HOME OWNERSHIP *IS POSSIBLE*

Understanding Your FHA Loan Options

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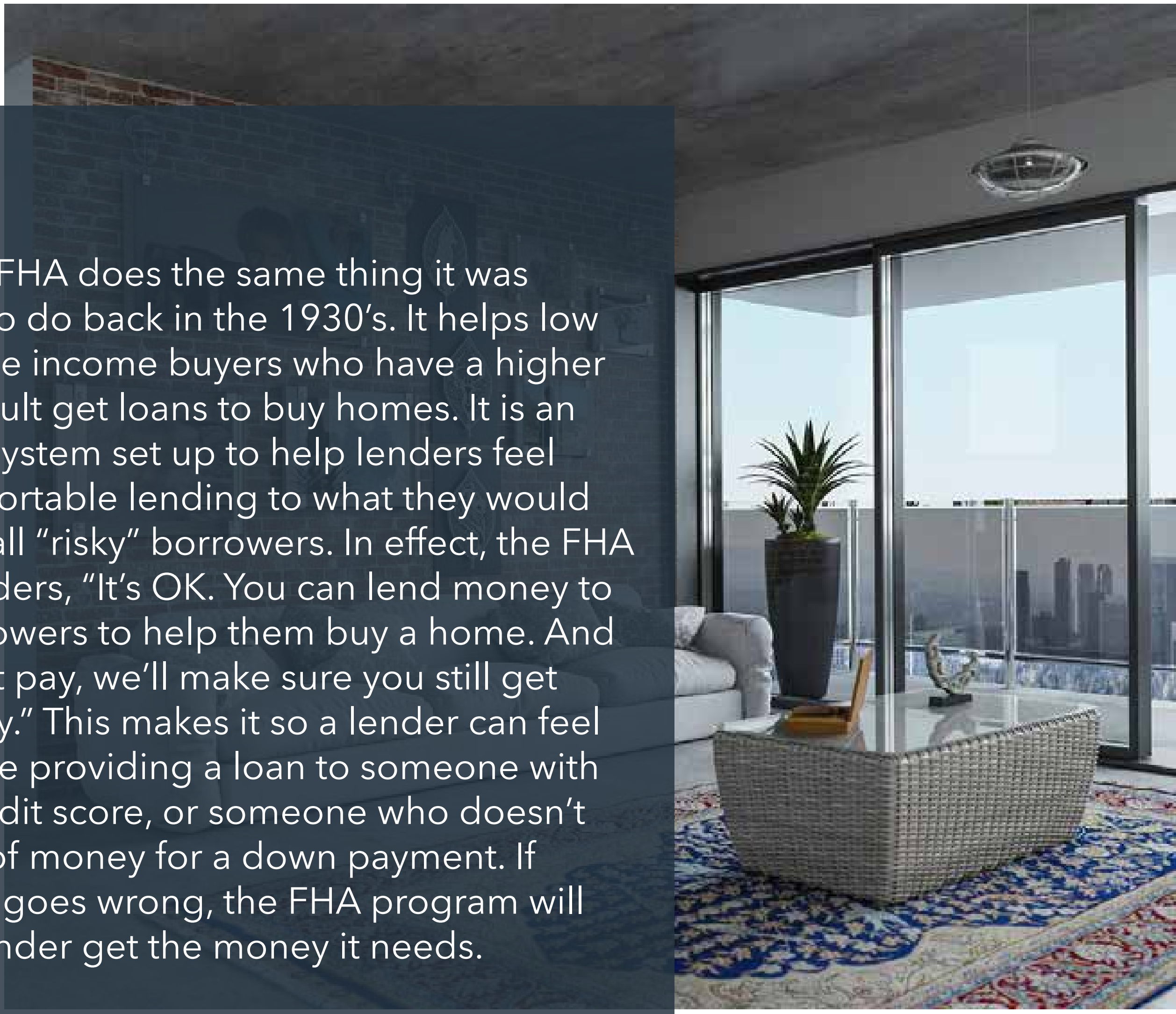
Introduction

What is the FHA and How Does It Impact My Lending Options?

The Federal Housing Administration, or FHA, was set up by the National Housing Act of 1934. It was a solution to a problem, a national crisis known as the Great Depression. The country was in a state of economic upheaval, and a lot of good people had their lives upended as their finances were crushed. However, these same people needed places to live. Furthermore, in addition to providing a place for families to live and grow, home ownership helps boost the economy. The FHA was set up as a program designed to get Americans in homes while simultaneously providing a much-needed jolt to the U.S. economy.



Today, the FHA does the same thing it was designed to do back in the 1930's. It helps low to moderate income buyers who have a higher risk of default get loans to buy homes. It is an insurance system set up to help lenders feel more comfortable lending to what they would normally call "risky" borrowers. In effect, the FHA says to lenders, "It's OK. You can lend money to these borrowers to help them buy a home. And if they can't pay, we'll make sure you still get your money." This makes it so a lender can feel comfortable providing a loan to someone with a lower credit score, or someone who doesn't have a lot of money for a down payment. If something goes wrong, the FHA program will help the lender get the money it needs.

The great news for us today is even though the Great Depression is long gone, the FHA is still here to help borrowers who wouldn't usually qualify to get into a beautiful home. Just like it did for people in the 1930's, it gives you some exciting options that would otherwise be impossible. In this eBook, you will learn about how the FHA works, and how this program can help get you the keys to your dream home.

Chapter 1

FHA Loans vs. Conventional Loans

To fully understand how an FHA loan can work for you, it will be helpful to understand why they are necessary—as well as how they differ from conventional loans. Banks and other lenders are just like every other business: they want to make money. When people pay interest on loans, lenders make a profit. When people default, the lender loses. This results in a ripple effect that impacts the lender's income, shareholders, and overall business. So, it is understandable that a lender wants to be as sure as possible that it is getting the money it lent out—and with that all-important interest.

One way a lender ensures they are lending money to someone who will repay it is by checking the potential borrower's credit score. Your credit score is a number derived from a complex formula. This number is supposed to represent how likely you are to repay a loan. If the number is low, it sends a message to the lender that the borrower may end up defaulting, leaving the lender empty-handed. Granted, we all know whether or not we can pay back our loans, but lenders felt they needed a more tangible representation of the risk they were undertaking. When a lender sees a higher credit score, it is more likely to give the borrower money because it feels the money will be repaid.

Another tool lenders have to mitigate the risk they undertake when lending money for a home is the down payment. The money you put down on a home is viewed by the lender as "skin in the game," so to speak. It is also nonrefundable. This means if the borrower defaults and the lender is able to foreclose and then sell the home for its assessed value, it still makes a profit: the amount of the down payment. That's why lenders like to see a hefty down payment.

How Conventional Loans Work

A conventional loan, while good for many buyers, is really designed to benefit people with more money to spend up front as well as those who have higher credit scores. Here is a basic breakdown of the elements of a conventional loan.

Credit Score Requirements

With a conventional loan, the credit score generally has to be 620 or higher. To the lender, this means less risk. For this reason, a lender that does not offer FHA loans will often deny an applicant with a score lower than 620.

The Interest Rate Can Be Fixed or Adjustable

A conventional loan can also have either a fixed interest rate or an adjustable one. A fixed interest rate means the rate stays the same for the life of the loan. For instance, if your rate at closing is 5.00%, it will stay at 5.00% until you pay off the loan. An adjustable rate can change during the life of the loan. During the recent financial crisis, some people ran into problems because of adjustable rates. After a while, the rate went up, causing the borrower's monthly payment to jump up as well. Many people defaulted because of this. However, some borrowers and lenders find ways to benefit from adjustable rate loans. These people lean more towards conventional loans in order to take advantage of that option.

They Can Be Used to Purchase Commercial or Investment Property

Another aspect of conventional loans is they can be for either a residential or commercial property. A commercial property is one that is designated as a place of business, and it is typically zoned accordingly. People who want to borrow money and plan on using it at least in part for a business will gravitate more towards conventional loans, particularly if the property has more than 49% of its floor space designated for a business. A conventional loan also allows you to purchase investment property—property you don't have to live in. This is not the case with an FHA loan, as will be discussed below.

Down Payment Requirements

The down payment of a conventional loan tends to range from 5% to 20%. Depending on the amount borrowed, this can be prohibitively high for a borrower to pay. However, a high down payment means a lower monthly mortgage, which is attractive to those looking for a conventional loan.

