Fundamentals of PERSONAL FINANCE

Making informed financial choices

Your Path to Home Ownership

Good financial decisions start with good financial information. With *Fundamentals of Personal Finance: Making Informed Financial Choices*, you have this handbook and others to help you gain the financial savvy and confidence you need for success.

This self-help series makes learning about finances easy with practical tips, step-by-step guidance, and charts. Regardless of your life stage or situation, there's a topic to meet your needs. Ask your credit union about the following titles:

- **Your Investment Choices**
- **Your College Savings Answers**
- **Your Insurance Options**
- **Your Retirement Guidelines & Goals**
- **Your Budget Blueprint**
- **Your Path to Home Ownership**
- **Your Vehicle Buying Road Map**
- **Your Guide to Financial Fraud Prevention**

You've made a good financial decision already by sitting down with this handbook. It's time now to turn the page to a stronger financial future.

Information provided by

EQUAL HOUSING LENDER

AMERICA'S CREDIT UNIONS™

800-356-8010, ext. 4157
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Contents

Your Path to Home Ownership

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.

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

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.

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 × 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 × 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 × 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 weekends. Is this a neighborhood where you could feel at home?

Also, what are the property taxes in this part of town? Are there restrictions in this neighborhood that would limit your ability to add on to the house later?

Make a list of your "must haves" in terms of location. For instance, how important is it to you that your kids can walk to school, or that you're near a bus line to commute to work, or that a park is nearby? You may not get it all, so decide now what location attributes are absolutely essential to you. With that, you'll be a more focused shopper.

The house itself

Location of components within the house is important, too. We're talking here about floor plan. Again, draw up that "must have" list. Do you need a space for a home office, away from noisy parts of the house? Do you want a family room adjacent to the kitchen or would you prefer it to be in the basement? Is a spare bedroom essential because you regularly have house guests?

Pin down your needs and wants. If you're buying a home as a couple, the two of you will have a lot to discuss as you draw up your wish lists.

Exterior design, interior floor plan, and general appeal inside and out are important. So, too, of course, are structural and mechanical soundness—the qualities not always visible to the naked eye. More on that in the "House Inspection" section on p. 17. Never buy a home without a professional inspection. Sadly, that's a lesson some homeowners learn the hard way.

Compare several houses. Take all the time you need to find the right choice for you. Do a second walk-through before you make an offer on a house, no matter how "perfect" it seems on the first visit.

Chances are no house will meet 100% of your expectations and wishes. Inevitably, you'll make a few compromises. But sacrificing too many of the features ranking high on your "must have" list will lead to misery. All the more reason to know precisely what's most important to you—before you launch your house hunt.

Preapproval vs. Prequalification

You may encounter both these terms as you do your homework on buying a house. These processes are not the same, although many people confuse them.

Prequalification simply involves a rough calculation of the mortgage payment you can afford. Your credit union lender can help you with this.

Preapproval means you're essentially good to go. You formally apply for the mortgage and pay an application fee. The lender determines that you are eligible for a mortgage of a certain amount.

So why is it called *pre*approval, rather than approval? That's because before making a final commitment to you, the lender must verify your information regarding employment and salary. Also, the lender needs to see a professional appraisal of the house you select to be sure its value is at least equal to the selling price.

Thanks to automation in today's mortgage lending, your lender usually can give you a preapproval in a short time, perhaps even immediately after you apply. Ask your lender for details.

Working With an Agent

Much confusion exists about the role of the real-estate agent (also called a broker, or Realtor® if the person is a member of the National Association of Realtors) in the house-buying transaction.

If you see a house advertised in the newspaper and call the agent listed, that agent is working for the seller. Many buyers probably would assume as much. But if you pick an agent to help you scout for houses, that agent *also* is bound by professional obligations to look out for the sellers' interests—unless you strike a different agreement, in writing, between you and the agent. More on that later.

This is a vital bit of information, not mere hair-splitting. Because that agent is duty-bound to safeguard the seller's interests, he or she can't tell you, for instance, why the seller is selling, unless the seller gives permission to do so. The agent can't divulge concessions the seller is willing to make on price or give you any other information that might work against the seller.

On the other hand, the agent is obliged to relate to the seller any information the buyer reveals. If you make an offer of $200,000 on a house and confide to the agent that, if necessary, you'd boost your offer another $10,000, the agent must inform the seller.

