The Bay Area Home Buying Guide

Bridgepoint Funding

www.bpfund.com

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An educational resource for Bay Area home buyers

Presented by Bridgepoint Funding
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Introduction: An Educational Journey

Hello, and welcome to the *Bay Area Home Buying Guide*. We have created this e-book as an educational resource for home buyers in the San Francisco Bay Area.

If you've been watching or reading the news, you'll know that our housing market has changed dramatically over the last decade. We experienced a housing bubble, a housing crash and, more recently, a robust recovery. A lot has changed.

This book will bring you up to speed on current real estate and mortgage trends. It will also explain every aspect of the home-buying process, from the initial planning stages all the way through to the final closing.

Visit Our Blog for Even More Information

If you find this book helpful, and you'd like to keep up with Bay Area real estate trends, be sure to follow our blog. We publish mortgage and housing news on a weekly basis, most of it tailored to the Bay Area. You'll find our most recent articles at: www.bpfund.com/blog.

We hope this guide helps you in your journey to buy a home.

Sincerely,

The Bridgepoint Funding Team

The 11 Steps Covered in This Book

If this is your first time buying a home, you might not even know where to begin. Don't worry. That's only natural. And that's where this book comes in. This book divides the process into 11 steps, making it easier to understand.

While the home-buying process varies slightly from one buyer to the next, it *usually* follows a certain pattern or sequence. So let's talk about the steps involved.

Here are the 11 steps covered in the book:

1. Start saving money for your home-buying expenses.
2. Establish your housing budget.
3. Review your credit reports and scores.
4. Decide which type of home loan works best for you.
5. Shop for a mortgage and get pre-approved.
6. Find a real estate agent.
7. Start shopping for a house.
8. Make an offer to buy a house / negotiate with the seller.
9. Have the home inspected.
10. Get home insurance.
11. Close the deal and get your keys!

Over the next few pages, you'll find a brief overview of these 11 steps. This will familiarize you with the terminology and concepts we'll be using. After the overview, we will delve further into the details of each step. But let's start with the overview…

Step 1. Start saving money for your home-buying expenses.

Home buyers often incur out-of-pocket expenses in the form of down payments and closing costs. These are typically paid on closing day. So it's wise to start a housing fund to cover the various costs associated with buying a home.

The more money you can save, and the sooner you start saving it, the better. Unless you use a VA loan or a USDA loan to buy a house, you'll probably have to make a down payment of some kind. It might range from 3% to 20% of the purchase price, or even more, depending on the type of loan you use and other factors. This will be your largest expense. You'll also have to pay closing costs (unless the seller is willing to pay them, or you get a credit from your lender), and these can add up to thousands of dollars. We will discuss down payments and closing costs in more detail later on. For now, start saving!

Step 2. Establish your housing budget.

You should have a housing budget in mind, before you even start talking to mortgage lenders. This is the amount you can realistically afford to pay toward a mortgage each month. To start with, all you need is a piece of paper, a pen, and a calculator. Later, we will discuss the budgeting process in more detail.

Step 3. Review your credit reports and scores.

When you apply for a home loan, the lender will review your credit reports and scores to see how you have borrowed and repaid money in the past. Your credit score partly determines whether or not you can qualify for a loan. It also affects the amount of interest you'll pay.

Your credit score is based on the information compiled within your credit reports. So you should review both of these things before shopping for a mortgage. When reviewing your credit reports, you're primarily concerned with accuracy and errors. You should also check your credit *scores* to see where you stand.

Step 4. Decide which type of mortgage loan you want to use.

FHA. Conventional. ARM. Fixed-rate. Jumbo. You've got quite a few choices to make, when it comes to mortgage loans. Making the right choice now can help you avoid problems later on.

In the "Step 4" section of this book, we will focus on the two primary choices you'll have to make as a home buyer: (1) Do you want to use a fixed or adjustable-rate mortgage loan? (2) Do you want to use a conventional or government-backed loan? We will examine the pros and cons of each.

Step 5. Shop for a mortgage and get pre-approved.

Mortgage pre-approval is the next logical step to buying a home (unless you're an all-cash buyer, of course). You've got a housing budget on paper. You've started saving your money. You've checked your credit reports and scores. And you've researched the different types of mortgages to see which one suits your situation. Now you're ready to talk to a mortgage lender.

We will discuss this process at length later on. Here's the short version. Pre-approval is when you work with a lender to determine two things: (1) whether or not you're qualified for a loan, and (2) how much the lender is willing to give you. Once you know how much you can borrow, you can start shopping for homes that fall into that range.

Step 6. Find a real estate agent.

Is this your first time buying a home? Will you be purchasing a home in a city that's new to you? In either of these scenarios, it would be wise to seek help from a real estate agent. In a typical real estate transaction, the seller is often the one who pays the agent's commission. So, as a buyer, there's really no reason for you to fly solo.

An experienced agent can help you navigate the latter steps of the home-buying process, especially steps 7 and 8 below. Your agent will help you *succeed*.

Step 7. Start shopping for a house.

For most people, this is the most exciting step in the home-buying process. But you'll notice that it's step #7, more than half way down the list. We've recommended that you do six other things before visiting the first house. Here's why:

If you follow the steps recommended in this book, you'll have two important pieces of information before house hunting. You'll have your own personal budget (step #2), along with a pre-approval amount from a lender (step #5). Now you can confidently shop for homes that fall within *both* of those amounts. This will help you narrow down the list of homes you want to visit.

Step 8. Make an offer / negotiate with the seller.

When you've found a house that meets your needs, you're ready to make an offer. This is one of the most important steps to buying a home. Make a reasonable offer, and the seller will be more likely to accept it. Make an offer that's too low, based on the current market value, and you risk losing the house.

Your offer should be based on comparable sales. These are similar types of houses that have solid in the same area recently. It's also important to consider current market conditions in the area (e.g., sellers' market vs. buyers' market). Remember, the seller's asking price might be realistic, or far-fetched. You won't know until you look at the "comps" and study the market. In step #8 of this book, you'll learn how to evaluate the asking price and make a smart offer.

Step 9. Have the home inspected.

Are you a residential contractor? Do you have a background in home construction? If so, you can probably inspect the property by yourself. But the rest of us are better off hiring a professional home inspector to get the job done.

A home inspection is a non-invasive examination of the house that usually takes place after the offer has been accepted. It's "non-invasive" because the inspector won't be pulling up carpet or prying off any panels to examine the home. He will examine everything he has access to, and nothing more.

The inspection is entirely for your benefit. It gives you a better picture of the home's true condition. A layperson can only tell so much about a house. We have an untrained eye. We can't look at a circuit breaker and spot safety issues. We can't see the not-so-obvious signs of water damage when there's no water present. We can't tell the difference between "cosmetic" and structural cracks. But home inspectors can. They receive special training to identify these types of problems.

Step 10. Get home insurance.

A homeowners insurance policy protects you against financial losses related to your home. A tree branch falls onto your roof. A fire burns part of your home. A thief makes off with some of your electronics. Home insurance can protect you from these types of financial losses. Step #10 of this book explains the key concepts you need to understand before shopping for an insurance policy.

Step 11. Close the deal and get your keys!

The period of time between the purchase agreement and the final settlement is commonly referred to as the "escrow period." The transfer process itself is referred to as closing or settlement. The two terms are interchangeable, though "closing" is the more common term in California. It involves a lot of paperwork and the final distribution of funds. The seller gets paid, if applicable. The real estate agents receive their commissions. The lender's fees will be paid. You'll sign a lot of documents. And you'll walk away with the keys to your new house!

This book is built around the 11 steps outlined above. And don't worry. They might seem confusing to you at this stage. But by the time you finish reading this book, you'll understand these concepts inside and out.

Step 1: Save Money for Your Home-Buying Expenses

How much money do you need to save to buy a house? This will depend on several factors. Here are some of the expenses you may encounter when buying a home:

- Down payment
- Closing costs
- Cash reserves (in some cases, but not always)
- Home appraisals and inspections
- Moving expenses

Let's talk about some of these items in more detail:

Down Payment

Your down payment will likely be the largest expense. Depending on the type of loan you choose, you might have to make a down payment of 3% - 20%. On a mortgage of $200,000, that would fall somewhere between $6,000 and $40,000, respectively. So the first thing you need to do is research the different types of mortgage loans, to determine what kind of down payment you might be facing.

Note: Some loan programs, such as the VA loan, offer 100% financing. In these scenarios, a person could buy a home with no money down whatsoever.

If you put down less than 20%, you might have to pay for private mortgage insurance (PMI) as well. There are ways to avoid this cost, though. You just have to make sure that the loan-to-value ratio of any *one* mortgage does not exceed 80%. We will discuss PMI in more detail later on.

Closing Costs

You'll also need enough money to cover your closing costs, which are due on closing day. These are the various fees and charges you incur during the home-buying process. The seller might chip in to cover some of your costs (which is known as a "seller's concession"), but you shouldn't count on this. You should save enough money to cover these costs on your own, in case that's what happens.

Closing costs can range from 1.5% to 3.5% of the loan amount, but it varies. In some case, a borrower might receive a lender credit to cover part or all of the closing costs, especially on government loans. Your lender should give you a detailed estimate of your closing costs when you apply for the loan.

Cash Reserves

Some mortgage lenders require borrowers to have a certain amount of "cash reserves" on hand. This is money you have in the bank, *above and beyond* your down payment and closing costs. Basically, they want to make sure you have enough money for your first few mortgage payments. Some lenders have reserve requirements, while others do not. It varies. Ask about it up front, when you apply for the loan.

Moving Expenses

Will you have to rent a U-Haul truck to move your furniture? Do you need to buy *new* furniture? Are you planning to hire movers? Be sure you save enough money to cover these costs as well. Many buyers focus solely on their mortgage-related costs, to the point they forget about their moving expenses. Plan ahead.

Tips for Saving to Buy a House

Here's a checklist to help you save funds for the home-buying process:

1. Consider the potential costs of buying a house. Unless you use the VA or USDA loan programs, you'll probably have a down payment. This could range from 3% - 20%, depending on the type of loan. You'll also have closing costs, and those can add up to thousands of dollars.

2. Think about the items you spend money on each month. Some of them are necessities, while others are luxuries. Which of those luxuries can you do without? If you eat dinner out a lot, consider making more dinners at home. This will help you save money to cover your housing expenses. Apply this same discipline to all you do between now and your closing day, and you'll be better prepared.

3. Consider creating a separate bank account for your housing fund. If you dip into your checking account on a daily basis with your debit card, it might be better to have a *separate* account for your home-buying fund. That way, you won't chip away at those funds without realizing it. Something to consider.

4. Every time you're about to buy something you don't absolutely need, think about your priorities. Think about that house you want to buy, and how you're going to need every penny to make it happen. Do you really *need* that new TV right now?

Don't Forget Your Monthly Budget

The information above explains how much money you might need to buy a house. In addition to planning for your up-front costs, you should also create a budget for your monthly mortgage payments.

The important thing is to have a firm number in mind, as to what you can comfortably afford each month. In the next chapter, we will examine the housing budget in more detail.

Step 2: Determine Your Housing Budget

How much of a monthly mortgage payment can you take on, without sacrificing your quality of life, your savings, etc.? If you don't have a specific number in mind right now, you've got some homework to do.

Before talking to mortgage lenders, you'll want to sit down and review your monthly income and expenses. Come up with a maximum mortgage payment, and try to stay within that range when shopping for a home.

For starters, compare your net monthly income (or "take-home pay") to your *non*-housing-related monthly expenses. Non-housing expenses might include gas, food, credit card bills, car payment, entertainment, and savings account contributions. The money left over is what you have available to put toward a mortgage payment. You don't want to use this *entire* amount—that would leave you without any emergency funds. But it does give you a starting point for your monthly home-buying budget.