Private Mortgage Insurance (PMI)

However, if the down payment on a conventional loan is too low, private mortgage insurance (PMI) might be required. This is due to the fact that PMI is needed for loans with under 80% loan to value (LTV). For instance, if the home is valued at $400,000, and the borrower puts down 10%, (or $40,000) 90% of the home's value (or $360,000) is being borrowed. This LTV level triggers PMI because too much is being borrowed, so the bank needs to feel more secure as they lend the money. If the amount borrowed had been only $320,000 (80% of $400,000), there would be no need for PMI.

How FHA Loans Are Different

As you can see from the characteristics of a conventional loan, there are elements of it that could present obstacles to many potential borrowers. The FHA loan program is designed to remove those obstacles to make home ownership easier for a wider variety of people.

Credit Score Requirements

An FHA loan only requires a credit score of 500 or higher. This removes a major hurdle for many borrowers. Some people have enough money to put down and to make monthly payments, but their credit is below 620. With the FHA option, much of the credit barrier, regardless of your financial situation, is removed.

Fixed Interest Rates

With an FHA loan, the interest rate will be fixed, meaning it will stay the same for the life of the loan. This is a plus for borrowers who want to know what they will be spending for many years to come. Further, because of inflation, the amount of the mortgage will be significantly "less" as the value of the dollar goes down. In other words, $1000 today will be worth more than $1000 20 years from now. Because all FHA loans have a fixed rate, you will always experience this benefit if you choose to go the FHA route.

You Must Live in Your FHA-Acquired Home

At least for a year, that is. If you use an FHA loan to buy your home, it must be your primary residence for at least 12 months before you can rent it out. After that, you are free to do whatever you like with it.
Also, no more than 49% of the floor space can be used as a place of business. For most borrowers, these requirements are not a problem. However, it is possible for those who need a place of business to be still able to acquire one due to the money they save on the down payment for an FHA loan, which is the next benefit.

The Down Payment Can Be as Low as 3.5%

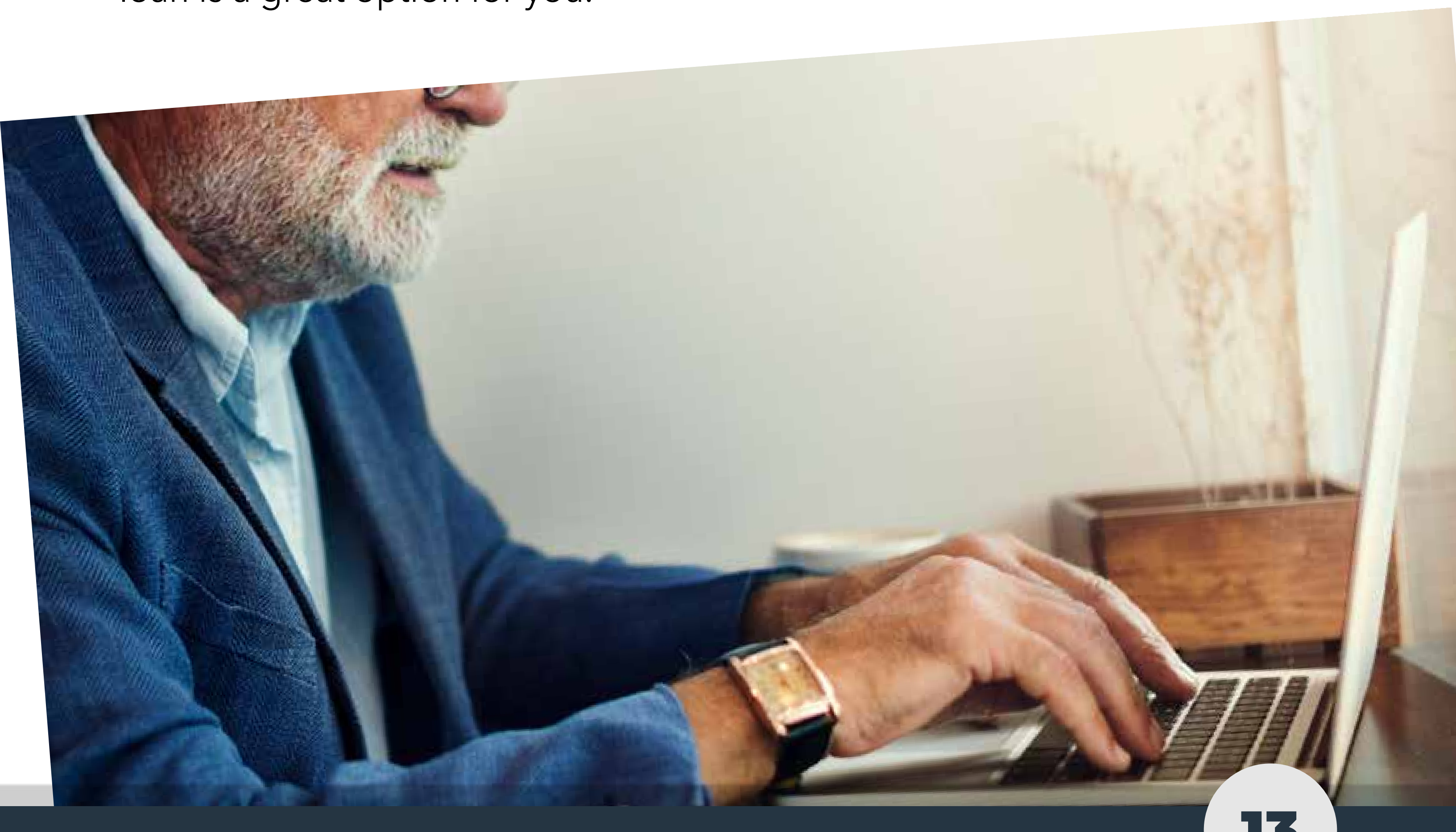
This is one of the strongest selling points for an FHA loan. If your credit score is above 580, your down payment can be a very comfortable 3.5%. If your score is between 500 and 579, the down payment requirement is 10%. This means, with the 3.5% option, if you are buying a home for $400,000, your down payment could be as low as $14,000. This opens the door for many buyers to grab a beautiful home using an FHA loan.

You Have to Purchase Insurance with an FHA Loan

In order to secure an FHA loan, you have to pay 1.75% of the value of the loan in insurance. This money is what helps fund the FHA program. If a buyer defaults, it is this money that is used to help the lender not suffer a huge loss. The good news is this amount can be included in the loan, so it doesn't increase your upfront costs. You could also choose to pay it up front if you would like.

The FHA Difference

By now, you are likely beginning to see the advantages of getting an FHA loan. The program makes home ownership a viable option for a great number of prospective home buyers. If you have a credit score between 500 and 619 and you would like to have a lower down payment, an FHA loan is a great option for you.



Chapter 2

Do I Qualify?

When it comes to getting credit, the word “qualify” almost seems like a misnomer. In every other area of life, we have the chance to qualify based on our merit, abilities, strengths, and potential. What makes qualifying for credit difficult is the seemingly arbitrary nature of how we as applicants are quantified: the credit score. But with an FHA loan, there’s good news.
If your credit score is 500 or above, you qualify for an FHA loan. In this chapter, we’re going to take a look at how your credit score will impact your interest rate and down payment options.

The Basic Credit Requirements

A score of 500 or slightly above can be the result of any number of things, but here's the point: if you're over the 500-point threshold, you can get the loan you want. However, that's not the end of the story. Your credit score will still affect your interest rate and down payment. First, let's examine the impact on your interest rate.

As we discussed earlier, lenders are in the business of making money off the interest they charge you. If they see you as a higher risk, they feel they have also to increase their potential reward. Here's a brief explanation of how this works.

Let's say a lender, we'll call it America Bank, agrees to give you a 30-year loan for a home that costs $400,000. Because your credit score is 536, they require you to pay 10% down, so the amount you end up financing is $320,000. Let's have a look at how America Bank can use the interest rate to their benefit.

If you get an interest rate of 6%, your monthly payment for interest and principle alone would be $1,918.56, PMI, real estate taxes, and insurance not included. However, if they choose to give you a rate higher than 6%, they make much more money. If the rate is 7%, your monthly payment is $2,128.97, or $210.41 more per month. Over the life of the loan, that means America Bank makes an extra $75,747.60. If the rate is raised like this for several people, the money adds up quickly. In the end, however, if the extra monthly amount is affordable for the borrower, everyone is happy.