Your initial reaction might be "That's not right!" But think about it. Who's paying the agent's commission? That agent may spend many hours showing you 20 houses all over town, but you pay nothing for that service. The seller pays the agent, not you. Thus, the agent's duty, in the traditional agent arrangement, is to protect the position of sellers, not buyers.

Another option: buyer agents

When you hire a buyer's agent, that person looks out for your interests. He or she can tell you anything about the house, neighborhood, or seller that might be advantageous to you, the buyer. Similarly, he or she won't divulge information you'd prefer the seller not know about you.

A buyer's agent earns a fee for services. Practices vary on how this is handled. For instance, you might pay a fee to the agent, or the buyer's and seller's agents may split the seller-paid commission. Be sure you understand the payment arrangement before signing a contract with a buyer's agent.

Is hiring a buyer's agent necessary to protect your interests in the purchase transaction? Not at all. Many home buyers find the house they want, get a good deal, and work solely through sellers' agents. It's the only way it was done for decades.

The important point is that you understand exactly what the relationship

is between you and your agent, whichever type you choose. And keep this in mind as you go through the house-hunting process. A seller's agent may effuse that a certain house is "so perfect for you." But given the agent's allegiance, you have to be the objective one, just as you would in any other purchase transaction.

Familiarize yourself, too, with local practices in using buyer or seller agents, which vary considerably across the country. Then decide what type of agent relationship best suits you.

Do it yourself?

Rather than using an agent, you could do your own house hunting by browsing through newspaper classified ads and Internet listings, and cruising neighborhoods to search for for-sale signs.

Count on investing much more of your personal time if you choose the do-it-yourself route. You'll have to do the scouting, rather than having an agent do it for you. Buyers often mistakenly believe they'll save money by not using an agent. But sellers pay agents' commissions, not buyers, although that may differ if you decide to hire a buyer's agent who works solely for you.

Bear in mind that agents don't have access to all information relevant to your search. Houses that are "for sale by owner," or FSBO (fizbo), aren't in the multiple listing service (MLS). You'd need to find these on your own through print or Internet ads, lawn signs, or notices posted on bulletin boards in such places as grocery stores or libraries.

Selecting a real estate agent

Whether you decide to work with a buyer's or seller's agent, here are a few pointers to help you choose the right person. You may want to meet with and interview a few before you choose one.

- **Is this a good match?** Does the agent listen to you and understand what you're looking for in a home? Does he or she seem to have the energy, dedication, and patience to help you find what you want? Will you enjoy being around this person quite a lot in the coming weeks or months?
- **Ask around.** Check with friends, relatives, and work colleagues for recommendations for an agent. They know you. They may have worked with an agent they think you'd like and respect.
- **Ask for references.** If you can't get recommendations from people you know, and must choose an agent who's unknown to you, ask for references from other buyers who have worked with this agent.
- **Is the agent familiar with your targeted area?** It will be a big plus if the agent knows the community or neighborhood where you're hoping to buy. How many property transactions has he or she handled in this particular area?
- **Does the agent belong to MLS?** The multiple listing service (MLS) is a database listing houses for sale in your area, often including pictures and lots of details about each house. Be sure your agent is an MLS member.
- **Professionalism.** Ask about professional credentials the agent has earned.

Making an Offer

Eventually all your preparation and searching pay off, and you find a house you'd like to call your home. You're ready to make an offer. The jitters often set in at this stage, especially if you're a first-time buyer. You worry that the seller won't accept your offer ... that someone else will outbid you ... that you'll blow this opportunity.

Take a deep breath and keep a couple of key points in mind. First, if this deal falls through, you will find another house that you like. Second, you know what you can afford, so stick to it. You don't want to live with an impulsive mistake that will haunt you every time you cut a check for the monthly mortgage payment for years to come.

The process

To make an offer, you complete a form called a "purchase and sale agreement" or some other name, depending on your location. Your agent can help you fill out the form, although some states require that an attorney draw up the offer. If you're under no such requirement, it's still a good idea to have an attorney review the document before submitting it.

You'll accompany your offer with a check, often called earnest money or a good-faith deposit. This indicates to the seller that you're a serious buyer.

