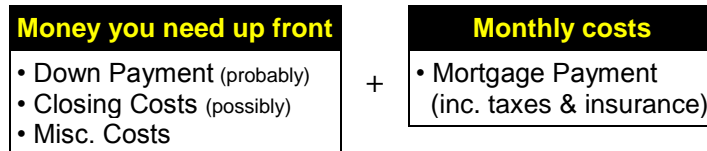
\$225,000, there are houses available for much less. In 2004 I bought two tiny houses on the same lot for \$86,000 total, or \$43,000 per house.

How much will my monthly payments be?

- **Your monthly payments will probably be 0.75% to 1.15% of the purchase price.** On a \$150,000 home that's \$1125 to \$1725/mo. This includes taxes and insurance. We'll cover how to estimate your monthly payment more accurately on the next page.
- The bigger your down payment, the lower the monthly payments.
- The lower the interest rate, the lower the monthly payments.
- The longer the loan, the lower your monthly payments. But it's better to get a shorter loan so you pay it off quicker and save on interest, if you can afford the higher payments.
- Don't forget that you can lower your monthly obligation by renting out a room or two (or a whole side, if you buy a duplex).

To afford a house you'll need the up-front money as well as money for the monthly payments

Here's a summary:



Money you'll need up front

- **3 to 20% of the purchase price for a down payment.** The actual amount depends on what kind of loan you get and how good your credit is. Your bank might offer a zero-down loan, but if you can afford to make a down payment, you should do so, because you'll get a lower interest rate and because your monthly payments will be lower.
- **1 to 8% of the purchase price for closing costs.** You might not have to pay this up front. The bank might be willing to add it to your mortgage. (Add them to the mortgage if you need the cash, but pay the closing costs up front if you don't.) The actual amount of closing costs depends on how good a deal your lender is willing to give you, and the price

of the house. The more expensive the home, the less the closing costs are as a percentage of the total price.

- **\$250 to \$800 in Miscellaneous Costs.** These are things like the application fee for the loan, the fee for the bank to run your credit report, professional inspection of the home, and an appraisal (if you can't get the appraisal added to the closing costs).
- **Putting these three things together,** on a \$150,000 house you'll need
 - \$4500 to \$30,000 for the down payment (unless you get a 0% down loan)
 - \$0 to \$12,000 for the closing costs
 - \$250 to \$800 for miscellaneous costs

Total: \$4750 to \$42,800. Yes, that's quite a difference. You'll learn more about estimating the costs for your own situation as you go through this guide.

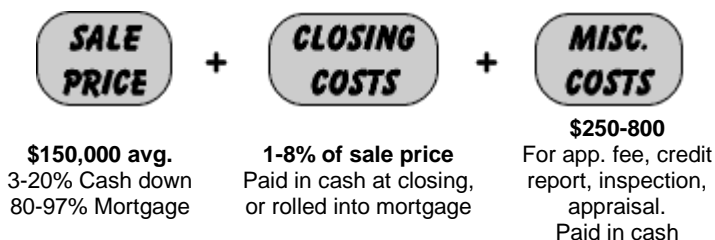
How to get a mortgage (a loan)

You generally need four things to qualify for a mortgage:

1. Money to make the down payment.
2. Income that's 2 to 3 times higher than your mortgage payment. (more on figuring mortgage payments in a minute)
3. Two years of solid employment history (same job or field).
4. Decent (not perfect) credit.

There are sometimes ways around this if you lack one or two of those, but usually not if you lack three or four. More on this later.

All the costs involved in buying a home



Closing costs are fees charged by the companies and government offices which process the loan and the

sale of the property. They're generally 1 to 8% of the sale price. You might be able to have the closing costs added to the mortgage so you don't have to pay them up front.

Where the money comes from

Sale Price	Down Payment (cash)
	Loan (mortgage)
Closing Costs	Cash, or added to mortgage
Misc. costs	Cash

Here's a summary of what you've learned -- to buy a house you make a down payment in cash, get a bank loan for the rest, and pay the closing costs in cash.

Remember that you might be able to have the closing costs added to your loan instead of paying them in cash.

Remember also that the amount of money you have to put down varies depending on the type of loan you get and what the bank requires, and the closing costs vary too.

How to find and buy a home

1. **Read the rest of this guide**, especially the parts about estimating how much home you can afford. The rest of this guide covers everything below.
2. **Get a copy of your credit report** and clean up your credit record as much as possible.
3. **Go to your bank, ask to talk to a loan officer**, tell them you want to buy a house, fill out an application, and get what's called a Pre-Qual Letter. You may have to pay an application fee of \$40 or so.
4. **Find a realtor** (get referrals from friends). The seller pays the commission to your realtor, so it costs you nothing to have a realtor. Your realtor serves you by letting you know what houses are available that meet your needs (they have access to a special database) and by answering your questions about the process. In theory a realtor should also help you get the best price but don't count on it because the more you pay for the house, the more the realtor makes in commission.
5. **Tell the realtor what part(s) of town you want to live in, what kind of house you want, and how much the bank said they'd loan you.** Your realtor will give you a list of houses that match your criteria. Go look at them.
6. **When you find a house you want get the Disclosure from the seller.** This is a list of problems with the house that the seller knows about, and which the seller must give you by law.

7. **If the Disclosure doesn't sour you on the house, ask the realtor how much you should offer.** It's rare that you accept the price given by the seller, usually you'll offer slightly less than they're asking. Get a list of Comparables (similar homes that have sold in the same area recently) from your realtor so you can get an idea of how much the house is worth.
8. **You'll make the offer by signing a contract.** If the seller accepts your offer then they'll sign too. At this point you're generally obligated to buy the house and the seller is generally obligated to sell, though depending on the wording of the contract either of you could have the right to walk away from the deal under certain circumstances.
9. **Have the house professionally inspected.** You generally have to pay this yourself, at the time, and it will cost \$350 or so. If the inspection turns up problems not listed on the disclosure which will cost a lot to fix, try to get the seller to lower the price or fix the problems before the sale -- or walk away from the deal if your contract allows that and that's what you want.
10. **The bank will have the house appraised to make sure it's worth what you're paying for it.** (They don't want to loan you \$200,000 to buy a house that's worth only \$150,000.) You might have to pay this up front, otherwise it will be added to your closing costs. Besides paying for it up front if that's required, you're not involved in this step of the process.
11. **Find an insurance agent (ask friends for referrals) and get a quote.** You can certainly price-shop 2-3 different companies if you like. Pick one and tell them you want the insurance. The cost will be added to your closing costs, you don't have to pay this at the time.
12. **Closing.** You go to the office that's handling the closing (a title company or an attorney, usually selected by the lender or the seller), to take care of the paperwork. You'll owe some money, such as the down payment, and closing costs unless you got those rolled into the mortgage. You've either already arranged with your bank to wire the funds to the closing company, or you bring a bank check with you to closing. You don't need to get a check for the mortgage loan, the bank will wire that directly to the office handling the closing.

That's the short version of how to buy a house.

To learn the details of all those things, keep reading...

How much home you can afford?

As you know from the basics page you just read, to buy a home you need both up-front money as well as the ability to make monthly mortgage payments. You therefore might be tempted to ask,

"How much will I need in order to make the monthly payments?"

But actually we'll approach this question from the other direction: We'll find out the most expensive house you can buy given your income and savings. This is called *how much home you can afford*. You won't necessarily buy the most expensive home you can afford, but you still want to know what your upper limit is. You don't want to waste your time looking at homes you can't afford, and you also don't want to pass up homes you *thought* you couldn't afford but which might actually be within your reach.

