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**how to buy a
home**

How to Buy a Home

For many people, owning a home is the true “American Dream.” Homeownership has many benefits: your hard-earned money will *build equity* in a home instead of going to a landlord; you gain *tax benefits*, since items related to home-buying, like mortgage interest, are tax-deductible; and you can take pride in homeownership.

Most homebuyers obtain a mortgage to help finance this major purchase. Since buying a house or apartment is the largest acquisition most people ever make, and the most complex, you first need to understand everything it entails. Ask yourself:

1. How much home can you afford?

The standard rule of affordability is to allow 28% of your gross income for housing costs, and no more than 36% on total debt obligations. If your gross income totals \$40,000 a year, you can afford approximately \$933 per

month in home payments. Another rule of thumb: multiply your gross annual income by 2.5 for the home price you can afford (on a \$40,000 salary, that’s about \$100,000). These are only estimates; a mortgage lender will base the loan amount and interest rate on your income, debt, savings, length of time on your job and credit history.

You will need to make a *down payment* on the property you buy. It could be as little as 3% to 5% of the sale price, but sellers prefer the standard requirement of 20%. If yours is lower, you will need to pay monthly for *private mortgage insurance* on the difference between your down payment and 20%. If someone helps you with your down payment, the mortgage lender will probably require a letter from that individual. A home purchase also entails *closing costs*, typically 5% to 7% of the mortgage amount.

While those sums may seem staggering, *programs exist to help low- and moderate-income buyers with down payment and closing costs*. Check out federal government programs, in particular the Federal National Mortgage Association (“Fannie Mae”), Federal Housing Association and Veterans Administration.

2. How do mortgages work?

Mortgages are home loans from financial institutions, repayable over a period of one to 30 years. The most common *amortization*, or pay-down, period is 30 years. You will receive a monthly bill for what you owe the lender, which will include a share

of your *loan principal and interest* (the fee charged for the privilege of borrowing). The amortization schedule on a 30-year fixed-rate mortgage requires paying mostly interest for the first five years. That portion declines over the life of the loan.

Good news for buyers: Interest rates are at historic lows in 2009. If you can obtain a *fixed-rate mortgage*, you will pay a set rate of interest over a defined period of time, and your payments will stay constant during the loan’s entire term—a boon for your budget. An *adjustable, or floating-rate mortgage (ARM)*, is less predictable, and riskier. ARMs carry a fixed rate for a defined number of years; then the rate “floats,” being adjusted periodically according to an underlying benchmark, or index. A fixed-rate mortgage is the way to go.

3. Homeowner tax benefits.

When you hold a mortgage, you will no longer claim the “standard deduction” on tax returns. Instead, you *itemize* your deductions and use them to lower your taxable income (as you may do with 401(k) or IRA contributions).

The total of your deductions multiplied by your overall tax rate is what you will save. *Mortgage interest*, which totals about 95% of mortgage payments in the first five years of a 30-year loan, is fully tax-deductible. You may also deduct *property taxes* on the mortgage and some *closing costs on a primary residence*.

Let’s say your gross income is \$36,000 a year. You contribute \$250 a month to your 401(k) or IRA; pay \$7,200

of mortgage interest for the first year, and \$150 a month in real estate taxes; and \$1,000 of your closing costs are deductible (consult an accountant to be sure). Due to amortization, each mortgage payment pays down more principal and less interest. For example, the first payment of \$600 could be \$597 for interest and \$3 toward principal, while the second could be \$596 in interest and \$4 in principal.

Gross Income	\$36000
Deductions:	
401(k) Contribution (\$250/month)	\$3000
Mortgage Interest	\$7200
Real Estate Taxes (\$150/month)	\$1800
Closing Costs	\$1000
Total Deductions	\$13000
Taxable Income	\$23000
Tax savings (at 28% tax rate)	\$3640

4. Start planning now.

Start planning now. Obtain copies of your credit-bureau reports and credit scores; work to improve your scores. Report any errors you find. Establish a plan to erase bad (high-interest) debt and decrease good debt. Be sure bills get paid *on time*, since

that accounts for 35% of your credit score. These actions can boost your FICO score and show lenders that you are a good credit risk. Borrowers with credit scores above 710 usually get the most favorable mortgage rates.

Begin saving for the down payment, closing costs and additional expenses. If you can afford a \$100,000 home, for example, you will need \$20,000 for the down payment, \$5,000 for closing costs and perhaps an extra \$50 per month for utilities. Create a budget. If you hope to own a home in five years, you'll need \$25,000 by then; that means saving \$417 a month over a 60-month period. Set up a monthly auto-transfer of \$417 per paycheck into a "new home" savings account. If your paycheck won't cover that, take on a second job for a while and deposit the wages in your new home account.

Show stable employment. Mortgage lenders look for stability of income and employment in borrowers; preferably, you'll have worked for the same company at least a few years. It is best not to switch jobs just before you want to obtain a mortgage.