Your deposit goes not to the seller, but into an escrow account, usually held by the real-estate agent. Your money will be returned to you if the seller rejects your offer. If you back out of the offer after submitting it, you stand to lose your deposit. If the seller accepts your offer, your deposit eventually becomes part of your down payment.

Besides accepting or rejecting your offer, the seller may take one other action: making a counteroffer—that is, offering different terms of the sale such as another suggested selling price. Each time an offer or counteroffer is put on the table, the parties have a certain number of days to respond (varies by locality or contract). The agent or agents involved act as intermediaries in relaying offers and counteroffers between buyer and seller.

Once the seller accepts your offer or you accept a counteroffer, the agreement is legally binding. You have a contract. Too late now to decide that the price is too high after all, or that you like another house better.

How much?

The hardest part of making an offer is deciding on a dollar figure. The seller's asking price is a starting point, but typically a buyer will offer less. No hard-and-fast rules exist here, however. If you think the price is fair and the house is likely to sell fast, you may want to offer what the seller is asking. On the other hand, if you deliberately low-ball the price, knowing the house is worth more, you'll insult and annoy the seller, who may react by digging in deeper on the asking price.

So, common sense must prevail, coupled with solid information, such as:

- **Market value**—Find out how much comparable houses in the area have sold for in recent months. This information is available through your city clerk's office. Or you may get this information through a comparative market analysis (CMA) report prepared by the agent. You definitely can ask for a CMA if you're using a buyer's agent. A seller's agent may or may not be open to sharing such information, depending on the seller's wishes.
- **House condition**—The market analysis tells you how the house you're considering compares in terms of size, number of rooms, and other similar properties. That's only a start. Look at those other properties from the street. How does their condition compare with that of the house you're considering?
- **Seller's motivation**—Why is the owner selling the house? Has the owner purchased another home and needs to sell this one promptly? Has the house been on the market for a long time? Is the house in foreclosure? Whatever information you can glean about the seller's situation (again, the seller's agent will not divulge this without the seller's permission) may help you in deciding how much to offer.

Contingencies and other provisions

These are crucial elements in the offer. Contingencies are conditions that must be met before the contract will take effect. Your offer to purchase will be contingent upon:

- **The results of a professional house inspection**—Do not skip this step. Sure, both the seller and the seller's agent are legally bound to tell you about any known defects in the property. And you've thoroughly checked the house yourself. But an inspector's trained eye may notice problems you miss. Include a statement in your offer that it's contingent upon a good report from a professional home inspector. More on this in the "House Inspection" section on p. 17.
- **Obtaining financing**—This contingency states that the offer depends on whether you can obtain mortgage financing for a stated amount at acceptable terms. It also will state how long you have to obtain financing. If you got preapproval, you're a step ahead here.
- **An appraisal**—Before issuing you a mortgage, the lender will require a professional appraisal to be sure the house has sufficient value. If the appraisal is lower than the purchase price, you may not get the mortgage. In that case, this contingency would allow you to withdraw your offer.

You may want to insert other provisions into your offer, as well. For example, you might stipulate that the owner repair a cracked window before the closing date. Also, if certain items in the house are included in the sale, such as draperies or a dishwasher, be sure this is written into the contract. Don't rely on the seller's verbal statements alone.

Finding a Home Loan

Shopping for a mortgage is an equally critical part of the house-buying process. You and your mortgage are going to be together for a long time. So choose carefully and be sure you understand exactly what you're getting.

Today, borrowers face a mind-boggling assortment of types of mortgages and lenders who offer them. Here we'll cover a few of the basic decisions you face.

Fixed-rate vs. adjustable-rate

A fixed-rate mortgage will carry the same interest rate throughout the life of the loan. With an adjustable-rate mortgage (ARM), you'll get a lower rate at the outset. But it can rise or fall at specified intervals, such as every one, three, or five years.

An ARM's interest rate is tied to a financial index, such as U.S. Treasury notes. These loans come with two caps: one to limit how much the rate can climb at each adjustment, another to limit the increase over the life of the mortgage.

The fixed-rate loan and ARM each have pluses and minuses. With a fixed rate, you know you'll never face a rate hike for as long as you have the mortgage. But, with a lower-rate ARM, you'll start out with smaller monthly payments. That lower rate also means you may qualify for a bigger mortgage amount than you could get at the higher fixed rate.