Here's the super-quick rule of thumb: Most people can afford a home that costs up to three times their annual household income, if they can make a 20% down payment and have only a moderate amount of other debt. If you have little to no debt and can put 20% down you can probably buy a house worth up to four times your annual income.¹

Examples: If you make \$57,200 a year (which was the median household income for first-time homebuyers in 2006) and have money for a down payment saved, you can probably buy a \$171,600 home if you have moderate debt (debt payments of <12% of your income), and a \$229,000 home if you have little or no debt. But of course, this is just a quick rule of thumb and you'll want to get a more accurate figure. The rest of this page will help you with that. Also, if you're income is small but you're sure you can make the mortgage payments and you have excellent credits there may be other options for you, which we'll get to later.

The first concept for figuring how much home you can afford is pretty simple. Since you pay for your house with a combination of a down payment and a bank loan, the total of both is the cost of the home:

Down Payment + Biggest Loan You Can Get = How Much Home You Can Afford

The down payment part of the equation is easy to figure -- this is the total of your savings that you're willing to put into your house. (We'll cover down payments in more detail on the next page.) We assume you have money for a down payment because if you don't then you probably can't afford any home, since it's hard to get a loan with 0% down. You usually need a bare minimum of 3% of the purchase price down, more typically 10% or more.

The amount you can get from a lender is a little trickier since it's based on many factors. Here's a calculator that will help you with that.

Fill in Your Details		See how much home you can afford -- rough estimate		
\$ <input type="text" value="3000"/>	Monthly Income (before taxes)	15-yr.	30-yr.	
\$ <input type="text" value="0"/>	Monthly Debt Payments <i>(Min. pmts. on credit cards, auto loans, student loans)</i>	\$ <input type="text"/>	\$ <input type="text"/>	Most expensive home you can afford
\$ <input type="text" value="10000"/>	Money available for Down Payment	\$ <input type="text"/>	\$ <input type="text"/>	Maximum Loan
Fill in the Financing Details		\$ <input type="text"/>	\$ <input type="text"/>	Down Payment
<input type="text" value="6.0"/> %	Mortgage Interest Rate <i>Avg. rate was 5.4% in July 2004. Get current rates from Yahoo.</i>	(<input type="text"/> %)	(<input type="text"/> %)	
<input type="text" value="2.0"/> %	Annual property taxes & insurance (% of home price) <i>Check with your county tax office and an insurance company to get your local figure</i>	\$ <input type="text"/>	\$ <input type="text"/>	Total Monthly Payment
<input type="button" value="Calculate"/>		\$ <input type="text"/>	\$ <input type="text"/>	Monthly Principal & Interest Payment
		\$ <input type="text"/>	\$ <input type="text"/>	Monthly Taxes & Insurance

Formulas from [Wizard of Odds](#), [DollarBank](#) and the [Motley Fool](#), with clarification from [Financial Planning Toolkit](#).

Here's what's important about the values in

the table above

- **Putting 20% or more down opens lots of doors.** When you can make a down payment this big you're almost certain to qualify for *some* kind of loan. The bank will be willing to loan more money than otherwise, and you won't have to pay for [private mortgage insurance](#) (PMI), which in turn helps you afford even more home.
- **Debt holds you back.** The more debt you already have the less home you can buy. Decreasing your debt allows you to afford a more expensive home, everything else being equal. There's more on this on our pages about the [Debt Ratio](#) and [How much loan can you get?](#)
- **Buying a duplex or a house with a garage apartment increases your buying power.** When you get a home with a unit you can rent out, you can count the rent you'll receive as income. This can allow you to buy a substantially more expensive home than otherwise -- which will be a much better investment. Your net monthly payments could actually wind up being cheaper, too, once you subtract the rent you'll receive.
- **30-year loans vs. 15-year loans.** The advantages of a 30-year loan are that the monthly payments are lower, and with a 30-year mortgage you can qualify for a much larger loan and buy a much larger (or nicer) house. The downside is that you have to make payments for an extra 15 years vs. a 15-year loan, and you'll pay a lot more total interest over the life of the loan. Still, in most cases you'll go with a 30-year loan. We'll cover the differences between these later, but if you can't wait then read about [15 vs. 30-year loans](#).
- **We've left out one important thing -- closing costs.** You'll need to either pay the closing costs from your savings (lowering the amount you have available for a down payment), or qualify for a loan that's a little larger than the house you want to buy, and have the closing costs added to the loan (which is called "rolling the closing costs" into the mortgage).

How much do homes cost?

Now that you have an idea of how much home you can afford, how do you find out whether that's enough? That is, are there homes to be had for the amount you can afford? We'll cover that

later (in the [start looking](#) section), but here are two quick pieces of advice.

First, don't get sticker shock by looking at the pictures ads of homes for sale in the newspaper, or in those real estate magazines, because it's the more expensive homes that get advertised. Cheaper houses definitely exist, it's just not cost-effective for realtors to buy big ads for cheap houses.

Second, you can get an idea of [the cost of homes in a given neighborhood](#) at Zillow.com.

Ignore the national median figure of \$225,000 in 2006. Homes could be way less or way more than that depending on where you live and the size & condition of the home you want to buy.

Figuring your monthly payment

Figuring the max you can afford is all fine and good, but once you have a specific home in mind you'll want to know what your payments will be on *that* home. We have [a separate page on figuring your monthly payment](#) in more detail, but here's a quick table to give you a rough idea. A general rule of thumb is that your monthly payment will be between **0.75% to 1.15%** of the purchase price.

Estimated Monthly Payment based on Home Price

*for 5/10/20% down on a 30-year loan • includes est. taxes & insurance
see [the calculator](#) to figure your situation*

	\$100,000	\$150,000	\$200,000	\$250,000	\$275,000	\$300,000
6.00%	800 / 745 / 646	1199 / 1118 / 969	1600 / 1490 / 1292	1999 / 1863 / 1616	2199 / 2050 / 1777	2400 / 2236 / 1938
6.33%	820 / 765 / 663	1230 / 1147 / 995	1640 / 1530 / 1326	2050 / 1912 / 1659	2255 / 2103 / 1824	2460 / 2294 / 1990
6.67%	841 / 785 / 681	1262 / 1177 / 1022	1682 / 1570 / 1362	2103 / 1962 / 1703	2313 / 2158 / 1874	2524 / 2354 / 2044
7.00%	862 / 805 / 699	1293 / 1207 / 1048	1724 / 1610 / 1398	2155 / 2011 / 1747	2371 / 2213 / 1922	2586 / 2414 / 2096
7.33%	883 / 825 / 717	1325 / 1237 / 1075	1766 / 1650 / 1434	2208 / 2062 / 1792	2429 / 2268 / 1971	2650 / 2474 / 2150
7.67%	905 / 845 / 735	1358 / 1268 / 1103	1810 / 1690 / 1470	2263 / 2114 / 1838	2490 / 2325 / 2022	2716 / 2536 / 2206

Next lesson: Learning about Down Payments

The Down Payment

« [Back: How much home can you afford?](#) «

» [Next: The Loan](#) »

Nobody pays cash for a house. Instead, you pay for most or all of it by getting a loan from a bank, called a *mortgage*. You will also probably make a **down payment** of 3 to 20% of the sale price, though sometimes it's possible to pay nothing down. Since everybody wants to know how to get a house with zero down, we'll cover that first.



No-money-down loans

You can probably get a Zero Down Payment loan if your credit score is excellent (~700+). If you qualify for a VA (veterans) loan, you might be able to get by with a slightly lower credit score.

