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A Home-Buying Primer

IF YOU'VE NEVER BOUGHT A HOUSE BEFORE, much of the jargon and terminology could prove daunting. After all, who would give "discount points" or "5-1 adjustables" the slightest thought unless they absolutely had to? We've arranged this short primer on the basics of buying a home as a series of questions and answers that try to address the basic issues with which every home buyer must grapple.

1. "Do I really need to use a real estate broker?"

The first thing you need to know about real estate brokers is that they typically work for the people selling the home -- not you. The standard practice is for the seller to hire a broker, who then takes over marketing the home and seeking out potential buyers. For this, brokers usually are paid around 6% of the sale price, which gives them a built-in incentive to find the seller the highest price they can.

That sounds simple enough. But as you begin to drive around town with seasoned agents, you'll quickly find that they act like they are, in fact, working for you. So don't get too cozy. You will probably be tempted to tell an agent the highest price you are willing to pay for a house or the size of down payment you can afford. Don't. The agent is obligated to pass those details on to the seller, which could hurt you in any negotiation. Also, don't feel obliged to buy a home through one particularly helpful broker. Use several to have the widest selection of possible homes.

You don't need to use a broker at all if the house you want is being sold by an owner himself. Indeed, you'll have a lot more room to negotiate on price if the broker's 6% fee is absent from the equation. It's also not that difficult to sell your house without a broker, though it is a significant commitment of time and energy -- one you may not be willing to make.

Are all brokers bad? Of course not. A good agent can be very helpful, if only because he or she has access to a large database of listings in your neighborhood of choice. Agents can also

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recommend schools, local contractors, and mortgage brokers. (Although, you shouldn't rely too heavily on their advice; they've been known to take kickbacks.) And they can often help steer you through the home buying process, while smoothing out bumps in the negotiations. Remember this, too: An agent's fees are always negotiable. Are you and a seller at loggerheads over who's going to repair that damaged furnace? Maybe it should come out of the broker's fee.

In the past few years, so called "buyer's brokers" have become more popular in certain parts of the country. Unlike traditional real estate agents, they work for -- and are often paid by -- the buyer. They are supposed to help assure you get the best deal. They can be invaluable if you are moving to a town or part of the country you are unfamiliar with or have little time for house-hunting. The problem is, their terms often require that you use only them for a set time period. That's fine if you trust the broker and just want someone to screen homes for you. But it can leave you hamstrung if you'd like to go out and do some looking on your own or if you want to use a number of brokers. Also, compensating a buyer's broker can be tricky. Paying by the hour adds up, but paying a percentage of the purchase price gives a broker the wrong incentive: Getting you to pay the highest price returns the most to him. Sometimes, a buyer's broker will settle for splitting the fee with the broker who has the listing.

2. "How do I figure out which type of loan makes sense?"

The answer to the first question is easy enough: Mortgage products proliferate because lenders, hungry for business, are trying to rope you in any way they can. That certainly makes mortgage shopping confusing, but it also means you can probably find a mortgage tailor-made to meet your needs.

At the most basic level, mortgages come in two categories: fixed rate and adjustable. In both cases "rate" refers to the rate of interest you pay the bank for the privilege of borrowing its cash.

Fixed-Rate loans

A fixed-rate mortgage is so called because its interest rate doesn't change over the life of the loan, no matter what rates do on the open market. Many people feel more comfortable with a fixed rate, because they know their monthly mortgage payments will remain steady over the years, making at least one aspect of their monthly cash flow predictable. The downside is that you pay for that comfort: Lenders charge a higher rate of interest for fixed-rate loans. Why? Because they figure that if interest rates shoot up, they lose the opportunity to make more money on the funds they are lending you.

The standard fixed loan lasts for 30 years, but if you can handle higher payments and want to build up your equity in your home faster, you can opt for a 15-year fixed. With a 15-year, you'll get a lower rate and pay much less interest over the life of the loan. The payments each month, however, will be quite a bit higher since they aren't being stretched over so long a period.

A fixed rate makes the most sense for those who plan to stay put in their new home for a long time. You pay a little more in interest, but it is stretched over a longer period so the monthly

effect can be minimal. And if you're buying when rates are low, locking in a good deal is probably worth it.

Adjustable-Rate loans

Adjustable-rate loans get their name because the rate you pay changes according to a set formula as interest rates fluctuate on the open market. As noted above, the upside is that lenders charge a lower rate for such loans because you are taking on some of the interest-rate risk. This makes your monthly payments lower -- at least in the beginning. Such loans provide a way for many buyers to afford a larger loan amount for a given monthly payment. An adjustable works out wonderfully if rates drop -- something you should never count on. But watch out if interest rates rise. In a year or two, your payments could far exceed what you would have paid for a 30-year fixed.

3. "How does a bank decide if I get a loan or not?"

There are many factors that go into the bank's decision, from how long you've been at your job to how many credit cards you carry. The most important thing lenders look at, however, is your ability to meet your obligation to them, which is a function of your income and debt levels.

To gauge your ability to pay, lenders look at a pair of numbers called the "housing ratio" and the "total-obligation ratio."

