The Road to Homeownership

A first home is the single most exciting purchase many people make in their lifetime. It can also be a wise personal and financial decision. Homeownership provides a sense of security, considerable tax advantages, and the opportunity to build equity. As an investment, real estate can be an excellent option, as it balances out a portfolio and can act as a hedge against riskier securities. Further, the equity amassed in a home can be used for other goals, such as retirement income, education costs, or to pass on to loved ones.

If you are considering homeownership, it's never too early to start planning. Though the process can feel long and overwhelming at times, it's really nothing more than a series of practical steps.

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Calculate How Much Home You Can Afford

A great place to start is to understand the price of home that you can afford. Keep in mind that there is often a difference between the amount of loan you qualify for and how much debt you can comfortably take on. In other words, just because you can, doesn't mean you should.

For qualification purposes, most lenders require that total housing costs not exceed 33% of gross monthly income, and total debt payments per month (including the mortgage) not surpass 36%. Therefore, if you owe nothing and earn $40,000, according to a lender, $1,100 in monthly housing costs is within your range. If you make $80,000, you may be able to qualify for $2,200.

The down payment you make and type of financing you receive are key factors to consider when figuring out the price of home you can purchase. The table below illustrates the difference these variables make in monthly housing costs for a $150,000 home and a $350,000 home.

A	B	C	D	E
Home value	$150K	$150K	$350K	$350K
Down payment	$30K (20%)	$15K (10%)	$70K (20%)	$35K (10%)
Financing (30-year fixed)	6.5%	7%	6.5%	7%
Principal and interest	$ 750	$898	$1,769	$2,095
Property taxes (est. 1.25%)	$155	$155	$365	$365
Homeowners insurance*	$125	$125	$165	$165
Monthly housing costs (PITI)	$1,030	$1,178	$2,299	$2,625

**Projected figure for single family home with standard construction. Rates depend on such factors as location and deductibles.*

To know how much you can really afford to spend on housing costs, complete the Monthly Budget Worksheet on page 3. List all of your current expenses in the Current column. The figure you are presently spending on housing costs and other expenses will help you determine how much mortgage payment you can comfortably afford.

Example: You currently spend $1,200 on housing costs, have $15,000 for a down payment, and can get a mortgage loan for 4%. Based on Table A; column C, a $150,000 with a $964 mortgage payment may be within your price range.

If, after completing the budget worksheet, you find that you do not have enough to purchase, or that you would like to buy a more expensive home, consider making adjustments to your budget. In the *Proposed* column, list projected changes to your expenses and income. Be conservative and realistic. You may be able to change your circumstances enough to make the dream of homeownership a reality.

Check Your Credit Report

Access copies of your report from the three major credit bureaus – Equifax, Experian and TransUnion – at least 60 days before you plan to apply for financing. Visit www.annualcreditreport.com or call 877-322-8228 to receive copies of your reports.

When you receive your credit reports, read them carefully to make sure all information is accurate. If there is erroneous information on your reports, immediately dispute it with the bureaus.

Your Credit Score

Lenders rely on credit scores to determine their risk in lending you money. The most common scoring model is the FICO score, developed by Fair Isaac Corporation. FICO scores range from 300 to 850. The higher your score, the lower their risk – and the better interest rate you will likely be offered. Most mortgage lenders look for a score of at least 620.

FICO scores are based on many factors. The five categories (in order of greatest weight) are:

- **Payment history -** Late payments have a significant negative impact, particularly when the lateness is frequent, recent, or severe.

Monthly Budget Worksheet

HOUSING EXPENSES	CURRENT	PROPOSED
Rent/mortgage	$	$
2nd Mortgage	$	$
HOA (association dues)	$	$
Property taxes	$	$
Homeowner's insurance	$	$
Renter's insurance	$	$
Gas/electric (average)	$	$
Water/sewer/garbage	$	$
Home maintenance	$	$
Monitored alarm	$	$
Gardening	$	$
Pool/hot tub service	$	$

OTHER EXPENSES	CURRENT	PROPOSED
Savings	$	$
Car payment #1	$	$
Car payment #2	$	$
Gasoline	$	$
Maintenance/repairs	$	$
Auto insurance	$	$
Auto registration	$	$
Tolls/parking/mass transit	$	$
Telephone	$	$
Cell phone/pager	$	$
Groceries	$	$
Household items	$	$
Health insurance	$	$
Prescriptions/doctor visits	$	$
Daycare/babysitting	$	$
Alimony/child support	$	$
Tuition/lessons	$	$
Student loans	$	$
Taxes (monthly repayment)	$	$
Life insurance	$	$
Union dues	$	$
Beauty/barber	$	$
Movies/video rentals	$	$
Internet access	$	$
Cable/satellite	$	$
Dining out	$	$
Vacations/travel	$	$
Laundry/dry cleaning	$	$
Storage fees	$	$
Books/music/dvds	$	$
Clothing purchases	$	$
Gifts/cards	$	$
Pet care	$	$
Banking fees/postage	$	$
Cigarettes/alcohol	$	$
Religious	$	$
Charity	$	$
Sports/hobbies/clubs	$	$
Gym	$	$
Other	$	$
Other	$	$
TOTAL EXPENSES	$	$

