

Unlocking the Door to Homeownership



A first home is the single most exciting purchase many people make in their lifetime. It is also, in the majority of cases, 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 is often an excellent option, as it balances out a portfolio and can act as a hedge against riskier securities. Further, the money amassed in a home can be used for other goals, such as retirement income, higher 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 be long and may feel overwhelming, it's really nothing more than then a series of practical and educational 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 percent of gross monthly income, and total debt payments per month (including the mortgage) not surpass 38 percent. Therefore, if you owe nothing and earn \$40,000, according to a lender, \$1,100 in 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. Table A illustrates the difference these variables make in monthly housing costs for a \$150,000 home and a \$350,000 home.

TABLE A				
A	B	C	D	E
Home value	\$150,000	\$150,000	\$350,000	\$350,000
Down payment	\$30,000 (20%)	\$15,000 (10%)	\$70,000 (20%)	\$35,000 (10%)
Financing (30-yr, 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 following worksheet. 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 seven percent. Based on Table A; column C, a \$150,000 with a \$1,178 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.

Monthly Budgeting 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	\$	

Other Expenses	Current	Proposed
Books/music/dvds	\$	
Clothing purchases	\$	
Gifts/cards	\$	
Pet care	\$	
Banking fees/postage	\$	
Cigarettes/alcohol	\$	
Religious	\$	
Charity	\$	
Sports/hobbies/clubs	\$	
Gym	\$	
Other	\$	
Other	\$	
Other	\$	
Other	\$	
Other	\$	
Other	\$	
Other	\$	
Other	\$	
Other	\$	
TOTAL FOR MONTH	\$	

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 FOR MONTH	\$	

NET	Current	Proposed
Total Income for Month	\$	
Total Expenses for Month	—	
Over/under	=	

Adjust for the Tax Benefits of Homeownership

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. Table B illustrates the estimated annual deduction for a \$150,000 home and a \$350,000 home.

TABLE B		
Home value	\$150,000	\$350,000
Estimated monthly interest and taxes	\$850	\$2,325
Annual deduction (estimated monthly interest and taxes X 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
<u>-\$10,200</u>	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	
<u>x 28%</u>	
\$ 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
<u>-\$27,900</u>	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	
<u>x 33%</u>	
\$ 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.

Plan For Up-front Costs

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

Down Payment

While a 20 percent down payment used to be the norm, by obtaining a second mortgage or purchasing mortgage insurance it is now possible to purchase with as little as three to five percent down. 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 two percent 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 it is stipulated in the contract.

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 three to five percent 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.

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 in the end.

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 rates including prime, treasury bill, and LIBOR.

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

A homeowner's insurance policy 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's association dues. These fees 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.

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.

Check your credit report

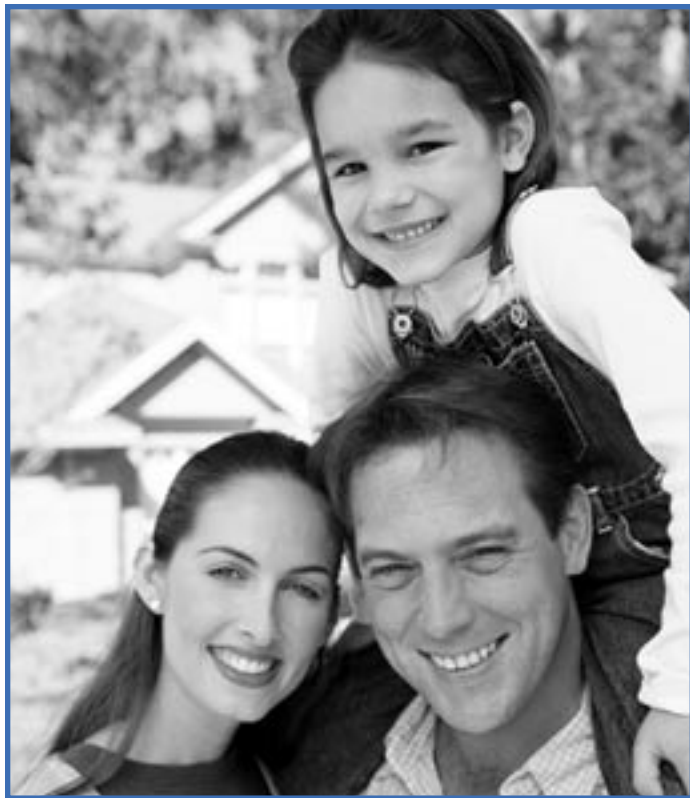
Access copies of your report from the three major credit bureaus – Experian, TransUnion, and Equifax – at least 60 days before you plan to apply for financing.

When you receive your credit reports, read

Pre-qualification Versus Pre-approval

Pre-qualification is a general projection on how much of a loan you might qualify for. The amount you are truly eligible for may be different based on your tax returns, credit report, and other factors.

Pre-approval is closer to 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.



them carefully to make sure all information is accurate. Errors can significantly impact your ability to get a desirable home loan. 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 and Company. 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 significant categories (in order of greatest weight) include:

Payment history

Late payments have a significant negative impact, particularly when the lateness is frequent, recent, or severe. Bankruptcies, judgments and collection accounts are major factors in lowering your credit score.

Amounts Owed

Large balances, 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 credit can lower your score (though mortgage and auto loan inquiries within a fourteen-day period will be considered as one inquiry). Promotional inquiries have no impact on your score.

Types of Credit in Use

Having a variety of credit instruments where you have proved responsibility of use has a positive impact on your credit score.

If your score isn't where you want it to be, you can take steps to improve it by:

- Paying down your debt
- Paying on time, every time
- Avoiding transferring balances to new cards
- Keeping your credit card balances well under the maximum available limit
- Only applying for the credit you need and closing cards you don't use
- Repaying collection accounts, judgments, and liens

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 section of the newspaper, or enlist the help of a realtor.

Realtors earn commissions paid by the seller, and so their services are free to the buyer.



To find a realtor, 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.

Understand (and Prepare For) The Mortgage Loan Approval Process

Keeping your employment steady – at least in the same field – for at least two years prior to getting a mortgage loan indicates stability. Avoid making any large credit purchases before applying for a mortgage, since the debt load that you take on can seriously impact your loan amount.

Gather your financial paperwork. Lenders will



need information about all of your assets, including cash, investment accounts, and property you own. Compiling this information beforehand will make the lending process much more efficient. When that is done, you are ready for loan pre-qualification through your financial institution.

When you are ready to make an offer on a home, your realtor can help you negotiate the price, arrange for an inspection, and sign the contract. You will fill out a loan application, provide the financial documentation you've compiled, and pay any applicable fees.

You will then receive a Good Faith Estimate and a Truth in Lending Statement from the processor, who will verify the application information and order a credit report and appraisal (which could impact the offer). The underwriter will either approve or reject the loan application. If the loan is approved, you will receive a commitment letter from the underwriter.

Upon approval, the processor turns the file over to a pre-closer who ensures the appropriate mortgage insurance is approved. The pre-closer or closer arranges for a survey and mortgage title policy, and prepares documents for the closing.

You make a final inspection of the home within 24 hours of the scheduled closing. Then you, the seller, the lender's representative, and the closing agent attend the closing or settlement.

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

BALANCE offers a variety of free and low-cost services to help you get out of debt, design a money management plan, and achieve your financial goals. For more information about how BALANCE can help you master your money, call us toll-free or visit us online:

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