PART

One

FINANCE

Do Not Go Shopping Until You Know How Much Money You Have to Spend

Chapter 1 Get Ready to Buy

Tools and Suggestions to Maximize Buying and Borrowing Power

Traditionally, buying a home in the United States required that a buyer fund 20 percent or more of the purchase price. But over the years, first government-insured home loans and then other types of home loans requiring the buyer to fund only 5 or 10 percent of the purchase price have flourished and are common, even after the real estate crash. By taking out such a loan, a financially stable person can realistically afford to purchase a home. This chapter gives advice on maximizing your ability to obtain a home loan, that is, a mortgage. It will also help you evaluate how much money to spend on a home based on your individual family needs and spending power.

MAKE A LIST OF YOUR ASSETS AND LIABILITIES

Never go shopping unless you know how much money you have to spend.

Start by making a list of your total assets, income, and liabilities. This will provide data that can be easily analyzed by you and by a lender, not only to determine how much money you can comfortably borrow, but also to determine how much of your income will be needed to pay the cost of operation and maintenance of your home. The list will also prove helpful when you complete a lender's application for financing, as well as in preparing a cooperative or condominium application for submission to the board of directors reviewing your financial ability to afford the cost of a home.

Accessible Income

The list's first section should include monies immediately at your disposal, including cash, checking and savings account balances, stocks, bonds, and retirement accounts (IRA and 401(k) accounts). Add to this any gift from a relative or monies from a trust or bequest. These are the funds that you will use to provide the down payment—the amount of money that you will pay for the property to be held until closing by the buyer's attorney, the real estate broker, or the escrow company.

Enduring Income and Other Assets

The second part of the list is made up of your total enduring income, which is the steady income you receive monthly, yearly, or regularly that can be predictably counted. Examples of enduring income include your yearly salary, profits, and the value of any property owned, including the fair market value or listed price of a home to be sold, if any, or the property's rental income if it is an investment property. If applicable, social security or disability benefits, alimony, and monies from a divorce agreement should also be included in this list.

These two parts of the list will show your total income and assets.

Liabilities

The third and final part of the list should be titled *liabilities* and should include every penny of monies you owe to anyone. Separately list both your monthly payments and the total amount of each debt. Liabilities typically include recurring monthly expenses, such as utility bills, insurance payments, charitable pledges, tuition payments, alimony payments, mortgage payments, and any other type of loan, including student and car loans as well as credit card debt.

Proof of Assets

Remember, depending on the type of loan, your lender may need proof of your listed assets. Please see Chapter 2, *How to Get the Cheapest Loan at the Best Rate,* for the details on lenders' requirements. You should therefore collect the necessary documentation of your assets when preparing your list of total assets. For example, lenders usually require three of the most recent monthly bank statements, two years' tax returns, at least one W-2 form (the tax statement your employer is required to provide every year for tax purposes, which summarizes your yearly income), a few recent paycheck stubs proving employment and detailing salary, as well as proof of most of your assets. For proving an existing home's value, an actual listing or an appraisal will usually suffice. If the house is under contract, provide a copy of a signed sales contract. A written separation or divorce agreement can be provided as proof of monies required to be paid to you as a result of a marital breakup.

Use this list when you talk to a lending professional to determine the amount of money you can afford to borrow from a lending institution and your borrowing power.

CREATING A BUDGET AND LIVING WITHIN YOUR MEANS

Once the three parts of the list have been completed you can realistically analyze and determine your buying power. Many financial planners assert that no more than 25 to 33 percent of your salary after tax and other income should be used to pay for the monthly cost of a home. Others preach that you should not spend more than 40 percent of your after-tax income on housing. In New York City, many large apartment building owners rent only to persons whose total income equals 40 times the monthly rent. Instead of embracing a certain formula, I advocate first conducting an analysis of your total income and expenses. By following this path, you will identify your previous spending habits and may be able to eliminate unnecessary items from your future spending. Remember, how much you earn is only relevant after you subtract your necessary expenses. The amount you are able to save is the key.

Together, total income, assets, and liabilities provide an excellent X-ray of your finances. So, we can use these numbers to take a closer look at your monthly spending. You can start with housing, transportation, food, medical/dental insurance, phone, cable, and clothing. Add any other fixed costs such as loans, credit card debt, and car payments. You may want to put as many items as you can on a credit card for a month or two in order to keep better track of your spending habits. Keep a separate tally for your housing expenses.

