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A Financial Primer for First-Time Homebuyers

You've learned plenty of consumer lessons haggling with automobile dealers to buy a car, reckoning with rental apartment leases and landlords, and dealing with college loan debt. But as instructive and enlightening (and at turns, frustrating) as these experiences can be, in all likelihood they will not fully prepare you for the highly involved and often stressful process of purchasing your first home.

For first-time homebuyers, the more you understand about the entire process, from the financial steps to take in preparing for the purchase, to shopping for and securing a mortgage, to the choices you make you officially become a homeowner, the more positive the experience is likely to be. Here the personal finance experts at the Financial Planning Association offer suggestions to help first-timers minimize their stress and maximize their investment.

To make yourself more attractive to lenders:

Banks and other mortgage lenders don't hand out home loans to just anyone. To secure a mortgage, a borrower needs to prove to the lender that they're on solid financial footing and capable of meeting the terms of the loan. And the more solid that footing is, the more favorable their loan terms are likely to be. Thus the upfront effort you put into making yourself a more attractive borrower can save hundreds, even thousands of dollars, in costs. To strengthen your borrowing position:

Reduce the amount of debt you're carrying. Most lenders take a hard look at a borrower's debt-to-income ratio — how much debt a person or household carries in the form of loans, credit card balances, etc., compared to total household income. Most lenders look for a ratio that's below 38%, and preferably in the 25-35% range. The lower a potential borrower's ratio, the more favorably a lender tends to view them. That often translates into better loan terms, including a lower interest rate.

Increase your credit score. Lenders look closely at a person's credit score when weighing whether to loan them money to purchase a home. Generally speaking, the higher the credit score, the more favorable the loan terms. A score of 750 or higher is "ideal" for potential borrowers, according to certified financial planner Leon C. LaBrecque, managing partner at LJPR, a wealth management firm in Troy, MI. One way to boost credit score is by lowering the ratio of debt-to-credit limit on credit cards, says LaBrecque. Essentially that entails paying down the balance on credit cards while at the same time preserving the credit limits on those cards. "Don't close credit card accounts, because that can impact your credit score negatively," he advises. "Instead keep the accounts open, just don't use them as much." He suggests targeting a debt-to-credit limit ratio of 10% or less.

To find the best mortgage deal:

As the old song goes, "You better **shop around**," because subtle and seemingly insignificant differences in the fees and costs associated with a mortgage (from the actual interest rate to closing costs and other fees) can translate into hundreds and sometimes thousands of dollars in savings, at the time of purchase and over the life of the loan. "I suggest looking on the Internet first, then talking with at least two other lenders," says LaBrecque. "Be sure to get the full [annual percentage rate] from them, so you're comparing apples to apples."

To give yourself an edge in landing the home of your dreams:

Consider getting pre-approved for a mortgage. In situations where multiple buyers may be vying for a property, those who are pre-approved by a lender for a mortgage of a specified amount often have an edge over buyers who are not pre-approved. Pre-approval means a lender has agreed to provide a buyer with a mortgage for up to a specific amount. A seller who knows you're pre-approved may be more inclined to accept your offer.

To be a shrewd borrower:

Find a way to dodge private mortgage insurance. Borrowers who are unable to come up with a certain amount for a downpayment — the threshold for most lenders is 20% of the home's cost — usually are obligated to purchase private mortgage insurance, or PMI. PMI can be pricey, costing 0.5% to 1% of the loan amount each year, or up to $1,000 for every $100,000 borrowed. So "if you're anywhere close" to being able to make a downpayment of at least 20%, LaBrecque suggests findings the means to do so, such as by borrowing money from a family member.

"Be careful of overspending on a home," cautions Russ Weiss, a certified financial planner with the Marshall Financial Group in Doylestown, Pa. "I like to keep the mortgage/taxes/insurance at about 20-25% of gross monthly income. Mortgage brokers will allow you to borrow up to 45% of income, but that [amount of debt] can make someone house-poor."

If flexibility is a priority, start with a 30-year mortgage. While the prospect of paying off a mortgage in 10 or 15 years can be attractive, a shorter mortgage term usually means significantly higher payments than those associated with a 30-year mortgage. Those higher payments can be difficult to make if circumstances change unexpectedly (such as with the loss of a job), says LaBrecque. In many cases, the preferred route for people who want to aggressively pay down a loan is to pay more than the required amount on a 30-year mortgage, because once committed to a 10- or 15-year mortgage, they can't choose to convert that to a 30-year term.

If cost-efficiency is a priority, don't foreclose on a shorter-term mortgage. A shorter, 15-year mortgage can have its merits. To determine if one can work for you, do an apples-to-apples comparison of costs, taking into account the larger mortgage interest deduction you'll likely be able to claims with a 15-year mortgage (as compared to 30-year mortgage on the same amount borrowed). Determine what the net cost would be to you and then amortize it to see how much more per day you'd pay with each. For several dollars a day, it may make sense to take the shorter mortgage.

Favor a fixed-rate loan over a variable-rate loan in order to lock in a low interest rate. Many observers expect interest rates to increase in the not-too-distant future. If they do, people with variable-rate loans will be required to pay higher rates.

Once you've purchased a home:

Take advantage of tax breaks. Talk to an accountant or financial professional about tax benefits such as the tax deductibility of mortgage interest (for homeowners who itemize deductions on their tax returns) and tax credits for purchases of energy-efficient appliances and the like.

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