# Getting Ready to Buy a Home

## *Part 1: Know Your Current Financial Situation*

**Related Topics**

- Part 2: Get Your Credit in Shape for a Home Purchase
- Part 3: How Lender Ratios Affect the Size of Your Home Loan

**Quick Summary:**

- Know the two prices you can pay for every home.
- Sit down and add up your assets, liabilities and income *before* you start looking for a home.
- Act more swiftly and confidently as a homebuyer once you really know your financial situation.

**The benefits of knowing your current financial situation**

Buying a home involves money—your money and a lender's.

As part of the home-buying process, you'll be filling out a loan application and providing financial details and documents to a lender. When you do this, you are painting a financial picture of yourself for a lender. Lenders look at your savings, income, credit and debt to determine the specifics of the loan, including the size of a loan and the loan terms, including the interest rate. The better you look on paper, the better the loan you can get. All of your financial information is very useful to you, too, to help you determine the affordability of a home purchase and to make you a more knowledgeable buyer.

So whether you're buying your first home or your tenth, there are essential steps for every home purchase transaction. If you do all your *home*work in advance, you will:

- save yourself money and aggravation
- streamline the home-buying process and
- avoid the common pitfalls that can jeopardize or stop your home loan and home purchase transactions.

**Determine how much you can really afford**

Buying a house is both a financial decision and an emotional decision. That's why it's important to remember that there are two prices on every home purchase.

- First, there's the maximum amount you *can* afford to spend if you push to the absolute financial limit.
- And second, there's the maximum amount you *should* spend taking into account your financial, career and personal situation.

These two prices may not be the same. You may not want to push yourself to your financial limit. With either home price, you need to know your financial essentials before you start looking for your dream house. Here's where you start.

**Gather and understand the essential information on your assets, liabilities and income**

When you were in school, it sure would've been easier if your teachers told you all the test questions weeks or months before you took your tests. With home buying, you not only get to see the questions in advance, you can look at your answers before you turn in your paperwork and see if they need improving. The first step to help get this real-life advantage is to:

- Make a detailed list of your assets – include a brief description of every asset and the current market value of each asset

  Divide up your list between retirement assets (those held in an IRA, 401(k) or other retirement plan) and non-retirement assets. Although both types of assets are looked at by a lender in determining your financial stability, only non-retirement assets are usually used by you for a downpayment, other home purchase expenses as well as the expenses that come with owning and maintaining a home.

- Make a detailed list of your liabilities – on each debt, include a brief description, the amount currently owed, the size of the monthly payment, the interest rate and whether and when a balloon (large) payment is owed. Having a detailed list of all of your debts and their costs can help you choose the right mortgage (home loan) for you.

- Organize and make a copy of your W-2's and federal income tax returns (for up to the last three years); pay stubs or financial statements to verify your current year's income; copies of statements verifying your bank accounts, stock, mutual fund and retirement assets; and other relevant financial information to explain your circumstances. Having this information on hand makes it easier and quicker to complete loan applications and to find the loan options that will work for your particular circumstances.

Your next step is to make sure your credit is in good shape before you try to buy a home.

Get Your Credit in Shape for a Home Purchase >>

# Getting Ready to Buy a Home

## *Part 2: Get Your Credit in Shape for a Home Purchase*

**Related Topics**

- Part 1: Know Your Current Financial Situation
- Part 3: How Lender Ratios Affect the Size of Your Home Loan

**Quick Summary:**

- Four to six months before you start looking for a home, check your three credit reports and correct any errors. Also check your credit score.
- Avoid new debt and cut spending to reduce your debt and build up the size of your downpayment.
- Pay your bills on time and take steps to improve your credit reports and credit score to help you qualify for a lower interest rate and possibly a larger loan.

**Why your credit reports and credit score are so important**

When you ask a lender for a loan, they want to know how creditworthy (and trustworthy) you are. Your credit reports and your credit score can help lenders (and also employers, insurance companies, landlords and others) make that decision. Those aren't the only tools lenders use to judge you, but they are among the most important ones.

Your credit history can help determine whether you qualify for a loan, the type of loan, the size of a loan and the interest rate on the loan. That's why it's in your best interest to have a credit score and credit reports that are error-free and show that you are reliable, trustworthy and able to pay back a loan.

**Steps to take four to six months before you start looking for a home**

To make it easier to get a home loan and one with a lower interest rate, take these steps four to six months before you want to buy a home:

- Make sure your credit reports from the three main credit reporting companies (Equifax, Experian and TransUnion) are accurate and take steps to correct any errors.

- Pay your bills on time so you don't hurt your credit rating.

- Reduce your debt load to help you qualify for a home loan. See How Lender Ratios Affect the Size of Your Home Loan

- Stay away from new debt.

- Cut your spending to build up your savings for a downpayment.

**Credit reports vs. credit score**

A *credit report* is a dollars and cents report that shows how well (or poorly) you've been doing in paying your bills, how much debt you've taken on and how long you've had the debt. This type of report contains a lot of specific dollar details as well as public information records such as bankruptcies and tax liens.

