

IN THIS CHAPTER

- » Understanding how much mortgage debt you can truly afford
- » Estimating your likely homeownership expenses
- » Considering your other financial goals

Chapter 1

Determining Your Borrowing Power

If you're like most folks, the single biggest purchase you'll make during your lifetime will be when you buy a home. And to make that purchase, you'll likely have to borrow money by using a loan called a mortgage. The cumulative payments on that mortgage will likely far exceed the sticker price on your home due to the interest you'll pay.

Most people thinking of purchasing a home focus solely on the price of the home. But the vast majority of people purchase real estate with financing. So although the purchase price is important, the reality is that the mortgage terms that you're able to secure and negotiate will determine the monthly payment that you can afford and will dictate the maximum price you can pay for your new home.

In this chapter, we help you tackle this first vital subject to consider when the time comes to take out a mortgage — how much mortgage can you really afford? *Note:* We intend this chapter primarily to help people who are buying a home determine what size mortgage fits their financial situation. If you're in the mortgage market for purposes of refinancing, please also see Chapter 11.

Only You Can Determine the Mortgage Debt You Can Afford

Whether you meet in person, talk by phone, or start online and follow up face to face with a reputable mortgage lender representative, you'll be asked about your income and debts. Assuming that you have a good credit history and an adequate cash down payment, the lender can quickly estimate the amount of mortgage debt you can obtain.

Suppose a mortgage lender says that you qualify to borrow, for example, \$200,000. In this case, the lender is basically telling you that, based on the assessment of your financial situation, \$200,000 is the *maximum* amount that this lender thinks you can borrow on a mortgage before putting yourself at significantly increased risk of default. Don't assume that the lender is saying that you can *afford* to carry that much mortgage debt given your other financial goals.

Your overall personal financial situation — most of which lenders, mortgage brokers, and real estate agents won't inquire into or care about — should help you decide how much you borrow. For example, have you considered and planned your retirement goals? Do you know how much you're spending per month now and how much slack, if any, you have for additional housing expenses, including a larger mortgage? How much of a reserve or rainy-day savings fund do you have? How are you going to pay college expenses for your kids? Are you or will you soon be helping to care for elderly relatives?

In the following sections, we start you on the path to answering these questions.

Acknowledge your need to save

Unless you have generous parents, grandparents, or in-laws, if you want to buy a home, you need to save money. The same may be true if you desire to trade up to a more costly property. In either case, you can find yourself taking on more mortgage debt than you ever dreamed possible.

After you trade up or buy your first home, your total monthly housing expenditures and housing-related spending (such as furnishings, insurance, and utilities) will surely increase. So be forewarned that if you had trouble saving before the purchase, your finances are truly going to be squeezed after the purchase. This pinch will further handicap your ability to accomplish other important financial goals, such as saving for retirement, starting your own business, or helping to pay for your own or your children's college education.

Because you can't manage the unknown, the first step in assessing your ability to afford a given mortgage amount is to collect data about your monthly spending (see the following section). If you already track such data — whether by computer, app or pencil and paper — you have a head start. But *don't* think you're finished. Having your spending data is only half the battle. You also need to know how to analyze your spending data (which we explain how to do in this chapter) to help decide how much you can afford to borrow comfortably.

Collect your spending data

What could be more dreadful than sitting at home on a beautiful sunny day — or staying in at night while your friends and family are out on the town — and cozying up to your calculator, banking and credit card transactions, and most recent tax return?

Examining where and how much you spend on various items is almost no one's definition of a good time (except, perhaps, for some accountants, IRS agents, actuaries, and other bean counters who enjoy crunching numbers for a living). However, if you don't endure some pain and agony now, you could end up suffering long-term pain and agony when you get in over your head with a mortgage you can't afford.

Now some good news: You don't need to detail to the penny where your money goes. That simply isn't realistic. What you're interested in here is capturing the bulk of your expenditures and allowing for some margin for unanticipated expenses, plus savings for an emergency fund. Ideally, you should collect spending data for a three- to six-month period to determine how much you spend in a typical month on taxes, clothing, transportation, entertainment, meals out, and so forth. If your expenditures fluctuate greatly throughout the year, you may need to examine a full 12 months of your spending to get an accurate monthly average. You also want to include any known changes in upcoming expenses. Maybe your child will be starting preschool next year at a private institution or your car is getting old and you know you'll soon want or need to get a new vehicle.

