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Your Path to Home Ownership

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All About Home Loans



Buying a home is an anxiety-producing process. It's also one of life's great adventures. The better prepared you are at the outset, the more fun and the less frustration you'll encounter along the way to becoming a homeowner.

Use this booklet to guide you through the maze of questions and procedures involved in buying a home. The information on these pages will help you determine whether you should buy, what to buy, how to be a smart buyer, and more.

A booklet such as this covers the basics of home buying. More questions will crop up as you move through the process. But the good news is you can count on the people at your credit union to provide you with more information. They can provide advice particularly suited to you and your individual financial circumstances.

But first, educate yourself about the general steps involved in buying a home. Learn as much as you can about what lies ahead. Then you'll know the right questions to ask later, and you'll feel more at ease throughout the home-buying process. By reading this booklet, you'll be off to a good start in your journey toward becoming a homeowner.

*It takes time to recoup the costs
of buying and owning a home.*

Should You Buy or Rent?

When asking yourself this question, place the emphasis on the second word. Both renting and buying have pluses and minuses. In the end, it comes down to what makes the most sense for *you*.

Of course, to be a candidate for home buying, you need adequate income and

savings, and your credit history must be in good shape. We'll get into this in more detail later in the "Can You Afford to Buy?" section.

Another issue on the financial side is that home ownership allows you to build equity, or the financial stake you have in your home. Equity grows as your home's value increases due to market changes and

Home Ownership and Tax Breaks

Home ownership becomes a major expense, but also will provide some tax breaks.

Mortgage interest

For most homeowners, the biggest home deduction is mortgage interest. Because the bulk of your monthly mortgage check goes toward interest—especially in the early years of home ownership—all that interest is deductible if you itemize. Interest tax breaks don't end with your first mortgage. If you refinanced your house and took out extra cash or took out a home equity loan or line of credit, this interest also is deductible.

Points

If you paid points to get a better rate on a home loan they offer a tax break as well. The IRS (Internal Revenue Service) allows you to deduct points in the year you paid them if, among other things, the loan is to purchase or build your main home, payment of points is an established business practice in your area, and the points are within the usual range.

Property taxes

Another large portion of your monthly loan payment is real estate taxes. You can generally deduct taxes that you've paid on your property in the year you pay them. These taxes will be an annual deduction as long as you own your home and itemize.

Home improvements

Though home improvements and repairs are generally nondeductible, they can provide a tax break when it comes time to sell your house. This is because when you sell your house, you add the cost of the improvements to the purchase price to determine the cost basis in your home. Regular repairs and maintenance are not considered improvements, however, if repairs are part of an extensive remodeling project, the entire job may be considered an improvement.

These are only some of the tax breaks that come with home ownership. The government often provides a number of other tax breaks that expire in one year or only are for home buyers in certain categories. Check with a tax adviser or the IRS Web site—irs.gov—for more information.

as you pay down the mortgage. Making home improvements further boosts your equity. As a homeowner, you'll have something to show for your money. Renters, on the other hand, end up with nothing but a fistful of canceled rent checks.

But to answer the rent-vs.-buy question, you must weigh many other factors, both financial and personal, such as:

- **What are your plans for the near future?**

If you intend to stay put for the next few years, you might think about buying a house. On the other hand, if you're expecting a job transfer or you think you'll want to move to a new city in a couple of years, you'd be better off renting for now. That's because it takes time to recoup the costs of buying and owning a home. Beyond your down payment, you also pay mortgage application fees, closing costs, and other upfront expenses. Plus you'll face upkeep and repair costs. And you'll need to pay a real-estate agent a commission to sell your home, unless you want to take on the job of selling it yourself. To recover these expenses when you sell, you need to have been in your home long enough for it to increase sufficiently in value. Sometimes you can break even in just a few years. Usually it takes more like five to seven years. A lot depends on how rapidly—or if—housing values are climbing in your area. Keep an eye on what the market is doing and what the predictions are for the next few years.

- **Do you have a good idea what you're looking for?** Maybe you're still new to your city or area. You need some time to acclimate yourself, to find out which neighborhood suits you best. Renting gives you time to scout around and determine where you want to live.