Logically, the lower the credit score, the higher the interest rate. For instance, if our imaginary rate went as high as 8%, the monthly interest and premium payment would be a full $429.49 higher. That gives the lender an extra $154,616.40 over the life of the loan. This increased amount is the upside for the bank. It can be used to convince shareholders and investors that the bank is making good lending decisions.

And as long as the borrower can afford the extra amount per month, it's a win-win all around.

Even though you can qualify for an FHA loan, if your credit score is closer to the 500 range, your interest rate will go up. Exactly how much depends on the lender. However, don't let this deter you. Often, higher rates are still affordable. You never know until you do the numbers, and the important thing is you qualify; you're in the game.

Other Credit Requirements to Consider

The down payment and credit score are just two of the requirements for an FHA loan here is a complete list of all of there if requirements:

- Borrowers are required to have a consistent employment history or worked for the same employer for a minimum of two years
- Borrowers are required to have a valid Social Security number. They must have lawful residency in the United States and also be of the legal age to sign a mortgage in the state in which they reside.
- A minimum down payment of 3.5% must be paid. If the down payment money was received as a gift from a relative, that is OK.
- New FHA loans can only be applied for if the house you are buying is your primary residence.

- Borrowers are required to have a property appraisal. This appraisal must be done by an appraiser with FHA approval.

- The total amount of the Mortgage payment, HOA fees, property taxes, mortgage insurance, and homeowners insurance should equal less than 31% of borrower's gross income. There are instances where you may be approved with a percentage as high as 40%. In that case, your lender will have to provide the reason why the mortgage is worth the added risk.

- The total amount of the mortgage and all other debt (credit card payment, student loan, etc.) typically needs to be lower than 43% of the borrower's gross income. There is a chance to get approval with a percentage as high as 50%. In this case, your lender will have to provide the reason why the mortgage is worth the added risk.

- Borrowers are required to have a minimum credit score of 580 to receive maximum financing with a down payment minimum of 3.5%.

- Borrowers are required to have a minimum credit score range of between 500 and 579 for the maximum loan to value of 90% with a minimum down payment of 10%.

- Usually, Borrowers should have two years out of bankruptcy and have a record of re-established good credit. Consideration could be given to those who are out of bankruptcy for 1 year if there were circumstances beyond their control that caused the bankruptcy and have since managed your money responsibly.

- Typically, borrowers are required to be out of foreclosure and re-established good credit for 3 years. Consideration can be given to those with extenuating circumstances but have since improved their credit. If you had to move to a new area and suffers foreclosure because you could not sell your home, this does not count as an exception to the 3-year foreclosure rule.

- The property is required to meet minimum standards at the time of appraisal. If the property does not meet these standards and the seller does not agree to make the required repairs the only option is to pay for the required repairs up front at closing and the money is to be held in escrow until the repairs are complete.

How Much of a Down Payment Do You Need?

As the lender tries its best to mitigate its risks, the down payment becomes another tool. Because the down payment is money that goes directly to the lender at closing, this is cash in their pocket. It cannot be "defaulted on," and is, therefore, an instant asset. The acquisition of a cold, hard asset sweetens the deal for the lender, and the bigger the asset, the sweeter the deal. That's why lenders are willing to lend to people with lower credit scores if they can require a larger down payment. For an FHA loan, this means one of two down payment options for you.

If your score is above 580, your down payment will be as low as 3.5% of the value of the purchase. Let's examine what that means.

Using our earlier example, if America Bank lends you money for a home that costs $400,000, your down payment amount will be calculated based on that amount. If your score is 587, you will be able to put down just 3.5% of that $400,000, or $14,000. This would result in a total amount being financed of $386,000 ($400,000 - $14,000).

On the other hand, if your score is between 500 and 579, you can still get a loan, but you will have to pay 10% down. In our example, this means you will be coming out of pocket to the tune of $40,000. (While this may seem like a steep amount, it is far lower than what is paid for some conventional loans, which can be twice this amount.) Therefore, the total amount you finance would be $320,000 ($400,000 - $40,000).

Even though an FHA loan's lower down payment requirements are very attractive, it may make more financial sense for you to pay a higher down payment. Here's why: It lowers your monthly payments and increases the amount of equity you have in your home. Equity is how much your home is worth after taking into consideration how much you owe on it. Mathematically speaking, it's the amount you owe subtracted from the value of the home. For example, if you have a home worth $400,000, and you owe $350,000 on it, you have $50,000 of equity. In America Bank example, choosing to make a higher down payment can have a relatively significant effect on your monthly payment as well as your equity. If you have a credit score of 587, but choose to pay 10% down instead of 3.5%, the equity you have in your home goes from $14,000 to $40,000, and the monthly payment drops from $2,314.27 to $2,158.38. Over the 30-year life of the loan, you would save $56,120.40. This is why, for some people, a lower monthly payment is worth the upfront costs of a higher down payment.

What if Your Credit Score Is Lower Than 500?

This is all well and good as long as your credit score is above 500. However, if it's less than 500, you may have to do a little bit of work. The credit reporting bureaus and the processes they have put in place are not perfect. Sometimes they make mistakes. There's a chance this has happened in your case, and something needs to be removed from your report. You can dispute your report and try to get negative things removed from it. That could make your score go up high enough.

There are also some myths that once debunked, can help you improve your credit score. Educating yourself about how the credit system works can help you get your score up above 500 and get you into the home you want.

Chapter 3

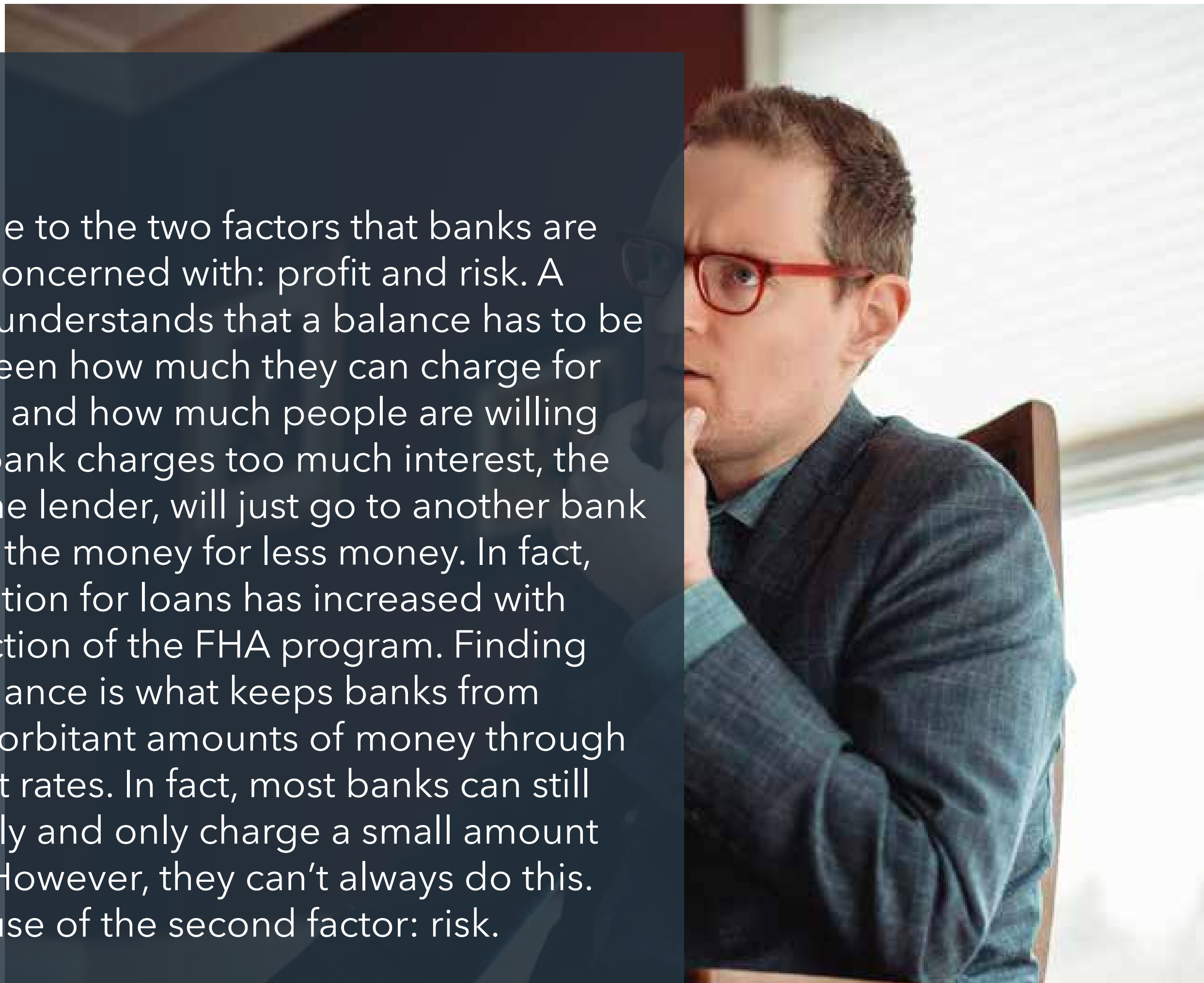
How Do FHA Loans Work?