Track your spending for a few months. Housing, transportation, and food will take up a large chunk of your income. Also note the changes that may be expected in your spending once you own a home. For example, if you are paying rent for your present housing, determine the difference between your estimated mortgage payments, real estate taxes, and other home expenses (fuel, electricity, gas, maintenance) compared to the rent and utilities you are currently paying. Remember that interest paid on your home loan and real estate taxes are tax-deductible but no deduction is allowed for rental payments. Compare the monthly housing expenses and whether, at that level of expense, you were able to save a comfortable amount of money each month. If you are living with your parents or anywhere else where you are not paying rent, consider if there are any other payments that might be eliminated upon the purchase of a new home. Can you give up a car if you move from the suburbs to the city? If you are already an owner, you should be able to afford the difference between the old and new housing expenses.

Once you find the amount you are comfortable spending for your total monthly housing expenses, you will be ready to intelligently shop for a home and choose the proper mortgage.

Your total housing expenses include monies spent through closing and after closing for maintaining a property. The biggest ongoing expenses will likely be the mortgage payments and real estate taxes.

After a conversation with your lending professional, you will have an estimate of the amount of money you will be able to borrow and the monthly mortgage payments necessary to repay the loan. Then include your yearly housing costs such as homeowner's insurance, heating and cooling, electricity, water, repairs, and common charges for a condominium or maintenance for a cooperative apartment. For cooperative apartment ownership, remember that the taxes and part of the mortgage on the building are paid out of monthly maintenance payments. Usually the largest single expense is the down payment amount, which is discussed below.

If your analysis concludes that you need more time to save before buying a home, you should set some saving and spending goals. Your ultimate goal should be not only to create a budget but also to put away as much savings as possible out of your income. Many of my clients have started with a piggy bank. Others have created bank accounts exclusively for deposits to be used only for purchasing property.

MY STORY: BUDGETING AND TRACKING SPENDING

My Grandpa Bob Vance was my most important cheerleader and teacher about budgeting and saving. Grandpa Bob sold picture frames for a living, and he was the richest person I had ever met. I had no idea how to define *rich*, but he had the most beautifully decorated apartment in Encino, California, his car always looked new and, unlike so many others in my world, he never complained about money. During my college years at Rutgers, Grandpa Bob began his long campaign to get me to keep track of every dollar I spent so that I could analyze where my money was going each week. It wasn't until after law school that I actually listened to his advice. He spent countless hours discussing money and business with me, and I can sound off his favorite success sayings as he would repeat them countless times with his deep confident voice. Two of his favorites were: "It is not how much you make but how much you save" and "Fear is false evidence assumed real." Years later I named my real estate company BP Vance, after my grandparents, Bob and Paula Vance. Although 80 years old at the time, my Grandpa loved flying to New York and seeing their names in large white letters on the big green façade.

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Grandpa Bob urged me to keep more money in my savings account, and he helped me plan for big ticket items like spring break trips. In fact, it wasn't until I realized how badly I wanted to save a down payment for a home that I finally started tracking my spending. Every time I spent money, an entry went on my yellow pad with the date. Everything I doled out money for was noted: food, laundry, clothes, toothpaste, groceries, books, and even the hot dog from the corner vendor. A few pages into the pad, I separately listed my fixed costs and liabilities, which at the time included my rent and education loan payments. As these would change, so would the entries in my legal pad. Eventually, I created a large stack of pads, and my ability to track forced me to be accountable to myself and motivated me to save money in every way possible.

This simple tracking tool allowed me to focus and track my spending and begin to develop my budgeting. Since I had to acknowledge my spending every time I made a purchase, many times I would think twice before indulging myself with a luxury. Over a few weeks and months I noticed patterns. Still, I decided that some extravagances such as weekend dinners at restaurants, although still not strictly necessary, were nevertheless worthwhile. So this simple method both caused me to save money and allowed me to take my first steps toward realistic budgeting.

Unfortunately, at that time, my budgeting demonstrated that I could not afford a home until I learned how to make more and save more. So I set my goals. A little less than three years later, I became a homeowner.

My method of tracking spending developed before the Internet. As the years progressed and as I taught this method, I watched friends and clients build upon its simple philosophies by using computer spreadsheets and Web tools to track spending and budgeting. It was clear that the yellow pads to which I owed my success were a thing of the past, but Grandpa Bob's wisdom remained timelessly valuable with the newfangled tools available to implement it.