Also, consider your future job security, as well as that of your spouse (if applicable). None of us can predict the future. But there's always a possibility that one of you could be laid off in the future. Because of this possibility, it's wise to have an emergency fund in the bank. Many experts recommend keeping three to six months worth of living expenses in the bank, to serve as an emergency fund.

Housing Budget First, Pre-approval Second

Mortgage pre-approval is a helpful step during the home-buying process. This is when the lender reviews your financial situation to determine how much they are willing to lend you.

Pre-approval will help you narrow down your property search. It will also make sellers more inclined to accept your offer, since you've been "vetted" by a lender already.

But there's an important distinction to be made here. Pre-approval does not tell you how much of a house you can *comfortably* afford. That's something you have to determine on your own, and it's best to do so before you talk to mortgage lenders.

Step 3: Review Your Credit Reports and Scores

Credit reports and credit scores play a part in the home-buying process, at least where mortgage loans are concerned. Mortgage lenders use them as a risk-assessment tool, when considering loan applicants.

Of course, if you're paying cash for a house, you won't even need a home loan. In that case, you can probably skip this chapter entirely. But for the *average* home buyer, credit is an important consideration. It can help or harm your chances of getting a loan.

This chapter is split into two parts, to prevent confusion and improve understanding. People often confuse their credit reports and scores, even though they are two different things. So we've given a sub-chapter to each item:

- Step 3(a) - Check Your Credit Reports
- Step 3(b) - Check Your Credit Scores

When you finish reading this chapter, you'll understand how your credit affects you during the mortgage approval process.

Step 3(a): Check Your Credit Reports

Mortgage lenders use your credit score to see how you have borrowed and repaid money in the past. This score is based on information found within your credit reports. So we need to start our discussion on the reporting side of things. Here's what you need to know about the credit-reporting process, and how it affects you when buying a home.

1. What is a credit report?

You can think of your credit report as a record of your financial activity. In particular, it shows how you have borrowed and repaid money over the years (through loans, credit cards, etc.). In the United States, consumer credit files are maintained by three different credit-reporting companies: TransUnion, Equifax and Experian. Authorized lenders and creditors can request a copy of your credit report(s) from these companies.

2. What's the difference between credit reports and scores?

Your credit report is a record of financial activity. Your credit *score* is a three-digit number based on the information found within the report. Your FICO credit score (the one used by most mortgage lenders these days) is a number between 300 and 850. You have three scores, one for each of the reporting companies mentioned above.

Your credit history usually starts when you open your first credit card account, or when you take out your first loan (a personal loan, a car loan, etc.). The creditor or lender who creates this account for you will report it to the three credit-reporting agencies.

If you pay all of your bills on time, you'll have a "clean" credit report without any negative or derogatory items. This will result in a higher credit score. But if you have late payments, debt collections, or other negative items, they will drive your score down.

You have three different credit reports, which are maintained by three different companies. So it's possible to have three reports that are all slightly different. Keep this in mind if you ever have to dispute negative items on your credit reports. You have to handle it through the specific company that produced the errors.

3. What's included in my credit report?

Your reports will include the following information:

- Personal information such as your name, SSN, current address, employer, etc. This comes from the information you give to creditors and lenders.
- Information about your credit accounts, past and present. This comes from lenders and creditors who report on each credit account you have with them. They

typically report the type of account, when you opened it, the credit limit, and your history of making payments.

- Public records. This includes any legal judgments that have been made against you (of a financial nature). It includes bankruptcy filings, foreclosures, tax liens, and other monetary judgments.
- Inquiries. Whenever somebody "pulls your credit," it will show up on your report. It should also show the name of the company or individual who requested your credit file.

You may find other information in your credit report, in addition to what is listed above. But these are the most important items.

4. How do I get a free copy of my credit reports?

You can do this by visiting AnnualCreditReport.com. This is the official website that is jointly managed by the three credit-reporting companies. This site is regulated by the federal government.

5. When should I check my credit report?

It's generally a good idea to review your credit report before you apply for a mortgage loan. The sooner the better. That way, if you find any errors on your reports, you can get them corrected before applying for the loan.

6. How do I correct errors in my credit report?

You would start by contacting the company that produced the erroneous report. Remember, the credit reports maintained by TransUnion, Equifax and Experian are unique. These companies do not share information between themselves. Much of the information will be the same across all three reports (and companies), but they are still individual documents. So you need to dispute the error through the appropriate company.

All three of the reporting companies have a "disputes" section of their websites. You can find it by visiting the home page of their websites. You can also do a Google search for the company's name followed by the word "dispute" (e.g., "Experian disputes").

Step 3(b): Check Your Credit Scores

This step in the home-buying process is optional but recommended. It could help you spot issues that might prevent you from getting a home loan.

When you apply for a mortgage loan, you will quickly discover how important your credit score is. This three-digit number can help or hurt your chances of qualifying for a home loan. But where does your score *come* from? What do the numbers mean? How can you improve it? You'll find answers to these questions and more in this chapter.

What Is a Credit Score?

Credit scores are three-digit numbers that indicate how well (or how poorly) a consumer has borrowed and repaid money in the past. These scores are based on information found within a person's credit report, and they are usually produced by computers. The FICO credit score (which is commonly used by mortgage lenders) ranges from 300 to 850. A higher score is better, when it comes to mortgage approval.

Lenders use credit scores to evaluate the potential risk posed by lending money to a particular borrower, and to mitigate losses due to bad debt. In short, these three-digit numbers help them understand how likely you are to repay your debt.

If you've been responsible with your borrowing in the past, you should have a good score. This will improve your chances of qualifying for a loan. On the other hand, borrowers with credit issues in the past (such as late payments, delinquencies and foreclosures) tend to have lower scores.

Credit Score Needed for a Mortgage Loan

Different lenders have different standards, when it comes to credit score "cutoff" points. Additionally, lenders tend to look at the big picture when evaluating loan applicants. So a low credit score, in and of itself, may not necessarily be a deal-breaker. With that being said, a higher credit score will likely improve your chances of qualifying for a home loan.

Generally speaking (emphasis on the word "generally"), mortgage lenders want to see a score of 600 or higher for loan approval. But this number is not set in stone. So don't be discouraged if you fall below this level. Talk to a lender anyway, to find out where you stand. To qualify for the lender's best mortgage rate, you'll probably need an even higher score, possibly in the mid 700s or higher. But again, these are generalities. Every lending scenario is different, because every borrower is different.

How to Improve a Credit Score

If you've already checked your credit, and discovered you have a score of 740 or higher, you can probably skip ahead to the next section. You're already in or near the "excellent credit" category. Of course, it never hurts to know how to boost your score, in the event that it drops some day. Here's how to do it.

According to MyFICO, the company that developed the FICO credit score, you can boost your FICO score by paying all of your bills on time, and reducing the amount you owe on your credit card(s). Cleaning up any errors on your credit reports may also help.

To learn more about FICO credit scores and how they work, visit www.myfico.com.

Step 4: Choose the Right Type of Mortgage Loan

This is one of the most important chapters in the book, if not *the* most important. Choosing the right type of mortgage loan can prevent a lot of headache and heartache down the road. This chapter will help you make an informed decision.

When choosing a type of home loan, you have two primary choices to make. Do you want a fixed or adjustable-rate loan? Secondly, do you want a conventional or government-insured loan? Once you answer these two questions, the rest of the process is pretty straightforward.

There are pros and cons to consider with each of these questions. For example, a fixed-rate mortgage loan offers more stability but generally has a higher interest rate. An adjustable-rate mortgage might be cheaper in the short term, but it's more unpredictable in the long term. A government-insured FHA loan could minimize your down-payment expenses, but it requires additional mortgage insurance that might make it more costly.

First Choice: Fixed or Adjustable Rate

Most home loans can be placed in one of two categories. They either have a fixed rate of interest, or an interest rate that adjusts over time. As a home buyer, this is one of the first decisions you'll have to make about the type of loan you want to use.

A fixed-rate mortgage loan has the same interest rate for the entire life of the loan. An adjustable-rate mortgage (ARM), on the other hand, has a rate that will adjust periodically with some predetermined frequency, usually once per year.

Most of the ARMs in use today are actually "hybrid" loans that start off with a fixed rate for the first one to seven years. After that, the rate begins to adjust annually.

You might be better off choosing a fixed-rate mortgage if you're going to be in the home for a long time. If you think you'll only be in the home for a few years, an ARM loan could be a good way to save money. ARM loans become unpredictable when you stay beyond the first adjustment phase. That's when the rate starts to fluctuate with market conditions. Usually, this means the rate will rise from one period to the next. And your monthly payment will rise along with it.

So how do you choose between these mortgage types? First, you need to understand how they work. Next, you need to consider the pros and cons of each type. And lastly, you should choose the loan that best supports your long-term housing plans.

Let's recap the key differences...

- ***Fixed-rate mortgage:*** This type of home loan carries the same interest rate for the entire term (length) of the loan. The interest rate makes up part of your monthly payment. So if you get a mortgage with a guaranteed fixed rate, your monthly payments will stay the same size as well.
- ***Adjustable-rate mortgage:*** These are also referred to as ARM loans for short. Unlike the previous option, this type of mortgage has an interest rate that changes over time. This also means your monthly payment will change over time. It might adjust up or down, depending on market conditions at the time of adjustment. But they usually adjust upward, resulting in larger monthly payments over time.
- ***Hybrid ARM loan:*** Most of the adjustable-rate mortgages offered today are considered "hybrid" loans. They get this name because they start off with a fixed rate for a certain period of time. After that period, the rate will begin to adjust. A popular example is the 5/1 ARM loan, which carries a fixed rate of interest for the first five years. The rate will then change every year after that. Some lenders offer 1-year, 3-year and 7-year ARMs, as well.

You can probably see the benefit of using a fixed-rate loan. Your payments will never go up, no matter how long you stay in the house. But what about the ARM loan? Why would anyone choose a home loan with so much unpredictability built into it? The answer lies within the initial savings.

During its initial fixed-rate stage, a hybrid ARM loan generally has a lower interest rate than a traditional 30-year fixed-rate mortgage. The average initial rate for a 5/1 ARM loan, for example, is usually 0.7% to 1.2% lower than the average rate for a 30-year fixed mortgage. So you might pay less money in interest during that time, if you went with the adjustable loan. Just remember that the ARM loan's rate can potentially rise over time.

If you want to see the difference in current rates across the different mortgage types, check out Freddie Mac's weekly market survey. You'll find it here: http://www.freddiemac.com/pmms/

So we've seen the pros and cons of these two types of mortgages:

With an ARM loan, you could potentially save money during the first few years by securing a lower rate (when compared to a 15- or 30-year fixed mortgage). But after the initial fixed-rate period, your ARM loan's interest rate will begin to adjust to keep pace with market conditions. They often adjust upward, which means you would have a larger monthly payment.

With the fixed-rate option, you'll have the same interest rate for the entire life of the loan. This is true even if you keep the loan for 30 years. You might pay a higher rate than the initial rate on an ARM loan, but you won't face the kind of long-term uncertainty that comes with an adjustable loan. You're basically paying a premium for long-term predictability.

Think about your long-term plans. How long do you think you'll be in the home? Is this a temporary "starter home" you might be selling in a few years? If so, you might consider using an ARM to reduce your interest costs. If you plan on staying in the home for many years, you might be better off with a fixed-rate loan that offers greater stability.

The Smart Way to Use an ARM Loan

There are situations where you can use the ARM loan to save money, while avoiding the risk and uncertainty of the adjustment phase. Here's an example:

A family moves to a new city and buys a home. It's only a three-year job assignment, after which they'll be moving again. These folks could use a 3-year or 5-year ARM loan to secure a lower interest rate. The rate would remain fixed for the first three to five years, depending on the terms of the loan. So they would end up selling the house before the first adjustment period (or shortly thereafter).

