5 Things Every Aspiring Home Buyer Should Figure Out Before Applying for a Mortgage

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To the uninitiated, mortgages might seem like the most complicated obstacle in their financial future. Conventional and non-conventional loans? Private mortgage insurance? Thirty-year mortgages? There's enough terminology to scare off even the most well-funded first-time home buyer. Fortunately, all this mortgage-related language is learnable with a little effort.

If you want to buy a house, you're going to need to figure out all this mortgage mumbo-jumbo, and no better time than the present, when mortgage rates are at record lows. Read on for five things you need to figure out before you start your home search, and you'll be set when it's time to start talking to mortgage lenders.

Just remember: If it all seems overwhelming, a financial planner (or a money-savvy friend or family member) can help guide you through the process. Buying a home is a marathon, not a sprint, and you don't have to do it alone.

1

Figure out how much mortgage you can afford

Unless you have a secret cache of cash tucked away somewhere—enough to spend a couple hundred thousand dollars on your dream home—you'll need to borrow money to buy a house. The mortgage size you can qualify for, then, will determine which properties fall within your price range. Before you begin seriously looking at houses, you need to figure out how much mortgage—and by extension, how much house—you can afford.

"Your income does dictate the capacity of your loan," says Andrea Koryn Williams, CFP, CLU, ChFC, a wealth management advisor with Northwestern Mutual.

When you try to qualify for a loan, you'll need to provide proof of income. Lenders will also check your credit reports to identify what other forms of debt—student loans, personal loans, car loans, etc.—you have. They'll use this info to calculate your debt-to-income ratio: the amount of money you owe in relation to your income. Lenders want to make sure your monthly debt payments, including your proposed mortgage payments, will be affordable considering your income.

"Most loans require a 43 percent debt-to-income ratio," says Michelle Hammond, a home lending advisor with Chase Private Client. "For example, if a client makes $120,000 per year, that is equivalent to $10,000 per month in gross earnings. Therefore, a client with this scenario can usually qualify to spend up to $4,300 per month for all expenses appearing on the credit report—not just housing."

In other words, your income needs to be high enough that you can easily afford your mortgage payments in addition to any other loan payments. To calculate how much mortgage you can afford, divide your annual salary or household income by 12. Multiply that number by 0.43. If you have other debts, subtract those monthly payments from the number. This final sum is the largest monthly mortgage payment you can afford. For a more detailed breakdown of how much mortgage you can afford, there are a number of free online mortgage calculators; Nerd Wallet has a great one.

It's not a great idea to apply for the largest loan possible, though. "A good rule of thumb is to ask yourself, 'How much should I borrow?' instead of, 'How much could I borrow?'" says Kathy Cummings, SVP of homeownership solutions and affordable housing programs at Bank of America "This approach focuses on the amount that comfortably fits your budget."

Hammond says there are several other factors, including credit score and down payment size, that can determine how much mortgage you can afford, but income is a useful starting point because the ability to repay the loan is key.

When you're calculating your mortgage options, don't just pay attention to that monthly payment, though. Prospective homebuyers need to understand that the monthly payment doesn't show the whole picture, says Nancy DeRusso, SVP and head of coaching at Ayco, a Goldman Sachs company that offers company-sponsored financial counseling programs

DeRusso says people tend to focus on that monthly payment size, but there's more to it, including closing costs, appraisal and home inspection fees, utilities, repairs, and more. Some of these costs will be upfront and paid at the time of purchase, but others will increase the monthly cost of owning your home. To get a sense of what these costs will be, DeRusso recommends speaking with your lender or realtor about upfront costs and, once you have found your dream home, with the current homeowner about monthly or annual expenses they faced.

2

Check your credit

In addition to looking into your income, lenders will look at your credit score and credit reports. Higher credit scores make borrowers more attractive to lenders and can help you get a lower interest rate, but lenders will adjust their expectations for credit scores based on the economic environment, Williams says. If times are hard and many people are unable to make payments, lenders may tighten their restrictions and be less willing to lend money to those with lower scores; they may approve people with lower credit scores more freely if conditions are good.