A ground-level understanding of how FHA loans work requires some background knowledge about the lending system. The basics of getting a loan have not changed for many, many years. We are going to look at some of the basic components of borrowing and then apply that to the principles behind FHA loans.

The Interest Rate Factor: The Profit and Risk for the Bank

The lending process essentially turns money into a commodity. A commodity is something that can be purchased. For instance, bread is a commodity, and the price of bread is based on the price of several other commodities including the wheat it takes to make the bread, the sugar inside it, and even the fuel it took to transport all of these things, including the bread, which had to go to the store where you bought it. Typically, we use the money to purchase commodities, but to understand the lending process, we have to see money as a commodity in and of itself.

The lender, which is usually a bank, possesses the commodity of money. This is true of both FHA and traditional mortgages. However, the borrower wants to possess the commodity and therefore has to pay for it—just like with a loaf of bread. With bread, there's a price tag displayed on or near the loaf. That price can change from day to day or week to week. The price the borrower pays to get money is, in reality, no different, and it's called interest. The price of money, or the interest rate, can also change. This is primarily because the amount of interest is based on the base interest rate of the country. The base interest rate is set by the Federal Reserve Bank. This is just a normal bank run by normal people. Even though it has the word "federal" in its name, the government doesn't run this bank. (With the FHA, the federal government does run the program, providing insurance for lenders.) However, the government borrows from this bank, as do other banks—the same banks that lend regular people money. In order for these banks to make a profit off the commodity of the money they are lending, they have to charge a rate that's higher than the base interest rate. This is because the base interest rate is how much they had to pay to get the money from the Federal bank in the first place. So when the citizens of the country borrow money, they are paying an interest rate higher than the base interest rate.



This is all due to the two factors that banks are very much concerned with: profit and risk. A smart bank understands that a balance has to be struck between how much they can charge for their money and how much people are willing to pay. If a bank charges too much interest, the customer, the lender, will just go to another bank and borrow the money for less money. In fact, the competition for loans has increased with the introduction of the FHA program. Finding the right balance is what keeps banks from charging exorbitant amounts of money through high interest rates. In fact, most banks can still run profitably and only charge a small amount of interest. However, they can't always do this. Why? Because of the second factor: risk.

How Risk Affects Interest Rates

An FHA loan is all about reducing the risk for the lender. Let's illustrate how risk factors into the lending decision. Let's say you have two friends that need money. They both need $100, and they come to you with their hands open. They tell you they are getting paid the following week and will have the money for you then. Because you know they can pay you back, you say you will let them borrow the money. Further, not only do they promise to pay you back, they tell you they will give you back even more than the $100 you are going to lend them. You have to decide how much extra to charge each friend.

One friend has borrowed money from your brother, your sister and your cousin, and he never pays them back on time. In fact, he still owes them some money from the last time he borrowed from them. The other friend has also borrowed money from your brother, sister and cousin, but he always paid them back on time, and he is debt-free right now. When it comes to repaying people, the first friend has a bad reputation, and the second friend has a good reputation. As you decide how much to charge each friend to borrow $100 from you, which one are you going to charge more? Likely, you would charge the first friend, the one with the bad reputation, a bit more than the second friend. This is because you are taking on more risk when it comes to the first friend. And as an investor you live by the following principle: the greater the risk, the greater the reward.

A bank is just like you. It wants to get paid for the amount of risk it is assuming. This results in higher interest rates when the bank feels somebody has a higher than average possibility of defaulting on their loan. It may not seem fair to judge what someone will do in the future based on how they acted in the past, but when it comes to financing, everything has to be quantified and given a number, including risk.

How the Bank's Fear of Risk Affects You

If your credit score is less than 620, the bank is going to see you as "risky." It doesn't want to assume the unpredictability that comes with loaning to someone with an uneven credit history. Even if you make a lot of money, the bank will not bend. Further, even if you make more money now than when you made the mistakes that resulted in bad credit, the bank will still not bend. This is why the FHA program was created.

Why the FHA Exists: It's All About Risk

A bank is going to make money because people are always going to want to buy something they cannot afford at the moment. There is no chance the commodity of money is going to lose its value anytime in the near future. So the amount of the interest rate has little to do with profit because the profit will always be there. The issue is risk. If a thousand people borrow from a bank, and they are all paying a relatively low interest rate, the bank is still going to be OK as long as they pay the money back. However, if some of those people are seen as those who could potentially not pay the money, back, the bank, which still wants to make a profit off these people, has to charge more money when it lends them money. The problem arises when the economy weakens and many more people have financial situations that make them look risky. The bank could simply decide not to lend them money, but that results in two problems: 1. The bank won't be making money and 2. People won't have houses to live in.

When the FHA was created, the mission was to lessen the risk that was stopping the banks from lending money to potential homeowners. Because the banks had every right as private entities to cross their arms and say, "No, we'd rather lose potential money than lend to these people," the government decided to do something that would gently uncross their arms and make them feel more comfortable opening their vaults to help people buy and build homes.

The government formed the FHA, which said, in effect, "Listen, go ahead and lend money to these folks, and if they don't pay you back, this program will pay you back for them." The government found a way to eliminate the risk.

How the FHA System Avoids Going Broke

A logical question now arises: Wouldn't the FHA system just go broke because it has to pay every time someone defaults on a loan? The answer: No, because the FHA, which is an insurance system, has its own insurance. Every time someone borrows using an FHA loan, they pay either the upfront 1.75% or another amount based on the annual FHA MIP. This ensures the FHA will not go broke. But how does that work? It's only 1.75% (or less with MIP). To understand how the system stays alive, let's look at some very important numbers. Because it is predictable and steady, we will use the upfront MIP of 1.75% in our example.

The average default rate for a mortgage is about 0.72%. That means there is a less than 1% chance of someone defaulting when they borrow money to buy or build a home. In other words, only one out of 139 people default on their mortgage. If that one person defaults, that means 138 did not. Keep in mind each borrower is paying 1.75% of the price of the home. If we only focus on the percentage numbers, the bank will still come out smelling like roses if that one person out of 139 defaults. Here's why: 138 x 1.75 = 241.5% So the bank, given the current default rate, still makes a 241.5% profit that more than covers the loss. Now let's put some numbers to it.

If the home costs $400,000, each person has to pay 1.75% of that, or $7,000, in FHA mortgage insurance. $7000 x 138 = $966,000. This is how much the bank makes. Even though the bank lost $400,000 in the process, there is a clear profit of $966,000 - $400,000 = $566,000. But it gets even better for the bank when you take into consideration the down payment.

Each borrower had to put money down when they purchased the home. This money goes straight to the bank. If the average down payment was, say, 8%, that means the average person put down $32,000. $32,000 x 138 people = $4,416,000. If we add the money from the FHA mortgage insurance, $966,000, to that, we get $4,416,000 + $966,000 = $5,382,000. In other words, the bank, before a single monthly payment is made, makes $5,382,000 off of 138 people. Because the person who defaulted also had to pay the insurance and make a down payment, that number gets bumped up to $5,382,000 + $7,000 + $32,000 = $5,421,000. So when the bank loses the $368,000 left over after the down payment from the one person who defaulted, it still makes $5,053,000. And this is assuming all of the money was paid back before monthly payments were made. In reality, each monthly payment earns the bank even more money.