No-money-down loans loans surged in popularity in the 2000's, going from 4.5% of loans in California to 20% from 2000 to 2007. ([HGTV](#)) Among first-time homebuyers the figure was even higher, with a whopping 43% of them paying nothing down in 2006, up from 28% just two years prior to that. ([Washington Post](#)) But banks got burned on these loans because people who couldn't scrounge up a down payment were more likely to default on their loans (duh), which is part of what caused the mortgage lending crisis. (See sidebar.) So today banks require a higher credit score than in the past for Zero-Down loans. If you're a veteran, your chances of getting a no-money-down loan are greater since there are special VA loans.

The Subprime Lending Crisis

Here's what happened in a nutshell: Subprime basically means "bad credit", so a subprime loan is a loan made to someone with bad credit. Lenders gave these out like candy from about 2000-2006. And of course, people with bad credit are more likely to fail to make their payments and have their houses

repossessed by the bank ("foreclosed"). When a bank forecloses on a house it then sells the house to get back the money they loaned out for it to be bought in the first place. But wait! The real estate market took a dip in 2006, so those repossessed houses were suddenly worth a lot less. So a bank might have loaned out \$200,000 on a house, but was only able to sell it for \$180,000. Uh-oh. Multiply this by thousands of homes, and you can see that lenders lost a lot of money. Ta-Da! That's the Subprime Lending Crisis. Lots of these subprime lenders went bankrupt. One of the casualties was New Century Mortgage, a huge lender with nearly \$2 *billion* in market capitalization, and which had actually handled the loan on one of my homes. (Not that I got a subprime loan -- my credit is excellent. New Century handled regular loans too.)

As a result of this subprime mess, it's now a lot harder for subprime borrowers to get loans. Lenders are being a lot more careful about whom they lend to.

But this begs the question: Should you get a zero percent down loan just because you can? Not necessarily. Here are reasons to think twice about getting a 0% down loan:

- **More likely to lose your home.** If you can't make a down payment it's either because you didn't have the financial discipline to save, or you're not making enough money. Either of those things makes it more likely that you won't be able to make the payments on your house, and that you'll get foreclosed on and lose your house. A study in Denver showed that [over half of foreclosures involved nothing-down loans](#). Ouch.
- **Higher monthly payments.** The less money you put down, the more you're borrowing. And the more you're borrowing, the higher your monthly payments.
- **Nothing down means a smaller home.** The less you put down, the less the bank is willing to loan you. That means your options will be more limited as far as what homes you can buy. With a down payment -- any down payment -- you can get a bigger loan, and are more likely to be able to get the home you really want.
- **Harder to find the loan.** No-money-down loans are harder to find than something-down loans, which are ubiquitous.

- **Harder to qualify.** It's harder to get a bank to give you a no-money-down loan than a loan where you put anything down.
- **Private Mortgage Insurance.** If you put nothing down on a conventional loan, you'll have to pay for [private mortgage insurance](#). Actually, you'll pay this for any down payment less than 20%, but the less you put down, the more the PMI, and the longer you have to pay it.

So I encourage you to put down at least 5% if you can. I'm not saying that you should never pursue a zero-down loan, but if you get one just make damn sure you can afford it!

80/20 Loans

Often if you're able to put 0% down, then it works just like you expect: You get a single loan for 100% of the purchase price. But sometimes your lender or broker will offer you an 80/20 deal, where you get one loan for 80% of the price, and another for 20% of the price. Why on earth would they do that, rather than keeping it simple? Because it's typical for the 20% loan to carry a higher interest rate, which makes more money for the bank.

But there's an advantage for you: With a 100% loan you usually have to pay for [private mortgage insurance](#) (PMI), while with an 80/20 loan you usually don't.

So which is better? It's different for each situation. For an apples to apples comparison, you need to find the total monthly payments, including PMI, for each loan deal you're offered, over the life of the loans.

Don't plan on borrowing the down payment from relatives

The down payment has to be *your* money. Why? Because when the bank gives you the main loan on your house, they've calculated that you won't be able to pay back your loan if you take on additional debt, and borrowing the down payment is additional debt. Also, if you don't make your payments and they have to repossess the house and sell it, they'll often want to sell it for less than it's worth so they can sell quickly, and your down payment prevents them from having a loss if they do that.

But what if someone *gives* you the money for a down payment (your parents, maybe)? That's okay as long as you get an [FHA loan](#), but not if you get a conventional loan. (Realize though that many sellers won't agree to an FHA loan because it sometimes adds a little red tape and because the inspectors are more strict about the condition the house has to be in before it can be sold.)

Should you use your free cash to make a bigger down payment or to pay down debt?

A very common question among homebuyers is, "Should I use my extra cash to pay down my credit card debt, or should I save it all for the down payment?" That requires a detailed answer, so just for you, I've written [a detailed answer](#).

How big a down payment should you make?

If you can afford to put 20% down, you should. You'll get a better interest rate, won't have to pay for [private mortgage insurance](#), will qualify for a larger loan, and will save a bundle on interest.

In fact, if you can afford it, there's nothing wrong with putting down *more* than 20%, as long as you still have enough free cash on hand for emergencies. Remember, once you put money into your house, it's not easy to get it back out, so keep that in mind before you deplete your emergency savings.

The Loan (aka, "The Mortgage")

Basics

The loan you get from the bank is called a **mortgage**, also called a **note**. (We'll talk more about how to [get a loan in a minute](#).)

The bank loaning the money is the **lender**. The amount you pay to the bank each month is your **mortgage payment**. The rate of interest on the loan is the **mortgage rate** (or the **interest rate**).

If you don't make your mortgage payments then the bank will repossess the house. (This is called **foreclosure**.) Then they'll sell it to make sure that they can recoup the money they loaned to you, and [that you didn't pay back](#).

The number of years it takes to pay back the loan is called the **term**, which in the U.S. is either 15 or 30 [years](#). There are pros and cons of each:

15-year mortgage	30-year mortgage
<ul style="list-style-type: none"> • Saves a bundle on interest • Pay off the loan in half the time 	<ul style="list-style-type: none"> • Easier to qualify for • Lower monthly payments • Allows you to buy a higher-priced home • Keeps your cash liquid

How do you choose between the two? If you want the most flexibility then take the 30-year loan. You can still save on interest and pay your loan off early by paying the bank a little extra each month (or whenever you can afford it). The difference is that with a 30-year loan you get to dictate how much extra you want to pay, and therefore how much you want to save. With a 15-year loan you have to make bigger payments every month whether you like it or not.

On the other hand, if you can definitely afford the payments on a 15-year loan, and you don't trust yourself to make extra principal payments on a 30-year loan, then take the 15-year loan and enjoy the fact that you'll save a bundle of interest and pay off the loan in half the time, without having to do anything special.

If you're satisfied with that advice then keep reading. Otherwise you can check out more about 15- vs 30-year mortgages in the appendix.

Right now you should figure out how much money you have saved up that you can use for a down payment, unless you know you can get a loan with no down payment.

Paying back a mortgage

You pay back your loan by making a payment every month. At closing you'll usually have the opportunity to sign a form which lets the bank draft the payment automatically from your bank account each month, which is very convenient. If you decline to do the auto-draft, then it's your responsibility to make your payment each month on your own initiative. The bank won't send you a monthly bill.

Part of your payment goes towards the **principal** (the amount the bank loaned you), and part of it is **interest** (the bank's profit from lending you money). So when the bank loans you \$100,000 you pay them back that \$100,000 and then some. If you only had to pay back the same \$100,000 they gave you then there wouldn't be anything in it for them. That's why they charge interest.

Even though part of your monthly payment is for principal and part is for interest, you make only one payment to the bank each month, and that payment amount stays the same for the life of the loan. You don't have to know how much of your payment is for principal and how much is for

interest, and you generally don't need to know, but if you're curious, you can see my page on how to figure mortgage interest. At the end of the year the bank will send you a statement for your taxes (since you'll get to deduct the interest you paid if you itemize), and the statement will tell you how much interest you paid over the year.