- **How do you like to spend your spare time?** As a homeowner, expect to spend a chunk of your weekends raking, mowing, cleaning gutters, and making minor repairs. Can you live with that? Or would you rather devote all your leisure time to other pursuits? If so, keep renting.

- **How do you want to spend your extra money?** Houses require constant feeding, beyond the utility bills renters pay. Home maintenance expenses eat into your budget, whether it's \$30 for a new kitchen faucet or \$7,000 to replace the roof. Maybe you'd prefer to spend your surplus cash on, say, a trek to Nepal instead.

- **Could you benefit from the tax breaks?** One of the perks of home ownership is that mortgage interest and property taxes are tax-deductible. You list these as itemized deductions at tax time. Itemizing deductions means you forego the standard deduction. Some homeowners, however, are money ahead with the standard deduction, rather than itemizing deductions. Keep in mind, too, that the interest portion of your mortgage payment dwindles as the years go by, and likewise so does your tax deduction. (See "Home Ownership and Tax Breaks" on p. 3 for more details.)

- **Do you long to own a home?** This question may be, more than any other, at the heart of the buying decision. Maybe you're itching to plant your own garden, decorate a home to suit your tastes, and get out from under a landlord's restrictions. In spite of the extra expenses, added home chores, and the occasional headaches, you still truly want to buy a place to call your own. That's a strong sign you're ready to buy. Indeed, the emotional aspects may carry as much weight in this decision as the financial ones.



Can You Afford to Buy?

You've grappled with the personal readiness issues discussed in the previous section. Now you're set to crunch some numbers to find out if you can afford a house.

Monthly payment

A helpful guideline here is the 33/38 rule. The first part of this says that your monthly house payment (including mortgage principal and interest, property taxes, and home insurance) should amount to no more than 33% of your monthly gross income (what you earn before income taxes, Social Security, and other deductions come out of your check).

As an example, someone grossing \$4,000 a month should spend no more than \$1,320 ($\$4,000 \times 0.33$) per month for house payments.

The rest of this guideline advises that your total monthly debt obligations should add up to no more than 38% of your gross income. For someone earning

\$4,000 a month, that would be \$1,520 ($\$4,000 \times 0.38$). That amount should cover all debt payments made each month: mortgage, credit card, college loans, car payment, child support, and so on.

Many lenders will follow the 33/38 rule in determining how large a mortgage they're willing to give you.

These are just guidelines, however. In the end, you have to decide how large a house payment you can manage, based on your financial situation. You may prefer to be tied down to smaller house payments than the allowable maximum. Perhaps you want to, or must, leave elbow room in your budget for other ways to use your money, such as for travel or caring for a relative.

A lender will consider these guidelines, your credit history, and the property in making a home loan.

So run the numbers to see what's possible, and then assess how that stacks up against your personal budget. Need further advice? Talk to someone at your credit union.



More than a house, you're
buying a neighborhood—
with all its charms and flaws.

See the mortgage calculators at creditunion.coop to help determine how much house you can afford and what your monthly payment would be.

Down payment

Typically a mortgage lender will require a down payment equal to at least 5% of a home's purchase price. A \$222,000 house would require a minimum \$11,100 down payment ($\$222,000 \times 0.05$), which would leave \$210,900 to borrow.

Again, special programs, such as those for veterans, may demand less than 5% down, or even no down payment. Other programs also may be available to buyers depending on the buyer's credit standing, income, and the type of property being purchased—for example a condo or single-family residence. Geographic location also plays a huge role in what types of loans are available and how much of a down payment is required.

In this dynamic environment borrowers may have many loan options available—advantages may provide a tax break, lower rate, higher qualifying ratio, or lower down payment.

Your credit union lender can inform you about programs available in your

area and their eligibility requirements.

Buyers who pay less than 20% down typically must buy private mortgage insurance (PMI). This is insurance for the lender, not the buyer, though the buyer pays for its cost. It protects the lender in case you default on the loan. The premium is rolled into your monthly house payment, although you may have to pay the entire first year's premium up front, at closing. Once your equity reaches 20%, you'll be able to drop PMI.