They're not as daunting as they sound. The first is just the percentage of your gross monthly income that you'll need to spend on housing expenses after you buy the new home. It includes your mortgage payment, taxes, insurance and maintenance. Lenders will want to see a ratio of 28% or lower. The total-obligation ratio, meanwhile, is the portion of your income that goes to covering both your housing expenses and any other obligations, such as credit cards, car loans and child support. There, your lender will want to see a ratio of 36% or lower. Both of these ratios are often negotiable upward.

4. "How much cash am I going to have to produce upfront?"

These days, not much. Ideally, you would have enough cash for a 20% down payment, closing costs equal to about 3% to 5% of the purchase price, and enough left over to cover two or three months of monthly housing expenses. That gives you a big chunk of equity in your house upfront and makes the lender happy -- something that usually translates into a better deal. The trouble is, coming up with that much cash can be all but impossible for many first-time buyers. After all, we're talking $40,000 on a $150,000 loan or $70,000 on a $250,000 mortgage.

The good news is that lenders over the last couple of years have become increasingly willing to finance as much as 95% or even 97% of a home. The reason: They can now unload the risk of such loans onto somebody else. To limit their exposure, many lenders regularly sell their loans to the Federal National Mortgage Association (Fannie Mae), which then bundles them into securities which are eventually sold to investors. It used to be that Fannie Mae only would buy loans for 80% financing. But it recently standardized the lending criteria for 97% financing and will now buy these loans, making lenders much more willing to provide them to you. It's now common for first-time buyers to put down only 5%, or $7,500 on a $150,000 loan.

While this sounds enticing, remember that puny down payments have their price. First of all, you start with very little equity in your home. Also, if you don't have 20% to put down, you'll probably have to ante up for mortgage insurance (which protects the bank against default and can top $1,000 a year if you put 5% down on a $200,000 loan).

If you are buying in an urban area or have low to moderate income, look into programs offered by your city or state that provide below-market loans with little or no down payment required. If you're really cash-strapped, you can get 100% financing by "piggy-backing" a second loan equal to 20% of the purchase price on top of your 80% loan. But that 20% second mortgage will come at a much higher rate.

5. "Just what are points, anyway?"

Lenders and home buyers are constantly referring to "points" when talking about mortgages. This is a fancy term for the considerable fees you pay when you take out a loan. One point is equal to 1% of your loan amount. So, if you need a $150,000 mortgage and you have to pay one point in fees, that charge equals $1,500. Lenders refer to points variously as loan-origination fees, discount fees or buy-down fees.

Like the interest you'll pay each month, points are essentially finance charges -- only you pay them up front. Lenders blend them with interest rates to come up with the characteristics of the loan. For example, the more points you pay up front, the lower the interest rate the bank will charge you over the course of the loan. Also, like interest, points are 100% tax deductible in the year you pay them.

6. "How do I know the house won't fall apart?"

You won't know for sure until you move in, but the best way to protect yourself is to hire an experienced home inspector to check the house's structure and systems, including the roof, heating, plumbing, electrical and air conditioning systems.

The cost of a home inspection ranges between $250 to $500. If you can, have the home inspected after you agree on a price, but before you sign the contract and put down a deposit. If you are in a rush to go to contract to lock in the deal, make sure your contract states that the terms of the purchase are conditioned on the approval of a professional home inspector.

Just because you need to hire a pro, doesn't mean you can't do some checking around yourself before you make an offer. Check for soft spots in the flooring and look for freshly painted patches on the ceiling or walls that could be hiding water damage. Turn electric switches and water faucets on and off. If it's summer, turn off the air conditioning and turn on the heat to make sure it works. Likewise, if it's winter, test out the air conditioning. Tour the basement looking for water on the floor and see if the hot water heater looks rusted or cracked. A little diligence before you start negotiations could save you a lot of time, effort and disappointment.

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Now it's time for your attorney to order title searches and other final documents required by the bank and to schedule the closing -- the time and place where cash and ownership of the property changes hands.

The closing can take an hour or two and requires the presence of eight to 10 people -- you, your attorney, the seller, his attorney, the bank, its attorney, and the broker. You'll spend the bulk of the time signing documents and endorsing certified checks.

This is where you can expect to shell out the bulk of the cash. Along with the rest of the down payment, you'll have to cover an assortment of fees known collectively as "closing costs." Lenders are required under federal law to give you a "good faith estimate" of all these charges and you should come ready to pay with a certified check. If your bank requires mortgage insurance (which is likely if you aren't putting at least 20% down) you'll also need to pay the first premium. Ditto for homeowners insurance.

Be sure to inspect the home right before you actually close the deal. Make sure it is in good condition and any property, such as light fixtures or built-in bookcases that you were told you would get with the house are still there. All the appliances should work and it should be broom clean. After the closing is over, have the locks changed and the home is yours.

9. "Where do the tax benefits come in?"

You've heard again and again how buying a home is the best tax break around. Maybe you've even been called a chump for renting. After all, paying $1,200 a month for your mortgage is really the equivalent of paying $900 a month in rent. But how does that work exactly?

Here's the deal: Mortgage interest (including points) and real estate taxes are tax deductible. That doesn't sound very sexy, but it adds up. Since most of what you pay for your mortgage in the first years is interest, on a $1,200 mortgage payment you get to deduct about $1,080 a month. That reduces your taxable income by about $13,000 a year. If you're in the 25% tax bracket, that deduction is worth $270 a month.

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