Mortgage interest

Interest is the fee you pay for the privilege of borrowing money. It's how the bank makes a profit by giving you a loan. Naturally, the lower the interest rate, the better for you, because you'll pay less total interest. And since the interest is part of your monthly payment, a lower interest rate means a lower monthly payment, too. Finally, a lower interest rate means you can afford a more expensive house. (Let's say you've got \$1500/mo. to pay towards a home. When less of that \$1500 goes to interest, more of it can go towards paying off the cost of the home, which means you can afford a pricier house.) So when you get to the point where you're shopping for a loan, you'll try to get the lowest rate possible.

Incidentally, in July 2010, U.S. mortgage rates dropped to 4.58%, the lowest rate in over 50 years. (Star Tribune)

Maybe you remember percentages from high school, so you figure that if you have a \$100,000 loan at 6% you'll be paying the bank back \$106,000? Nice try, but that would work only if you paid back the loan after one year. The 6% rate is an *annual rate*, so you're going to pay that 6% every year. (You won't pay quite as much as $\$6000 \times 30$ though, because you pay interest only on the outstanding balance, not the original loan amount and as time goes by your balance gets lower.)

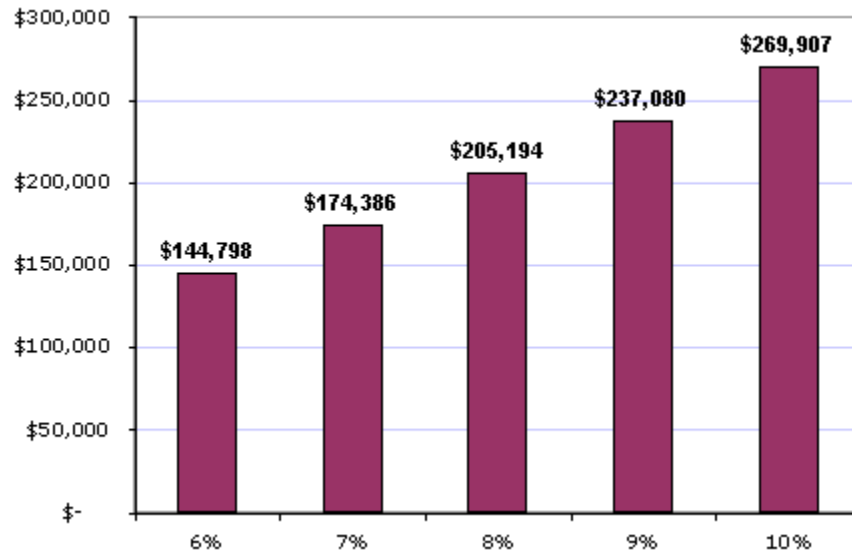
The actual amount of interest you pay each month is the current outstanding balance, times the interest rate, divided by 12. (e.g., \$150,000 left on a loan at 6%, means you'd pay $\$150,000 \times 6\% \div 12 = \750 in interest for that month.) If your eyes just glazed over then don't worry about it, it's not important, I just provide the details for those who want to understand everything completely. Here's all you need to know:

1. Over the life of the loan, you'll be paying the bank a lot more than just the interest rate times the loan amount.
2. When comparing loan offers from two different banks, just a single percentage point of difference means a big difference in how much interest is paid.

3. For the first several years most of your payment goes to interest, not principal. On a 30-year, 7% mortgage, in year #15 over 75% of your monthly payment goes to interest and not equity. After 15 years you won't own half your house, you'll own only 27% of it.

Here are some pretty pictures to demonstrate the first two points. We'll assume a \$125,000 loan for 30 years at various interest rates.

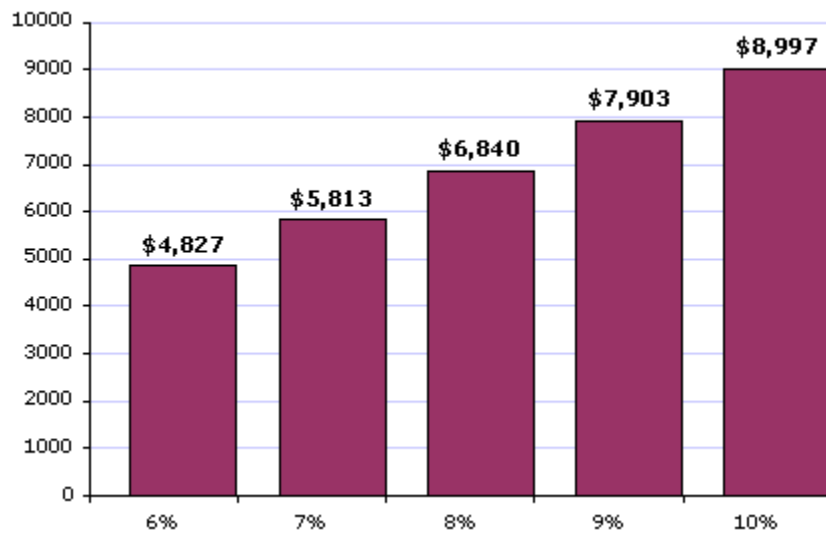
Total Interest Paid Over the Life of the Loan



So even at a very low interest rate of 6%, you're paying \$145,000 in interest on a \$125,000 loan. So you borrow \$125,000 and pay back \$270,000 -- more than double what you borrowed!

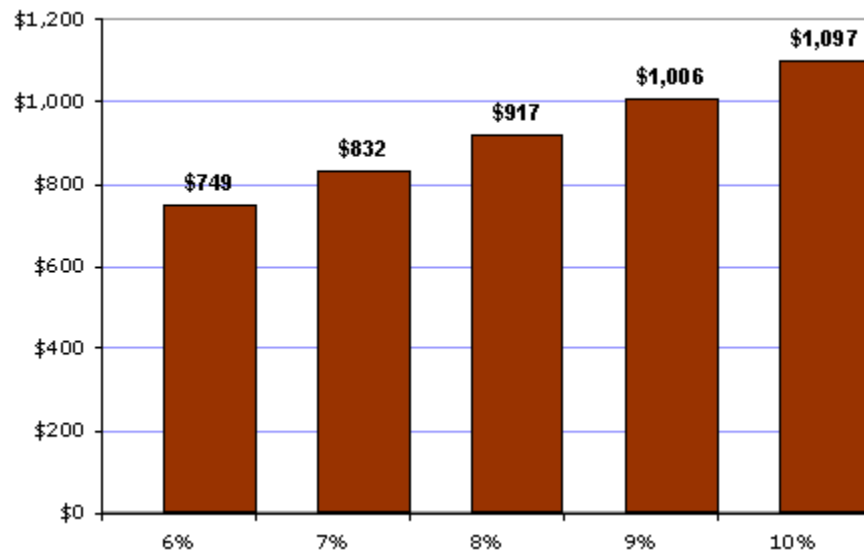
It's even worse if you have a higher interest rate. Note how going from a 6% to 10% interest rate means you pay an extra \$125,000 over the life of the loan. So the total you'd pay on a \$125,000 loan at 10% would be \$125,000 principal + \$269,907 interest = \$394,907! Quite a lot to pay back for a \$125,000 loan, huh?

Average Yearly Interest (\$125,000 loan, 30 years)



Here again, going from 6% to 10% interest means you pay an extra \$5000 on average in interest each year!