The Other Protection for Lenders: The Down Payment

While we have touched on how the down payment helps the banks, the reason behind the differences in the amounts of the down payments made will help further explain why this is a solid program for all parties involved. It all comes down to a numbers game. On average, a certain percentage of people are going to default, and that percentage was factored in when the decision to have people with credit scores between 500 and 579 pay the higher down payment of 10%. Again, it's all about risk. The jump from 3.5% to 10% is large enough to give the banks a nice cushion to protect their profits while still providing loans for a wider array of people. Once again, everyone is happy.

What Is Loan Insurance and How Does It Affect an FHA Loan?

Loan insurance, sometimes called mortgage insurance, is a requirement for an FHA loan. An FHA loan does not have the strict requirements of a conventional loan. Therefore, it has 2 different kinds of mortgage insurance premiums that you can choose from. The first one is paid in full upfront or it can be financed throughout the life of the mortgage. The second one is a monthly payment. This mortgage insurance is required in order for the buyer to secure the loan.

More About Mortgage Insurance and Its Costs

There are two types of mortgage insurance on an FHA loan: mortgage insurance premium and upfront mortgage insurance premium. These are in place in order to fund the FHA program. Without these insurance programs, there would be no money to support the program because the government is not using its revenue to fund the FHA. As you pay these mandatory amounts, you are helping not only yourself but others get FHA loans now and in the future. The first expense is one that all FHA borrowers have to pay, and it's called Upfront Mortgage Insurance Premium (UFMIP).

UFMIP is appropriately named because it is a one-time, upfront, monthly premium payment. That means the borrower will pay a premium of 1.75% of the home loan. This happens regardless of the borrower's credit score. For example, if a mortgage is valued at $400,000 x 1.75%= $7,000. This amount can be paid upfront at the closing or it can be rolled into the mortgage. If it is rolled into the mortgage, you are chipping away at it month by month, but you are also paying interest on it. But even though this will inflate your costs, if you don't have the money to pay at closing, it may make financial sense to roll it into the mortgage. However, there is another insurance premium that must be paid on top of the UFMIP, the MIP or Mortgage Insurance Premium.

Mortgage insurance premium (MIP) is an additional cost that is in conjunction with your mortgage payment. You have the choice to pay upfront mortgage insurance at the time of closing or you can roll it into your mortgage. If you choose an annual MIP, it is broken down into monthly payments and refigured each year based on your home's loan to value ratio. (LTV)

If you'd like to see how all factors of an FHA loan come together to produce your monthly payment, **check out this FHA loan calculator**. Here, you can see how the MIP changes based on the value of the home as well as how everything comes together to figure your payment.

Even though this insurance involves an extra cost, it gives the lender the financial leeway to give the borrower the money needed for a new home. Without these premiums in place, the FHA could not function because there would be nothing backing the program. They literally gives the lenders the freedom to help make your home dreams come true.

Who Are the Lenders That Provide FHA Loans?

The good news is this: it should be relatively easy for you to find a lender that offers FHA loans. Most banks these days and mortgage companies that offer home financing will generally offer FHA products as well. FHA home loans have become increasingly popular, so many lenders are trying to get in on the game.

There are certain requirements for a lender to be able to provide this type of financing. They must have approval by the Department of Housing and Urban Development (HUD). HUD manages the Federal housing administration's mortgage insurance program.

They also have an online database of approved lenders. More than half of first-time homebuyers use FHA loans. As a result of its popularity, many banks and lenders offer FHA loans to borrowers. There are a lot of options. If you have a banking relationship at a local bank, a car loan or even an existing mortgage, you can start there. Give them a call and speak to one of the loan officers, or you could even visit their website to see if they offer FHA financing.

How Your Credit Score Affects Your Down Payment

As previously mentioned, when your credit score is 580 or above, your down payment can be as low as 3.5%, and when your score is between 500 and 579, it can only be as low as 10%.

It may seem illogical to force people with lower scores to pay more to get a mortgage. However, this makes the overall picture safer for the bank because they get to take in more money up front. The cushion this provides helps them weather the occasional default. Otherwise, they would risk going under, and a system full of failing banks would cause not just potential homeowners, but businesses and public institutions do not have enough money to do things that have become necessary in a first world economy. Therefore, the FHA requires this so that while the people are benefitted, the bank is protected. This decision is not based on an affection for the banks, but rather respect and acknowledgment of how important banks are to the economy.

In the end, it is good for everyone involved because lenders make a profit and regular people get to purchase homes they love.

Chapter 4

Advantages of FHA Loans

We have discussed how loans benefit borrowers on a basic level and how the benefit lenders that provide the loans, but the benefits can be better understood by looking at the situation of a borrower a little more closely.

The Power of Home Ownership

Having a place to live and owning a home are two vastly different things. Anyone with a monthly income can have a place to live if they are willing to rent or lease a home. However, living this way comes at a cost. Every month, money is being spent that will never be seen again. With a mortgage, particularly in the early months and years, the vast majority of the money goes to the lender in the form of the principle. That money is also never seen again by the borrower. The difference is that at least some of that money is still going towards the principal balance of the loan. The borrower is chipping away at owning their home. Therefore, the home of someone who rents is a liability, but the home of someone with a mortgage can be an asset.

This is especially important if the individual wishes to sell the home in the future. With the passing of each month, as the principle is being diminished, the net value of the home is increasing by an equal amount. In a market where home prices are appreciating, there is more value added to the home as well. Given a standard market, all other things being equal, a homeowner gets a little bit richer every month, while a renter maintains his current level of wealth.

Lower Down Payment

An FHA loan is typically one of the simplest kinds of mortgage loans to qualify for. What's also great about it is that it requires a low down payment. On top of that, you can have a lower credit score than conventional loans require. A down payment of 3.5% is a requirement for maximum financing.

Even borrowers with a credit score as low as 500 can meet the requirements for an FHA loan. However, you will need to have a larger down payment if your score is between 500 and 579. Your down payment will have to be 10% of the price of the home.

Government Backing Means Lower Interest Rates

Because the government's FHA program supports the lender, the interest rate can be lower. This is thanks to the fact that the pressure to find a borrower who is going to pay the loan back is decreased. If the borrower defaults, the FHA mortgage insurance will offset the loss. This is good news for borrowers.

When the interest rate is lower, your pockets are fatter. Using the example of a home priced at $400,000, we can see the power the buyer gets at a lower rate. If you are buying a $400,000 home with a 3.5% down payment, you are financing $386,000. If your interest rate were 5.5%, your monthly payment would be $2,191.67. However, with an FHA loan, the government's support allows the lender to lend you your money at a lower rate. If, for example, the rate were 4%, your monthly payment would drop all the way down to $1,842.82. That's a savings of $348.85 every month. For many individuals and families, this amount of savings can make a huge difference in their monthly finances. This can help pay for a car note, monthly expenses around the house, or even schooling for a child.

What a 203k Loan Is and How it Affects You

The answer to this all depends on the cost of the repairs and your long-term goals regarding the home. You essentially have to ask yourself two questions: 1. Is the remodeling of the home going to increase its value enough to cover the cost? 2. If it is not going to increase the value enough, am I willing to accept that because I still get to be in a nicer home? The answers to these questions, particularly the second one, can get complicated.

We often make decisions based on what feels good, and we shouldn't feel bad about that. Part of being human involves satisfying our intricate emotional needs, and a home can be a huge part of that. If the home is a well-appointed, nicely finished product, it is going to make us feel good about ourselves. It's only natural to equate the beauty of your home with your own identity—at least in part. The ramifications of this can be complex, but there's an easy way to simplify them: Ask yourself how much you are willing to pay for the satisfaction of having the home of your dreams. It may help to consider the value of other things you may have already decided you can't live without. For instance, your vehicle may be of a higher grade than you need. It could be newer, graced with interior or exterior enhancements, or the engine or even the drive train could be modified. All of these things cost money, and likely none of them were "necessary." It can be the same when considering a 203K FHA loan. Even though you are spending more money, the product you get, a sense of peace of mind due to the beauty of your home, may be worth it.

Is it Worth it to Get a 203k Loan to Improve a Home?

The answer to this all depends on the cost of the repairs and your long-term goals regarding the home. You essentially have to ask yourself two questions: 1. Is the remodeling of the home going to increase its value enough to cover the cost? 2. If it is not going to increase the value enough, am I willing to accept that because I still get to be in a nicer home? The answers to these questions, particularly the second one, can get complicated.

