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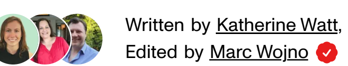
Mortgages, Credit Scores and Down Payments: 6 Things to Know Before Buying a Home

Eager to become a homeowner but don't know where to begin? We'll tell you how to get started.

OUR EXPERTS



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how to buy a home

With so much economic uncertainty, it's understandable if you're hesitant about moving or making your first home purchase. After all, it's a big commitment. But, knowing some key pieces of information about your own finances, as well as the homebuying process, can make all the difference.

Despite concerns about the economy, 85% of first-time homebuyers believe homeownership is an important long-term investment, according to a recent survey from TD Bank. And nearly half of those surveyed said that they had already begun preparing by saving for a down payment or

establishing a housing budget.

Before you begin to look for your dream home, you'll want to make sure you can make it a reality. Aside from determining what you can afford, doing such things as boosting your credit score, saving for a down payment and getting preapproved for a mortgage will help put you in the best position to buy.

Here are some tips to help get you into the right home.

1. Boost your credit score

If you plan to take out a mortgage (that's most people), your credit score is the most important factor in whether you'll be approved and what interest rate you're qualified for. Lenders look at your credit score and history to see if you (and, if applicable, a co-borrower) are a responsible credit borrower. The higher your credit score, the more likely you are to score a home loan at the lowest rate available to you.

The minimum credit score required for conventional mortgages backed by Fannie Mae or Freddie Mac is 620. However, individual lenders may set their own higher standards. To get the lowest interest rate, you'll want to improve your credit score to at least 740.

It's possible to get approved for a mortgage with a low credit score, but you'll likely end up with a higher interest rate. Even a small difference in your interest rate could save -- or cost -- you thousands of dollars over the life of your loan.

You can boost your credit score by:

- **Making timely payments:** On-time payment history is the biggest factor in calculating your credit score. If your payment history is a little spotty, start making on-time payments right away. Sign up for autopay whenever you can to make sure your payments are never late.
- **Lowering your credit usage:** Your credit utilization -- the ratio of your credit card usage to available credit -- is how much you owe each month. If you're carrying a balance month-to-month on your credit cards, lenders might think you don't have enough cash on hand to make mortgage payments. Lower your credit usage by paying off your credit cards in full at the end of the billing cycle. If your credit score is pretty good, ask your credit card issuer for a balance increase. This will also lower your credit utilization.
- **Removing bad marks:** Check your credit score for free at AnnualCreditReport.com. You can pull your credit report from all three major credit bureaus: Experian, Equifax and TransUnion. From there, you'll be able to see if there are any errors. If you have any mistakes, contact the bureau to report it. Also, contact the creditor that reported the error to see if you need to do anything to fix it.

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Read more: Everything You Need to Know About Credit Scores

2. Start saving for your home early

The purchase price is just one piece of the puzzle. When you buy a home, you'll need cash on hand to cover upfront closing costs and, in some cases, a down payment. This could end up costing tens of thousands of dollars. While saving for these costs might delay your home-

buying timeline, it makes a big difference in what you can afford.

A 20% down payment is the standard recommendation, but it's not required. It's possible to buy a home with a smaller down payment -- some conventional loans require as little as 3% for a down payment -- and in some cases you can avoid a down payment altogether. You can qualify for a mortgage -- either FHA or conventional -- without a down payment, but you'll need to pay private mortgage insurance, or PMI, on top of your monthly payments. PMI payments don't go toward your principal or interest balances; they go toward your mortgage lender as a layer of protection in case you can't pay back your loan. With a 20% down payment, you're likely to avoid PMI payments and score a lower interest rate (without paying for points).

Closing costs include all fees associated with processing the mortgage and tend to average 3% to 6% of the purchase price.

Where you keep your savings depends on when you plan to buy your home. If it's within the next year or so, you may want to stick with a high-yield savings account. The returns aren't as high as they would be if you invested in the stock market, but you won't risk losing any money. Plus, the best HYSA's offer much more competitive interest rates than you can get with a standard checking or savings account.

If you have a bit more time until you plan to buy, you can consider opportunities that come with a higher return, but give you less flexibility, such as certificates of deposit, or CDs, and bonds. Both options are low-risk -- you won't end up with less money than you put in -- but will sometimes give you a better return than a savings account.

3. Consider what new mortgage fees mean for homebuyers

Those looking for a mortgage will have to take into account new changes to the upfront fees on loans backed by Fannie Mae and Freddie Mac as it could mean the difference between hundreds and thousands of dollars. These fees are based on several factors, namely a buyer's credit score and down payment. On May 1, these fees, also known as loan-level price adjustments, or LLPA, are adjusted based on a new framework, according to the Federal Housing Finance Agency.