Later in this chapter, we provide a handy table that you can use to categorize and add up all your spending. First, however, we need to talk you through the specific and often large expenses of owning a home so you can intelligently plug those numbers into your current budget.

Some thoughts on affordability . . .

The median home sales price in the United States is now just over \$400,000. In the aftermath of the government-mandated COVID-19 shutdowns, home prices spiked 30 to 40 percent, and in some locales even more. Self-anointed and

media-anointed experts and online influencers boldly proclaim that buying a home with a mortgage has become unaffordable and impossible for many people, especially younger folks early in their careers. Wouldn't it be nice to return to the early 1980s when the median home sales price was just \$100,000?

We have a far more positive and optimistic point of view on housing costs and those big, related costs like your mortgage payments:

- » Every generation — and we mean every — feels like housing is expensive and hard to afford. Recently, when fixed-rate mortgages were 7 percent, you may recall that mortgage rates breached 16 percent back in those supposed good old days in the early 1980s.
- » Housing prices increase over the decades due to modest annual inflation, which has also pushed the average employment income correspondingly higher. So, yes, \$400,000 median home prices sound so much worse than \$100,000 median home prices from the early 1980s, but median employment earnings have risen faster than the rate of inflation.
- » Let's remember what median means — it means that half of all homes sold have sold for less than that amount while half of all homes have sold for more than that amount. There is indeed a wide variation in home prices around the country. You won't get much for your money if you spend \$400,000 on a property in San Francisco's Pacific Heights neighborhood or near New York City's Central Park. But you will enjoy a nice-sized home in a decent area if you spend \$300,000 or \$400,000 in suburban areas like or near Raleigh, North Carolina; Nashville, Tennessee; Tampa, Florida; and Dallas, Texas; among many more.
- » The median home today is much bigger and has more amenities than the median home from decades ago. So for the median amount of money, you can get a pretty darn good home in a decent location.

Our bottom line: If buying and owning a home is important for you, you can and will find a way to make it work. It takes work and sacrifice. We believe in you, and we believe in the American Dream.

Determine Your Potential Homeownership Expenses

If you're in the market to buy your first home, you probably don't have a clear sense about the costs of homeownership. Even people who presently own a home and are considering trading up often don't have a great grasp on their current or

likely future homeownership expenses. So we include this section to help you assess your likely homeownership costs.

Making your mortgage payments

A *mortgage* is a loan you take out to finance the purchase of a home. Mortgage loans are generally paid in monthly installments, typically over either a 15- or 30-year time span. Chapter 4 provides greater detail about how mortgages work.

In the early years of repaying your mortgage, nearly all your mortgage payment goes toward paying interest on the money that you borrowed. Not until the later years of your mortgage term do you rapidly begin to pay down your loan balance (the *principal*).

As we say earlier in this chapter, all that mortgage lenders can do is tell you their own criteria for approving and denying mortgage applications and calculating the maximum that you're eligible to borrow. A mortgage lender tallies up your monthly *housing expense*, the components of which the lender considers to be the mortgage payment, property taxes, and homeowners insurance.

Understanding lenders' ratios

For a given property that you're considering buying, a mortgage lender calculates the housing expense and normally requires that it not exceed 40 percent or so of your monthly before-tax (*gross*) income. So, for example, if your monthly gross income is \$5,000, your lender may not allow your expected monthly housing expense to exceed \$2,000. If you're self-employed and complete IRS Form 1040, Schedule C, mortgage lenders use your after-expenses (*net*) income, from the bottom line of Schedule C (and, in fact, add back noncash expenses for items such as real estate and equipment depreciation, which increases a self-employed person's net income for qualification purposes).



REMEMBER

This housing expense ratio completely ignores almost all your other financial goals, needs, and obligations. It also ignores property maintenance and remodeling expenses, which can suck up a lot of a homeowner's dough. Never assume that the amount a lender is willing to lend you is the amount you can truly afford.

In addition to your income, the only other financial considerations a lender takes into account are your debts or ongoing monthly obligations. Specifically, mortgage lenders examine the required monthly payments for other debts you may have, such as student loans, auto loans, and credit card bills. They also deduct for alimony, child support, or any other required payments. In addition to the percentage of your income that lenders allow for housing expenses, they typically allow an additional 5 percent of your monthly income to go toward other debt repayments.