INCOME	CURRENT	PROPOSED
Job	$	$
Spouse's job	$	$
Part-time job	$	$
Rental/room & board received	$	$
Commissions/bonuses	$	$
Tax refunds	$	$
Investment income	$	$
Government benefits	$	$
Unemployment insurance	$	$
Child support/alimony	$	$
Support from family/ friends	$	$
Other	$	$
TOTAL INCOME	$	$

NET	CURRENT	PROPOSED
Total Income	$	
Total Expenses	–	
Over/under	=	

Bankruptcies, judgments and collection accounts are also major factors in lowering your credit score.

- **Amounts owed** - Large balances on revolving accounts like credit cards or lines of credit, particularly if they are close to the credit limit, can lower your score.
- **Length of credit history -** Long relationships with creditors have a more positive effect on your credit score than newer relationships.
- **Pursuit of new credit -** Frequently applying for new credit can lower your score. Promotional inquires have no impact on your score.
- **Types of credit in use** - Using a variety of credit instruments responsibly has a positive impact on your credit score.
- **Improving Credit -** If your score isn't where you want it to be, you can take steps to improve it by:
    - Paying down your debt and keeping balances low on revolving accounts
    - Paying on time, every time
    - Avoiding transferring balances to new cards
    - Only applying for the credit you need and closing cards you don't use
    - Keeping old accounts open

Plan for Up-front Costs

There are many costs associated with getting your foot in your very own door.

Down payment
While a 20% down payment was the norm in the past, by obtaining a second mortgage, taking advantage of a government program, or purchasing mortgage insurance it is now possible to buy a home with much less of a down payment. Keep in mind, however, that a substantial down payment works to your advantage – the more you have, the better the financing deal, the less you have to borrow, and the lower your monthly outlay.

Earnest money
Earnest money is a cash deposit of about 2% of the price of the home. It proves to the seller that you are serious about wanting to buy. When you submit your offer, the money is deposited into an escrow account. If your offer is accepted, it will be applied toward the down payment. If it is rejected, the money will be returned to you, provided that is stipulated in the contract.

Home inspection
Having a home inspection done by a qualified professional is your way of guarding against unseen and expensive problems popping up once you move into the home. Count on a comprehensive inspection costing several hundred dollars.

Closing costs
Closing costs include all fees required to execute the sales transaction, such as attorney fees, title insurance, appraisals, points, and tax escrows. Typically paid up front, the average cost of these fees is 3-5% of the purchase price.

Post-purchase reserve funds
You may need to prove to the lender that you have enough money to protect against potential cash flow problems. Most lenders like to see at least two months' worth of housing payments in reserve, either in savings or assets.

The extras
Extras are everything from moving costs to new furniture. If you plan to buy a fixer-upper or a home that doesn't come with major appliances, these expenses will have to be planned for. The price of "extras" will vary greatly. First-time homebuyers are often strapped for cash though, so prioritizing non-essential expenses is important.

Begin Saving

Because most people do not have immediate access to the large sums of cash required to buy a home, a savings plan will be necessary. After you have calculated the amount of money you need, decide when you would like to buy. Then divide the desired sum by the number of months you have to save.

> *Example: If your objective is to save $15,000 and you want to purchase a home in three years, then you'll need to set aside about $416 every month ($15,000/36).*

If the goal you have set for yourself is not feasible, consider expanding your time frame, saving for a less expensive home, or making changes to your income and expenses.

To make saving as easy as possible, have the determined sum automatically deducted from your paycheck or checking account and deposited into a separate savings account.

The Components of a Mortgage Loan

The four components of a mortgage loan are Principal, Interest, Taxes and Insurance – commonly referred to as PITI.

- **Principal -** The principal is the amount of money you borrow. Mortgage loans are set up so that you pay more interest than principal in the beginning, and more principal than interest as you get further into the payback.
- **Interest -** The interest rate you receive will greatly affect your monthly payment and total cost of the loan. Fixed interest rates remain consistent over the course of the loan, and adjustable (ARM) interest rates change based on a variety of financial measurement rates.
- **Taxes -** Property taxes may be included with your mortgage payments, or paid quarterly. The amount of tax depends on where you live, and is usually assessed as a percentage of the property value. You may also have to pay local government taxes.
- **Insurance -** Homeowners insurance protects you from financial losses on your property that might result because of fire, wind, or other hazards.