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How to Use a 203k to Turn a Profit

That being said, you can still make a money-wise decision when it comes to using a 203k. The simplest way to leverage a 203k to thicken your bank account is to decide to sell the home after you have lived in it the obligatory 12 months. As long as you keep the sum of the repairs plus the cost of the home, including a year's worth of interest payments, under the price the home will sell for a year from now, you make a profit. Here's an example.

You find a home that recently suffered a fire. Much of the home was undamaged, but the roof had a gaping hole burned right through it. This type of disaster destroys the value of a home. This, however, can be good news for you, the buyer. The current value of the home won't be much more than the value of the land. This is also good because it makes your starting point lower when it comes to the amount you will be borrowing. The home is in a fairly desirable neighborhood, and before it suffered a fire, it was an attractive property. You go in with a contractor and take a look around. After a thorough check, he notices the damage has made the house a cosmetic disaster but hasn't affected the "bones" of the dwelling. In other words, it can be fixed. The roof needs replacing, as do the upstairs floors, and the electrical system needs to be redone, along with some of the downstairs flooring due to water damage from the fire hoses. All-in-all, he can do the repairs for $50,000. The number sounds big, but the 203k is on your side. The home, being uninhabitable, can be obtained at a bargain. You ask the realtor, "Would $200,000 be insultingly low for the owner?" and he says no. You haven't made an offer, yet; you're just talking. You then do your comps. Comps, or comparisons, involve looking at similar homes in the area to ascertain how much your home—or a home you're interested in is worth. They have to be done on homes that are roughly the same size and with the same number of bathrooms and bedrooms as the one in which you are interested. You do quite a few, and it looks like the home will be worth $400,000 when it's fixed like new. The math suddenly gets exciting: $200,000 + $50,000 = $250,000. While that's a lot for a burnt home, $400,000 - $250,000 = $150,000 profit. Not bad.

That’s just one way a 203k can help you. The key is to think outside the box, be creative, and also be honest with yourself. Take into account the needs and desires of family members because they will have to live through the remodeling process with you, and the impact on them may be greater than the one you feel. But, regardless, if the numbers work, either for emotional reasons or financial ones, a 203k can be an excellent tool to get the most out of your home.

What if You Have Trouble Repaying the Loan? Any Help?

No one is impervious to hard times. Unexpected things can pop up that catch even the most careful planner off guard. But with an FHA loan, you may have some unique options not available to borrowers that use traditional loans.

Help From the FHA Insurance Fund

You may qualify for assistance by means of a one-time payment from the FHA insurance fund. Yes, the fund doesn't only work for lenders, it can possibly work for a borrower, too. There are two conditions, however.

Condition 1: The Length of Delinquency

Your loan must be at least 90 days--and not more than one year–delinquent. When a loan is "delinquent," that means you are behind on your payments. So you have to have missed at least 90 days worth of payments and not more than a year's worth of payments.

Condition 2: Evidence You Can Make Payments Again

There needs to be evidence that you can begin making full payments again. A Promissory Note needs to be signed, and a lien will be put on your home until it is paid off. A lien, in this case, is a legal arrangement that makes it so you can't transfer ownership of the property to someone else until certain conditions are met. The conditions here are the repayment of the money you get from the FHA. This is also a one-time offer from the FHA, so you can't get help from the FHA if you end up in the same situation again.

Trouble Because of a Natural Disaster

Often, when a natural disaster hits, the destruction or an injury related to the disaster makes it so someone cannot work for a time. An FHA loan can help protect you from foreclosure if you can't afford to make the payments due to a natural disaster if the President labels your area as a natural disaster area. The important thing is to be in constant contact with your lender if you think you won't be able to make your mortgage payments. Keep in mind the loan was a business decision by your lender—a decision to sell you money as a commodity.

They do not want this relationship to end prematurely. If you maintain constant communication with them, they will likely be willing to help you out. Regardless, do everything you can to avoid foreclosure. But if a natural disaster strikes, you will be glad you have an FHA loan. The protections that are possible would likely not be in place had the loan been a traditional one.

Chapter 5

Getting Started

Buying a new home can be the most exciting, yet stressful financial commitment you ever undertake. Even if you are not a novice and have done it several times, you may continue to find the process complicated and overwhelming, especially when it comes to applying for a mortgage loan. Maybe it is the unending paperwork you have to fill out or the nervousness from the uncertainty of not knowing if you will get approved or not. When the sales contract is signed, it is go time. Getting a home loan is the most important next step.

Firstly. FHA doesn't actually make the loan. It is funded by an approved FHA lender operating within strict FHA lending guidelines. So the first step is to find a lender that offers FHA loans. There are many lenders that will do an FHA loan because this type of loan is extremely popular. They are popular because they are easy to qualify for and offer lower down payment options.

If you're unsure how to find an approved FHA Lender, you can click here to go to the HUD department's very own FHA lender search.

What's the Next Step?

Once you have located a lender, you will need to provide them with the following information:

- Your (the borrower's) addresses for the past 2 years consecutively. The lender wants to see this because when a person moves around a lot, they are often seen as a more risky bet. The lack of stability, in the minds of some lenders, equates to lack of financial stability. However, if you have moved around more than most people over the two years prior to applying for the loan, don't worry. This is not a major factor in many lenders' eyes, and a brief explanation can potentially clear up any concern.

- Social Security numbers for all borrowers. Your social security number is the way you are identified in the United States and some other countries as well. Many of our financial decisions, educational choices, and other things are tied to this number. For the purposes of accurate identification, the lender will want to have this for everyone involved with the loan. Any credit-related mistakes made by the borrowers can be traced using their social security numbers. However, this is only the case if your social security number was provided as part of the credit agreement. If it wasn't provided and you weren't able to repay a loan, it won't show up on your credit report.

- Employment Information for the past 2 years consecutively. Similar to the request to see your home addresses over the last two years, this is meant to gauge your level of stability. Switching jobs frequently can mean a person is more likely than most to default because of the unpredictable nature of their employment. However, if you remain in the same profession as you go from job to job, this can work in your favor. There are several professions where it makes sense for someone to switch places of employment fairly frequently while remaining in the same general discipline. In addition, you may work for more than one company at once, and your contract with company A can expire while you still have an open contract with company B. Lenders see tons of applications all the time, so they will understand the basic ins and outs of employment. That being said, it is best to try to stay at the same job—and definitely in the same profession—for extended periods of time if you plan on applying for a loan in the future.

- A current pay stub from the most recent month. This is one of the more important things the lender will consider. The amount of the pay stub will be used inside a formula that calculates how much you can borrow. Your ability to repay the loan is the most important consideration on the lender's mind. Your pay is the best indicator of that. It may be tempting to work some overtime in order to beef up your stats, so to speak and then submit this documentation. However, this will not work because of the next two things the bank will request.

- Bank statements for the past 3 months consecutively. Bank statements can reflect two important aspects of your ability to repay your loan. First, your ability to make your down payment will be evident from a glance at your bank statements. However, with an FHA loan, this isn't that big of a concern because you are allowed to pay the down payment using money that has been given to you. Also, your regular pay can be cross-checked, at least somewhat, using your bank statements. Most people deposit their paychecks, either directly and immediately through a direct deposit done by their employer, or by putting it in themselves. If your pay stub is unusually high, your normal pay can often be confirmed using your bank statement. For instance, if you get paid twice a month, there will be six deposits in your bank account over the course of 3 months. If each of these is roughly the same but your last pay stub was for twice the normal amount, the lender may be justifiably concerned.

- Federal W2 forms for the past 2 years. This is an even more accurate way of determining your pay. This doesn't mean you should stop claiming deductions in order to prop up your income. The bank understands how the tax system works. However, if there is a huge discrepancy between what is on your taxes and what you are claiming your regular pay is, you may want to have a conversation with your loan officer to help explain why. Remember, it is all about risk for the bank, and you want them to see you as a solid, sure investment, so concise, honest communication is important.

- Federal tax returns or Income Statement and Balance Sheet if you are self-employed, for the past two years consecutively. People who are self-employed have the added responsibility of maintaining accurate records of their income. While artificially deflating your income can help you fool the government, this is against the tax laws, and it may come back to bite you when you are applying for a loan. If you are claiming you can afford to pay $3000 a month to repay your loan, but your tax records say you only made $35,000 the previous year, eyebrows will be raised. Again, honesty is important, and when it comes to finding the right loan and the right loan amount, being honest will be a protection for everyone involved, including you.