Calculating your mortgage payment amount

After you know the amount you want to borrow, calculating the size of your mortgage payment is straightforward. The challenge is figuring out how much you can comfortably afford to borrow given your other financial goals. This chapter should assist you in this regard, especially the previous section on analyzing your spending and goals.

Suppose you work through your budget and determine that you can afford to spend \$2,000 per month on housing. Determining the exact size of a mortgage that allows you to stay within this boundary may seem daunting, because your overall housing cost is comprised of several components: mortgage payments, property taxes, insurance, and maintenance (and association dues if the property is a condominium or has community assets like landscaped common areas, a community swimming pool, a fitness center or a clubhouse).

Using Appendix A, you can calculate the size of your mortgage payments based on the amount you want to borrow, the loan's interest rate, and whether you want a 15- or 30-year mortgage. Alternatively, you can do the same calculations by using many of the best financial calculators available for less than \$50 from companies like HP and Texas Instruments. (In Chapter 8, we discuss the ubiquitous online mortgage calculators, which are often highly simplistic.)

Paying property taxes

As you're already painfully aware if you're a homeowner now, you must pay property taxes to your local government. The taxes are generally paid to a division typically called the County or Town Tax Collector.

Property taxes are typically based on the value of a property. Because property taxes vary from one locality to another, call the relevant local tax collector's office to determine the exact rate in your area. (Check the website for your local municipality to find the current information about how property taxes are calculated or search for the name of the municipality and "property tax" online.) In addition to inquiring about the property tax rate in the town where you're contemplating buying a home, also ask what additional fees and assessments may apply. In California, many recently developed areas have special assessments (such as *Mello-Roos* districts), which are additional property taxes to pay for enhanced infrastructure and amenities, such as parks, police/fire stations, golf courses, and landscaped medians. Many other rapidly growing areas like Las Vegas, Phoenix, and multiple cities throughout Texas and Florida with newer developments have Public Improvement Districts with additional assessments that owners in these newer master-planned communities are responsible to pay, and these extra taxes often run for the first 20 to 30 years after the improvements are completed.

SO YOU THINK YOU CAN HANDLE EXCESS BORROWING?

Some people we know believe they can handle more mortgage debt than lenders allow using their handy-dandy ratios. Such borrowers may seek to borrow additional money from family, or they may overstate their income when filling out their mortgage applications.

Although some homeowners who stretch themselves financially do just fine, others end up in financial and emotional trouble. You should also know that because lenders usually cross-check the information on your mortgage application with IRS Form 4506T (the lender receives your actual tax return you filed, which certainly didn't overstate your income), borrowers who exaggerate their income or underreport their expenses, on their mortgage applications are caught and their applications denied.

So although we say that the lender's word isn't the gospel as to how much home you can truly afford, telling the truth on your mortgage application is the only way to go. It may be painful to find out that you don't qualify for the loan you need to purchase that home of your dreams, but you're likely better off in the long run not overextending yourself with mortgage debt.

We should also note that telling the truth prevents you from committing perjury and fraud, troubles that catch even officials elected to high office. Bankers don't want you to get in over your head financially and default on your loan, and we don't want you to either.

If you make a smaller down payment — less than 20 percent of the home's purchase price — your lender is likely to require you to have an *escrow account* (also called an *impound* or *reserve account*). Such an account requires you to pay a monthly pro-rata portion of your annual property taxes, and often your homeowners insurance, to the lender each month along with your mortgage payment. The lender is responsible for making the necessary property tax and insurance payments to the appropriate agencies on your behalf. An escrow account keeps the homeowner from getting hit with a large annual property tax bill.

As you shop for a home, be aware that real estate listings frequently contain information regarding the amount the current property owner is currently paying in taxes. These taxes are often based on an outdated, much lower property valuation. If you purchase the home, your property taxes may be *significantly higher* based on the price that you pay for the property. Conversely, if you happen to buy a home that has decreased in value since it was purchased, you could find that your property taxes are actually lower, but that is rare.