If you hope to buy a home in the near-future and will need a mortgage to pay for it, start working now to reduce your debt and your credit utilization rate—how much of your available credit you use in a given month—to boost your credit score.

3

Research types of loans

"Many people may not know that there are several types of mortgages," says Lauren Wybar, CFP, a senior financial advisor with Vanguard Personal Advisor Services. "A potential home buyer should understand the different types of loans available, how they may qualify, and the potential benefits they offer."

Once you have a sense of the amount of mortgage you can afford, begin researching the types of mortgages available to you. A 30-year fixed-rate mortgage is the most common mortgage in the U.S., but you have many more options, if you're interested.

Conventional loans vs. non-conventional loans

“A conventional mortgage is offered by a private lender, while non-conventional mortgages, such as FHA [Federal Housing Administration] or VA [Veteran Affairs], are government loans for specific qualified buyers,” Wybar says.

Conventional loans are open to the general population, offered by private lenders, and come with the standard down payment and terms most people associate with mortgages. Non-conventional mortgages are backed by government programs, such as the FHA or Department of Veteran Affairs, to make homeownership more accessible to certain groups.

“The barriers of entry are a lot lower,” Williams says of FHA loans, which are typically available to people with lower credit scores. Non-conventional loans also don’t always require a 20 percent down payment, which makes buying a home much more doable for many people. Non-conventional loans often have lower interest rates, too. They’re not without their downsides, though, namely the need to pay for mortgage insurance—more on that below.

Fixed-rate mortgages vs. variable-rate mortgages

With a fixed-rate mortgage, the interest rate for the loan is determined when the loan is taken out and remains the same for the life of the loan. (You can change your mortgage rate by refinancing, but the original loan will remain the same.) Variable-rate mortgages (also called adjustable-rate mortgages, or ARMs), on the other hand, have rates that can be adjusted over the life of the loan after an introductory period.

Variable-rate mortgages typically come with a lower rate and a lower monthly payment at the beginning of the loan, Hammond says, but they’re also notorious for landing borrowers in deep trouble: A form of adjustable-rate mortgages helped contribute to the late-2000s housing crisis. After a set period of time, the interest rates of variable-rate mortgages can shift, rising or falling in line with larger economic forces. If the rate falls, borrowers save money—but if the rate rises, borrowers can be confronted with larger (possibly unaffordable) monthly payments. The interest rates on variable-rate mortgages shift on a set schedule that can be annual or monthly, but whether they rise or fall is unpredictable.

Variable-rate or adjustable-rate mortgages can be used to the borrower’s advantage, but anyone looking to take out one of these loans should be certain they understand the potential implications. Done right, though, these mortgages can help borrowers save money.

“Clients that opt for variable rate mortgages should fully understand all risks associated with remaining in the loan once the introductory period is over and the rate becomes adjustable,” Hammond says. “Variable rate mortgages are typically an option for clients who plan to move within a certain timeframe or those who have the ability to fully pay a mortgage off within a short timeframe.”

Fixed-rate mortgages are certainly more consistent, but if they're taken out when rates are high and interest rates later drop, borrowers would have to refinance—a sometimes costly process—in order to take advantage of those lower rates. If you're able to take out a mortgage when rates are low, though, as they are during the COVID-19 economic crisis, you may be set for the life of your loan.

10-year, 15-year, 20-year, and 30-year mortgages

Though 30-year mortgages are most commonly talked about, you can get a mortgage for many different time increments. The number of years determines how much time you have to pay off your mortgage: The beloved 30-year mortgage gives people 30 years to repay the cost of their house loan, plus interest. A 10-year mortgage, on the other hand, gives people only 10 years to pay the full cost of their mortgage loan, with interest—but they're debt-free after only a decade.