Still, with an ARM you have to be able to live with the possibility of rising rates and thus bigger house payments, which could become more than you can afford.

For example, say you get a two-year ARM at 5.5% on a $211,000 loan. Your monthly mortgage payment for two years will be $1,198 (you'll get a fixed rate for two years and then your payment will adjust annually). But, for example, if after two years the ARM increases to 7.5%, your monthly payment would then be $1,475 for the next year.

If you plan to stay in the house for many years, you might feel more at ease with a fixed-rate loan. You know you'll never have to worry about rising rates. Of course, if rates fall, you'd have to refinance to take advantage of them.

On the other hand, if you're sure you'll sell the house in, say, five years, you might consider an ARM to save on house payments for that period. Still, you run the risk that your plans may change and you'll end up staying in the house longer. Your payments could soar with rising rates.

The overall rate environment also affects buyers' decisions. In a high-rate environment, some can afford to buy only if they get a lower-rate ARM. They bet on rates dropping in a few years, and then they can refinance with a fixed-rate mortgage. In a low-rate environment, buyers feel inclined to snag that low rate while they can get it. But even then, you could be money ahead with a lower-rate ARM if you're certain you're going to move in a few years.

You've likely seen alarms about some ARMs in the past couple of years. Most credit unions didn't make the loans that caused the problems many homeowners are suffering through.

Unlike credit unions, for-profit financial institutions are keenly focused on trying to generate huge amounts of income. In recent years, they did that by originating large volumes of mortgage loans. Lenders earn fee income on each mortgage they issue. In many cases, they gave mortgages to people who shouldn't have gotten them, and often the mortgages had terms that were questionable.

Some of these loans resulted in negative amortization.

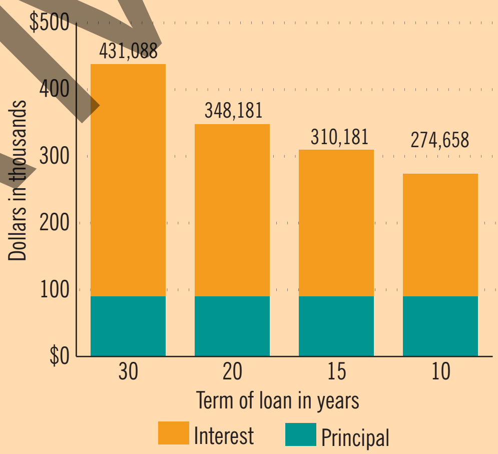
Negative amortization occurs when the monthly payments on a loan are not enough to pay the interest building on the principal balance. The unpaid interest is added to the remaining principal due. The combination of negative amortization and potential depreciation in home prices can result in a loan balance higher than the market value of the home. Homeowners in that situation are said to be "under water" on their home loans.

Use the calculators on your credit union's Web site or at *creditunion.coop* to help choose a type of home loan.

15- vs. 30-year mortgage

If you opt for a fixed-rate mortgage, you'll need to consider how long a repayment period, or mortgage term, you want. Common terms are 15 or 30 years; some lenders also offer 20-year fixed-rate mortgages. Some financial institutions even offer 40-year loans. Keep in mind, though, that interest costs

Mortgage Length Affects Total Cost



The monthly P & I payments for a $211,000 mortgage—figured at 6.5%—are considerably higher for a 15-year mortgage ($1,837) than for a 30-year mortgage ($1,334). But over the life of the loan, the total amount paid is considerably lower, as illustrated by this bar graph.

Source: CUNA's Home Buying Program Member Workbook will be higher than with shorter terms.

The shorter the term, the less interest you'll pay overall. The graph on p. 15 shows how dramatic the savings can be. But a shorter term also means your monthly payments are higher and you'll have to qualify for the higher monthly payment amount.

You have another option for shortening your borrowing period, and thus paying less interest in total. You could take a 30-year mortgage and then pay off additional principal, whenever you have extra money (and have no other high-interest debts and are meeting your savings goals). That way you won't be committed to the higher monthly payment of a 15-year mortgage. You'll pay extra only when you're able. Just be sure your lender applies that extra payment to principal only.