Tracking your tax write-offs

Now is a good point to pause, recognize, and give thanks for the tax benefits of homeownership. The federal tax authorities at the Internal Revenue Service (IRS) and most state governments allow you to deduct, within certain limits, mortgage interest and property taxes when you file your annual income tax return.

You may deduct the interest on the first \$750,000 of mortgage debt. (This mortgage interest deductibility covers debt on both your primary residence *and* a second residence.) The IRS also allows you to deduct the interest costs on additional borrowing known as home equity loans or home equity lines of credit (HELOCs, see Chapter 6) to a maximum of \$100,000 borrowed. (For mortgages originating before December 16, 2017, the deductible limit is \$1,000,000.)

Most people can deduct all or the vast majority of their property taxes. You may deduct your property taxes and state income taxes totaling up to \$40,400 in tax year 2026. This limit will increase 1 percent annually. At modified adjusted gross incomes above \$505,000 (this income threshold also increases 1 percent annually beyond 2026), high income earners see some of these deductions phased out.

To keep things simple and get a reliable estimate of the tax savings from your mortgage interest and property tax write-off, multiply your mortgage payment and property taxes by your *federal* income tax rate in Table 1-1. This approximation method works fine as long as you're in the earlier years of paying off your mortgage, because the small portion of your mortgage payment that isn't deductible (because it's for the repayment of the principal amount of your loan) approximately offsets the overlooked state tax savings.

TABLE 1-1

2026 Federal Income Tax Brackets and Rates

Federal Tax Rate (Bracket)	Single Filers	Married Filing Jointly
10%	\$0 to \$12,400	\$0 to \$24,800
12%	\$12,400 to \$50,400	\$24,800 to \$100,800
22%	\$50,400 to \$105,700	\$100,800 to \$211,400
24%	\$105,700 to \$201,775	\$211,400 to \$403,550
32%	\$201,775 to \$256,225	\$403,550 to \$512,450
35%	\$256,225 to \$640,600	\$512,450 to \$768,700
37%	\$640,600+	\$768,700+

Protecting with insurance

When you own a home with a mortgage, your mortgage lender will insist as a condition of funding your loan that you have adequate homeowners insurance, which includes both casualty and liability coverage. The cost of your insurance policy is largely derived from the estimated cost of rebuilding your home. Although land has value, it doesn't need to be insured, because it wouldn't be destroyed in a fire. That is also true for certain underground improvements. Buy the most comprehensive homeowners insurance coverage you can and take the highest deductible you can afford, to help minimize the cost.



TIP

As a homeowner, you'd also be wise to obtain insurance coverage against possible damage, destruction, or theft of personal property, such as clothing, furniture, kitchen appliances, audiovisual and electronic equipment, and your collection of vintage fire hydrants or that soon-to-be-priceless Beanie Baby collection your grandmother left you. Personal property goodies can cost big bucks to replace. Some prized possessions like jewelry, antiques, and collectibles are often excluded from your base policy and can require a special added coverage policy with limits that need to be set based on the replacement value of the items.

In years past, various lenders learned the hard way that some homeowners with little financial stake in the property and insufficient insurance coverage simply walked away from homes that were total losses and left the lender with the loss. Thus, in addition to sufficient casualty and liability insurance, lenders require you to purchase *private mortgage insurance* if you put down less than 20 percent of the purchase price when you buy (see Chapter 4 for details on private mortgage insurance). This is risk insurance that protects the lender by making the mortgage payments to the lender if you're unable to. This could be because you have a loss of income, whether from a job loss or an injury/illness.



REMEMBER

Private mortgage insurance is an extra cost that will factor into the calculation for the amount of your loan and reduce your ability to borrow. You may be able to avoid paying private mortgage insurance by using 80-10-10 financing. We cover this technique in Chapter 6.

Budgeting for closing costs

As you budget for a given home purchase, don't forget to budget for the inevitable laundry list of one-time *closing costs*. In a typical home purchase, closing costs amount to about 2 to 5 percent of the purchase price of the property. Thus, you shouldn't ignore them when you figure the amount of money you need to close the deal. Having enough to pay the down payment on your loan just isn't sufficient.



TIP

Some sellers may be willing to assist buyers by paying a portion of the closing costs. This is particularly true with new home subdivisions by major builders but is always negotiable with any seller. However, expect to pay a higher interest rate for a mortgage with few or no upfront fees.