How the interest rate affects the monthly payment



Types of loans

For the most part, you don't have to concern yourself with the difference between the three main kinds of loans (Conventional, FHA, and VA loan). It's your lender's job to try to pick the best loan for your needs and qualifications, not yours. But since you'll hear these terms bandied about frequently, you might want to know what they mean, so here ya go.

Conventional. This is a fancy word for "normal". A conventional loan is just a regular, normal loan.

FHA. The U.S. government offers the FHA loan program to make home-buying easier. The government guarantees part of the loan if you default, which means that they pay the bank if you fail to make your payments. Since the loan is partially guaranteed, it's easier to get. Don't get excited about the government making your payments for you, though -- if you fail to make your mortgage payments the bank will still take the house back from you. The government pays the bank *after* the bank has already repossessed your house. Note that not all sellers will agree to an FHA loan, because there's a little more red tape involved, and because the house can't be a fixer-upper -- the house has to be in excellent shape to pass an FHA inspection.

VA. VA loans are an option for veterans, and it's possible to put 0% down on one. Just like with FHA loans, the VA itself doesn't lend money, it just guarantees part of the loan so lenders feel comfortable lending the money. VA-guaranteed loans can be combined with second mortgages (which is when the bank makes the main loan covering most of the price of the house, and the seller makes a separate loan to the buyer for the rest of the price.) VA loans can be assumed by any future qualified buyer, so your hands aren't tied if you need to sell -- you can sell to anybody, not just another veteran. (visit the VA's home loan site for more)

Assuming a Loan

« Back: [The Loan](#) «

» Next: [Owner Financing](#) »

You probably won't be assuming a loan, since it's not common to do so, and it's not even necessarily a good deal even if it's an option. Therefore, I suggest you [skip this section and go on to the next one](#), unless and until you come across a house you like that's being offered with an assumption. There's a lot to know about buying a house, and taking the time to learn things that don't apply to you may only confuse and overwhelm you, and distract you from the things you *do* need to know.

[Skip this section and go to the next section, Owner Financing](#)

Assuming a Loan

Only in rare cases will you be able to *assume* a mortgage, which means that you take over the seller's mortgage and just continue making the payments on them. Is it a good deal? It depends.

First, let's look at the differences between assuming a mortgage vs. getting your own mortgage.

When assuming an existing mortgage, you'll have to pay some cash to the seller to compensate him/her for the amount of equity that (s)he has in the home. It's kind of like a down payment, since it's cash paid directly from you to the seller, but not exactly. The down payment made when you get your own mortgage is done because the lender requires it; they want there to be some equity already in the house in case you don't make your payments right away and they have to repossess it. On the other hand, when you assume the mortgage, you don't always have to satisfy the bank, but you do have to compensate the seller for the amount of equity that (s)he has in the property (i.e., the amount that the seller paid as a down payment, plus the amount of principal payments made towards the loan, plus the amount the property has appreciated since s/he bought it).

This amount you pay to the seller could be a little or a lot, depending on how much the owner put down when (s)he bought the house, how many years (s)he's been making payments, and how much the property has appreciated during that time. If the purchase price is \$120,000 and there's \$80,000 left on the mortgage, then you'd either have to pay that \$40,000 difference in cash (ouch), or get a separate loan for that \$40k. On the other hand, if the purchase price is \$120k but there's \$110k left on the mortgage, then you only have to come up with \$10k.

An assumed loan will be paid off faster since you're already X years into it when you start taking over the payments. Another advantage is that when assuming a loan, you also avoid having to pay most of the Closing Costs that you'd have when getting your own mortgage. (Closing Costs are covered later.)

If the house is sold with a **non-qualifying assumption**, that means you don't have to pass a credit check or demonstrate your ability to pay the mortgage. If it's a **qualifying assumption**, then you do.

What's the catch with all this?

- First of all, most houses simply aren't sold with assumable mortgages -- qualifying or not. Usually you'll have to get your own mortgage. Banks have increasingly prohibited their mortgages from being assumed, and even if there's no such prohibition, most sellers don't like to sell this way anyway.
- Second, you'll probably have to come up with a lot of cash to pay the owner for his or her equity in the house. If you have a lot of cash lying around you could probably qualify for your own mortgage and wouldn't need to assume one.
- Third, the interest rate on the mortgage you assume might be higher than the rate you could get on a brand-new mortgage from a bank now.
- Fourth, while you can insist on a Fixed Rate mortgage if you're getting your own loan, you might be assuming an Adjustable Rate mortgage, which might be a worse deal. You'll have to look at

the numbers to know for sure.

Here's the summarized advice:

Tip: Assuming a mortgage is often a good deal when you pay no more than 10-20% of the purchase price in cash, and when the interest rate isn't higher than current interest rates.

If you have to put more money than that into it, then you're tying up that money in the house. It might be better for you to get a different house with a smaller down payment, and invest the extra cash somewhere else, like a [socially-responsible mutual fund](#).

Tip: Get a copy of the loan papers (note) from the seller so you can review the exact conditions of the loan. Also, get an **assumption package** from the lender, which will tell you what you have to do to assume the loan.

Getting a New Mortgage vs. Assuming a Mortgage

	Get a New Mortgage	Assume an Existing Mortgage
Closing Costs	A lot	A little
Time to pay off loan	15-30 years	Less than 15-30 years
Credit Check / Prove ability to pay	Bank will run a credit check on you and see if they think you can afford the mortgage payments based on your income/debts.	Bank may or may not do this. (They'll do this on Qualifying assumptions, but not on Non-Qualifying assumptions.)
Amount of cash you need up front	5-20% for Down Payment, to show the bank that you're responsible with saving money, so they'll give you a loan	Payment to the seller to compensate him/her for the equity (s)he's built up in the house. No telling what the amount will be, depends on how much equity the owner has built. The smaller the amount of cash you have to front, the better the deal.
Interest Rate	Fixed Rate: Whatever the current interest rate is now. Adjustable Rate: Usually starts out lower than the current rate, then goes up over time.	Fixed Rate: Whatever the interest rate was when the mortgage was originally obtained by the seller (who was then the buyer). Adjustable Rate: No telling, you'll have to check with the bank. Note that assumable loans are more likely to be Adjustable than Fixed.

Owner Financing

« [Back: Assuming a Loan](#) «

» [Next: Qualifying for a Loan](#) »

It's rare that you'll be able to buy a house which the seller will finance for you. If that explanation satisfies you, then you can [skip this section and go on to the next one](#). If you happen to find an owner-financing opportunity, you can always return to this page later. There's a lot to know about buying a house and spending time learning things that don't apply to you may only confuse

and overwhelm you, and distract you from the things you *do* need to know.

Next topic: [Qualifying for a loan](#)

Owner Financing

(aka "Seller Financing")

You might be thinking, "Hey, could I just make payments directly to the seller instead of getting a mortgage? Then I wouldn't have to qualify for the mortgage." That indeed could be a good deal, except that owner-financed deals like this are rare. Here's why.

The seller has to pay off their existing mortgage before they can sell.

Let's say the seller is selling the house for \$150,000 house, and they've got \$110,000 left on the mortgage. If they sell it the regular way, where you get your own loan from a bank, then \$110,000 of the your new mortgage will pay off the seller's old mortgage, and the seller will wind up with \$40,000 in cash.

But if the seller wants to owner-finance to you, then s/he'll have to pay off the existing mortgage first. Does the seller have a spare \$110,000 lying around? Probably not. So in most cases, sellers *can't* owner-finance to you even if they wanted to, because they don't have the means to pay off their existing mortgage.

The seller wants all their cash up front.

With a regular sale, the seller gets all the cash up front. When they owner-finance, the money trickles in, month by month, for 30 years. So most sellers prefer a regular sale so they can get all their money up front. After all, what's the most common reason people sell a house? So they can buy another one. And they'll likely need the money from the sale of the old house to use as a down payment on the new house, or to fix it up, or both.