Choosing a lender

Deciding where to get your mortgage should not rely on interest rate alone. Here are several other factors to consider:

- **What's the lender's reputation?** How stable is this enterprise? Do you trust the lender to be straightforward and fair with you? Lenders have proliferated in recent years. Some advertise mortgage deals that actually are available only to select shoppers. Find out what that "personal" quote really means.
- **What else must I pay for?** The monthly payment is only part of it. Ask about the closing costs and *all* the fees the lender charges, so you run into no surprises later in the process.
- **Can I lock in a rate?** Rates can shift quickly. Ask if the lender will promise a rate that holds while your loan application is in process. Be sure the lender is clear about the conditions of the lock-in.

	Monthly payment on a:		
Interest rate*	40-year loan	30-year loan	15-year loan
5.5%	$515.77	$567.79	$817.90
6.5	585.46	632.07	871.11
7.5	658.07	699.21	927.01
8.5%	$735.09	$768.91	$984.74

**On a $100,000 loan*
Source: CUNA's economics and statistics department

- **What special programs are available?** Many communities have special mortgage programs targeted to, for example, first-time buyers. These programs might make home buying more affordable for you. Does the lender participate?
- **Is there a prepayment penalty?** Over the coming years, you might want to pay extra on principal from time to time, to pay off your mortgage faster. Does the lender penalize for this?
- **What about servicing?** Once you have the mortgage, someone has to service it—that is, keep payment records, provide account statements, and so on. This may or may not be the lender. Find out who it will be. If the lender uses an outside servicer, what happens if you have problems? Will your lender intervene on your behalf, or are you on your own in dealing with the servicer?

House Inspection

Avoid making yourself eligible for the home buyer's "I should have known better" lament. Have a professional house inspector go through a house before you buy it—even if the seller is a friend, and even if the seller and agent swear the house has no defects. Although they can be legally liable for any defects they cover up, you'll face the aggravation and expense of a lawsuit to gain compensation.

A professional inspection actually is a second inspection. Do a preliminary inspection before you hire a professional. After you make your initial tour of the property, visit again to look more closely. Check for foundation cracks, evidence of water leaks, adequate insulation, roof condition, basement dampness, condition of porches or decks, and so on. You might notice enough to eliminate the house from consideration.

If the house passes your inspection, then call in a professional. Resist any temptation to skip this step, or to cut corners. This is no time to rely on the semi-expert opinion of a brother-in-law who dabbles in home remodeling. The cost of hiring a professional inspector varies across the country. Expect to pay about \$300 to \$400. That's a small price to pay to prevent later heartache and huge repair bills.

Your offer to purchase should state that it's contingent on a professional house inspection. This gives you an out in case the inspector uncovers serious problems. Or, if you still want to buy the house, you can change your offer to make it contingent on the owner completing necessary repairs, or ask for a reduced selling price.

Do a preliminary inspection before you hire a professional.

Although the inspection won't occur until after you make an offer, act sooner to find a qualified inspector. Knowing whom to call will save you time later.

The inspection will need to be completed within a specified time period after you submit your offer.

It's also a good idea to tag along during the inspection. You'll learn a lot about the house, and the inspector's report will make more sense to you later.

Choosing an inspector

Not all house inspectors are created equal. A shoddy examination done by an inept or dishonest inspector is as bad as no inspection at all. Here are some pointers to help you in hiring:

- **Get referrals from friends.** Ask whom they have hired to inspect their homes. Think twice about relying on the agent's recommendations. Agents work for sellers, remember?
- **Ask about professional certification.** Many states don't license inspectors. Anyone can claim to be one and advertise for business. The American Society of Home Inspectors (ASHI) sets standards for inspection services. You may want to hire an inspector who's an ASHI member.
- **Ask if you'll get a written report.** This will give you documentation of needed repairs, as well as estimates of what they'll cost. Get it in writing.
- **Find out what the inspection entails.** Be sure you understand exactly what the inspection covers.
- **Find out if the inspector carries insurance.** The inspector's liability insurance should protect you if the inspector fails to discover major flaws that cost you money later.
- **Watch out for conflicts of interest.** Inspectors who also do home repairs or remodeling could be hustling for work.