So that covers your *first* major decision when choosing a type of home loan. Let's move on to the second decision you'll have to make. Do you want to use a conventional mortgage or a government-backed loan?

Second Choice: Conventional or Government Loan

A conventional mortgage loan is one that is not insured by the government in any way. The loan is made in the private sector with no form of government backing.

In contrast, a government-backed loan is insured or guaranteed by some type of federal agency, such as the Department of Veteran Affairs (VA) or the Department of Housing and Urban Development (HUD). Government loan programs include VA, FHA and USDA. The loan may still be made in the private sector, but the lender receives insurance or financial guarantees from the federal government.

Popular types of government-backed mortgages include:

- ***FHA loans***—The loan is made by an approved lender in the private sector and is insured through the Federal Housing Administration. If the borrower defaults on the loan, the lender gets reimbursed through the Federal Housing Administration.
- ***VA loans***—This program is reserved for military service members and their families. It can be used to finance 100% of a home purchase, which eliminates the need for a down payment. This program is managed by the Department of Veteran Affairs. If you're a military member, you should have a VA specialist somewhere within your command. They can provide you with details about the program.

- ***USDA loans***—These loans are also referred to as RHL, short for Rural Housing Loans. The program is overseen by the United States Department of Agriculture (USDA). This type of mortgage loan is reserved for people who live in certain rural parts of the country. There are income restrictions as well. They are sometimes referred to as "farmer loans," due to the geographical and demographic nature of the program. But you certainly don't have to be a farmer to qualify. The program is designed for low- to moderate-income residents of rural areas.

If you're a member of the military, you should seriously consider using a VA loan when buying a house. If eligible, you could buy a home with no money down, and possibly without private mortgage insurance (PMI). It's hard to beat that.

If you're not a member of the military, you could get a government-backed mortgage in the form of an FHA loan. This program is popular among first-time buyers in particular. It's not *limited* to first-time buyers; it's just well suited for this group. The down payment for an FHA loan can be as low as 3.5% of the purchase price or appraised value.

Potential Benefits of Using an FHA Loan

The HUD 203(b) Mortgage Insurance program, commonly known as the FHA loan, offers a path to homeownership for people who might not qualify for a conventional mortgage. In order to apply for this program, you will have to work with an "FHA-approved lender." These are lending institutions that have been approved by the Federal Housing Administration to participate in the program.

Here are the *potential* benefits of using an FHA loan:

1. Smaller Down Payment
Borrowers who use the FHA loan program can make a down payment as low as 3.5% of the purchase price or the appraised value, whichever is less. With a conventional or "regular" mortgage loan, borrowers often have to put down 5% or more (though there *are* conventional loan programs with down payments as low as 3%). This makes the FHA program popular among home buyers who don't have a lot of money saved for a down payment, which is often the case with first-time buyers.

2. Flexible Qualification Guidelines
Generally speaking, the qualification criteria used for FHA loans are a little less stringent than those used for conventional loans. This is due to the government insurance lenders receive through this program. The insurance protects lenders from losses resulting from borrower default. Borrowers who get turned down for conventional financing are sometimes able to quality for the FHA program.

3. Lower Credit Scores and Debt Ratios

If your credit score is a bit too low for a regular mortgage loan, you might find it easier to qualify for an FHA-insured home loan. This is another key benefit of FHA. The credit score cutoff is generally a little lower, when compared to conventional financing. The official minimum credit score used by FHA is 580, for borrowers who want to take advantage of the 3.5% down-payment option. (But mortgage lenders can impose their own guidelines on top of HUD's, if they choose.) The point is, borrowers with credit issues in the past *might* find it easier to qualify for an FHA loan.

4. Streamlined Refinancing
Borrowers who refinance down the road could enjoy yet another benefit of FHA loans. HUD offers a "streamline" refinance program that is designed to minimize the paperwork and hassle typically associated with the home refinancing process. In fact, an FHA streamline refinance can be done without a property appraisal, which is typically required in most refinancing situations.

5. Down Payment Gifts
Many different types of mortgage loans allow for down payment "gifts," and that includes the FHA program. This is when a family member (or some other approved donor) gives you money to cover part of your down payment. When using an FHA loan, you could have the *entire* down payment come in the form of a gift. This would greatly reduce your upfront, out-of-pocket expense.

6. FHA Loans Are Assumable
FHA loans are usually "assumable." This means that if you sell your house down the road, you could essentially transfer your loan to the new buyer. The home buyer will have to meet all HUD requirements and guidelines, before they can assume the loan. But there are some clear benefits here. For instance, if the homeowner's existing mortgage rate is lower than current rates at the time of the transaction, the buyer could assume the lower rate and save money over time. This gives the seller an advantage when marketing the house to potential buyers.

Using a Conventional Mortgage Loan

A conventional loan is one that is *not* insured by a government entity. These loans are made entirely in the private sector, without any government backing.

The primary benefit of using a conventional loan is that you could avoid mortgage insurance entirely. If you make a down payment of 20% or more, you won't have to pay for mortgage insurance. But if you put down less than 20%, you might have to pay for private mortgage insurance, or PMI. This would increase the size of your monthly payments.

If you can afford a down payment of 20% or more, the conventional versus FHA question is fairly straightforward. In this scenario, it would probably be best to use a conventional loan in order to avoid the extra cost of mortgage insurance.

People with smaller down payments have a tougher decision to make. For example, if you can only put 10% down on a conventional loan, you'll probably have to pay PMI. But PMI usually costs *less* than the mortgage insurance required for FHA loans. Ask your lender for a side-by-side cost comparison, so you can make an informed decision.

It's also possible to combine *two* loans, so that neither one of them accounts for more than 80% of the purchase price. This is known as a "piggyback" mortgage strategy. It allows borrowers to put down less than 20% while avoiding mortgage insurance. The 80/10/10 loan structure is a common example of this. With this strategy, the home buyer makes a down payment of 10%, takes out a first mortgage for 80%, and then uses a second loan to cover the remaining 10% of the purchase price.

The point is, there are ways to avoid paying PMI, even though it is *generally* required when the loan-to-value ratio rises above 80%. So don't be discouraged by the prospect of having to pay PMI. You might not have to. Contact us with any questions you have.

Note: Lender-paid mortgage insurance (LPMI) is available in some cases. This is when the lender covers the cost of mortgage insurance, in exchange for the borrower taking on a slightly higher mortgage rate. This is a great option for some borrowers, as it removes the extra cost of mortgage insurance from the borrower's shoulders. If this is important to you, be sure to ask your lender about it when applying for a loan.

Step 5: Shop for a Mortgage and Get Pre-Approved

In the previous chapter, you learned how to choose the right type of mortgage loan for your particular situation. Now it's time to actually shop for a loan. This chapter is broken into two sections to coincide with your next two objectives:

- Part 5a—Getting pre-approved for a mortgage
- Part 5b—Estimating your closing costs

In the first section, we will talk about the mortgage pre-approval process. This is when the lender reviews your financial situation, and tells you what they are willing to lend you. After that, you will learn how to get an estimate of your closing costs.

Step 5a: Getting Pre-Approved for a Mortgage Loan

It's generally a good idea to get pre-approved for a mortgage loan, *before* you begin the house hunting process. Sellers will be more inclined to take you seriously if you've been pre-approved by a lender, and real estate agents will be more willing to work with you.

In other words, *everyone* will take you more seriously if you've been pre-approved.

Pre-approval is when a mortgage lender reviews your credit and financial situation to determine how much they are willing to lend you. The idea is to get a rough idea what you can afford, and then shop for a home within those parameters. Later, after you've made an offer to buy a house, you would go back to your lender for final approval.

The pre-approval process determines two things. First, the lender will determine if you're qualified for a home loan. You must meet their minimum criteria for credit score, debt ratios, income, etc. If you meet those requirements, the lender will give you a maximum loan amount. They will also give you a pre-approval letter to use during the house hunting process.

Note: Getting pre-approved for a mortgage loan is not a guarantee. It does not obligate the lender in any way. You'll face an additional review process later on, in order to get your final approval. But pre-approval *does* bring more certainty to the process.

Don't Let the Terminology Fool You

Here are some commonly used terms relating to mortgage approval:

- ***Pre-qualification***—Through this process, you would provide the lender with very basic information about your financial situation. This might include your monthly income and debts. Based on this, the lender will give you a ballpark amount they might be willing to lend you. "Ballpark" is the key word here. It's not a very in-depth process. In many cases, you can get pre-qualified without even submitting a mortgage application. You can even do it online, without speaking to anyone.

- ***Pre-approval***—This is a more in-depth (and more useful) version of pre-qualification. When you get pre-approved for a mortgage loan, the lender will actually start to verify your financial background. This is what sets it apart from pre-qualification. They will start requesting financial documents as well, such as tax records and bank statements. They will also check your credit score. The pre-approval process gives you a more accurate idea of how much you can borrow.

- ***Conditional Approval***—This takes place after you have chosen a home and made an offer to buy it. In order to reach this stage, you would need to give your mortgage company a copy of the purchase agreement. You'll also go through an extensive underwriting process. The lender will probably require a home appraisal as well. Once you reach this stage, you can move on to the closing.

So what's the point of mortgage pre-approval? What purpose does it serve, if it's not a commitment or guarantee from the lender? Good question. Here's the answer...

How Pre-Approval Benefits You, as a Home Buyer

Getting pre-approved before house hunting is almost always a good idea. It makes sense when you think about it. If you skip the pre-approval, you could spend days or weeks looking at houses in a certain price range, only to find out that you're qualified for a lesser amount. What a waste of time. But when you *start* with the pre-approval, you'll have a pretty good idea what the lender is willing to lend you. You can then shop accordingly.

Here are the benefits of getting pre-approved by a lender:

- Getting pre-approved for a mortgage helps you identify any problems you have (too much debt, a low credit score, etc.). The sooner you can find out about these issues, the better. It gives you more time to correct them.
- Real estate agents will be more eager to work with you, since you've essentially been "vetted" by a mortgage lender.
- Sellers will take you seriously. Put yourself in the seller's shoes. Imagine you get two offers from potential buyers. One buyer has been pre-approved already and has a lender all lined up. The other buyer hasn't even *spoken* to a mortgage lender yet. If the offers were for the same amount, which one would you take? This is especially important in a hot market where multiple offers are common.
- Pre-approval also helps you narrow the field when house hunting. Once you know how much the lender is willing to offer, you can shop within that price range. This is the sensible approach to house hunting.

As you can see, this process helps you in several ways. No, it's not a final approval from the lender. You won't receive that until you've actually found a house and cleared the underwriting process. But it's the next best thing. It gives you a pretty good idea what they'll be willing to lend you, when the time comes.

Documents Needed for Pre-Approval

The list of documents needed for mortgage pre-approval will vary, depending on which lender you use and the type of loan. Most lenders will ask for some, or all, of the following items:

- Social security number and date of birth, for all signing parties and co-signers.

- Income verification (usually your two most recent pay stubs, showing year-to-date earnings).
- Employment verification. This would be a list of your employers for the last two years, including names, addresses and phone numbers.
- Place of Residence. You may need to provide the full address for any place you've lived over the last two years. Some lenders will ask for residences going back several years.
- Bank account information. Lenders usually request your account numbers and balances for any checking, savings, or money market accounts. They do this to verify your cash reserves.
- Tax documents. This usually includes W-2 statements and tax returns for the last two years. There's a 99% chance you'll need to provide these documents.
- Other assets. If you have CDs, stocks and bonds, or an IRA account, the lender might request statements to verify those assets.
- Credit information. They may ask for information regarding any outstanding loans you currently have, such as car loans and student loans.
- Real estate contract / purchase agreement. You probably won't have this document during the *pre*-approval process. But you'll need it for the final loan approval. The lender will want to see a signed / ratified copy of the sales contract between you and the seller. You may also need a receipt for the earnest money you paid.
- Gift letters. If you received "gift" payments from friends or relatives to help cover your down payment, you will need to provide a gift letter. The lender wants to make sure there is no repayment requirement (i.e., the money was *truly* a gift).
- Self-employment documents. People who are self-employed often have to provide some additional documents. This might include a profit-and-loss statement, federal tax statements, and/or balance sheets for the last two years.
- Monthly expenses. Some mortgage companies will ask for an itemized list of your monthly payments. This might include rent, credit cards, student loans, etc.