The new mortgage fee structure is meant to help homebuyers with credit scores under 700, by reducing their closing costs. Prior to the change, a homebuyer with a credit score between 640 and 659, and a 5% down payment, had to incur an LLPA of 2.75%. Now, that same purchase will incur an LLPA of 1.5%.

A borrower with a credit score of 680, and a 5% down payment, will see their fees drop -- from 2.75% to 1.625%.

In many cases, borrowers will save money on fees, with the exception of those with high credit scores and large down payments. A buyer with a credit score above 740 and a down payment in the 10% to 20% range, for example, could see a jump in fees from 0.125% to as much as 0.625%.

Overall, those with high credit scores will still pay less in fees than those with low scores. But buyers with low credit scores will face less of a penalty than they did previously.

You can see tables outlining the fee framework for Fannie Mae and Freddie Mac.

Buyers should consider negotiating with sellers on price to factor in the fees or see if there are other loan options available from their lender.

4. Get preapproved for a mortgage

Before you start browsing dream homes, find out how much home you can afford by getting preapproved for a mortgage. A preapproval is when a potential lender checks your background to make sure you qualify for a loan. Even though a preapproval doesn't guarantee you'll qualify for financing, it shows sellers that you're serious about buying a home and putting in an offer.

To get a preapproval, you can apply through your bank, a broker or an online lender. Most preapproval letters are valid for 60 to 90 days, and when it comes to apply for a mortgage, all of your information will need to be reverified.

Because preapprovals are loan applications that trigger a hard credit pull, first check to see if you prequalify. To prequalify, you need to answer a few questions based on your credit history and income to determine if you qualify for a loan. While a prequalification is based on your answers, a preapproval is based on what's available through credit bureaus, your bank accounts and other financial information. A prequalification carries less weight than a preapproval, but it's still worth doing.

5. Compare mortgage lenders

Once you have an idea of the type of mortgage you want, take the time to shop around and compare offers from different lenders. It's important not to rush this part of the process, because it will ensure you get the best rate and most amenable loan terms for your financial situation.

Lenders often publish their rates for different mortgage types online, which can help your research. However, the rate a lender advertises may not be the rate you qualify for. Your exact interest rate will depend on a variety of factors, including your credit score, debt-to-income ratio, down payment and the property itself.

When you submit a mortgage application, the lender is required to give you what is known as a loan estimate within three business days. Every loan estimate contains the same information, so it's easy to compare not only interest rates, but also the upfront fees you'll need to pay. Once you have several loan estimates in hand, you can compare and even use the different offers to negotiate with lenders for better rates.

6. Set your housing budget

When a bank or a broker preapproves your loan, they'll provide a preapproved loan amount. But even though you're preapproved for that amount, it's not necessarily the right amount to spend on a home. If buying a home means taking every penny of your disposable income, you may be caught short in an emergency. Consider how much room you have in your budget to make monthly payments on your home.

To get a good idea of what your monthly mortgage payment will look like, you can use CNET's mortgage calculator to estimate your monthly payments. But keep in mind that how much you feel you can comfortably fit into your budget may be more or less than what a bank is willing to lend to you.

Determining your ideal monthly payment will help shape your target price for a home. Your monthly payment is determined by your principal payment, interest rate, taxes, home insurance and whether or not you'll have to pay PMI.

To do this, review your budget and include what a potential new home payment looks like. Don't forget to factor in your property taxes, utilities and any maintenance costs associated with your new home (such as pool upkeep, for example).

Browse homes (finally!)

Looking at homes should be one of the last things you'll do in the homebuying process. After all, it doesn't make sense to do it any sooner without having an idea of how much you can afford as well as a preapproval letter. Looking at homes earlier in the homebuying process will only set you up for major disappointments as you'll have your heart set on homes that you may not qualify for.

Navigating the housing market isn't easy. There are ever-changing rules, which means having a qualified expert around can help make a complicated process much more manageable. Real estate agents are helpful in walking you through the homebuying process and to help you find the right people to tackle your needs. For example, an agent can identify neighborhoods with the best schools and negotiate costs with the sellers when it comes time to make your offer. They can also explain contract information when paperwork gets confusing, like seller disclosures and how much money to put in escrow.

Whether you attend open houses or you make appointments to view homes on your own, see as many as you can. Buying a home will likely be the most expensive purchase you ever make. Don't settle for anything less than what's best for you.

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