Each increment has its own benefits and method of determining interest rates, but generally, you save money overall with shorter loans. Your monthly payments will be much larger with a 15-year loan, but you'll pay less in the long run, because you pay less in interest—and you stop paying all together after 15 years, when the loan is paid off and you own your home in full. Shorter loans also tend to have lower interest rates, because lenders see shorter loan terms as less risky investments than longer ones, and allow owners to build home equity more quickly.

It all makes sense when you remember that interest is the cost of borrowing money: When you borrow money for more time, you'll have to pay extra for that time. When you borrow money from someone and it doesn't need to be repaid in full for 30 years, you have to pay for the luxury of time—and that extra payment takes the form of interest.

Before you scramble for a money-saving 10- or 15-year mortgage, remember that these loans have larger monthly payments. Longer loans have lower payments, which allows people to buy bigger, nicer, or better-positioned homes that they have more time to pay for. They can also save money for other purposes—education, retirement, etc.—or invest it while still paying down their debt. With shorter loans, you run the risk of getting a monthly payment that is so high that you're unable to save money.

While it's always possible to pay off your mortgage early, it's important to consider what loan term is best for your long-term financial plans.

4

Figure out your down payment

The down payment is the initial amount of money you pay for your home. Paying for a house isn't all through a mortgage: You also have to put down a little money upfront to purchase your property. Traditionally, lenders ask for 20 percent of the total cost of the home: If you're eyeing a $200,000 home, that means you need at least $40,000 for a down payment, plus any associated closing costs and upfront fees from the buying process.

Saving enough money for that down payment is a common barrier to home ownership: Even if people have enough income to afford monthly mortgage payments, saving up that much money can take years. Fortunately, there are loans that don't require a 20 percent down payment. Non-conventional loans, like FHA or VA loans, accept lower down payments based on a variety of factors, including income. There are also private and government-supported programs in most areas that can help with down payments, closings costs, and affordability to make home ownership more accessible, Cummings says.

Lower down payments sound great, but they usually lead to higher monthly payments. Back to that $200,000 home: If you make a $40,000 down payment, you only owe $160,000 plus interest. If you make a smaller down payment, you'll owe more money on your mortgage over the same amount of time, so your monthly payments will be larger. (There's also a possibility you'll have to pay private mortgage insurance or mortgage insurance, explained below.) The more you put down, the less you owe: You'll have a smaller loan to repay. A lower down payment may sound like a sweet deal, but before you go for it, consider how it will affect your monthly payments.

If you want to buy a home, research what kind of down payment you might need, and start saving. Even if you're able to pay less than 20 percent for your down payment, having extra money in the bank won't hurt you.

5

Read up on private mortgage insurance (PMI) and mortgage insurance

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Private mortgage insurance and mortgage insurance are added fees to your monthly mortgage payment. They're typically required when a home buyer makes a down payment of less than 20 percent of the home's purchase price and they protect the lender, not the homeowner, in case the homeowner is no longer able to make payments on their mortgage loan.

If a prospective home buyer is unable to find the money for a 20 percent down payment, lenders may see them as a risky borrower. They may still approve the mortgage loan, but in many cases, it will come with the requirement that the borrower pay a mortgage insurance premium. Private mortgage insurance is associated with conventional loans, with rates that vary by down payment amount and credit score. According to Hammond, it's typically an added annual cost of between 0.3 and 1.5 percent of your mortgage, though it can vary.

Most non-conventional loans—particularly FHA loans—require mortgage insurance. While the terms and rates vary depending on whether you have a FHA loan or a USDA loan, mortgage insurance increases your loan amount and the overall cost of your loan, according to the Consumer Financial Protection Bureau.

Consider private mortgage insurance and mortgage insurance the downside to making a smaller down payment. While you're saving money initially, your monthly payments will be larger than they would have been with a 20 percent down payment. In most cases, private mortgage insurance is no longer required once you have 20 percent equity in your home—once you've paid about 20 percent of the selling price of the home through your down payment and monthly payments. To determine that you have 20 percent equity, you'd likely need to refinance in order to remove the PMI mandate.