Again, this list of documents is not exhaustive. Nor is it universal. Document requirements vary. You may have to provide additional items that are not listed above, depending on your financial situation and the type of home loan you are using. Your lender should give you a detailed list of the documents they need. They might even have this list published on their website somewhere.

Step 5b: Estimating Your Closing Costs

When you use a mortgage loan to buy a house, you will have to pay closing costs on the loan. This is a collective term that refers to all of the fees and charges you'll incur along the way. In this chapter, we will take an in-depth look at the buyer's closing costs.

What Are Closing Costs?

Closing costs are the fees, charges and taxes required to (A) originate the mortgage loan and (B) transfer the property from seller to buyer. They are also referred to as settlement charges.

When you "close" on a property, you will finalize all of the paperwork and settle all of the outstanding fees and charges. This is also when ownership is transferred from the seller to the buyer. All of the fees accumulated during the mortgage process must be paid on closing day.

The buyer / borrower pays for most of these fees. In some cases, the seller may contribute money toward the buyer's closing costs. This is known as a "seller concession," and we will discuss it in more detail later.

How Much Are They?

The amount of closing costs you pay will vary based on three factors: (1) the lender you use, (2) the state in which you reside, and (3) the size of your mortgage loan. Location has a lot to do with it. New York, Texas and California are three of the most expensive states, with closing costs averaging well above the national average.

The home buyer's closing costs typically range from 3% to 5% of the purchase price, but they can exceed this in some cases. This is when there's a mortgage loan involved. Buyers who pay cash for a house encounter fewer closing costs, but they're not dealing with a mortgage lender (though there are still tax and appraisal fees to be paid).

If you multiply the purchase price by 3% and 5%, you'll have a ballpark range as to how much your closing costs will be. But this is just an approximation. The lender will give you a more accurate estimate of closing costs when you apply for the loan.

Breakdown of Fees and Charges

Here's a breakdown of some of the common costs associated with a home purchase, when a mortgage loan is being used. This list is not complete. You might face additional fees that are not listed below. But it does include most of the *standard* charges:

- ***Mortgage application fee*** — This is the price for submitting a loan application to the lender. On average, application fees range from $200 to $500, but they can fall outside this range as well. In some cases, the lender may agree to waive the application fee. Other times, they're a non-negotiable cost of doing business. It varies. And they're not always refundable either, so consider that before you apply with a dozen different lenders. Ask in advance about the application fee, and whether or not it's refundable.

- ***Loan origination fee*** — "Origination" is a fancy word for the start of something. In this context, it's when the lender charges you money for creating the loan. Origination services might include loan application processing, underwriting, and other administrative services. Origination fees are quoted as a percentage of the total loan amount. They usually cost around 1% of the loan amount. So the bigger the loan, the higher the origination cost.

- ***Credit report*** — When you apply for a home loan, the lender will check your credit reports and scores. (You should do this too, by the way.) The lender has to pay a fee when requesting this information, and they might pass the cost along to you. This is a relatively small fee, usually around $30 - $40. It might be listed separately, or included as part of the application fee mentioned above.

- ***Discount points*** — We talked about discount points earlier. You'll recall that it's a form of prepaid interest. One point equals one percent of the loan amount. Some borrowers pay mortgage points at closing in order to secure a lower interest rate. Discount points can significantly increase your total closing costs. For instance, if you pay one point on a $400,000 mortgage loan, you've increased your closing fees by $4,000 (1% of 400k).

- ***Title search and insurance*** — The title company will examine the title (ownership) for the home you are buying. They do this to protect from future liens or other claims of ownership. The owner's title insurance policy usually gives you coverage up to the amount you paid for the property, in the event that you lose the house through a title dispute.

- ***Home appraisal*** — Is the property worth the amount you've agreed to pay for it? This is one of the first questions the lender will want to know, after you present your purchase agreement. To find out, they'll hire a professional home appraiser to determine the current market value of the property. The appraiser's fee is usually added to the buyer's closing costs. You can expect to pay around $250 - $450 for the appraisal. These days, a lot of home appraisers are requiring payment up front, when the service is provided (as opposed to requesting it on closing day).

- ***Underwriting fee*** — The mortgage underwriter is responsible for verifying all of the information in your loan application. This person must ensure you meet all of the lender's guidelines and (possibly) the guidelines established by the secondary mortgage market or government agency. This cost might be part of the "processing" fee, or it might be listed separately. This fee generally ranges from $1,000 to $2,000, and averages about $1,300. Lenders and banks have different names for it. They might call it an admin, underwriting or processing fee.

- ***Property survey*** — The survey shows the exact size and layout of the property and lot. Lenders use this to make sure the house is not encroaching on another property (among other things). If there's already a current survey, the lender might not order a new one. Some lenders will request a new survey even if one has been done recently. The cost can vary, but it's usually a few hundred dollars.

- ***Government recording fees*** — The government records the change of ownership / deed anytime a home is sold from one person to another. As you would imagine, they charge a fee for this recording. These fees typically range from $50 to $150.

- ***Home insurance premium*** — Your lender will likely require you to have a homeowners insurance policy in place, before you can close on the home. Most lenders will require you to pay the first year's premium on or before closing day. So while it's not a lender-related fee, it can still count toward your total closing costs. According to the Insurance Information Institute, the average homeowners insurance premium is around $1,000 per year.

The Loan Estimate

As you can see, there are a lot of different types of mortgage fees, and a lot of variables along the way. The numbers presented above are just ballpark figures.

Fortunately, there's an easy way for you to get a more accurate estimate of *your* closing costs. It's a document known as the Loan Estimate.

In October of 2015, the Consumer Financial Protection Bureau (CFPB) introduced a new form called the Loan Estimate. It replaced the Good Faith Estimate form that mortgage lenders used to give to borrowers.

In short, the Loan Estimates is designed to help you understand the terms and costs associated with your loan. So it's a very important document, from the borrower's perspective.

This document also helps with comparison shopping. By having a standard form that details the full costs of the loan, you'll be better able to compare multiple offers from different lenders.

The Closing Disclosure

You'll receive another cost-related document shortly before your closing day. It's known as the Closing Disclosure. This five-page document provides *final* details about the mortgage loan you've selected. It includes the loan terms, your projected monthly payments, and how much you will actually pay in closing costs.

Mortgage lenders are required to provide your Closing Disclosure three business days before your scheduled closing. This gives you time to compare your final terms and costs to those estimated in the Loan Estimate you received earlier. The three days also gives you time to ask your lender any questions before you go to the closing table.

Note: You can find both of these documents online, along with helpful information that explains them. Start here: http://www.consumerfinance.gov/know-before-you-owe/

Using Discount Points To Lower Your Mortgage Rate

During the mortgage process, you will probably be given the option to pay discount points on your mortgage loan. This is a form of prepaid interest. One point equals 1% of the loan amount. So if you paid one point on a $250,000 mortgage loan, you would be paying $2,500 (or 1% of the loan amount).

Generally speaking, there is a "seesaw" relationship between discount points and mortgage rates. This means you can raise one to lower the other. Some borrowers choose to pay more points at closing in order to lower their mortgage interest rates. The mortgage rate reduction will vary from one lender to the next, but a point will *typically* lower the rate by around 0.25%.

In order for this strategy to work, you have to stay in the home and keep the mortgage loan for a certain period of time. Remember, you're paying more money at closing in order to reduce the interest rate over the term of the loan. If you only stayed in the home for a few years, you probably wouldn't save enough money (from the lower rate) to justify the extra amount you paid at closing. You wouldn't recoup your investment.

But if you stay in the home for many years, the lower mortgage rate will more than justify the discount points paid at closing. That's why borrowers often use this strategy in conjunction with a 30-year fixed-rate mortgage loan, for the long-term savings.

What Is Your Top Priority?

Using discount points to reduce your mortgage rate is a matter of priorities. You have to think about what you're trying to accomplish:

- If your top priority is to make your mortgage payments as small as possible, then you should consider paying points to negotiate a lower rate.

- If you're more concerned with reducing your upfront closing costs, you should consider forgoing the discount points even if it leaves you with a higher rate.

Remember, the points are paid upfront, while interest is paid on a monthly basis over the term of the loan. Which one works best for you?

Step 6: Find a Real Estate Agent

This will be a short chapter, because it's an optional step. You are not *required* to use a real estate agent when buying a home. But it's a good idea to do so, especially if you're a first-time buyer and/or purchasing a home in a new area you're not familiar with.

In most cases, it's best to get pre-approved by a mortgage lender before you look for an agent. That's why we've presented the book in this order. Some agents won't even work with buyers until they've been pre-approved by a lender (or have some other kind of financing lined up). They'll *talk* to you without a pre-approval, but they probably won't line up any house tours. There's a valid reason for this.

Put yourself in the agent's shoes for a moment:

Showing houses to a client can be time-consuming. Imagine that you're an agent, and you're spending about 5 - 7 hours a week on a particular client. Eventually, the buyers find a home they wish to purchase. So they go to a mortgage lender to get approved for a loan. They've skipped the pre-approval process entirely, so you're not sure what's going to happen. It turns out that your would-be buyers have bad credit and a mountain of debt. The lender rejects their application. Ouch! They've wasted your time as well as their own.

This is why real estate agents prefer to work with buyers who have been pre-approved. It's perfectly reasonable, when you think about it.

Let's assume you've been pre-approved by a lender, and you're now ready to work with a real estate agent. What next? How do you find a real estate agent in your area? You can find a local agent in several ways.

You can seek recommendations from people you know and trust—family members, friends, coworkers, etc. This is arguably the best way to find an agent, because the recommendation is coming from a known source. Do you know someone who has bought a home recently? Start there. Find out who they worked with, and if they were happy with the services they received. Your mortgage lender might also be able to recommend a real estate agent.

Here are three more ways to find a real estate agent:

1. Find and Read Local Real Estate Blogs

A lot of real estate agents are into blogging these days. They publish blogs to share information about their local housing markets, and also to connect with new clients. If you haven't done so already, try to find some real estate blogs in your area.

You can start simply by doing a Google search for "real estate agent blog" followed by the name of your city. Bookmark the ones that seem promising, for future reference.

There are two reasons for doing this. It can help with choosing an agent, and it's also a great way to learn about your local real estate market (which is very important in its own right). You can learn about home prices, market trends, new neighborhoods, foreclosure statistics and more.

2. Leverage Your Network

Even if you don't have a close friend or family member who has purchased a house recently, you can probably get recommendations through your extended network. A coworker, a neighbor, a Facebook friend—these can all be a good source for referrals.

The benefit of getting input from a third party is the fact that they are neutral. They're not being paid to recommend a certain agent. There's no incentive for doing it, other than helping you out. So you'll probably get the straight scoop.

Start casting your net as soon as possible. When you meet people, let them know you're in the market for a home, and that you need help choosing a real estate agent. You'll be surprised how eager people will be to help you out. Most people love to recommend products and services they've been pleased with in the past. It's human nature!

3. Consider Using the NAEBA Website

There are different types of real estate agents. The listing agent is the one who represents the seller. A "dual agency" might represent both parties. While the definition varies slightly from state to state, a dual agency is where one brokerage firm represents both the seller and the buyer in a single transaction.