Inspection Checklist

- ❑ Siding—any rotting wood, dented vinyl, etc.
- ❑ Foundation—any sign of movement or cracking, water seepage, insect or rodent infestation
- ❑ Insulation
- ❑ Doors and windows—weather-stripping, locks, storms and screens, condition of trim
- ❑ Roof—get right up on it to look for loose shingles, deteriorating masonry on the chimney
- ❑ Drainage system—gutters, soffits
- ❑ Chimney—flashing, mortar
- ❑ Porch, deck—condition of steps, railings
- ❑ Garage
- ❑ Ceilings, walls, and floors in all rooms
- ❑ Interior stairways
- ❑ Basement—evidence of water seepage, ventilation
- ❑ Attic—insulation, rafters, collar beam, ventilation
- ❑ Plumbing—types of pipes, insulation, evidence of leaks or corrosion
- ❑ Electrical—circuit breaker or fuse box, type of wiring, number of outlets in each room
- ❑ Hot water heater
- ❑ Heating and air conditioning
- ❑ Septic tanks, wells, or sewer lines (other than municipal lines)
- ❑ Driveway and walkways
- ❑ Common areas in condominiums or cooperatives

Inspection vs. appraisal

Buyers sometimes confuse these two concepts, but these processes serve entirely different purposes.

An inspector examines a house, inside and out, to make sure there are no structural, mechanical, or other flaws. He or she assesses the house's condition, not whether the selling price is reasonable.

An appraiser determines a home's market value. Appraisers are not trained or experienced in assessing structural or mechanical soundness. A lender will require an appraisal before giving you a mortgage. This assures the lender that the home's value is at least equal to the mortgage amount.

Never assume that a favorable appraisal must mean a house is structurally and mechanically sound. An appraisal is not a substitute for an inspection.

Additional inspections

In some parts of the country, lenders will require termite inspections. This may not be included in the regular inspection. Usually the seller pays for this.

You also may want to hire someone to test for environmental hazards. Radon, for example, is a naturally occurring radioactive gas that can accumulate inside homes and cause health problems. Contact your local public health department for more information.

Lead-based paint may be a problem in older homes and can pose health hazards, especially to young children. The seller must disclose information about lead-based paint known to exist in the house. You also can hire an inspector who has been certified to inspect for lead paint. You could include this inspection result as another contingency in your offer to purchase.

If you build new

Inspections apply, of course, to houses already standing. You might choose to buy a new house still under construction. Or you may have a house built from scratch according to a builder's model plan or a customized design.

In these cases, a great deal depends on the builder. Talk to others who live in homes this builder constructed. Did total costs come in on target? What was the quality of the work? Was the house finished by the promised date? Were there any communication problems? Also, check records at your local consumer protection agency for any complaints. Find out all you can about the builder's reputation, experience, and workmanship.

Insurance

Here is a recap of the types of insurance involved in home ownership and information about other types of insurance you may wish to buy.

Homeowners insurance

This insures your property against loss and damage. Your mortgage lender, who has a big stake in this property investment, will require that you carry homeowners insurance. It covers:

- Damage to or destruction of your house, such as by fire, tornado, and so on.
- Liability if someone gets hurt on your property.
- Loss or damage to personal property, or the contents within your home.

Typically, your homeowners insurance premium will be part of your monthly house payment. Your lender holds this amount in escrow, and pays the insurance bills for you. You may, however, have to pay the entire first year's premium at closing.

You'll need to select a policy before your house closing. Policies vary widely in price and coverage, so shop around and compare what you're getting for your money. The policy should cover the *replacement value* of your home, not the purchase price. Check if the policy has an inflation rider, which automatically increases the coverage amount as your property value increases year to year.

Homeowners insurance does not w include protection against floods. If your house sits in a federally designated flood-prone area, you'll have to obtain a separate flood insurance policy.

PMI (private mortgage insurance)

This is coverage for the lender, not for you—but you pay the freight. If your lender gives you a mortgage equal to more than 80% of your home's purchase price, the lender might require you to carry PMI. This protects the lender in case you default on the loan. If that were to happen, the PMI company would pay the lender a predetermined portion of the outstanding loan, to cut the lender's losses.

The PMI premium is added into your monthly house payment, so remember to include this when you're figuring what you can afford. You can petition your lender to drop PMI once your equity hits 20%. The lender has a responsibility here, as well. The Homeowners Protection Act of 1998 *requires* lenders to cancel PMI policies on mortgages when the loan-to-original value is 78% or less (that is, your equity level has reached 22%). Talk to your lender if you have questions. Make it a practice to check whether you need PMI annually.