5. Initiate the buying process.

When you've saved nearly enough money for a down payment and closing costs, **get pre-qualified for a mortgage.** A "pre-qual" is a free written assessment of your income, savings and credit that estimates the loan amount for which you can

qualify. A potential lender or a mortgage broker will run a credit check on you, and require other financial information. (You have no obligation to use this lender or broker when you are ready to buy.) The pre-qual request will show on your credit report as an inquiry for credit, and eases your way when you are ready to make an offer on a property.

Select a lender (bank) or mortgage broker to provide you with the pre-qual letter. (Ask people you know to refer a lender or broker.) A **bank**, or **direct lender**, can provide the actual loan for your home, on 80% of the purchase price. A **mortgage broker** is not a lender, but works with multiple lenders to locate mortgages for you. (The broker takes a percentage, so your interest rate and fees will likely be higher.) Brokers are a good alternative if you have less than 20% to put down. The lender will send an *appraiser* (at your expense) to the property to verify that the value of the home equals or exceeds the amount you are borrowing.

If you qualify for a \$200,000 mortgage and have a 20% (\$40,000) down payment plus closing costs, you should only consider homes up to \$240,000. *Do not let a lender convince you that you can afford more than the guidelines given earlier.*

Narrow your search with a list of requirements, for example: neighborhoods, number of bedrooms, square footage, views, parking, proximity to schools and parks. Look first and foremost for a sound structure in a safe area

tip

Home ownership brings additional costs. Be sure to weigh the new expenses you may incur, such as higher utility bills and transportation costs, appliances that need repair and home improvements. Call the local electric company with the address of the property you're considering, and ask for the amounts of utility bills over the last few months. Build all of those costs into your budget.

tip

Here's an easy rule-of-thumb to determine your *tax savings*: add up all your deductions and multiply that amount by your tax rate on gross income ($\$13,000 \times 0.28 = \$3,640$ savings).

(location is everything in real estate). Cosmetic changes like wall colors are relatively inexpensive. Determine whether you want a co-op, condo, single-family or multi-family house. In a *co-operative apartment*, you own *shares in a legal entity* that owns the building. You'll pay maintenance fees that go toward building upkeep and real estate taxes. In a *condominium*, you own the unit outright, and maintenance fees pay for upkeep of common areas and sometimes, heat and hot water.

Start your search. There are many ways to find a home: word of mouth, newspaper ads, Web sites, realtors, and sales by owners. It's standard for the seller to pay the realtor's fee, but ask to be sure.

Make an offer. When you see a home you want, let the realtor know how much you're willing to pay. Once you and the seller agree on price, you will sign a written contract drafted by the realtor or the seller's attorney that states your offering price, the amount of your down payment and proposed closing date. (A first-time homebuyer with a pre-qual letter is often a preferred candidate since the purchase doesn't depend on selling an existing home.) You'll need to provide a deposit, or *binder* (\$1,000-\$20,000), which will temporarily be held in *escrow*, typically an attorney trust account.

Hire an attorney. Ask a friend or your realtor to recommend someone who specializes in real estate, preferably for a *flat fee that covers the entire sale process* rather than an hourly rate. S/he will protect your interests throughout the process and will work with the seller's attorney on the paperwork, reviewing all documents and discussing them with you. If the contract contains something unreasonable, you may cancel the deal; after that, there is no turning back. You must pay the balance of the down payment within 10 days, typically, and your lawyer will collect all closing costs, including mortgage, title, survey and insurance costs, on your behalf.

Secure your mortgage now. Shop around for the best interest rate; bankrate.com offers reliable comparisons. You'll work with a lender's *loan officer* who is responsible for your *mortgage approval*. Lenders charge various fees as part of the application/approval process, as do *mortgage brokers*. Typically, you'll request to guarantee, or "lock in," an interest rate for 30-60 days to protect yourself against rising rates. The lender can now provide a *good-faith estimate* of all the costs involved in your home purchase.

Choose an insurance agent. The agent represents an insurance company that will provide a *homeowner's insurance policy* to cover your property in case of damage. You typically pay the first year's premium on your homeowner's policy and provide the lender with proof of payment before a *closing date* is scheduled.

Schedule a title search. The seller will select a title company, where an officer reviews the property records and verifies that the seller is the property's legal owner. After a *surveyor* (usually chosen by the title company) verifies measurements of the property and land, the title company confirms ownership in writing.

Hire a home inspector, who will inspect your property to verify that it is in good condition. The inspector provides a written report of any structural issues or recommended repairs, for which you pay a fee. Your attorney can negotiate resolution of any issues with the seller.

Take a final walk-through of the property after all terms and conditions are met, usually the day before you close. Be sure the house is in agreed-upon condition and that no damage occurred when the owners moved out. If there are damages, the seller must pay for repairs.

Prepare for the closing. The entire offer-to-closing process may take from three weeks to two months. At the closing with your attorney and the seller's, you will sign a number of documents and present certified or cashier's checks for all closing costs and proof of homeowners' insurance. Your attorney will tell you the exact amounts required.

Now you can gather friends and family in your new home, and celebrate!

For more information about Bottomless Closet programs, call 212-563-2499 or visit www.bottomlessclosetnyc.org.

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