And then we have the exclusive buyers agent, or EBA.

As the title implies, an EBA agent or firm works exclusively with buyers. The term is used to describe an agent who never represents sellers. Choosing a real estate agent in this way has some obvious benefits. You'll know that your agent is representing you, and *only* you. There's no chance for a conflict of interest.

You can find an EBA in your area by using the organization's website. The organization is called the National Association of Exclusive Buyer Agents. The web address is www.naeba.org. Just look for the button or link that says "Find an EBA."

What Does a Buyer's Agent Actually *Do*?

The buyer's real estate agent plays an important role throughout the home-buying process, but especially during the early stages. Your agent will help you screen homes to see if they meet your needs, and will also help you evaluate the asking price based on current market conditions.

Once you find a home you'd like to buy, your agent will help negotiate the deal between you and the seller, serving as a go-between for offers and counter-offers until an agreement is made.

Here are some of the things buyer agents do for their clients:

- Help their clients decide what features and qualities they need from a home
- Screen all homes for sale in the area to identify possible candidates
- Take the buyers on tours of properties including open houses
- Point out the positive and negative features of each property
- Evaluate each home to see if it meets the buyer's needs and wants
- Determine the market value of a desired home based on comparable sales
- Write up the purchase offer and submit it to the seller and/or listing agent
- Help the client negotiate with sellers and make counteroffers as needed
- Facilitate the scheduling of the real estate settlement / closing process
- Keep in touch with all parties to ensure everything is on track for closing
- Take the buyer on a final walk-through of the property just before closing day
- Attend the closing or settlement with their clients (in some cases)

Most importantly, your agent should keep the communication flowing and the transaction moving forward. Communication and process management are two key duties of a real estate agent.

Step 7: Start Shopping for a House

As a home buyer, you probably already know *some* of the things to look for in a house. It needs to be big enough to accommodate your family. It needs to be located in the right part of town. And it needs to be priced within your budget.

But these are just the *basic* criteria to look for when buying a house. In order to choose the right home, you need to delve a little deeper. In this chapter, we will examine some of the most important things to look for in a house.

1. The Price of the House

Most home buyers realize they need to buy a house that falls within their budget. But they might not realize their house-hunting budget comes from two different sources.

There are two numbers you should keep in mind when shopping for a home. The first one is your own personal budget, and the second one is the pre-approval amount given to you by the mortgage lender (if applicable). We have covered both of these items in previous chapters of the book.

Of course, if you have enough money to pay cash for the house, you can scratch the part about the mortgage lender. But the average home buyer will have to consider *both* of these spending limits.

- **Budget:** Before you apply for a mortgage loan, you should already have a monthly spending limit in mind. This comes from your own personal budget. It's not something that is imposed by a mortgage lender. You need to find out how much you are comfortable spending each month, because the lender might actually approve you for more than that amount.

- **Pre-approval:** Before house hunting, you should also consider getting pre-approved by a mortgage lender. As mentioned earlier, this is where they review your financial situation and give you a maximum loan amount. This amount might be higher or lower than your personal housing budget.

Price is one of the three most important things you should look for in a house. Suitability and resale value are also important. The house should suit your lifestyle and your family. It should also have a potential for resale value, in the event that you sell the home down the road. But from a house-hunting perspective, it all starts with the price.

For starters, you'll want to make sure the price of the home falls within your budget. But you also need to *validate* the seller's asking price against current market conditions. The last thing you want to do is buy a home that is significantly overpriced. So, how do you perform this kind of validation? You examine recent sales in the neighborhood. And that happens to be the next item on our list...

2. Comparable Sales Prices in the Area

If you already know where you plan to buy a house, you can start researching recent sales in the area. The goal here is to find out how much homes have been selling for, so you can validate the seller's asking price.

Some homeowners price their homes realistically based on comparable sales and market trends. But it doesn't *always* work that way. Some homeowners overprice their homes when they first bring them onto the market, for a variety of reasons. In order to tell the difference between the scenarios, you have to look at recent sales data.

You will probably hear your real estate agent use the phrase "comparable sales," or comps. This is industry jargon for similar homes that have sold recently in the same area where you are buying. If you can pull up sales data for similar houses that have sold recently, you'll have a pretty good idea what your chosen house is worth in the current market. This is arguably the best way to determine the current market value of a property.

3. The Overall Condition of the Home

It's best to choose a property that matches your capacity for maintenance. If you love to do home-improvement projects, and you have the time and money to support that passion, you might choose a fixer-upper. But if you *don't* have the time, knowledge or resources for such projects, you might be better off choosing a home that is move-in ready.

During the house-hunting process, you will have several opportunities to evaluate the condition of the property. Your first opportunity is when you visit the home for the first time. While touring the home, keep an eye out for any obvious signs of disrepair.

You'll have another opportunity to reevaluate the home if and when you decide to come back for a second visit. It's common for home buyers to visit a property more than once, before making an offer to buy it. Use this opportunity to focus on the condition of the property, and the potential cost of repairs or renovations (if any).

Your *third* opportunity to evaluate the property is the home inspection. This happens after you make an offer to buy a house. The home inspector knows exactly what to look for in a house, in terms of structural integrity and functionality. This process can be a real eye-opener for you. We will discuss it in more detail later.

4. The Size and Layout of the House

If you haven't done so already, you should make a list of features you need in a house. One of the obvious factors is the size of the home. You can use your current living conditions as a guide here. Is your current house or apartment too small for you? Is it just right? Or does it have a bunch of extra space you don't need? What's the square footage of the place? Use this as a guide when determining your requirements for the new house.

Size is an obvious thing to look for in a house. But the layout is equally important. Don't just walk through the property and focus on the size. Think about how you live your life, and how this house would enhance or detract from that.

Do you entertain a lot? Does this house have an open floor plan that would cater to dinner parties? Do you need a dining room right off the kitchen? Do you prefer to have a master bedroom upstairs or down? Or maybe you want a one-story home instead of two?

When you're visiting the house for the first time, try to imagine yourself living there. Think about your daily activities. Will this home accommodate your lifestyle? The layout is not something you can change (at least not easily), so you need to consider it carefully.

With that being said, you have to remember that the Bay Area real estate market is *very* competitive. Inventory is limited in some areas. As a result, it can be tough to find everything you want in a home. So it's important for home buyers to be open-minded, realistic, and flexible.

5. Bedrooms and Bathrooms

This is an offshoot of item #4 above. You should choose a home that has the right number of bedrooms and bathrooms for your family. This much is obvious. But the size and location will also play a role in your decision.

Are the rooms large enough for the furniture you have right now? If you're not sure, come back with a tape measure. It's common for buyers to bring measurements and tape measures along, when visiting a house. The last thing you want to do is buy a home only to find out you have to sell some of your furniture.

The *location* of the bedrooms and baths is equally important. Do the bedrooms back up to a noisy street? Is the master bedroom upstairs when you prefer it to be down? These are all things you need to look for in a house, in order to make the best choice.

6. Kitchens and Bathrooms

Kitchens and bathrooms contribute a lot toward the future resale value of a home. You've probably heard this before. Generally speaking, these are also two areas where you'll get the most return on your investment, if you do a remodeling project.

If you buy a house that has a nice kitchen with modern appliances, you've got some good resale value right from the start. The same goes for the bathrooms. The master bathroom is especially important.

If you buy a house with an outdated kitchen, you're going to hurt your resale value. This might not be an issue if you have the resources to renovate the kitchen down the road. But if you lack those resources, you want to look for a house that has decent bathrooms and kitchen to start with.

Six Questions to Ask When Shopping for a Home

Here are six important questions to ask when shopping for a home. Keep these questions in mind before and during the house-hunting process.

1. What kind of house are you looking for?

Be specific here. Make a detailed list of the things you need in a house. This list should include the following:

- The minimum square footage you need
- Whether you prefer a one-story or a two-story home
- The architectural style you prefer
- The required number of bedrooms and bathrooms
- Location of the master bedroom (upstairs or down)
- Size and layout of the kitchen
- Type of appliances and counters in the kitchen
- Size of the yard or lot
- Availability and type of heating / cooling
- Public water vs. well water
- Public sewer vs. septic tank

Creating this kind of list will help you in two ways. First, it will force you to identify your priorities. You can even divide the list into two columns for "needs" versus "wants."

Secondly, this process will make your real estate agent's job easier. These days, agents don't sit in front of the computer and scour hundreds of listings to find your ideal house. Instead, they usually plug your desired features into a database to generate a list of suitable properties. So your agent needs to know exactly what you're looking for.

2. Where do you want to live?

When you buy a house, you're also buying into the neighborhood or community around the house. Here are some questions to ask about the surrounding area.

- What's the demographic makeup? Is the neighborhood comprised of younger families, retirees, or college kids? You want to choose a neighborhood that is compatible with your current lifestyle.
- What about the crime rate in the area? You can get access to this information online, usually through the local police department's website.
- What about access to shopping, distance to work and school, etc.?

These are important questions to ask before settling in a particular area.

3. What are the schools like in the area you're considering?

It's important to consider the local schools before buying a house, regardless of whether or not you have kids. The quality of schools will affect your property value, as well as your home's resale potential. Homes located within good school districts generally hold their value better than those in less desirable districts.

If you *do* have kids, you have even more reason to research the local schools. You want them to get a quality education.

Remember, you're not just buying a house. You are also buying into the neighborhood and the area around that house—and that includes the schools.

4. What's your real estate market like?

Before buying a house, it's a good idea to research the current real estate market in your area. Home prices and other real estate conditions will vary from one market to the next. So it's not enough to research state or national housing trends. You want to find out what's going on in the area where you're planning to buy.

Key questions to ask here:

- Are you in a buyer's market, with high inventory and low demand?
- Or is it a seller's market, with low inventory and high demand?
- Or maybe the market is fairly "neutral" right now.
- How long do homes stay on the market, before being sold?
- Are multiple offers common in your area? Bidding wars?

This will affect everything from the amount you offer on a house to the way you negotiate. For example, you probably wouldn't want to make a below-market offer in a seller's market, because the seller would likely have other (and possibly better) offers to choose from. But that same strategy might work for you in a slower market. This underscores the importance of studying the local real estate market, *before* you dive in.

So where do you find this kind of information? Our blog is a great place to start. It offers a wealth of information on the local housing market. (You'll find the website address in the header of each page.) The business section of the local newspaper is another good source for housing information.

You can also talk to a friend or family member who has bought a home recently. They can tell you what they learned about the market. And, of course, a local real estate agent can be helpful.

And don't forget to use Google. If you do a series of Google searches pertaining to the housing market in your area, you'll find a wealth of useful information. For example, here are some searches I would do to research the market in Oakland, California:

- "Oakland home prices"
- "Oakland housing predictions"
- "Oakland housing market"
- "Oakland real estate trends"
- And so on...

5. How long are homes staying on the market, on average?

This is another important question, because it relates to your bargaining power. If houses are selling quickly, you probably won't have much leverage when negotiating the price. In a fast-moving market, the seller can expect another offer to come along soon. This reduces your bargaining power.

But if the average home is staying on the market for 90 days or more, it means you're probably in more of a buyer's market. In this situation, you have more leverage for negotiating. When homeowners have been on the market for a long time, they are more willing to negotiate the price. This works to your advantage, as a buyer. But it all starts with understanding the local housing market.

The real estate term for this is "average days on market." You can find this information online, or by speaking to a local real estate agent. When shopping for homes on a website such as Realtor.com, pay attention to the amount of time each home was listed. You might see a trend.