Here are the major closing costs and our guidance as to how much to budget for each:

- » **Loan-origination fees and charges:** Lenders generally levy fees for appraising the property, obtaining a copy of your credit report, preparing your loan documents, and processing your loan. They'll also whack you 1 to 2 percent of the loan amount for a *loan-origination fee*. Another term for this prepaid interest charge, as we explain in Chapter 9, is *points*. If you're strapped for cash, you can get a loan that has few or no fees; however, such loans have higher interest rates over their lifetimes. You may be able to negotiate having the seller pay these loan-closing costs. The total loan-origination fees and other charges may add up to as much as 3 percent of the mortgage amount.
- » **Escrow fees:** These costs cover the preparation and transmission of all home-purchase-related documents and funds. Escrow fees range from several hundred to over a thousand dollars, based on the purchase price of your home.
- » **Homeowners insurance:** Lenders generally require that you pay the first year's premium on your homeowners insurance policy at the time of closing. Such insurance typically costs from several hundred to several thousand dollars, depending on the value of your home and the extent of coverage you desire.
- » **Title insurance:** *Title insurance* protects you and the lender against the risk that the person selling you the home doesn't legally own it. This insurance typically costs from several hundred to a few thousand dollars, depending on your home's purchase price. Happily, the premium you pay at close of escrow is the only title insurance premium you'll ever have to pay *unless you subsequently decide to refinance your mortgage*. Oddly, there are places like Northern California where the seller (not the buyer) pays for the "main" title policy. This is purely a matter of local custom. Ask your agent what the custom is where you are buying.
- » **Property taxes:** At the closing of your home purchase, you may have to reimburse the sellers for property taxes that they paid in advance. Here's how it works. Suppose you close your home purchase on October 15, and the sellers have already paid their property taxes through December 31. You have to reimburse the sellers for property taxes they paid from October 15 through the end of the year. The prorated property taxes you end up paying in your

actual transaction are based on the home's taxes and the date that escrow actually closes. These taxes cost from several hundred to a couple of thousand dollars. In some parts of the country, if you paid more than the prior owner for the property, you may also receive a supplemental property tax bill from your tax collector after you close escrow, seeking payment for the incremental increase in the property taxes for your prorated period of ownership.

» **Attorney fees:** In some eastern states, lawyers are involved (unfortunately from some participants' perspectives) in real estate purchases. In most states, however, lawyers aren't needed for home purchases as long as the real estate agents use standard, fill-in-the-blank contracts. If you do hire an attorney, expect to pay at least several hundred dollars.

» **Property inspections:** As advocated in *Home Buying For Dummies* (Wiley), you should always have a home professionally inspected before you buy it. Inspection fees usually cost at least several hundred dollars (larger homes cost more to inspect of course). Be sure to carefully review this report and ask for additional information or hire a specialized contractor to conduct further investigation for any noted item of concern. If you are able, accompany the inspector when they inspect the property.

» **Private mortgage insurance (PMI):** If you make a down payment of less than 20 percent of the purchase price of the home, mortgage lenders generally require that you take out private mortgage insurance that protects the lender in case you default on your mortgage. You may need to pay up to a year's worth of premium for this coverage at closing, which can amount to as much as several hundred dollars. One terrific way to avoid this extra cost is to make a 20 percent down payment.

» **Prepaid loan interest:** At closing, the lender charges interest on your mortgage to cover the interest that accrues from the date your loan is funded — generally one business day before the closing — up to the day of your first scheduled loan payment. How much interest you actually have to pay depends on the timing of your first loan payment.

If you're strapped for cash at closing, try the following tricks to minimize the prepaid loan interest you owe at closing:

- First, ask your lender which day of the month your payment will be due and schedule to close on the loan as few days in advance of that day as possible. (Payments are usually due on the first of the month, so closing on the last day of the month or a few days before is generally best.)
- Ask whether your lender is willing to adjust your monthly due date closer to the date you desire to close on your loan.

- Never schedule a closing to occur on a Monday because the lender will generally have to put your mortgage funds into escrow the preceding Friday, causing you to pay interest for Friday, Saturday, and Sunday. (Some lenders may be able to accommodate a Monday closing by same-day wiring the funds for an afternoon closing.)