The three main credit reporting agencies are:

- Equifax, www.equifax.com
- Experian, www.experian.com
- TransUnion, www.tuc.com

You can use one central website, www.annualcreditreport.com, to request one free credit report from each of the three credit reporting agencies every twelve months. You can order all three at the same time if you want. Four to six months before the home-hunting process begins, request your credit report from all three agencies. Review the reports carefully and notify the agencies of any errors. The reason you're requesting these reports so far in advance is to allow time to correct any errors.

A *credit score* is a three-digit number (higher is better) that lenders and others use to help them determine whether you're a good credit risk. Also known as risk scores, the most widely used one is the *FICO*® from Fair Isaac (www.myfico.com). The three credit reporting agencies also offer a credit score. You may have different credit scores from Fair Isaac as well as each credit reporting agency.

A higher score means you are seen as a better credit risk. A higher ranking can also mean it's easier for you to qualify for a loan or for a loan that's at a lower interest rate. That could save you thousands or tens of thousands of dollars in interest over the life of a loan.

**What affects your credit score?**

Your credit score is a numerical rating that grades you as a potential borrower by looking at factors such as:

- Your bill-paying history
- The length of your credit history
- Your tendency to look for new credit
- Your credit mix (how much installment and revolving debt you have)
- Your debt ratio (how much debt you have compared to how much you could have—your available credit line)

For more information on credit scores, go to *www.myfico.com*.

Note that different lenders have different standards for what is considered a "good" credit score.

Now that you know how to gather the information on your financial and credit situation, in Step #3 see the financial ratios lenders use to help them make decisions on home loans.

How Lender Ratios Affect the Size of Your Home Loan >>

# Getting Ready to Buy a Home

## *Part 3: How Lender Ratios Affect the Size of Your Home Loan*

**Related Topics**
- Part 1: Know Your Current Financial Situation
- Part 2: Get Your Credit in Shape for a Home Purchase

**Quick Summary:**

- Most lenders use the 28% housing expense ratio and the 36% total obligation ratio to help determine how big a loan you can afford.
- See how your numbers come out on the ratios to know what you can afford to buy.
- Take steps to improve your numbers before making a home purchase.

**How big can your home loan be?**

If you take out too big a loan, you may not be able to repay it. That's why it's important for you to know upfront about the two general tests lenders use to determine the maximum size of your home loan:

- the 28% housing expense ratio and
- the 36% total obligation ratio

Ideally, you want to meet both percentage tests.

If you can't pass these 28% and 36% ratio tests, keep in mind that different lenders may use different percentages (higher or lower) or have their own tests. Even if a lender is okay with offering you a loan that'll require an even higher percentage of every paycheck to pay your housing and debt costs, that doesn't mean it's necessarily a good idea for you to take on that much debt. Remember, there are two prices on every home purchase—the maximum you can afford to spend and the maximum you should spend knowing your financial, career and personal situation.

**28% housing expense ratio**

For this test:

- Add up all of your estimated yearly housing costs—mortgage payment plus property taxes, property insurance and any homeowner's condominium or cooperative's fees on your home.
- Count the full costs without taking into account any tax deduction for these expenses.
- Divide your yearly housing costs by your yearly household annual gross income.
- If your yearly housing costs are no more than 28% of your household annual gross income, you pass this test.

To see monthly numbers instead of annual amounts, divide the numbers in steps 1 and 2 by 12 (for 12 months). See the chart below for an example.

**36% total obligation ratio**

For this test:

- Add up all of your yearly housing costs (from the 28% ratio above) plus your annual credit card payments, car payments and other loan payments.

- Divide that total by your household annual gross income.

- If the total costs are no more than 36% of your household annual gross income, you pass this second test.

Again, you'd divide by 12 to see the monthly numbers. See the chart below in the example.

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**Example**

Jane and John's annual household income is $60,000. That's $5,000 per month in income.

To pass test #1 (the housing expense ratio), their 28% maximum for these expenses could equal up to $1,400 per month (see the chart below). To pass test #2 (the total obligation ratio), their 36% maximum for housing costs plus the other debt expenses could equal up to $1,800 per month.

## 28% and 36% Ratio Chart

| **Annual/Monthly Household Income** | 28% of Monthly Income (Housing Expense Ratio) | 36% of Monthly Income (Total Obligation Ratio) |
|---|---|---|
| $40,000/$3,333 | $933 | $1,200 |
| **$60,000/$5,000** | **$1,400** | **$1,800** |
| $75,000/$6,250 | $1,750 | $2,250 |
| $100,000/$8,333 | $2,333 | $3,000 |

**Two ways you can improve your ratios**

First, a larger downpayment will reduce the size of your home loan and reduce your house costs. This lowers your numbers under both ratios (lower is better). Of course, by using more of your savings or the sale proceeds of other assets as a downpayment, you may be reducing your income, too.

Second, if you pay off some of your non-housing debt, this will improve your numbers under the 36% ratio test.

Now that you know about the ratios lenders may use to determine how much you can afford and some steps you can take to improve your ratio results, take a look at the next section to learn how to create a personal budget for buying a home.