How and Where to Find Real Estate Listings

There are many ways to find homes for sale in your chosen area. Here are some of the most common techniques:

1. The Multiple Listing Service

You can look for homes on the Multiple Listing Service (MLS). This is a nationwide database of properties for sale. All real estate agents have access to the MLS. It's a basic service they provide to their clients. Your agent will probably create a personalized "portal" or filter for you. He or she will enter certain parameters based on your needs and wants—minimum size, location, number of rooms, etc. This will generate a list of homes that meet your basic criteria.

2. Realtor.com, Trulia.com and Zillow.com

The Internet can help you accomplish many different steps in the home-buying process. But it's *particularly* useful when it comes to screening homes for sale. It saves you a lot of drive time and wasted trips. There are dozens of property-search websites online these days. But you can see most of the market by using the three biggest listing websites: Realtor.com, Trulia.com, and Zillow.com.

Some listing agents prefer one website over another, while other agents will list their properties on all three sites. You don't want to miss out on the ideal home just because you're using the wrong site. So use all of them. All three of these websites allow you to save your searches, which makes it much easier the next time you visit.

3. RealtyTrac for Foreclosure Listings

In some U.S. cities, foreclosures, bank-owned homes and "short sales" make up a significant portion of the local real estate market. If you don't include these properties in your housing search, you could be overlooking a lot of inventory. Some of these properties show up on the three websites mentioned above. Bank-owned homes, in particular, may be included in those listings.

But if you're serious about buying a "distressed property," you should sign up for RealtyTrac.com. It will give you access to pre-foreclosure and foreclosed homes in your area. It's not free, like the other three sites recommended above. But they do offer a free trial. Try it out and see what you think.

4. Yard Signs

Believe it or not, some sellers don't use the Internet when listing their homes. And there's always a chance you missed a property or two during your web-based search. For both of these reasons, it's a good idea to drive through your desired neighborhood(s) at least once a week. Keep an eye out for yard signs. If you find a house you want to visit, just write down the listing agent's phone number from the sign and give it to your agent.

Checklist for Finding the Right Home

Every house-hunting scenario is different, because every home buyer is different. But there's a certain sequence that takes place in *most* cases. Here are the common steps:

1. ***Budgeting***. Establish a home-buying budget by comparing your net monthly income to your monthly expenses. Do this before applying for a loan. Try to stay within your budget when shopping for a house.

2. ***Pre-approval***. Get pre-approved by a mortgage lender to find out what they are willing to lend you. That way, you can focus on finding homes that fall within (A) your budget and (B) your pre-approval amount.

3. ***Criteria***. Make a list of the absolute essentials you need from a home. These are the things you cannot change, such as the location and the number of bedrooms and bathrooms. In a separate column, write down the things you *want* in a home but could live without.

4. ***Agent***. Once you've been pre-approved by a lender, you can find a real estate agent to work with. Agents have access to certain tools that can help you find a home faster, such as the MLS and professional networks. Your mortgage loan officer might be able to recommend an experienced agent.

5. ***Websites***. Familiarize yourself with the three biggest websites for property search. These are Realtor.com, Trulia.com and Zillow.com. Some homes will appear on all three sites, while others will be exclusive to just one site. So you'll want to use all three when searching for homes in your area.

6. ***Neighborhoods***. Don't just focus on the homes themselves. Start narrowing your search to certain neighborhoods. If you've lived in the area for some time, this will be easy. If you're new to the area, ask your agent which neighborhoods match your lifestyle and preferences (demographics, lot size, price range, etc.).

7. ***Short list***. Make a list of the homes for sale you want to visit, and give it to your agent. Your agent should also create a list of homes that match your needs. The more houses on the list, the better chance you have of finding the one for you.

8. ***Evaluation***. When visiting a particular property, evaluate it against your list of needs and wants. You can even print out a separate list for each home and check things off as you walk through. Write the address at the top. Make lots of notes.

9. ***Comps***. When you've found a house you like, you'll want to evaluate the seller's asking price. Remember, sellers sometimes overprice their homes when they first come on the market. Use comparable sales to justify the price.

10. ***Offer***. When you've found the right home for you, make a smart offer by using the comps we talked about above. We will cover this in more detail in the next chapter.

In the next chapter of this book, you'll learn how to make a smart offer based on market research and sales trends.

Step 8: Make an Offer / Negotiate With the Seller

Making an offer is a crucial step in the home-buying process. If you offer too much, you could end up overpaying for the home. On the other hand, if you offer too little, the sellers might ignore you. The key is to offer a fair market value for the home, one that is based on comparable sales. And that's exactly what we will discuss in this chapter.

Is the Asking Price Reasonable?

Is the seller's asking price reasonable, based on current market conditions? This is the first question you need to ask yourself. Because the answer to this question will determine (or *should* determine) how you handle the offer. It's important to realize that some sellers overprice their homes when listing them for sale. That's why it's called an "asking" price—it's what the seller is asking for.

Real estate listing agents (those who represent the seller) typically encourage their clients to price their homes realistically, with current market conditions in mind. They do this to help the seller ensure a quick sale. So the *majority* of homes on the market are priced reasonably. But you might come across the occasional overpriced home. That's why it's so important to understand the market and to look at comparable sales.

If the house is priced above comparable sales, or comps, you might be able to justify offering less than the asking price. On the other hand, if it's priced *below* comps, undercutting the asking price would be a risky move, and you might lose the home to another buyer.

You'll also want to find out if there are multiple offers on the home already, as this will affect your offer strategy. Buyer agents usually ask about this in advance, before writing an offer.

Bottom line: Before you can decide how much to offer when buying a house, you need to know how the property is priced by local market standards.

Using Comparable Sales to Make an Offer

How do you know when a home is priced realistically, and when it's overpriced? To determine this, you'll need to find out how much other homes have sold for in the area. In particular, you want to find out what *similar* homes are selling for in the area. This is what real estate agents refer to as comps, which is short for comparable sales. In fact, your real estate agent should pull up a list of comparable sales before you make an offer. This will help you decide how much to offer for the house, based on current market data.

The key to using comps is to find homes that have sold recently and in the same area as where you're buying. A home that sold six months ago five miles away is not very useful as a comp. But a similar home that sold two weeks ago in the same neighborhood you're considering is an excellent comp. If you can gather data from three or more of these sales, you'll have an easier time shaping your offer.

Is the House Unique in Some Way?

Next, you need to consider any features that might add value to the house you're considering. Does it have certain features that make it more attractive than the comps? If so, you might have to offer more than the average sale price from the comps.

This is why it's a good idea to take notes about each home you're considering, when you're touring it for the first time. Write down all of the unique features of the home—the lot, the view, kitchen upgrades, outdoor kitchen, pool, etc. This will help you decide how much to offer in relation to the comps.

Example: Let's say you have three comparable sales with standard "builder-grade" kitchens. But the house you want to buy has a completely renovated kitchen that stands apart from the rest. It has high-end cabinets and counters, a professional range like Wolf or Viking, a wine cooler, recessed and pendant lighting—you name it. These features will add value to the home. So the homeowner could justify a higher asking price than the average of those comps (the homes with mediocre kitchens).

The same goes for a nicer view, a bigger and better lot, a swimming pool, and other value-adding features of the home.

So let's recap. When making an offer, remember that it's called an "asking price" for a reason. It's what the seller is asking to get. But it may not reflect the true market value of the home in the current real estate market. So you (and your real estate agent) need to do some homework to find out how realistic the price is.

Start by viewing the property and making notes on what it has to offer. Then pull up some comparable sales for the area. Consider the "target house" against the comps, factoring in any unique features it might offer. This is how you come up with a reasonable offer amount. Just realize it's not an exact science. The goal is to make a *reasonable* offer based on current market data. There is no exact price for a home.

The seller has probably done all of this as well. They might have looked at their home from a buyer's perspective, factoring in the unique features in order to determine the asking price. If the home has a lot of interest (lots of visits, multiple offers, etc.), then the seller probably did a good job pricing the home.

Putting the Offer on Paper

So you've done your research, and you decided how much to offer for the home. What's next? Now you'll need to write up a purchase offer for the property. In most cases, this means using a standard "real estate purchase agreement" form and filling in the blanks.

Purchase agreements usually include the following:

- The amount the buyer is offering to pay
- The amount of deposit the buyer is putting down
- Contingencies such as home inspection and loan approval
- Who is paying closing costs
- Proposed closing date

You might put additional items into your offer. These are just some of the most common components. This is another area where an experienced real estate agent can help you.

This is one of the most important steps in the buying process, as it can determine whether or not your offer gets accepted. It's especially critical in the Bay Area real estate market, due to the high level of competition. Do your homework, consider the comps, and make a smart offer based on current market conditions.

In Depth: Offering Less Than the Asking Price

Spend some time researching real estate offer strategies online, and you'll probably encounter a "rule of thumb" that says you should always offer less than the asking price at first. Some people have gone so far as assigning an arbitrary percentage to this rule. For example, they might say you should offer 5% below the asking price for starters.

These "rules" are not only misguided, they are downright risky for the buyer. The reason is that they don't take unique pricing scenarios and market conditions into account. Every pricing scenario is different. Your strategy for making an offer should reflect current market realities—not some general rule of thumb. You must carefully consider the seller's initial asking price, based on the market value of the home.

Consider the difference between these common scenarios:

- Some sellers price their homes realistically, based on comparable sales.
- Some sellers tend to overprice their homes, based on what they need to pay off their mortgages.
- Some sellers will actually price their homes below market value, in order to sell as quickly as possible.

Given these three different scenarios, how could one say that it *always* makes sense to offer below the asking price? Sometimes it does—other times it doesn't. It varies.

In addition to the differences in pricing strategies, there are vast differences from one real estate market to the next. In a seller's market, it would be unwise to offer less than the asking price (if that price truly reflects the current market value of the home). While in a buyer's market, you have less to lose by offering below the asking price. Even if the seller rejects your initial offer, they may come back with a counteroffer.

In Depth: Using Comparable Sales or "Comps"

In the previous section, we talked about comparable sales or comps. If you're working with a real estate agent, he or she should pull up a list of comps for the area where you want to buy. A comparable sale is simply a house that has sold recently in the area where you're searching. It should be similar in style and price to the house you are considering.

The three most important aspects of a comparable sale are proximity, similarity and age. Here's what those qualities mean:

- ***Proximity*** refers to the distance between the comp and the target house you are considering. Home prices vary from one city to another, but they can also vary from one area to the next within the same city. So you want to find sales data for homes that are in the same area where you are trying to buy. This will result in a more accurate comparison, and will help you shape your offer.

- ***Similarity*** doesn't need much explanation. To find the best comps, you'll want to focus on sales data from houses that are similar to the one you're considering. That's precisely what "comparable" means.

- ***Age*** simply means that you want to find the most recent data available when you are putting together your offer. Home sales from six months ago are not very useful when evaluating a seller's asking price, because market conditions change.

When you find home sales that have these three qualities, you've found your comps!

Step 9: Have the Home Inspected

The home inspection is another important step in the home-buying process. This is when you bring in a professional inspector to examine the foundation, structure, electrical system, plumbing and roof of the house you're buying. The goal is to identify any serious safety or repair issues within the house.

Let's begin this chapter with 20 of the most frequently asked questions regarding home inspections.

1. What is a home inspection?

It's when a licensed home inspector reviews the house to find structural, electrical or mechanical flaws. The home inspection is designed to protect buyers by revealing problems they might not have noticed otherwise. It is a "non-invasive" examination of the property, which means the inspector will not cause any damage to the home while inspecting it.

2. Why is the home inspection necessary?

The inspection helps you understand your investment. It gives you the peace of mind that comes from knowing the true condition of the home. The home inspection also gives you a way to back out of the contract, if the inspector finds something you are unwilling to accept (if you have a contract contingency to this effect).

3. When does the inspection take place?

The inspection usually occurs shortly after the seller accepts the buyer's offer. You want to schedule it as soon as possible, so you'll have time to make repair requests. Also, if the inspector uncovers something bad enough to be a deal-breaker, you'll want to know about it sooner rather than later. It's usually the buyer who schedules the inspection.