When one friend who had taken my advice showed me her computerized spreadsheets illustrating years of budgeting and spending tracking, I was completely dazzled. Her cross-referencing and graphs were marvels; they were like nothing I had ever seen on paper. For those who wish to use them, there are programs such as Quicken, which are more specifically aimed at money management than generic spreadsheet programs.

But the real point of this story is not that you should use this or that program or should use a yellow pad of paper or a pale green one. By keeping spending records you can, like me, develop the self-control and awareness necessary to get the big items you want without frittering away your resources on the small ones.

You can also combine this method with balancing your checkbook and putting as many items as possible on your credit card as long as the credit card charges are paid in full at the end of every month. While this may seem to be the exact opposite of advice you usually receive, in fact, credit card payments allow you to track your spending without having to pull out paper or a computer. The credit card companies not only provide you with a monthly itemized bill, but most will also give you a quarterly or yearly printout upon request and some of them will even break it down into categories.

When you use a credit card, your money stays in the bank and earns interest for an extra 30 days until you pay off your credit card bill.

Of course, this method only works if you pay your full balance on the credit card every single month as soon as the bill arrives. Be careful not to leave the payment to the last day. Some credit card companies purposely structure their late fees to be far above the legally permissible interest and therefore they actually want you to be late in your payments. But if you pay your full balance as soon as the bill arrives you save a lot of money and also improve your credit score.

Many credit card companies allow a grace period in which no late fee will be imposed after the due date. Be sure to check with your company about this. Also check any programs where you can earn money, airline miles, or other so-called gifts. Of course, they are not really gifts; you are paying for them either with your money or the money of the merchants where you are shopping.

So whether using paper or a computer, Grandpa Bob's saving plan really does work as long as you have the passion to make it a success. As he would tell you with a smile, "You must believe, in order to achieve."

THE DOWN PAYMENT AND PRIVATE MORTGAGE INSURANCE

Today, a down payment usually equals between 5 and 10 percent of the purchase price, depending on the property's location. Newly constructed luxury homes and apartments may require a higher down payment. In many areas, the standard down payment equals 10 percent of the property's purchase price. The down payment is, however, a negotiated number and the state of the market usually dictates the number.

Sellers typically require between 5 and 10 percent of the purchase price not only because attorneys and real estate agents tell them it is the standard, but also because a signed contract means that the home will be taken off the market for a number of months. The possible loss of a buyer's down payment usually eliminates any incentive for a buyer to walk away from a deal. If there is no initial down payment, a buyer may be emboldened by other attractive homes on the market and walk away from the deal despite a signed contract prohibiting such conduct.

Never be afraid to negotiate with a seller to decrease the amount of the down payment. In most cases, the worst that can happen is that the seller will say no. Holding your money in escrow provides very little value to sellers, since it cannot be used until the actual sale or closing occurs. From your perspective, if the closing does not occur because the sellers are waiting for their new home to be built or because of a messy divorce battle over the property, or for a number of other creative reasons, as little money as possible should be tied up.

You, or the seller, may even decide not to close for some reason. If this happens, it benefits you to have contributed as small a down payment as possible as a seller can retain only this amount of the purchase price upon a failure to close, if the property contains less than four units.

Be aware that many lenders and cooperative apartment boards require that you pay at least 20 percent of the purchase price (and sometimes even more) at the closing, but it is rare for them to require a down payment of more than 10 percent of the purchase price.

As a buyer, you can contribute as much money as you desire toward the property at the time of closing and after. You may even overpay your loan payments in order to pay off your home loan earlier than its stated maturity date. However, it is important to be aware that if your loan includes a prepayment penalty (a charge for paying off a loan before a certain date), you may be penalized for paying the loan down before that date. Lenders are required to notify a borrower in writing of a prepayment penalty before the closing, so that you won't be surprised by its existence at closing.

Paying at least 20 percent of the purchase price at closing is necessary to avoid private mortgage insurance (PMI). PMI provides insurance to a lender for homes where the buyer obtains a loan for an amount that is greater than 80 percent of the home's value. PMI charges vary depending on the size of a loan, but typically equal 1/2 of 1 percent of the loan, and this amount is usually paid monthly with your mortgage payment. Except for certain high-risk and delinquent borrowers, and certain VA and FHA loans, PMI mortgage premiums and coverage end when the loan-to-value ratio equals 80 percent or the borrower has paid 20 percent of the value of the loan. Although the Homeowners Protection Act of 1998 requires lenders to automatically cancel PMI upon this occurrence, this does not always happen. So, the borrower should be sure to remind the lender to eliminate this fee at the proper time. Many banks will discontinue PMI upon receiving sufficient proof of increases in market value, such as by an appraisal.