Mortgage life insurance

This is protection for you, the borrower, in case something happens to you and you can't pay your mortgage. This policy would pay off your mortgage in full if you were to die. Some plans also have a disability option, which pays your mortgage payments for you while you're disabled. People at your credit union can help you determine what types of coverage you may need to assure that your family won't lose its home if something happens to you.

Closing Day

This is it! On closing day, the house officially becomes your new home. The actual closing ritual varies depending on local custom. In some places, a closing goes by a different name, such as settlement, title transfer, or escrow. Those attending might include some combination of buyers, sellers, attorneys, real-estate agents, a lender representative, and a title (or escrow) company representative. As for location, the closing might occur at the office of the lender, an attorney, or a title or escrow company. Orchestrating the whole event is the closing agent, who might be an attorney or someone from one of those offices just mentioned.

Preparation

Before closing day, you must attend to several matters:

- **Know the closing costs.** No later than the business day before closing, your lender will provide a statement showing you the final figure and a breakdown of all the costs (you got an estimate shortly after you submitted your application). Look over the statement to be sure all is in order. Usually, you'll need to provide a cashier's or certified check for the closing amount (plus the down payment) at the closing. Your loan officer might bring this for you, if he or she attends the closing.
- **Secure homeowners insurance.** You'll need to bring a policy and/or receipt showing payment, usually for the entire first year's premium.
- **Do a final walk-through.** Shortly before closing, take another thorough tour of the house, including attic, basement, and garage. Has the seller taken care of needed repairs as spelled out in the contract? Is there any new damage you didn't notice before? Are any items missing that the seller agreed to leave behind (appliances, carpets)? Anything left behind that was supposed to be removed?

Closing costs

The settlement statement will show all the closing costs due, and which are the responsibility of the buyer or the seller. Local practices vary. Among the typical closing costs listed on the settlement statement are:

- **Points**—These are one-time fees due to the lender. Each point is equal to 1% of the mortgage amount. Often you'll pay points if you are trying to "buy down" (reduce) the interest rate below the current market rate.
- **Loan origination fee**—Covers the lender's administrative costs in processing the loan.
- **Appraisal fee**—A professional appraisal assures the lender that the house value is equal to or greater than the selling price.
- **Credit report fee**—The lender gets a credit report to assess your creditworthiness. The borrower pays for this, typically $15 or more, and usually at the time of application.
- **Interest**—You'll pay interest to the lender to cover the period from the closing date until your first mortgage payment, which may be several weeks off.

- **Private mortgage insurance premium**—Usually required if your down payment is less than 20% of the selling price. You might have to pay the first year's premium at closing, or it may be incorporated into your monthly mortgage payment.
- **Hazard insurance premium**—This is your homeowners policy. Usually, you'll pay the first year's premium before closing.
- **Reserves or escrow accounts**—This is an account your lender sets up to cover the property taxes and insurance premiums your lender pays for you.
- **Settlement or closing fee**—The fee the title company or escrow company charges for performing closing duties.

Now, it's a done deal! You own a home.

- **Title search fee**—A fee for verifying that the seller owns the property and that there are no legal claims against it.
- **Title insurance premium**—This is a one-time premium for insurance that protects the lender and buyer against defects in the title (deed) to the property.
- **Recording fee**—Local government entities charge a fee for recording the deed.
- **Transfer taxes**—State and/or local governments may place a tax on the sale of property.

Closing documents

Among the many papers you'll sign at the closing, some of the key ones, besides the settlement statement described previously, include:

- **Note**—This represents your promise to pay the lender according to the agreed terms.
- **Mortgage or deed of trust**—This is the legal document securing the note and giving the lender a claim against your house if you default. It spells out your responsibilities as the borrower.
- **Truth in Lending (TIL) statement**—Required by federal law, the TIL statement aims to assure that the borrower understands the loan and knows exactly what he or she is agreeing to. One of the numbers you'll see on the TIL statement that sometimes confuses buyers is the annual percentage rate (APR). This is higher than the mortgage rate because it amortizes in your closing costs. Federal law requires that the lender provide you a TIL statement within three days after you applied for the loan. It will be in the lender's packet along with an estimate of your closing costs. You'll see it again at the closing.
- **Deed**—This paper transfers ownership of the house to you. If you're buying the house with a spouse, partner, or friend, be sure all the names you wish to appear on the deed are listed.