Scraping together even just a 5% down payment may seem a huge hurdle, especially to first-time buyers. A caution: Don't sink every last dollar you have into a down payment. You'll need cash to cover closing costs (see next page), pay for regular maintenance and repairs, hire movers, perhaps buy new furniture.

Plus, you have other things in your life to save for, such as retirement and college. You also should maintain a savings reserve equal to three to six months' living expenses to cover financial emergencies. Plunking down every dime you have for a down payment on a house will leave you financially stretched and emotionally stressed.

Many young buyers just starting out get help from parents or other relatives to meet their down payment. Your lender will ask to see a letter verifying this money is a gift, not a loan. If it's

the latter, it would be factored into your debt obligations in determining how big a house payment you can handle.

Closing costs

The closing is the final ritual in the process of becoming a homeowner. It involves signing lots of papers and some sizable costs, which could range from 3% to 6% of the mortgage amount (see “Closing Day” on p. 21).

For that \$211,000 mortgage in our earlier example, the closing costs might be anywhere from \$6,330 to \$12,660. Local practices across the country vary a great deal, however, in terms of which closing costs are paid by the buyer or seller.

In addition to various lender fees, closing costs include charges for a property appraisal, escrow payments, deed recording fee, and more. The closing costs are due in full on closing day. You’ll probably need cash to cover these, as well as the down payment. Depending on your down payment and potential equity in the house you buy, you may be allowed to roll the closing costs into your mortgage. It never hurts to ask whether this is possible.

Your lender will provide a written detailed estimate of your closing costs—known as a good faith estimate—within three business days of accepting your mortgage application. You’ll get an exact figure by one business day before closing.

Your 33/38 Calculations

Gross monthly income _____

× 33% or 0.33 =

Your allowable
mortgage payment _____

Gross monthly income _____

× 38% or 0.38 =

Your allowable
debt load _____

Minus:

Car payment _____

College loans _____

Average monthly
credit card payment _____

Child support _____

Other _____

Your allowable
mortgage payment _____

Note: The lender would approve you for the smaller of the two amounts at the bottom of these columns.



The Hunt Is On

Brace yourself: While shopping for a house, you may learn more than you want to know about the range of your mood swings. You'll have moments when you'll feel excited about the process. At other times, you'll bottom out, worrying you'll never find a house you like *and* can afford.

Some sources claim that buyers tour at least 15 houses before they find one that suits them. And that doesn't count all the ones they simply drive by and eliminate without an inside visit.

But somehow, despite the ups and downs, it all works out in the end. You can, however, dramatically diminish the agony of this process if you thoroughly think through what you want before you start looking. Here are a few pointers.

First, get preapproved

Your credit union lender can preapprove you for a mortgage amount. That figure, coupled with the down payment, defines what house price you can afford. The lender will draw up a letter indicating the mortgage amount for which you've been preapproved.

One benefit of obtaining a preapproval letter is that you can show it to the seller, who will take this as a sign that you're a serious buyer, rather than a window-shopper. In fact, real estate agents in some areas require that a buyer have a preapproval letter from a

lender before they'll show the buyer any houses.

Even if it's not a requirement in your area, preapproval is a crucial step. You won't waste time looking at houses outside your price range. If at first you set your sights on houses that later turn out to be beyond your financial means, you'll feel your dreams have been dashed. Spare yourself the heartache by getting preapproved as your first step in house hunting.

Location, location, location

A couple arranged with a real-estate agent to view a house one Sunday afternoon. They loved the house and the neighborhood seemed fine, so they bought the house. Unfortunately, they were new to town and didn't know until after they'd moved in that their street, so quiet on a Sunday afternoon, was heavily trafficked during weekday rush hours. Now they wish they'd never bought the house, but they're stuck until the price climbs enough to at least break even when they sell.

House-buying sagas contain many such stories. Buyers forget they're purchasing more than a house. They're buying a piece of a neighborhood, with all its charms and flaws.

So do more than walk through the house. Stroll the neighborhood. Talk to neighbors. Come back at different times of the day and evening, weekdays and