» **Other fees:** Recording fees (to record the deed and mortgage), courier and express mailing fees, notary fees — you name it. These extra expenses usually total about \$200 to \$300. **Note:** Ask your mortgage lender for a complete listing of all fees and charges.

Managing maintenance costs

In addition to costing you a monthly mortgage payment, homes also need flooring, window treatments, painting, plumbing, electrical and roof repairs, and other types of maintenance over time. Of course, some homeowners defer maintenance and even put their houses on the market for sale with lots of deferred maintenance (which, of course, will be reflected in a reduced sales price that is often much greater than the cost of making those simple repairs).

For budgeting purposes, we suggest that you allocate about 1 percent of the purchase price of your home each year for normal maintenance expenses. So, for example, if your home is worth about \$400,000, you should budget about \$4,000 per year (or about \$333 per month) for maintenance.

With some types of housing, such as condominiums or planned unit developments (PUD), you pay monthly dues into a common interest development (often referred to as a homeowners association), which takes care of the maintenance for the community. In that case, you're responsible for maintaining only the interior of your unit. Check with the association to see how much the dues are currently running, anticipated future monthly or quarterly dues increases or special assessments, what services are included, and how they've changed over the years.



TIP

Robert has been a long-term board member or property manager for common interest developments and he always advises any home buyer who is considering a purchase in an association to ask to see the latest Reserve Study. A Reserve Study is required in many states and is prepared by an independent qualified specialist who will clearly indicate the components that are the association's responsibility to maintain, repair, or replace as well as the estimated future cost and how much is currently available to cover these future costs.



WARNING

Often, in a Reserve Study, there will be a “percent funded” number that can tell you how much money has already been collected versus what will be needed in the future when the work is done. Fully funded (90 to 100 percent) associations are rare, with most in the 50 to 80 percent range, which is reasonable. Be careful of any association with current Reserve Study funding levels below 50 percent because that may put you on the hook for higher dues or surprise assessments down the road.

Financing home improvements and such

In addition to necessary maintenance and furnishings, also be aware of how much you may spend on nonessential home improvements, such as adding a deck, remodeling your kitchen, and so on. Budget for these nonessentials unless you’re the rare person who is a super saver, can easily accomplish your savings goals, and has lots of slack in your budget.

The amount you expect to spend on improvements is just an estimate. It depends on how *finished* a home you buy and your personal tastes and desires. Consider your previous spending behavior and the types of projects you expect to do as you examine potential homes for purchase.

Consider the Impact of a New House on Your Financial Future

As you collect your spending data, think about how your proposed home purchase will affect and change your spending habits and ability to save. For example, as a homeowner, if you live farther away from your job than you did when you rented, how much will your transportation expenses increase? If you currently don’t live in a common interest development (that is, a community with a homeowners’ association), you’ll quickly learn about dues and sometimes special assessments, which are rarely anticipated and included in your budget.

Table 1-2 can help you total all your current expenses and estimate future expected spending.

TABLE 1-2

Your Spending, Now and After Your Home Purchase

Item	Current Monthly Income Average (\$)	Expected Monthly Income Average with Home Purchase (\$)
Income		
Gross salary	_____	_____
Bonuses/overtime	_____	_____
Interest/dividend	_____	_____
Miscellaneous	_____	_____
Total Income	_____	_____
Taxes		
Social Security	_____	_____
Federal	_____	_____
State and local	_____	_____
Housing Expenses		
Rent	_____	_____
Mortgage	_____	_____
Property taxes	_____	_____
Homeowners' association dues	_____	_____
Gas/electric/oil	_____	_____
Homeowners/renter insurance	_____	_____
Water/sewer/garbage	_____	_____
Phone (landline and/or cellphone)	_____	_____
Internet	_____	_____
Furnishings/appliances	_____	_____
Improvements	_____	_____
Maintenance/repairs	_____	_____
Food and Eating		
Groceries	_____	_____
Restaurants and takeout	_____	_____