At the end of the closing, the closing agent will give you a packet containing copies of the above and all the other documents you've signed. You also might receive some later, after closing day. Keep all these papers in a safe place.

Now, it's a done deal! You own a home.

Home Remodeling

The remodeling urge may strike early on or not until you've lived in the house for several years. Examine the roots of that impulse before you commit to tackling projects.

Perhaps the house needs structural or mechanical improvements, such as better electrical wiring or new roofing. Projects such as these are essential to keeping your home in good condition and maintaining its value—protecting your asset.

Or maybe you want to make changes so the house feels more "homey" and better suited to your family's way of life—say, a modernized kitchen or a new family room in the basement. Again, these are worthwhile investments, especially if your family will be living in this home for many years.

Proceed with more caution, however, on what might be called "status improvements." Sometimes these end up being "over improvements." For example, pouring $60,000 into a new, state-of-the-art kitchen in a $140,000 house may be money you'll never recoup—especially if it would boost the selling price far above the going rate in the neighborhood. That could make the house harder to sell someday.

Certain remodeling projects tend to yield a higher rate of payback at resale. In general, bathroom and kitchen remodelings tend to rank highest. They're the most heavily used rooms and tend to become outdated quicker.

Each year *Remodeling* magazine publishes its "Cost vs. Value Report" examining the costs recouped for various types of home improvement projects. The actual cost and percent payback vary widely from one market to another, and even among neighborhoods in the same market. Much depends on local contractor rates, house values, the rate of local property value increase, and the quality of the contractor's workmanship.

But, again, payback at selling time is only one of many reasons for remodeling. Equally important, maybe more so, is whether the remodeling adds to your enjoyment, safety, and comfort while you live in the house. Just be clear on what your motives and rationale are before you proceed.

Hiring a contractor

The remodeling results—both in terms of your satisfaction and resale value—depend greatly on the quality of the work. Here are some guidelines for hiring a contractor:

- **Interview several.** Be highly suspicious of those who come door-to-door looking for work. Instead, shop and compare. Ask around for recommendations. And meet with contractors to discuss your project and the estimated costs.
- **Check out your chemistry.** You'll be working closely with the contractor for perhaps weeks or months. Is this someone you can talk to and who seems willing to listen to you?
- **Ask for references.** Get names of other homeowners who have hired this contractor. Find out if they were happy with the workmanship, communications, final costs, and so on. Ask the contractor if you can see completed projects similar to yours.
- **Get it in writing.** That includes both the bids you obtain when you're shopping around, and also a contract, if it's a substantial job, with the remodeler you decide to hire.

Financing the remodeling

If you need to borrow to pay for your remodeling project, talk to your credit union lender. One possibility is to borrow against your home equity—that is, the value of your stake in the house. Say you bought a house for $140,000 and put $7,000 down. After five years, you've paid off $20,000 in principal, and the house value has climbed $25,000. Your equity would be $52,000 ($7,000 + $20,000 + $25,000).

You can borrow against your equity, either in the form of a home equity loan or a line of credit. Typically, your lender will let you borrow an amount equal to as much as 80% of your equity, or in this case $41,600 (0.8 × $52,000).

Home equity loans or lines offer two key advantages:

- The interest rate is lower than you'd pay for a credit card or personal loan.
- The interest you pay usually is tax-deductible (ask your tax adviser).

Here's how home equity loans and lines differ. With a loan, you borrow a set amount at a fixed rate of interest. With the line of credit, you draw on the line, much like you use a credit card, up to the specified dollar limit. You pay a variable rate of interest that's tied to an index, such as the prime rate.

A loan might be your best choice if you need a lump sum for a remodeling project to be completed in a short period of time. Or you might prefer the line of credit if, for instance, you were taking on several projects stretched out over several months or years. Your credit union lender can help you decide whether a loan or line best suits your needs.

Some lenders may exceed the 80% limit in equity lending, going to 100%. But borrowing more means bigger monthly payments. Remember, you're borrowing against your house. You'll have to make payments on both your mortgage and your home equity loan or line of credit. Failing to do so could mean losing your home. So be sure you're dealing with a trusted lender, like your credit union, who won't get you in over your head.

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