- For veterans, A Certificate of Eligibility. When a person serves in the military, the country wants to find ways of expressing its gratitude. This isn't limited to being able to board a plane first. It applies to FHA loans as well. Another reason why veterans are helped when it comes to FHA loans is that helping veterans—who gave up so much in order to serve their country—makes sense because they put themselves in a bad financial position by devoting large amounts of time to serving. If you are a veteran, it is important to get a Certificate of Eligibility.

In fact, the lender may refuse to close the loan without seeing this certificate. Veterans can get slightly better terms than regular civilians when they sign up for an FHA loan. It's the country's way of saying, "Thank you for your service."

- Pay for the FHA appraisal of the property. Appraisal of the property to be purchased is a crucial step for the lender. After all, it's the lender that will be paying for the property, and if there is a default, it's the lender that will take possession of it. Pessimistically--but realistically--thinking, the home you are buying could soon be the asset of the lender. The lender is, therefore, going to want to check out its investment. The appraisal will involve a close look at the property, the home itself, and the surrounding areas to gather comps that will be used to determine the value of the home. If there are obvious problems with the home that result in a value that's too low, the lender may demand that they are fixed before going forward with the loan. It also has the right to cancel the deal altogether. However, you are protected under the offer agreement you sign with the seller. A standard agreement will have a clause that stipulates the home must pass an inspection that decides how much it is worth. This appraisal often ends up benefitting you, the buyer. When the seller sees that the value of the home is lower than he thought, he will sometimes drop the price just to make sure the property sells. True, another buyer's bank may come up with a higher appraisal, but it may not be worth it for the seller to risk getting the sale rejected again. Therefore, paying for the appraisal of the property should be seen as an investment instead of a burden. Another reason for getting an appraisal works in your favor is because appraisers are trained to see things that may end up costing you big money down the road. A good appraiser will include these in the report. If the sale of the house still goes through, you will have a punch list of things you can address in the near or long term.

- Pay for a credit report. Your credit report, as we have discussed, is a very important consideration of the lender. It is filled with information regarding your borrowing history, including defaults, late payments, repossessions, foreclosures, and the like. Further, it can also contain good things such as a steady, reliable repayment history. It can also show improvement in your creditworthiness. For instance, if, like many people, you made some poor credit decisions right after you left school, but you then cleaned things up and refined your credit habits, this will be evident on your report, too. Mistakes you make when it comes to paying your debts last for different amounts of time on your credit report. It is illegal for negative things to be kept on your report for longer than the time allowed. If something is on there that should have been deleted, you have the right to dispute it and get it removed. This can make your score increase swiftly, and if you have the slightest inclination that a negative thing shouldn't be there, dispute it right away.

Providing this information will help get the ball rolling. Another way of looking at how the bank thinks as they read your information is to imagine the decision-maker sitting across from you asking the following questions:

- Is your employment steady and reliable for at least two years? In other words, do you have the income to pay this money back?

- Are you a valid US citizen and can lawfully and legally sign a mortgage in the state where you live? The legal arm of the U.S. government doesn't allow it to go after people not within its jurisdiction unless they get permission from the person's home country. To prevent you from sneaking away without paying—and without ramifications--the bank has to make sure you are bound by U.S. law.

- Do you have the minimum down payment amount of 3.5% or 10% to go toward the purchase price? In most cases, this will be in your bank account. If it is not, you are going to want to put it there. This will avoid unnecessary delays in deciding whether you are eligible for the FHA loan.

- Will your mortgage payment be less than 31% of your gross monthly income? Gross monthly income is the amount you make before all expenses. If your mortgage payment is more than 31% of this, you have a much higher possibility of defaulting. This is due to the fact that there are other necessary expenses you will have to pay in addition to your mortgage. If they are taken care of, but there isn't enough money left over to pay your mortgage, the lender has made a bad investment.

- Is your totally monthly debt less than 43% of your monthly income? The way we choose to make financial decisions is reflected in the amount of debt we carry. Even if we feel fairly comfortable with our ability to pay our debts, lenders have to look at statistics that help them make an objective decision. In their minds, stats don't lie. If your monthly debt is greater than 43% of your monthly income, you may be seen as a big risk because you have a tendency to purchase things on credit. Purchasing on credit exposes you to increases in interest rates as well as penalties if you have trouble paying your obligations. Either of these could take a chunk of your available money away and render you incapable of repaying your mortgage. If possible, it may be wise to consider paying off some credit accounts before you apply for a loan.

- If you've gone through bankruptcy, have you had at least 2 consecutive years with good credit? Bankruptcy is not necessarily the death knell many think it is. Things happen, and lending institutions understand this. If you can show your credit history after a bankruptcy has been strong, the bankruptcy itself will have less of an impact on the lender's decision to grant you the loan. It is particularly important, therefore, to not give up good borrowing practices just because you have had a bankruptcy. You can recover and still get the house you dream of thanks to an FHA loan.

- If you've gone through foreclosure, have you had at least 3 consecutive years with good credit? Like a bankruptcy. A foreclosure is not necessarily the last nail in the coffin for a borrower. Of course, it won't help, but what will help is if you can show you have been able to bounce back and make better credit decisions in the wake of the foreclosure. A lender wants to know that you are dedicated to repaying your loan, and the best way to show this is by establishing a habit of financially responsible decision-making. If you've done this for at least three years after a foreclosure, don't let the foreclosure itself discourage you from applying for an FHA loan.

- Do you have a minimum credit score of 580 or 500? We have discussed the impact of your credit score already in detail. The reason it is important for the lender to verify this is because they will be held liable for the lending decision. If they lend to someone with a credit score lower than the minimum and the person defaults, they won't be able to access the FHA benefits they would need to recover financially. So don't take it personally. It's a numbers game, and as a borrower, you have to play along—as does the lender.

- If these questions are answered satisfactorily, then you will be on your way to a new FHA loan. Remember to think of the loan from the perspective of the lender. They are selling you temporary money, and they want to be sure you can and will pay it back. Understanding how the lender thinks will make it easier for you to give them what they want.

How to Improve Your Credit if Your Score is Below 500

As we've discussed, you will need a credit score of 500 or higher in order to get an FHA loan. Even under the FHA program, a lender needs to limit what it sees as a risk. So what can you do if your credit score is lower than 500? Here are some tips:

Keep your Credit Card Balances Low

In order to understand why this is important to your credit score, we can refer to the example we used earlier regarding lending money to some friends. If you are considering whether to lend to two people, and they both agree to pay you back, you are going to think about their behavior before you make your final decision. If one of your friends is always borrowing money from folks and paying them back just a little of what they owe and then borrowing again, and again, again, this may not bode well for them as they ask you for money as well. You don't want to be the next person they are slow to pay back. It's the same with your credit. The best way to borrow money is to take it, spend it, then pay it back quickly. It should be as if, in reality, you are fully able to purchase the thing you are buying, but you just don't have the money on you at the moment. To get the item, you need to use some credit, but you will be able to pay it all back very soon. That is very different from when someone simply does not, and will not, be able to afford what they are buying. It's important to note that we are talking about credit card purchases here, not home or car loans, which obviously are going to be so large that it will be impossible to repay them in the short term. The credit reporting bureaus will reward you for paying down your balances and keeping them low. Let's look at an easy way this can be accomplished.

If you have a credit card with a balance of higher than 30%, ask your credit card company if you can make multiple payments in a month. Most will say yes. Now, instead of making one payment that is just the minimum payment or perhaps slightly more than the minimum, you can pay off a little more than you usually would. How? It's all about finding sacrifices. There are things in your life that you pay for that can likely be sacrificed in order to give you a little more cash to put towards your credit card debt. For instance, how often do you eat out for lunch? If you eat out 4 times a week, and each time it costs $10, you can put an extra $40 towards your credit card debt every week. That equals to $160 per month, which can make a sizeable dent. Instead of buying lunch, you can just grab some leftovers form dinner the night before, and be well on your way to improving your credit score.