Socially-Responsible Stocks

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• Bicycles **click here to visit**

Another reason the seller might not want to owner-finance is that they don't expect to live another 30 years in order to collect all the payments. This is especially true if the seller is over 40.

So you see, sellers usually either can't seller-finance, or they don't want to. That's why you'll rarely find houses that are owner-financed.

Of course there are exceptions. Here are cases when owner-financing is a possibility.

- **Financing as an investment.** If the seller doesn't need all the proceeds from the sale right away, then owner-financing a home can be a great investment. When you put money in the stock market, you might get 6%, or maybe a little more -- or you could *lose* 5, 10, or 20%, or *all of it*. By contrast, owner-financing gives the seller a *guaranteed return* of whatever the interest rate on the loan is. Further, sellers who owner-finance can charge a higher interest rate than banks because seller-financing often makes the deal attractive to the buyer, especially if the buyer couldn't qualify for a bank loan. The main risk to the seller is that the buyer will fail to make the monthly payments (known as "defaulting" on the loan), but in that case the seller can reclaim the house ("foreclose" on it) and sell it to get their money back. The seller is fine as long as they can sell the house for at least as much as is left on the loan.
- **You offer a higher interest rate.** One way you might be able to convince an owner to seller-finance is to offer to pay a higher interest rate. Of course, you wouldn't make such an offer if you're able to qualify for a bank loan, but if you *can't* get a bank loan, then offering a higher rate directly to the seller might be what it takes to get you into the home you want. Also, once you've had the home for a year or two and your financial situation improves you might be able to move that loan to a bank.
- **The seller finances only *part* of the loan.** Once I wanted to buy a home but I couldn't come up with the last \$36,000. (I had no more cash left and couldn't get a bigger loan.) But I really wanted the house. So I asked the owner to owner-finance just that small part of the cost of the house, and I offered him twice the prevailing interest rate. He accepted. A year later I was able to easily move that loan to a bank at half the interest rate, so I only had to pay the higher interest for one year.

If you do find an FSBO deal, there's a good chance that neither side will be using a realtor. Whether you use a realtor, all the papers for the sale are handled by and signed at the office of a title company, which makes sure (among other things) that the home is really the seller's to sell, and that there aren't any outstanding claims against the property. If you want further protection, you can hire an attorney to check the paperwork, though most people don't opt for this. I've never done it.

Qualifying for a Mortgage Loan

« [Back: Owner Financing](#) «

» [Next: Understand Closing Costs](#) »

Banks don't loan money to just anybody. They want to feel secure that you're able and responsible enough to pay them back. So you'll usually need these things in order for the bank to give you a loan:

- **Enough money for the [Down Payment](#)** (3 to 20% of the purchase price)
 - **Two years of steady employment** (same job or field)
 - **Good (not perfect) [credit score](#)** (~660+, as of 6/09)
- **Monthly income that's 2 to 3 times higher than your expected monthly mortgage payment**

If you don't have all four items above right now don't fret. You still have some options.

- **Meet with a lender anyway.** Don't just assume you can't get a mortgage. It can't hurt to go talk to a bank and see whether they're willing to give you a loan. Even if they won't give you a loan they can probably help you by letting you know where the deficiencies are, so you can work towards qualifying in the future.
- **Try for a Low-Doc or No-Doc Loan.** As I write this in 2009 these are fairly rare now because banks lost a lot of money by giving these out like candy, but as time goes by I think banks will offer more of these again. Not as many as they used to, but it will still be an option for some people, so I'll continue to keep this section here.

Anyway, these loans are for people who can't (or don't want to) provide details about their income or their employment. The most popular is called a **Stated Income loan** because you just "state" how much income you have without offering any proof. It's also called NIV for "No Income Verification" because your income isn't verified. With **No Ratio** and **No Doc** loans, you don't even say how much you make. You can think of these as "Don't Ask, Don't Tell" loans. The No Doc is also called NINA, for "No Income & No Asset verification". Because income is never proven with any of these loans I joking call them the "Drug Dealer Loans", though of course there are many legitimate reasons for wanting a loan of this type.

Since the bank is taking a bigger risk on you with a No-Doc or Low-Doc loan, the interest rate is higher than on a traditional loan, and the exact amount depends on your credit score, your lender's preference, and which flavor of low-doc/no-doc loan you get. The premium you'll pay will range 0.125 to 3.0 percentage points over a traditional loan.

I got one of these loans myself once. I had started a new business a year earlier and was easily making enough money to make the mortgage payments on the house I wanted, but because the business was brand-new I didn't have income *history* and there was no way a bank would give me a traditional loan. My good credit, and my willingness to pay a tiny amount of extra interest, was enough to get me the loan without having to supply any paperwork.

Here's how the different loans stack up.

What you need for each kind of loan				
	Regular Loan	Stated Income ("NIV")	No Ratio	No-Doc ("NINA")
Income	You provide proof (e.g., paycheck stubs, W2's)	You just tell the banker how much you make and they take your word for it	You don't even say how much you make. (Don't ask, don't tell.)	
Down Payment Needed	✓ Small	✓ Small to Bigger	✓✓ Bigger	✓✓✓ Biggest
Credit Required	✓ Fair	✓✓ Good	✓✓ Excellent	✓✓✓ Near-Perfect
Employment History	✓	✓		
Proof of Assets		✓	✓	Possible
Proof of Income	✓			
Interest Rate	✓ Lowest	✓✓ Higher (+0.125% to 1% higher)	✓✓✓ Highest	✓✓✓ Highest (up to 3% higher)

[More on Low- and No-Doc Loans from MSN.](#)

- **Use a Mortgage Broker.** A mortgage broker represents lots of different lenders so they can shop around to try to find one who will make you a loan. They charge a fee for this service but if you can't get a mortgage otherwise then it could be worth it. You can find mortgage brokers in

the homes section of the newspaper classifieds and in the yellow pages. A good online broker is [E-Loan](#).

- **Try to get the owner to finance all or part of the cost of the home.** Getting an owner to finance a home is difficult, but if you have no other options then it's worth a try. You can increase your chances of success by offering a higher interest rate and/or asking the owner to finance only part of the cost of the home. See our page on [owner financing](#).
- **Get a co-signor.** See if a family member or very close friend with a higher income and better credit than yours will *cosign* a loan for you. That means that the loan will be yours and you'll be responsible for paying it, but if you don't, the cosignor will have to pay it. Obviously the cosignor will have to have a great deal of trust in you for this option to work.
- **Have a friend or family member buy the house, and rent-to-own it from them.** Friends and family might be wary of co-signing a loan for you because their credit gets ruined if you don't make the house payments, and they have little recourse against you. A more attractive alternative is to have your friend or family member buy the house in their name, and then rent it to you with an option to buy.

Here's how it works: You'll make the mortgage payments and pay for taxes, insurance, and maintenance, as your "rent". You can get the house in your name by either making all the payments after 30 years, or by buying the house for the amount of the remaining mortgage once your credit improves enough for you to get your own loan. If you fail to make your payments, you forfeit your right to buy the house, and your friend/family member can either pick up the payments or sell the house. Either way, they're not out because they already own the house. They don't have to foreclose if you don't pay, because the house was already in their name. For that reason this arrangement can be more attractive to them than the idea of their being a cosignor.

In fact, if you don't have the money for a down payment, your friend/family member might loan you the money for the down payment as well -- usually for a slightly higher interest rate than the mortgage.

A downside of having someone buy the house for you is that the interest rate will be about 1% higher because the house will be considered investment property for the buyer and not a residence, since they're not going to live in it. Still, if the only way you can get yourself into your own home is to pay a little more interest, it might be worth it.