Potential mortgage related expenses
If you buy a home that shares a common area, you will likely have to pay homeowner association fees. These dues cover the property's management and upkeep of common areas.

You may have to pay private mortgage insurance (PMI) premiums if you borrow more than 80% of the home's worth. This type of insurance policy pays mortgage lenders for part of their financial loss if a loan is not repaid. You may drop this coverage when you have achieved 20% equity in the home.

Mortgage types

Fixed-rate mortgage
For a fixed-rate loan, the interest rate stays the same for the entirety of the repayment. The trade-off is that the interest rate is usually a bit higher than for other types of mortgages. The upside is that with the interest rate and monthly payment being fixed, there is less worry about an increase in outlay.

Adjustable-rate mortgage
Often referred to by the acronym "ARM," adjustable rate mortgages have a set interest rate for a set period but then the interest rate and monthly payment adjust at later fixed intervals. One appeal of an ARM is that they usually start off with a lower interest rate than a fixed-rate mortgage. Because of this, an ARM can be worth considering for someone who plans to sell the home in a few years or who anticipates a significant income increase. This is a very risky proposition though, since there are no guarantees that a home value will increase in the first few years of ownership, or that expected increases in income will come to fruition.

Interest-only mortgage
Again, the initial payment is lower with an interest-only mortgage since you are paying only the interest for a specified amount of time, usually several years. After that time, however, the payment becomes higher because it begins to include both principal and interest. This is another risky type of mortgage since there is no guarantee you will be able to afford the increased payments in the future.

Mortgage Term

The mortgage term is the length of your loan. Traditionally the most common term has been 30 years, but this number can vary anywhere from 10 to 50 years. Shorter loans usually have a lower interest rate, but they will always have a higher monthly payment since you are paying off the loan faster. A longer mortgage term means a lower monthly payment, but you will end up paying more interest over the life of the loan.

- **Government Programs -** A mortgage loan obtained through a federal government program can in many cases mean less stringent standards for qualifying and money saved in the long-run. The two most popular programs are:

- **VA loans -** VA loans are insured by the Department of Veterans Affairs and are only available to eligible veterans. No down payment is required.

- **FHA loans -** FHA loans are insured by the Federal Housing Administration, a division of HUD (the Department of Housing and Urban Development). A down payment of at least 3.5% is required.

Many states and cities have programs specifically for first-time homebuyers. They make it easier to buy a home by offering such things as down payment assistance, below-market-rate units, and/or low-interest loans. Contact your local housing authority for information about programs in your area.

Adjust for the Tax Benefits

While a mortgage payment may seem high at first, there are significant tax advantages to homeownership. Mortgage interest and property taxes are tax deductible, which increases your net income and offsets some of the cost of the mortgage payment. The following table illustrates the estimated annual deduction for a $150,000 home and a $350,000 home.

Home value	$150K	$350K
Estimated monthly interest and taxes	$850	$2,325
Annual deduction (estimated monthly interest and taxes multiplied by 12 months)	$10,200	$27,900

If your adjusted gross income was $40,000 last year, and you bought the $150,000 home, your adjusted gross income this year will be $29,800:

$40,000 adjusted gross income
– $10,200 mortgage deduction
$29,800 new adjusted gross income

Assuming you are in the 28 percent tax bracket, your tax savings will be approximately 28 percent of your total mortgage deduction:

$10,200
x 28%
$ 2,856 annually ($238 monthly)

If your adjusted gross income was $80,000 last year, and you bought the $350,000 home, your adjusted gross income this year will be $52,100:

$80,000 adjusted gross income
– $27,900 mortgage deduction
$52,100 new adjusted gross income

Assuming you are in the 33 percent tax bracket, your tax savings will be approximately 33 percent of your total mortgage deduction:

$27,900
x 33%
$ 9,207 annually ($767 monthly)

You can either receive a tax refund at the end of the year, or raise the number of standard exemptions to have fewer taxes withheld (equaling the amount you would have received as a tax refund). The net effect is the same – you are simply choosing to use your year-end tax refund on a monthly basis.

Getting a Loan

Application criteria
When lenders are considering whether to approve your loan application, they usually consider your:

Credit score
Most lenders require your credit score to be at 620 or higher to get approval for a loan. Normally, to qualify for the best interest rate you will need to have a credit score of 750 or higher.

Down payment amount and other assets
In most cases, a mortgage lender wants you to pay a certain percentage of the overall loan amount as a down payment on the home purchase. In the instances in which this is true, the amount of money you have saved for a down payment will determine what size of loan you will be able to qualify for. For example, if your lender is requiring a 10% down payment and you have $20,000 saved, you could qualify for a loan of up to $180,000 ($200,000 maximum purchase price – the $20,000 for the down payment.) Lenders also want to see that you have funds left over post-purchase.

Employment history
Most lenders prefer to see two years of consistent employment in the same field.