Get Rid of Small Credit Card Balances

The mathematical formula that credit card companies use is largely a mystery. But we do have some insights as to certain aspects of it that can be used to improve your score. One of these factors is the number of credit cards you have balances on. The more credit card balances you have—even if they're small—the lower your credit score will be. You aren't penalized for having a bunch of cards that you could potentially use to get credit, but you are penalized for using a lot of them at once. For instance, let's say you have seven credit cards. You have a large balance on one of them, and you have been chipping away at that for some time. As for the others, their balances are all fairly small. Fifty dollars here, $75 there, $40 there, etc. It's handy to be able to reach into your wallet and grab any card you want, or perhaps there are benefits to using some of those cards. However, any conveniences or benefits are offset by the damage this does to your credit score. The best thing to do is get rid of those balances altogether.

There a few different ways to get rid of small balances on your cards to help you qualify for an FHA loan. Some are better than others. For instance, you could use one credit card to pay off the smaller ones. This will may or may not help your score. It could hurt your score if doing that brings the balance of the "rescuing" credit card too high. Using the tip about finding ways to sacrifice things in order to save money would be a great way to tackle this issue. Also, some of the purchases you make on a monthly basis could possibly be eliminated or reduced, and the extra money could go towards getting rid of several small card balances.

Take Advantage of Windfalls

A windfall is when you get money you may not have been expecting or that was at least above and beyond what you normally get. A common example is when you get a tax refund. It can be tempting to spend this on vacation, a new TV or some other toy, but once you prioritize the purchase of a house, this money should be used to boost your credit. Anything that involves paying down your credit debt can be tackled using tax return money. Another source of windfall money is a bonus you get at your job. Maybe some of this could be used to go out to eat and celebrate, but the rest should go to paying down your credit card debt. This doesn't necessarily mean you have to cut up your credit cards, but getting rid of their balances will help the formula spit out a nicer number when your score is calculated.

Temporarily Adjust Your Lifestyle

This may be the step that takes the most work and dedication to accomplish. We all love the conveniences we have now, as well as the gadgets and little things that we fee add spice to our lives. However, in order to improve your credit score, you have to keep an eye on the big picture. Imagine how good you will feel as you turn that key to walk into your new home. Picture your housewarming party. Visualize your first dinner party or showing it off to your in-laws. Take some time to go as far as listing out, perhaps even drawing pictures of, things having a new home will allow you to experience. Once you get a firm grip on this future reality, it will be more tangible. Then making lifestyle downgrades won't be as hard. Here are some things you could do to save yourself a lot of money, and help you qualify for an FHA loan.

You could get a different car. Yes, we often tie our identities to our vehicles. If it isn't new enough, we ourselves feel like we're out of date. Or if it doesn't have enough power, we can internalize that feeling and feel weak ourselves. These are all arbitrary associations, and we have the power to change them. A car is just a thing you use to get from point A to point B. Telling yourself that again and again can help you get rid of your nice car and the big monthly payment it comes with. Then you can take the few hundred you're saving each month to pay down your credit card debt.

You can also rent a more affordable apartment or house. This will involve either changing areas or changing the size of your home, perhaps both. Why do you not want to live in a certain area? Is it due to legitimate safety reasons or irrational fears? Is it because it's a little too far from your job? Or perhaps you don't want others to judge you for living there. Whatever the reason, sacrificing living in the perfect neighborhood can save you a lot of money that will allow you to buy a home with an FHA loan in the near future. Then you can find a nice new home in the neighborhood you desire. If you can save by living in a smaller home, consider whether you really need all of the space you currently have. Are there some things you can get rid of that are taking up room that could be sacrificed? Again, it's important to visualize the end goal in order to have the strength to make these sacrifices, but it will be worth it.

You could also change your buying habits. Where we shop and what we buy, from food to clothes to accessories to entertainment and recreational activities, can all be adjusted in order to save money. The money you save can be put towards improving your credit. When you get into that new home with an FHA loan, it will be well worth the effort.

Keep Debt You've Paid Off on Your Credit Report

Sometimes when people pay off debt, they want it gone from everywhere—including their credit report. Doing this could hurt your overall credit report. Why? Debt that has been paid off is evidence of good purchasing practices and good credit management skills. You want paid-off debt on your behalf because it makes a positive statement about how you handle credit. Again, imagine things from the perspective of the lender. They want to be sure that you are going to pay back the money they sell you. If you have a history of paying back the money you've borrowed, they will see this and it will argue in your favor. However, if all they see are the things you are still trying to pay off, then that's the only input they have to go on. And it's not that great. Keeping paid-off debt on your report helps paint a more balanced picture of you as a borrower.

Do All of Your Applying at Around the Same Time

Applying for credit can make your score dip—just a little bit—each time you do it. That dip stays there for a year, and it's generally not a big deal. However, if you're trying to get your score above 500, every point counts. Here's the good news: certain kinds of applications, when done in quick succession, are only counted as one inquiry. If you make more than one of the following credit inquiries one after the other, your score will be impacted as if you only made one: mortgages, auto loans, and student loans. Let's look more closely at what this means for you.

If you are trying to buy a car, for instance, you are going to want to shop around, identify several cars you definitely would be interested in, and then go to the dealerships one after the other, perhaps visiting two or three in a two week period and another one the week after that. The benefit of doing this is it makes it look like you are a sound shopper for credit—at least according to the credit reporting bureaus' formulas. With the newest formulas, you have 45 days to apply for the same kind of credit multiple times. If you get it all of the applications done within that time period, they will impact your credit score only as much as just one inquiry would. So plan your credit shopping in advance. Apply in quick succession and instead of your score falling several points, it will only fall one point or a couple of points.

Be Timely When Paying Your Bills

The importance of paying your bills on time cannot be overstated. The problem is most people don't understand why it's so crucial to make all of your payments on time. Perhaps they think the most important thing is that the bill gets paid and the loan doesn't go into default. While this is certainly true, it's the wrong way to look at bill payment. Paying your bills on time is nothing less than a job for which you get a salary. Literally. Here's why.

As we talked about earlier, you can save significant money by getting a loan at a lower interest rate. The example we used was for a loan for $400,000. You may remember, if the interest rate is 1% less, you could save $210.41 a month. You should look at that as your salary—and it could be even higher. If you are going to apply for an FHA loan in the future, the rate at which you pay your bills will be the single biggest determining factor of your interest rate. If someone offered you $210.41 a month just to pay your bills on time, would you do it? Of course. Most bills can be automated using your bank account. If it takes you three hours to set up recurring automated payments on all of your bills, you just make $70 an hour. Nice work. But keep in mind this set up is going to keep paying your bills again and again until they're paid off. So you just made far more than $70 an hour. Excellent work. Improving your credit score is a job with a salary. See it that way and act accordingly, and watch it go up and up and up.

Using these steps, you will get your credit score up above 500 in no time at all. When in doubt, you can always consult credit-improving resources here, here, and here to fine-tune your approach.

Applying for a home loan can be intimidating. The paperwork can be long and complicated. Plus, there is the possibility that you may not be approved. Keeping your credit report squeaky clean is a great way to ensure the loan application process is pain-free.

Conclusion

Congratulations on beginning your search for a new home loan. In order to be successful, you may have to make some changes in your life. But be assured it will be worth it. Here are some things to keep in mind along the way.

It's going to take discipline. If you've ever played a sport, even just for fun, or learned an instrument or a specific skill, you know what it feels like to remain focused on a goal knowing in your heart you will get there. On a regular basis, you practice, train, practice some more, fall, get back up, and, ultimately, succeed. Your journey to getting the home of your dreams will require no less dedication and discipline. Just keep in mind that the sacrifice is well worth it. YouYou may make some mistakes along the way, but that's OK. It's like learning to play an instrument: you don't quit just because you play the wrong note. And you certainly don't quit just because it gets a little challenging. When you walk into that beautiful new home, the jingle of the keys will be music to your ears.

Keep in mind that you have to think like a lender as you prepare your application and the documents that go with it. Furthermore, you have to think like a lender in the years and months leading up to applying for the loan--even with an FHA loan. To them, you are an investment, and they only want to make sound investments. They are selling you a precious commodity: temporary money. You can reduce how much you pay for this commodity by getting your credit score as high as possible.
Remember this is a business arrangement. The bank is not doing you any favors; they are making money off your business, so walk in with your head high—regardless of your credit history. At the same time, you have to do your part to show you are a strong business partner. It will take time, organization, and a sense of focus to get everything in order, but you can do it. Don't forget that you have resources at your disposal. You getting this loan is good for you and your family, but it is also good for the economy as a whole, so the government is on your side, as is your potential lender. Therefore, feel free to ask as many questions as you need and never feel stupid or uncomfortable getting the info you need to make good decisions.

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