4. Who pays for it?

In nearly all cases, the buyer pays for the home inspection. It is designed to protect the buyer alone, so the buyer typically bears the cost.

5. How much does a home inspection cost on average?

The cost will vary based on location and the size of the home. You can expect to pay somewhere between $300 and $500 for a home inspection. Ask about the cost before you hire an inspector.

6. Is the inspection part of my closing costs?

In most cases, no. You will probably have to pay for the inspection when it's performed.

7. Do you need a home inspection to get a loan?

Banks and mortgage lenders generally do not require home inspections. But they usually *do* require a home appraisal. With that being said, it's still wise to have the property inspected. It gives you greater insight into the home's condition, not to mention the peace of mind that comes from this.

8. How do I find an inspector in my area?

Your real estate agent might be able to recommend an inspector. You can also find one through the American Society of Home Inspectors website (www.homeinspector.org). This is a not-for-profit professional association for home inspectors.

9. What does the process involve?

When the inspector arrives, he will begin examining the home inside and out. Once he has completed the inspection, he will review any discrepancies he found with you. He should give you a copy of the report, as well. You then have to decide what you're comfortable accepting, and what you're going to ask the seller to fix.

10. What does the inspector look for?

The inspector will look for problems with the home's heating and cooling system, structure, roof, plumbing, electrical system, windows and doors, foundation and more. They inspect all parts of the house, including the installed systems. Before you hire an inspector, you should ask what he is going to look for when he conducts the inspection.

The American Society of Home Inspectors (ASHI) publishes a standard of practices that outlines what you can expect. So if you choose to hire an ASHI member, you'll know exactly what you're going to get (or what you *should* get).

11. Does the home inspection check for termites?

Not usually. The inspector will tell you if he sees obvious termite damage, such as half-eaten rafters in the attic. But he won't perform a complete termite inspection. You would have to use a pest-control company for this service. Termite inspections are highly recommended in some areas, and less necessary in others. Ask your real estate agent if they're common in your area.

12. Does it check for mold in the house?

Not usually. The home inspector will alert you to any visual signs of mold or mildew that he finds. But he won't do a comprehensive mold inspection. Mold testing is a specialized service that requires special training and equipment.

13. How long does a home inspection take?

It depends on the size of the house and the speed of the individual inspector. It might take anywhere from two to four hours.

14. Should I be present for the home inspection?

As the buyer, you should definitely be present for the inspection. That way, the inspector can point out the discrepancies on his report. He might even let you accompany him through all or part of the inspection. This is a great way to learn about your future home, inside and out.

15. Can the seller attend the home inspection?

Technically, yes. It's their house. But most of the time, the sellers will get out of the way during the inspection. It's usually just the buyers, their agent, and the inspector.

16. What should I ask for after a home inspection, as far as repairs?

This will depend on the kind of real estate market you're in, and the severity of the item to be repaired. In a seller's market, you won't have much leverage to request repairs. In a buyer's market, you'll have more leverage. You should always consider the cost of the repair work when making these decisions.

It's customary for sellers to fix items that either (A) interfere with the proper function of the home, or (B) pose some kind of safety risk. For example, you should always ask for repairs to faulty electrical systems, a sink disposal that doesn't work, etc.

If there are multiple offers on the home, you'll have to tread carefully. Asking for a lot of repairs could cause your offer to be rejected in this scenario, especially if the other buyers didn't ask for anything.

17. Can you get out of a contract based on the home inspection?

Yes, if you include such a contingency in your purchase agreement. Your real estate agent might recommend putting this kind of contingency in the agreement. This allows you to back out of the deal if the inspector finds something that's unacceptable to you.

18. Does the seller get a copy of the inspection report?

No. Not usually. As the buyer, you're the one paying for the inspection. So the report becomes your property. Sometimes the buyer will give the seller a copy of the report when making repair requests, but it's generally not required.

In Depth: What Does a Home Inspector Actually Examine?

So, what does the home inspector actually *look* for during this process? While they might handle the process in different ways, most inspectors look for the same things.

The inspector will examine the roof to make sure it's in a good state of repair. He might do this by using a ladder to climb up to the roof. Or he might just look at the roof through a pair of binoculars, while standing out in the street. The goal is to ensure there's no major damage with the roof, because that would be a potentially large expense. They will check the condition of the shingles or tiles, the flashing around the chimney, and the overall integrity of the roof.

A *comprehensive* roof inspection might be performed separately, at the recommendation of the home inspector or real estate agent. The mortgage lender might require a separate and more thorough inspection, if the home appraiser says it's warranted. It varies.

The home inspector will look at the foundation of the house, and possibly the walls as well (since they connect to the foundation). The inspector wants to make sure there aren't any cracks or water damage that could be a serious problem down the road.

The home inspector will check the electrical system in the house. He will ensure that the system is safe, and that there are no overrated fuses, overloaded circuit breakers, or faulty connections. And, of course, he will make sure everything *works*. He will go room by room and turn on all of the lights and electrical fixtures, throughout the entire house.

The home inspector will examine the HVAC system, if there is one. HVAC stands for heating, ventilation, and air conditioning. He will look for proper function of any system that's currently installed—central air, furnace, baseboard heat, etc. When the inspector first walks into the house, he will probably turn on the air conditioner or heater to make sure it works. This is often the first thing they do upon arrival. The inspector will let the system run while performing the rest of the inspection. This allows for the testing of thermostatic controls as well.

The inspector will look at the plumbing system inside and outside of the house. This includes the sinks, toilets, bathtubs and outdoor spigots. He'll go room by room, systematically, to make sure all of these items work. He will also look for any leaks around plumbing pipes and fixtures.

The inspector will check any installed systems inside the house. In this context, "installed" means anything that is attached to the home where its removal would require tools. Garbage disposals are a good example. If the house has a sump pump in the basement for removing moisture, he will check it for proper operation.

The inspector will look for water leaks, or evidence of water leaks. He will check all the areas where water leaks generally occur. Inspectors know exactly where to look for this kind of thing—on floors, along the foundation, in basements, etc. Leaking water can be a sign of two problems. First, it can suggest that pipes need repair or replacement. Additionally, the water *itself* can cause damage and erosion to floors, ceilings and foundations.

This is just a bare minimum. The inspector will probably look at some additional areas, above and beyond the items listed above. When he's done checking these things, he will give you what's known as the home inspector's report. He will sit down with you and go over each item on the list, noting any problems he found along he way. He will explain what the problem was, and what might be required to fix it. The potential repairs are obviously important to you, because they bring additional costs along with them.

Negotiating the Repairs

Next, you need to decide what you're comfortable accepting, and what you're not willing to accept. If you're not comfortable accepting a certain item on the list, you'll have to ask the seller to fix it.

How much you ask the seller to fix will partly depend on your market.

- If you're in a seller's market, you might not be able to ask for much. The homeowner can probably expect another qualified buyer to come along soon. And the next buyer might not make any repair requests at all.

- If you're in a strong buyer's market (where sellers go further to accommodate buyers), the seller might be willing to fix most or all of the requested items.

So consider the market you're in, and consider how much you want the house. Remember, if it's something you can live with, be flexible. You don't want to lose the house over a minor issue.

Step 10: Get a Home Insurance Policy

A homeowners insurance policy protects you from losses resulting from damage to your home. Your mortgage lender will probably require you to have home insurance, before you can close on the loan. But even if they *didn't* require it, home insurance would still be a wise and necessary purchase on your part. It protects your investment.

Types of Homeowner Policies

Homeowners policies are somewhat standardized across the U.S. So the information presented below should be fairly accurate, regardless of where you live. But while the *types* of coverage are standard, the policies and costs can vary from one insurance provider to the next.

Home insurance policies are usually labeled with one of the "HO" designations below. Most home buyers choose the HO-3 policy, because it provides the broadest coverage for damages and losses.

- **HO-1** — This is a very basic or "bare bones" policy. An HO-1 policy usually provides limited coverage for the following perils: fire or lightning, aircraft collision, hail or windstorm, explosion, riot or civil commotion, vehicle collision with house, smoke damage, vandalism, theft, flying glass and volcanic eruption. The coverage itself is limited, so it's not a very popular option. In fact, it's no longer available in some states.

- **HO-2** — The basic homeowners plus. It provides coverage for all of the items listed under HO-1, plus a few more. It might also cover you from losses resulting from snow, sleet, ice, electrical surges, falling objects, and water damage from plumbing leaks or appliances.

- **HO-3** — Also known as the "special" policy. This is the most popular type of coverage. It covers all of the perils listed under HO-1 and HO-2, plus anything else *except* flood and earthquake (in most cases).

- **HO-4** — Renter's coverage. It covers your possessions from the perils listed above.

- **HO-6** — Condominium coverage. This policy provides coverage for your belongings, as well as any parts of the building that you own.

- **HO-8** — Older home. This type of homeowners insurance is similar to the HO-1, with one notable exception: It allows the replacement cost provision to be changed to repair cost, and in some instances actual cash value. This type of policy is mostly used for historic homes, where the replacement cost would exceed the market value. These policies usually pay what it would cost to repair or replace the damaged property, using modern construction materials.

How to Compare Home Insurance Policies

Comparing home insurance policies is fairly straightforward. You can get quotes from multiple providers to do an "apples-to-apples" comparison of cost and coverage. When comparing policies, pay particular attention to the type and amount of coverage, the premium, and the deductible. Also keep in mind that your mortgage lender might require a certain amount of coverage. Choosing a policy early on will help ensure that your closing isn't delayed.

You can't compare home insurance quotes without knowing what the policy covers—or what it *should* cover. So let's talk about the common types of coverage. There are three primary components of a policy, in most cases. A typical policy will cover the following:

1. The actual home (dwelling coverage)
2. The contents inside it (personal property coverage)
3. Lawsuit protection (liability coverage)

You need to have a firm grasp on these three items before you start shopping for a homeowners policy. Otherwise, you won't know if you're getting enough coverage. So let's talk about each one of these items in turn:

Part 1 - Protecting the Home Itself

This is the most important part of your home insurance policy, because it covers the house itself. This coverage will pay and/or reimburse you for the cost of restoring your home, if it's damaged by fire, lightning, hurricane, hail, etc. You'll have to refer to your particular policy to find out what types of disasters or "perils" it covers.

Most standard home insurance policies do *not* cover floods and earthquakes. So you might have to purchase extra coverage for those events, if you live in an area where they are common.

When shopping for a policy, it's generally best to buy enough coverage to rebuild the home in the event that it's destroyed. This is arguably the most important factor when buying insurance.

The standard home insurance policy will also cover attached structures, such as your garage or shed. But these structures are often covered for a lower percentage than the home itself. Just be sure to ask about this when shopping for insurance, and read the fine print within the policy. Don't purchase a policy until you know exactly what it covers.

The cost of construction rises over time. So you should ask the insurer if the policy they are offering includes a guaranteed *replacement cost* provision. Basically, this states that they will cover the full cost of replacing the home, even if the future cost of construction is more than the policy coverage. Replacement cost is one of the key items you'll have to compare when gathering quotes from different providers.

Many companies limit the amount of dwelling coverage to 20% above the amount for which the property is insured. For example, if you've insured the home for $200,000, and you have a replacement cost provision up to the 120% of the dwelling coverage amount, the company would cover the cost up to $240,000.

Twenty percent above baseline is a common coverage amount, but this too can vary. So keep it in mind as you compare insurance quotes. If a company only offers replacement-cost coverage that is 10% above the baseline, you might want to shop around for a better policy. They might be offering less than the standard amount of protection in your area.