- **Plan for the future.** Even if you can't buy a home right this very minute if you make home-owning a serious goal then within two years you can probably overcome most or all of any obstacles above.

Closing costs explained

[<< Back: Qualifying for a Loan <<](#)

[>> Next: Get your finances in order >>](#)

In addition to the down payment, you'll also have to pay closing costs -- miscellaneous fees charged by those involved with the home sale (such as your lender for processing the loan, the title company for handling the paperwork, a surveyor, local government offices for recording the deed, etc.). The amount varies, but could be, say, \$6000 on a \$130,000 house. The range is all over the map -- from 1 to 8% of the price of the home, though more typically 2-3%. These costs are significant -- especially after you've already had to come up with a lot of cash for the down payment.

Your lender will give you a more accurate estimate of closing costs on the purchase of a particular house you've selected. (Don't ask me about this, ask your lender.) This is called a "Good Faith Estimate". If they don't give it to you, ask for it.

Yahoo has a good page which summarizes typical closing costs.

Tip: Make sure to get the Good Faith Estimate (GFE) from your Lender. Review it and compare it to the **typical closing costs** listed at Yahoo. Direct any questions about it to your lender and your realtor (not to me).

Tip: Make sure there's no Yield Spread Premium on the GFE. If you use a mortgage broker and get a bad deal with an interest rate that's too high, the bank will give a kickback to the broker called a Yield Spread Premium (YSP). If you followed my advice on shopping for the best mortgage deal you're less likely to be in this position. If there's a YSP on the GFE, then you're paying too high an interest rate and should try to negotiate a lower one. Here's more on YSP's from ERate, Realty Times, and Wikipedia.

Tip: Roll in the closing costs into the mortgage. If you don't have enough cash to pay the closing costs, you can often get the closing costs added to the amount of the loan. For example, if the loan amount is for \$150,000, and the closing costs are \$4500, you'd add the closing costs to the loan amount so you'd actually be borrowing \$154,500 total. This is handy if you're short on cash after making your down payment.

You need two things to be able to roll in your closing costs like this. First, you have to qualify for the bigger loan. If the bank will only loan you \$150,000 from our earlier example and not a penny more, then you've already hit the maximum they're willing to loan. But don't get discouraged, because it's usually not a problem to get the bank to loan you a few thousand extra dollars extra.

The second thing is that the new loan amount can't exceed what's called the *Loan-To-Value ratio (LTV)*, which is the amount of the loan compared to the value of the house, based on the appraisal. In simple terms, let's say the house is worth \$100,000, and the bank will loan up to a 95% LTV, meaning they'll loan you up to \$95,000. If your credit isn't so good then the bank might only loan up to an 80% LTV, meaning they'll loan you only \$80,000.

Don't confuse the *price* of the house with the *value* of the house. The bank gets the *value* of the house -- what they think the house is worth -- from the appraisal, which is a report prepared by a professional which estimates the value of the house. The selling price could be higher or lower than the appraised value.

Okay, so the point of all this is, if you roll the closing costs into the mortgage, the new loan amount can't exceed your LTV. If the LTV amount was \$120,000, and the \$4000 closing costs would push the loan amount from \$118,000 to \$122,000, then the bank won't let you roll in the closing costs. You could get around this by making a larger down payment, so you don't have to borrow as much money from the bank, but if you have the extra money for the bigger down payment then you also have the extra money to just pay that money towards the closing costs instead of rolling them into the mortgage in the first place.

One way of rolling the closing costs into the mortgage is to have a **seller concession**. It's a little complicated so I recommend you just ask the lender if you can roll the closing costs into the mortgage the easy way. The lender might require that you use the seller concession method, though. If you have to go that route, the way it works is that you and the seller say that the sale price will be about 6% more than the price you agreed on, and then the seller "gives" you that extra 6% that you paid. For example, let's say the price was \$100,000 and you're putting 10% down, or \$10,000, so you're getting a loan for \$90,000. You and the seller decide to go the seller concession route, so you agree that the price should be 6% more, or \$106,000. That means you'll now put \$10,600 down and get a loan for \$95,400. See what happened? You got a loan for \$5,400 more than the original loan. That's what you use to pay the closing costs. The seller doesn't keep the extra money because part of the deal is that (s)he gives that extra money back to you at closing.

Tip: Ask the seller to pay some of the closing costs. If you're short on cash for the closing costs and can't roll the closing costs into the mortgage, ask the seller if they're willing to pay part of the closing costs. It's not unusual for buyers to ask for this. Usually the worst that can happen is that they say no.

-

Tip: Get the lender to pay the closing costs. If you're short on cash for the closing costs and can't roll the closing costs into the mortgage, some lenders will pay part or all of the closing costs, but in exchange you'll have to pay a higher interest rate on the loan, perhaps 0.25% or 0.50% higher. Ask your lender if this is an option if you need it.

-

Tip: Borrow the money from another source. If all of the above fails, try to borrow the money for the closing costs from another source, such as your parents.

Get your finances in order

« **Back:** [Understand closing costs](#) «

» **Next:** [Clean up your credit record](#) »

At this point you've learned [what it takes to buy a house](#). Now it's time to get prepared to do so. Here's your financial checklist:

1. **Pay down your debt.** The bank wants your total debt to be no more than about 38% of your income. If your income is \$3000/mo. then the bank figures your total debt can be \$1140/mo. But if you already have \$1000/mo. in debt, then you have only \$140/mo. left for mortgage payments. Pay down your debt as much as possible to increase your borrowing power. Pay down the highest-interest debt first (credit cards) before lower interest debt (car loans, student loans).

Once you pay off your credit cards get in the habit of paying them off every month and never carry a balance. Few things can kill dreams of home ownership better than credit card debt. Pay down that debt! If you have a hard time paying down your debt then use the technique advocated by Charles Givens: Pay Yourself First. Every time you get a paycheck, take a portion of that paycheck and apply it towards your goal of paying down your debt *first*. If you wait to take care of everything else first you may *never* have anything left over to pay down your debt with.

There's more about how debt holds you back in our sections on the [Debt Ratio](#) and [How Much](#)

[Loan Can You Get?](#)

2. **Get the down payment together.** If you don't already have a [down payment](#) saved, start saving now. If you have a hard time saving then use the Pay Yourself First technique mentioned above: Every time you get a paycheck, put a portion in your savings account *first*. Pay yourself first so that money is definitely saved. It may help to have a separate account for your down payment, so it's easy to see its size completely separate from any other savings you may have. Remember, having a sizable down payment is the #1 factor in being able to qualify for a loan -- especially being able to qualify for a *bigger* loan.
3. **Clean up your credit report.** Good credit not only helps you qualify for a loan in the first place, it helps you get a better deal when you *do* get a loan. This is a big topic so we cover it on its own page, [next....](#)

Credit Reports & Credit Scores

Problems caused by bad credit
<ol style="list-style-type: none">1. Inability to get a loan2. Higher interest rate if you do get the loan3. Larger down payment required if you do get the loan

« **Back:** [Get your finances in order](#) «

» **Next:** [Repairing credit](#), [Establishing credit](#), or [Find a lender](#) »

As I write this in June 2009, you generally need a credit score of at least 660 to get a mortgage. Not too long ago you could get a loan with as little as 580, but banks are more cautious these days because of the mortgage crisis (which was caused by lending to folks with low credit scores who ultimately defaulted on their loans).

Your credit score doesn't just dictate whether you can get a loan, it *also* impacts how good an interest rate you get. The worse your credit score, the higher the rate of interest. You might also have to have a larger down payment than otherwise. This

bears repeating: Bad credit doesn't just mean you might not get the loan in the first place, it means that if you *do* get the loan, you'll have to pay more interest, and you'll be required to make a larger down payment.