Item	Current Monthly Income Average (\$)	Expected Monthly Income Average with Home Purchase (\$)
Transportation		
Fuel/gasoline	_____	_____
Maintenance/repairs	_____	_____
State registration fees	_____	_____
Tolls and parking	_____	_____
Bus/train/subway fares	_____	_____
Appearance		
Clothing	_____	_____
Footwear	_____	_____
Jewelry (watches, earrings)	_____	_____
Laundry/dry cleaning	_____	_____
Hair	_____	_____
Makeup	_____	_____
Other	_____	_____
Debt Repayments		
Credit/charge cards	_____	_____
Home equity/installment loans	_____	_____
Vehicle loans	_____	_____
Educational loans	_____	_____
Other	_____	_____
Fun Stuff		
Entertainment (movies, concerts)	_____	_____
Streaming services	_____	_____
Vacation and travel	_____	_____
Gifts	_____	_____
Hobbies	_____	_____

(continued)

TABLE 1-2 (continued)

Item	Current Monthly Income Average (\$)	Expected Monthly Income Average with Home Purchase (\$)
Pets	_____	_____
Health club or gym	_____	_____
Youth sports	_____	_____
Other	_____	_____
Advisors		
Accountant	_____	_____
Attorney	_____	_____
Financial advisor	_____	_____
Healthcare		
Physicians and hospitals	_____	_____
Prescriptions	_____	_____
Dental and vision care	_____	_____
Therapy/counseling	_____	_____
Insurance		
Vehicle	_____	_____
Health	_____	_____
Life	_____	_____
Disability/long-term care	_____	_____
Educational Expenses		
Courses	_____	_____
Books	_____	_____
Supplies	_____	_____
Kids		
Child care	_____	_____
Diapers/formula	_____	_____
Toys	_____	_____
Child support	_____	_____

Item	Current Monthly Income Average (\$)	Expected Monthly Income Average with Home Purchase (\$)
Other		
Charitable donations	_____	_____
Alimony	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
_____	_____	_____
Total Spending	_____	_____
Amount Saved	_____	_____
(subtract from Total Income)		

Acting upon your spending analysis

Tabulating your spending is only half the battle on the path to fiscal fitness and a financially successful home purchase. After all, many government entities know where they spend our tax dollars, but they still run up massive levels of debt! You must do something with the personal spending information you collect.

When most Americans examine their spending, especially if it's the first time, they may be surprised and dismayed at the amount of their overall spending and how little they're saving. How much is enough to save? The answer depends on your goals and how good your investing skills are. For most people to reach their financial goals, they must annually save at least 10 percent of their gross (pre-tax) income.

From Eric's experience as a personal financial counselor and lecturer, he knows that most people don't know how much they're currently saving, and even more people don't know how much they should be saving. You should know these amounts before you buy your first home or trade up to a more costly property.

If you're like most people planning to buy a first home, you need to reduce your spending to accumulate enough money to pay for the down payment and closing costs and create enough slack in your budget to afford the extra costs of home-ownership. Trade-up buyers may have some of the same issues as well. Where you

decide to make cuts in your budget is a matter of personal preference. Here are some proven ways to cut your spending now and in the future:

- » **Purge consumer debt.** Debt on credit cards, vehicle loans, and the like is detrimental to your long-term financial health. Borrowing through consumer loans encourages you to live beyond your means, and the interest rates on consumer debt are high *and not tax deductible*. If you have accessible savings to pay down your consumer debts, do so as long as you have access to sufficient emergency money from family or other avenues.
- » **Trim nonessential spending.** Although everyone needs food, shelter, clothing, and healthcare, most Americans spend a great deal of additional money on luxuries and nonessentials. Even some of what people spend on the “necessity” categories is partly for luxury.
- » **Purchase products and services that offer value.** High quality doesn’t have to cost more. In fact, higher priced products and services are sometimes inferior to lower cost alternatives. With so many products available online these days, and local bricks-and-mortar stores willing to price match, a little research can go a long way to finding real savings.
- » **Buy in bulk.** Most items are cheaper per unit when you buy them in larger sizes or volumes. Superstores such as Costco, BJ’s Wholesale Club, Sam’s Club, Target, and Walmart offer family sizes and competitive pricing.

Establishing financial goals

Most people find it enlightening to see how much they need to save to accomplish particular goals. For example, wanting to retire while you still have good health is a common goal. And the good news is that you can take advantage of tax incentives while you save toward retirement.