Part 2 - Protecting Your Personal Property

In addition to protecting the house itself, you'll probably want to protect the items *inside* the house. This includes your furniture, clothing, electronics, and all of your other belongings. Add these items up in your head, just to get a rough estimate of the cost. It's probably a significant number, right? So you want to make sure your homeowners policy gives you enough coverage for these items.

It's a good idea to itemize the cost of all items within your home. This will help you determine how much protection you need from your home insurance policy.

Pay close attention to any dollar limits in this section of your policy. For example, your policy may only cover expensive items like jewelry up to a certain dollar amount. This is fairly common in homeowners policies.

Compare one home insurance policy to another, and you'll see some clear differences in the personal property department. There's a lot of variance in this area. At the same time, some industry standards have evolved over the years. Some insurance providers will automatically set the personal property coverage amount to a certain percentage of the dwelling coverage amount. Remember, the dwelling component of the policy protects the structure itself.

As a "default" setting, some companies will cover your personal property up to 50% or 75% of the dwelling coverage. For example, if the dwelling were covered up to $200,000, they would reimburse you for personal property losses up to $100,000 or $150,000 (using the 50 - 75% rule). But again, it varies.

When you get home insurance quotes, you should also keep an eye out for a distinction between "actual cash value" and "full replacement cost." These terms apply to the level of personal property coverage in your policy.

Full replacement is exactly what it sounds like. The company will reimburse you for the cost of your belongings for what they're worth at the time of replacement, even if the price has gone up since you first purchased the items.

If your belongings are insured for the ***actual cash value***, the provider will only reimburse you for the depreciated value. They'll use the amount you paid for the item at the time of purchase (which would probably be less than a comparable item at current market value). In other words, it gives you less coverage for your personal property.

As you might imagine, it costs more to have full replacement coverage. Typically, you'll have to pay 10% to 20% more to receive the higher level of protection. So it's a tradeoff. Some people want the maximum amount of protection, even if it increases their annual premium. Some people want to minimize their premiums at the expense of their coverage. It's a personal choice.

Part 3 - Protecting Yourself from Lawsuits (Liabilities)

Most homeowners policies come with some level of liability coverage as well.

According to the Insurance Information Institute, "liability covers you against lawsuits for bodily injury or property damage that you or family members cause to other people. It also pays for damage caused by your pets."

The Traverlers insurance company offers a similar definition: "The personal liability coverage within your homeowners policy provides coverage for bodily injury and property damage sustained by others for which you or your family members are legally responsible."

Liability coverage doesn't prevent lawsuits from happening. It just reimburses you for any legal fees or settlements you might incur, as a result of such legal actions. It's one more component to consider when you shop for an insurance policy.

Most policies come with a minimum amount of liability coverage, which usually starts at $100,000. But if your assets are worth a lot more than that, it's probably a good idea to increase the amount of liability coverage.

While such lawsuits are uncommon, they can and do occur. And the results can be severe. As you compare home insurance offers, you should also compare the amount of liability protection built into the policy. It's an important part of your overall coverage.

Here's a key concept to keep in mind regarding liability coverage. You can usually upgrade this type of coverage with very minimal cost to you. For example, it might be possible to increase liability coverage from $100,000 to $300,000 for as little as $20 difference in the policy cost. It's something worth considering.

Understanding Insurance Premiums and Deductibles

When shopping for home insurance, it's important to understand the difference between deductibles and premiums. These two components have an inverse relationship that affects the cost of your policy. Here's how it works.

The Insurance Deductible

A home insurance deductible is the amount you have to pay toward a loss, before your insurance company will cover the rest.

Let's say you have a $1,000 deductible on my home insurance policy. Let's further assume that a tree falls on your house and does $5,000 worth of damage. You have a $1,000 deductible, which means you'll have to pay the first $1,000 worth of damage caused by the tree. Your insurance company would pay the remaining $4,000. This is how a home insurance deductible works.

The Insurance Premium

An insurance *premium*, on the other hand, is just the amount you pay for your insurance. This is the money you pay your insurance company each year just to have a policy. This cost can be rolled into your mortgage payment (in most cases) or paid separately. At the time this book was last updated, the average home insurance premium in the United States was around $1,100. The cost will vary based on geography and the amount of coverage. Some states, like Florida, are more expensive than others.

The Inverse Relationship

As stated above, there's an inverse relationship between the insurance deductible and the insurance premium. So if you *increase* the amount of your deductible (the amount you must pay out of pocket toward losses), it will likely *decrease* your insurance premium.

Personal finance experts often recommend this as a money-saving strategy. The reason is because you know you'll be paying your premium, but you don't necessarily know if you'll have to pay a deductible. If you have a home insurance policy for ten years, and you don't file any claims against the policy, you will never have to pay any deductibles during that ten-year period. So that is why some people recommend increasing your home insurance deductible to decrease the premium amount.

Strategy: Raising the Deductible

You might be able to decrease your insurance premium by as much as 25% (or more) just by increasing the deductible by a small amount. For example, a common deductible amount for home insurance is $500. That means you would have to pay the first $500 of a loss before your insurance company would cover the rest. If you were to increase that $500 deductible to $1,000, you could potentially decrease your insurance premium by as much as 25%.

If you're mostly concerned with the annual cost of the premium, and you want to lower that amount, it might be wise to choose a higher deductible.

Step 11: Close the Deal (Closing / Settlement)

The real estate closing process can seem like a mystery to first-time home buyers. Most people know it involves a lot of paperwork. But aside from that, it's all a bit hazy. The purpose of this chapter is to fill in those blanks.

In a nutshell: During a real estate closing, ownership of the property is transferred from the seller to the buyer. All funds are distributed by the escrow company, and the new deed is registered in the buyer's name (usually). The buyer also has to bring a check for all of the mortgage and title fees accumulated along the way.

What Is a Real Estate Closing?

The real estate closing is also referred to as settlement. The two terms are interchangeable, though "closing" is the more common usage. This is the final step in a real estate purchase transaction. It's when property ownership is transferred from the seller to the buyer.

There will also be a final distribution of funds on closing day. The sellers will receive a check for whatever proceeds they earned from the sale. The real estate agents will receive a check for their commissions, if applicable. Home buyers typically provide a check for their closing costs in advance, anywhere from a day to a week before the scheduled closing date. Sometimes the lender or seller will cover the closing costs, so that the buyer pays nothing. It varies. We will talk more about these costs later.

What Happens on the Big Day?

This process involves a lot of paperwork. The escrow or title company will likely have most of the documents ready to go—they'll just need to be signed. As the buyer, you will probably have more paperwork to sign than the seller. You might sign your name anywhere from ten to thirty times during the closing process. You'll have to sign mortgage documents, legal disclosures, tax records and more.

Here are some specific things that happen at a typical closing:

- The buyer (or the buyer's lender) will provide a check for the amount owed toward the purchase price of the house.
- The seller will sign the deed over to the buyer. This act officially transfers ownership to the buyer. The seller will turn over the keys, as well.
- The title company (or in some cases a lawyer or notary) will register the new deed with the appropriate government office. This record will show the buyer as the new homeowner.

- The seller will receive any proceeds they earned from the sale, once their mortgage balance and closing costs have been paid.

Events Leading Up to the Closing

The time and date for the closing is usually written into the purchase agreement. The buyer makes an offer to buy the house. As part of the offer, the buyer will propose a closing date. The seller can make a counteroffer to propose a different date, or they can accept the buyer's suggestion. Like everything else in the real estate world, it's negotiable. It usually doesn't take long for the buyer and seller to agree on a closing day.

The closing date is usually scheduled to occur several weeks after the offer is accepted. This allows time for the events that must take place after the contract has been signed. You need to allow time for the home inspection, the appraisal, the underwriting process, and more.

The period of time between the offer and the closing is commonly referred to as the escrow period. This is what people mean when they say their house is "in escrow." It means the sale is pending, but they haven't yet closed the deal. They are still waiting for the closing day. The typical escrow period is around 30 days, but it can be longer or shorter than this. The buyer and seller must agree on the closing date, and thus the length of the escrow period, when negotiating the contract.

Several days before the actual closing, you'll receive a "Closing Disclosure" that shows your finalized closing costs. This is different from the "Loan Estimate" you should receive when you apply for the loan. As its name suggests, the *Loan Estimate* is an estimate of your closing costs. The *Closing Disclosure* you receive a few days before closing will show the actual amount you need to pay on closing day.

- You get the Loan Estimate when you first apply for a loan, within three days of submitting an application.
- You get the Closing Disclosure a few days before closing.

These are two important documents, so be sure to review them carefully and ask questions if needed.

What to Do Before Closing on a House

You've made an offer to buy a house. The seller accepted your offer. You've given your mortgage lender a copy of the purchase agreement. The closing date has been scheduled 30 days from now. Now what? What should you do before closing on a house, aside from waiting for the big day? And what should you *avoid* doing during this timeframe?

Things to do before you close:

- Try to keep your financial situation stable. You could still be denied for a mortgage loan, even *after* you've been pre-approved by the lender. The pre-approval is not a commitment or guarantee. You've been conditionally qualified for a loan. But you need to *stay* qualified all the way up to the closing. The less your financial situation changes, the better.

- You will need to bring a cashier's check with you on closing day. In most cases, the check will be made out to the title or escrow company who is managing the process. The check should cover the exact amount of your closing costs and any remaining down payment.

- A few days before your closing date, you should receive a Closing Disclosure from your mortgage lender, as well as an estimated closing statement The Closing Disclosure will have a finalized list of fees the buyer must pay. The cashier's check (mentioned above) should be made out for this amount. You can view a sample Closing Disclosure form online. Just do a Google search for "closing disclosure PDF."

- Make sure you have a homeowners insurance policy in place. Your lender will probably require this. Lenders usually require the first year to be paid in full. The lender may contact your insurance agent before closing day, to verify the policy and coverage amount.

Things to *avoid* before closing day:

- Try to avoid large expenditures before your closing. Implement a self-imposed "spending freeze," as much as possible. You obviously have to buy groceries, gas for your car, and other necessities. But try not to spend anything beyond that. Keep your money in the bank. Keep things as stable as possible, until *after* you close on the home.

- Avoid opening any new credit lines, such as credit cards. The same goes for buying a car, applying for a store credit card, etc. These things could alter your debt ratio and credit score, which might cause problems with your final approval. Remember, you want to keep your financial situation stable between pre-approval and closing.

- Avoid switching jobs before closing, unless it's completely unavoidable. A new job usually brings a change in income, as well. If your income goes down, it will alter your debt-to-income ratio in a negative way. A change in employment could also require a lot of paperwork changes, which might delay the closing.

Most of these dos and don'ts can be summed up with a single phrase—*status quo*. In most cases, it's best to maintain the status quo between the pre-approval and the final approval. Negative changes, such as income reduction or credit card delinquencies, could actually derail your home loan. And that's the last thing you want.

Parting Words

Despite the research and effort that went into this book, it is not meant to be the "final word" on home buying and mortgage loans. There are exceptions to many of the rules, examples and generalities mentioned in this book. Every home buying scenario is different, because every *buyer* is different. Some of the examples and scenarios presented in this book may not apply to your situation.

This handbook is not meant to take the place of professional real estate or mortgage advice. A real estate agent can tell you about the current state of your local real estate market. A mortgage broker or loan officer can answer your lending-related questions. It's wise to seek professional help when needed.

Mortgage guidelines and housing conditions change all the time. As a result, portions of this book may become outdated and/or less accurate over time. You should not make any financial decisions based *solely* on the information contained herein. This book is offered as reference material and does not constitute financial advice.

Bridgepoint Funding: Your Bay Area Mortgage Lender

This book was presented by Bridgepoint Funding, a mortgage company that has been serving the Bay Area for more than 15 years. We offer a variety of loan products and programs for home buyers who want to purchase a home in the Bay Area, and for homeowners who wish to refinance.

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