Income
The standard has traditionally been that lenders require the total of your mortgage payments not exceed 28-33% of your gross income each month, though some lenders may be willing to exceed that. Often referred to as the front-end ratio, this figure will be calculated by using two years of proof-of-income documents like paystubs or tax returns.

Debt
The normal requirement is that your monthly payments on existing debt not be above 36% of your gross income, although there can be some flexibility in certain cases for this number too. This percentage is often called the back-end ratio.

Applying for Financing

The best time to try to get approved for a mortgage is before you start looking for a specific home to buy, since being pre-approved will let you know your price range. Additionally, some sellers may require that you have financing for the mortgage in place before they accept your offer.

Pre-qualification vs. pre-approval
Pre-qualification is a projection of how much loan you might qualify for. The amount you are truly eligible for may be different based on your tax returns, credit reports or other factors. Pre-approval more closely resembles the real application process. It is a firm commitment from a financial institution that for 60-90 days, barring changes in your financial situation, they will finance a specific amount.

Searching for a Home and Making an Offer

Shop around
Once you know what you can afford and qualify for, it's time to start looking at homes that meet your personal criteria. You can shop on your own by looking through the real estate listings online, or enlist the help of a real estate agent.

Real estate agents earn commissions paid by the seller, and so their services are free to the buyer. To find an agent, ask friends and relatives for recommendations. Interview several realtors before deciding on one, and ask questions about the areas and types of homes in which you're interested. He or she should be well-acquainted with all the facts about a neighborhood that matter most to you, such as schools, safety, public transportation, traffic volume, or other issues that affect you and your family. As it could result in a conflict of interest, be wary of working with an agent who represents both you and the seller.

Decide What You Want From Your Home

Making a prioritized wish list of desired features can help to ease the process of finding your dream home. Common factors in choosing a house include price, number of bedrooms and bathrooms, square footage, closet/storage space, energy efficiency, type of home (such as single family or condo), location, garage(s), yard, school district, safety, and noise.

Making an offer

If you are working with a real estate agent, the agent will look at "comps" – similar houses that have sold recently in the area – to determine an appropriate value for the home.

The offer you make to the seller of a home usually has at least three components:

- Purchase price
- Closing date
- How long the offer is still good

Many offers have additional components, such as seller concessions, inclusions, and contingencies. Seller concessions are costs that the seller pays for the buyer, which reduce the amount of money the seller receives. Typical concessions include closing costs and cash back for repairs or renovations. Inclusions refer to what stays in the house. If you want the appliances, blinds, chandeliers, or anything else, make sure to put it in the offer. Contingencies are conditions that must be met in order for the sale to go through. A home inspection, financing, and an appraisal are common contingencies.

Once the offer is written, your agent will present it to the seller. Along with the offer, it is customary to give the seller earnest money, also called a good faith deposit. Usually the amount is between 1-3% of the offered purchase price. This money is part of the down payment and shows the seller you are serious about purchasing the house. The money should go in an escrow account, where funds are held for, but not owned by, a party.

Final Steps

Pre-closing period
Once your offer is accepted, you can arrange for the home inspection, which should be done by an independent, qualified professional, and either apply for a mortgage if you have not already done so or let your lender know you found a home if you were pre-approved. The lender will start to prepare for closing and may need additional documentation from you, such as proof of homeowners insurance. During this period, it is a good idea to periodically check in with the lender and make sure that they have everything they need. Now is also a good time to gathering quotes on homeowners insurance. If you have other types of existing policies, you may be able to save by bundling your insurance with one provider.

About a day or so before closing, ideally after the seller has moved out, consider doing a final walkthrough of the property. In the walkthrough, you should make sure the seller left everything he or she agreed to leave and that the property is in the same condition it was in before. This is the best time to bring up any problems since the seller has not yet gotten paid. Once closing passes, your options for getting the seller to do something are limited.

Closing
Closing is the day that the mortgage is finalized and the title of the house is transferred to you. In many states, closing is handled by a title company. If not, it may be handled by a closing company or attorney. You will need to bring photo identification and a cashier's check for the amount you are paying for closing costs and the down payment. You have a right to review the documents at least 24 hours before closing. You will probably want to hire a real estate lawyer to make sure you understand the paperwork and the process. The documents you will be signing include the:

- **Mortgage note** - The mortgage note is your promise to pay the lender according to the specified terms.

- **Mortgage or deed of trust** - This gives the lender the right to the title of the home if you do not pay the mortgage.

- **HUD-1 Settlement Statement and Truth in Lending Statement** - The HUD-1 Settlement Statement shows your closing costs, and the Truth in Lending Statement shows the amount you are financing, APR, and other loan terms. If you see any unexpected fees or the mortgage terms are vastly different from what you discussed, don't just sign the documents – ask the lender to explain them.

The process is complete and the keys are yours. Welcome home.