If acceptable to lenders, another popular method to avoid PMI is to structure two loans at closing. For example, buyers who would like 90 percent financing could take out a first loan of 80 percent of the property's value and a second loan for 10 percent of the property's value, thus avoiding the imposition of PMI. Note, however, that when lenders curtail the free flow of money, such a scenario would be difficult to obtain.

OBTAINING A CREDIT REPORT

When planning to purchase a home and take out a loan, one of your first steps should be to order a copy of your credit report. As a result of the Fair and Accurate Credit Transactions Act, a free credit report can be ordered from each reporting agency once a year, online or by phone.

Once you receive a copy of your report, make sure it does not contain any mistakes or incorrectly reported delinquent accounts. All credit reporting agencies provide mechanisms to challenge listed information and you can receive more detailed information by contacting the reporting company. Challenge negative remarks in your credit report, even if they are debatably true. Under federal law, if the company placing the negative remark does not respond within 30 days, the remark must be removed. In response to the challenging of information through hundreds of credit-reporting companies over the years, companies will now often remove negative information for minor defaults with an explanation or reason for the default.

However, companies vigorously seek to protect the reported information for severely delinquent accounts. Whether you are challenging a delinquent report or attempting to correct false information reported, the process can take anywhere from several weeks to several months. Therefore, checking your credit report should be one of the first tasks in the purchase process.

A potential homeowner should have a solid credit history with at least two credit cards (some lenders want to see five credit lines) used at least a number of times a year. Lenders are looking to see a credit history illustrating that the borrower responsibly handles his or her debt obligations by making timely payments. At the same time, too many active credit card accounts can cause the lender to decrease the amount of money they are willing to lend. Because you have access to it, lenders assume that you will use all of the eligible credit available on your cards. So, when determining the amount to be loaned, lenders will subtract from the total approved loan amount the maximum available credit provided to the credit cardholder. Hence if you qualify for a $100,000 loan and the credit card company provides $10,000 as a maximum to use on the credit card, the amount of your loan will probably be decreased by $10,000 to $90,000.

FICO SCORE

Almost all major lenders determine your ability to obtain a loan based on your FICO score (an acronym for Fair Isaac Corporation). A FICO score applies statistical methods to information in a credit report to determine lending decisions, including the interest rate to be charged and the amount of the loan to be offered to a borrower. The highest FICO score is 850 and most people strive to get a score of 720 or above in order to obtain the best interest rate, as any lower score would result in negative rate adjustments, meaning higher interest rates. It is necessary to have a minimum FICO score of around 620 to obtain a loan. It is important to note that when co-borrowers are involved, the bank will usually consider the lowest of the FICO scores in its lending decisions. A FICO score can only be raised by improving your credit report, hence the importance of obtaining a credit report early in the purchasing process.

By following the above suggestions in your pursuit of purchasing a home, you will increase your chances of buying a home you can afford while obtaining the greatest amount of savings and the lowest possible price.

CHAPTER SUMMARY AND INSIDER TIPS

- Open a separate bank account—call it your *saving for a home account*. Combine this with a piggy bank for the same purpose, and put as much money as you can, from a bit of change to a whole paycheck, into both of these funds.
- When close friends and family members ask what gifts they should get you for birthdays and holidays, if appropriate, ask for a donation to the buy-a-home fund. This may seem tasteless, but you might end up with a gift even greater than expected. If a gift is particularly large, you could even offer to name the backyard, a terrace, or other parts of your home after the gift-giver.
- The better organized are your proofs of assets and liabilities, the better your chances of convincing the bank to give you a loan, and having a lender's pre-approval letter handy makes the seller more likely to consider your offer. Remember that the most financially qualified buyer will probably be the one to close on the home.
- Check your credit report long before you start shopping for a home, as it may take months to resolve mistakes and complications.
- Challenge negative remarks in your credit report, even if they are debatably true. Under federal law, if the company placing the negative remark does not respond within 30 days, the remark must be removed.
- It is not how much you earn but how much you save that counts. The person that makes and saves $1,000 is richer than the person that makes and spends $1,000,000.
- Stay away from debt. Americans have a fascination with debt because of the tax deductions involved. But the amount you pay in interest throughout the years usually amounts to far more than the money saved through tax deductions.
- You should always put down as little as possible for your down payment at the time of signing the contract of sale. If you cannot close on your purchase for any reason, you do not want your down payment to become a gift to the seller. You can always add as much as you want at closing.