Money that you contribute to an employer-based retirement plan — for example, to a 401(k) or to a self-employed plan such as a SEP-IRA — is typically tax deductible at both the federal and state levels. Also, after you contribute money into a retirement account, the gains on that money compound over time without taxation.



WARNING

If you’re accumulating down-payment money for the purchase of a home, putting that money into a retirement account is generally a bad idea. When you withdraw money prematurely from a retirement account, you owe not only current income taxes but also hefty penalties — 10 percent of the amount withdrawn for the IRS plus whatever penalty your state collects.

If you're trying to save for a real estate purchase and save toward retirement and reduce your taxes, you have a dilemma — assuming that, like most people, you have limited funds with which to work. The dilemma is that you can save outside of retirement accounts and have access to your down-payment money but pay much more in taxes. Or you can fund your retirement accounts and gain tax benefits but lack access to the money for your home purchase.

You have two ways to skirt this dilemma:

- » **Borrow against your employer's retirement plan.** Some employers' retirement plans, especially those in larger companies, allow borrowing against retirement savings plan balances. Some companies offer first-time homebuyers a little financial assistance, so make sure you ask. Because you are borrowing your own money, the monthly payment (including interest) all goes back to your account. Also, monthly payments back to your retirement account do not count against your debt ratios.
- » **Implement a first-time home-buyer IRA withdrawal.** If you have an Individual Retirement Account (either a standard IRA or a newer Roth IRA), you're allowed to withdraw up to \$10,000 (lifetime maximum) per individual IRA account (so a married couple can access \$20,000) toward a home purchase as long as you haven't owned a home for the past two years. Tapping into a Roth IRA is a better deal because the withdrawal is free from income tax as long as the Roth account is at least five years old. Although a standard IRA has no such time restriction, withdrawals are taxed as income, so you'll net only the after-tax amount of the withdrawal toward your down payment.

Because most people have limited discretionary dollars, you must decide what your priorities are. Saving for retirement and reducing your taxes are important goals; but when you're trying to save to purchase a home, some or most of your savings needs to be outside a tax-sheltered retirement account. Putting your retirement savings on the back burner for a short time to build up your down-payment cushion is fine. However, be sure to purchase a home that offers enough slack in your budget to fund your retirement accounts after the purchase.

Making down-payment decisions

Most people borrow money for a simple reason: They want to buy something they can't afford to pay for in a lump sum. How many 18-year-olds and their parents have the extra cash to pay for the full cost of a college education? Or prospective homebuyers to pay for the full purchase price of a home? So, people borrow.

When used properly, debt can help you accomplish your financial goals and make you more money in the long run. But if your financial situation allows you to make a larger than necessary down payment, consider how much debt you need or want. With most lenders, as we discuss in Chapter 5, you'll get access to the best rates on mortgage loans by making a down payment of at least 20 percent. Whether or not making a larger down payment makes sense for you depends on a number of factors, such as your other options and goals. Here are some factors to consider:

- » **Loan terms and interest rate:** Most lenders offer their best mortgage rates when you put down at least 20 percent. A larger down payment may also further reduce your borrowing costs.
- » **Investment opportunities:** Consider what else you could do with the money. To come out ahead, your investments need to earn a return comparable to or greater than your mortgage rate.
- » **Reducing your emergency fund:** Avoid putting so much down that you drain your savings. Maintaining a solid financial safety net should be a top priority.
- » **Investment returns versus risk tolerance:** Higher returns typically require higher risk investments, such as stocks or real estate, which can be volatile and are not guaranteed.
- » **Tax considerations:** Mortgage interest may be tax-deductible, but investment earnings outside of retirement accounts are often taxable, reducing your net return.
- » **Alternative investment options:** Low-risk investments, such as savings accounts, CDs, or bonds, are unlikely to outperform your mortgage interest rate.
- » **Misconceptions about home value and mortgage size:** Your home's market value is independent of your mortgage balance — putting more money down doesn't protect you from price fluctuations.
- » **Psychological comfort level:** Some people prefer the security of a larger down payment and lower debt, while others are more comfortable investing and carrying a larger mortgage.

There's no one-size-fits-all answer. Choosing a down payment is about balancing opportunity, risk, and peace of mind. Weigh the potential returns of keeping money invested against the certainty of reducing debt and choose the path that best aligns with your financial profile and goals.