Here's an example from MyFico.com in June 2009 about how credit scores might affect the interest rate - and therefore the cost of the loan -- on a 30-year, \$200,000, fixed-rate mortgage.

Credit Score	Interest Rate	Monthly Payment
760 - 850	5.26%	\$1,540
700 - 759	5.48%	\$1,567
680 - 699	5.66%	\$1,589
660 - 679	5.87%	\$1,616
640 - 659	6.30%	\$1,670
620 - 639	6.85%	\$1,741

Payment based on \$200k home, 5% down, PMI, closing costs rolled into mortgage, includes estimated taxes + insurance. Loans are not generally available to those with credit scores below 660.

[Consumer Reports](#) also addresses this topic, saying, "*Over the life of [a \$150,000] loan, the people with the best credit scores may pay roughly \$138,000 less than those with the worst.*"

The higher your credit score, the less you'll pay for your mortgage. The lower your score, the more you'll pay. It's therefore important that you improve your credit score if it's low.

Average credit scores

The median U.S. score is 723. Here's how the American population's credit scores stack up.

Credit Score	Percentage of population
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with this score	
800+	13%
750 - 799	27%
700 - 749	18%
650 - 699	15%
600 - 649	12%
550 - 599	8%
500 - 549	5%
less than 500	2%
From MyFico.com, Aug. 2006	

Credit Report vs. Credit Score

Your *credit report* and your *credit score* are two different things. Your *credit report* is a list of things like your credit card and bank accounts, outstanding loans, and your payment history. Your *credit score* is a rating of how good your credit is, based on your report. In other words, your credit report is a bunch of pages, and your credit score is a number from 300 to 850.

The main things on your credit report that hurt your credit score are:

- Bankruptcy
- Outstanding (unpaid) debts
 - Late payments
- Credit card balances near the credit limit on those cards
- Liens (both outstanding and paid)

You increase your *credit score* by cleaning up your *credit report*. The score is based on the report, so get a clean report, and you'll have a good score. We'll cover cleaning up your credit report later, but for now let's continue learning about your report and your score.

You actually have three credit reports

The companies that keep track of your credit report are called credit reporting agencies (CRA's) or credit bureaus. There are three of them: [Trans Union](#), [Equifax](#), and [Experian](#). So you actually have *three* credit reports, since there are three CRA's that track your credit. They're usually very similar (often nearly identical), but sometimes they can differ. For example, most creditors report late payments to all three CRA's, but some might report late payments to only one or two CRA's rather than all three.

This means that if you need to clean up your credit report, you probably have to clean up three different credit reports. You never know which CRA your lender is going to consult about your credit (although some lenders will tell you if you ask). Many lenders consult all three CRA's, too.

You can get your own reports yourself because by law each CRA has to give you a copy of your report once a year if you ask for it. You start out at [AnnualCreditReport.com](#) which in turn sends you to each of the three CRA's websites. **But be careful!** These sites often make it hard to see how to get your report for free, while they put misleading come-ons for paid services right in front of you (free for the first 30 days after which they bill you every month). Many people sign up for these accidentally, thinking that that's what they need to do in order to get their credit report from the site. You can really get your reports from these sites for free, but you might have to hunt a while for the right options.

Also beware that these sites will generally try to sell you fake credit scores -- scores that are completely different from what your lender actually uses. To protect yourself against that, let's learn more about credit scores.

Kinds of credit scores

The most common kind of credit score is the FICO score, which is calculated by a company called Fair Isaac. Fair Isaac makes its money by selling the FICO scores on individual consumers to banks. When your bank buys a credit report from a CRA like TransUnion, it also buys the FICO score calculated from the TransUnion report. Since you have three different credit reports, you also have three different FICO scores. In fact, your bank might order all three scores.

While the FICO score is the most common, the three CRA's each have their own scores that they try to sell to the banks. TransUnion sells a "TransRisk" score and Experian sells a "ScoreX" score. Banks generally use the FICO score because it's the industry standard, but some banks might go with the CRA brand because it's cheaper.

Many banks have also devised their own system to calculate credit scores from credit reports. That way they don't have to pay anyone for the credit score.

So there are potentially seven different scores your lender might see:

- The FICO score from the three CRA's
- The proprietary score from the three CRA's
 - The lender's own internal score

So why is this important? Because if you're checking your credit score(s), you need to make sure you're looking at the same one(s) your lender sees! The best way to find out what scores your lender uses is to ask them -- they'll generally tell you. If you don't have a lender in mind yet, then get genuine FICO scores, because that's what most banks use.

Getting your credit scores

Paying for them

- **You can get your TransUnion- and Equifax-based FICO scores from [MyFico.com](https://www.myfico.com) for ~\$32.**
- You can get just your [Equifax-based FICO score](#) for \$16, which is okay only if you know that that's the only score your lender is going to look at.
- You can't buy your TransUnion-based FICO score alone from anywhere. The only way to get your TransUnion-based FICO score is to buy it together with the Equifax-based score from [MyFico.com](https://www.myfico.com).
- You can't get your Experian-based FICO score from anywhere, because Experian doesn't allow consumers to have it, even if they pay. Only your lender can see it. (Yeah, Experian has gotten a lot of flak about that.) You *can* buy [Experian's proprietary score](#) (which is what they want you to do), which will at least give you an idea of how good your Experian credit report is.
- **Beware of sites offering "Your Credit Score", since 99.9% of the time they're not real FICO scores.** That's true on even the TransUnion and Experian sites, which don't sell FICO scores directly. The *only* places to get real FICO scores are [MyFico.com](https://www.myfico.com) (TransUnion + Equifax) or [Equifax](#) (Equifax only).

Getting them for free

You can ask your lender for your score(s) once they've run your credit. Getting your credit scores *after* you've applied for a loan is kind of like putting your seatbelt on after you've already had a wreck, but if you've already applied for a loan, your lender will often tell you your score if you ask. In fact you should ask for a copy of the whole report(s), so you can get an idea of what the problems are if

your score is low. Most lenders make you pay for the report(s) before they order it, and if that's the case and they won't share it, point out that you paid for it, not them.

Of course, if the lender already approved your loan and you got a great interest rate, then your credit score is kind of a moot point. But if you didn't get the lowest rate possible, then you'll want to shop around at other lenders, and in that case you need to know what's on your credit report to see if you can clean it up to improve your score. (More on that later.)

Another possible way to get a free FICO score is through your credit card company. Most cards don't offer this service, but some do. For example, with my Washington Mutual card, I can login to my account online and see my FICO score based on my TransUnion report. The problem here is that you can't see the other two FICO scores, and if you're making an investment as big as buying a house, it's best to cover all your bases and get all three.

Do I need to improve my credit score?

That depends on how good your credit is, of course.

Excellent credit. If you know that each of your FICO credit scores is 760 or higher, your credit is excellent and there's no need to try to improve your score.

Good credit. If your FICO scores are between 700 and 759, then you have a choice: cleaning up your reports and getting your scores about 760 will get you a slightly higher interest rate, but not much. (See the table above.) So it's up to you whether it's worth your time in trying to improve your credit rating.

Fair to Bad credit. If your FICO scores are less than 700, or if you don't know your scores but you have your credit reports and can see that they list negative items, then it's time to start rebuilding your credit.

That's our next item.

Where to now?

- **If you know your credit is bad**, proceed to [repairing your credit](#).
- **If you don't have any credit**, then see [how to establish credit](#) if you don't have any.
- **If you know your credit is good**, then proceed to [find a lender](#).

