Real Estate

Financial planning can help reduce anxiety of buying a home

By Michele Lerner January 25

Before you start perusing real estate websites looking for your dream home, you first need to get serious about your money. Check your credit, save some cash and design a budget you can live with and you'll be on your way to buying your first place.

"There are really two important numbers you need to know when you want to buy a home," says Michael Smalley, Florida regional manager for Waterstone Mortgage. "You need to know how much you're comfortable spending on your housing payment each month, and you need to know how much cash you have for a down payment."

One of the biggest misconceptions is you need a large down payment to buy a home. The average down payment in a recent survey by NeighborWorks was 17 percent of the home's price. However, the median down payment for first-time home buyers was 5 percent in 2017, according to the National Association of Realtors.

Below are steps you need to take to put your finances in order, preferably at least three to six months before you plan to purchase.

Consult a loan officer. While it's smart to check your free credit report from each of the three credit reporting bureaus yearly at annualcreditreport.com, the credit score you see is different from what lenders see.

"Everyone should go see a lender and ask for the lender to pull their credit," says Douglas Benner, branch manager and senior loan officer at Sandy Spring Bank. "Your lender can help you look for errors and make suggestions about the best way to increase your score if it needs improvement. For example, paying off an old collection won't immediately boost your scores."

The minimum credit score for many loan programs is 620. Borrowers with compensating factors such as a higher down payment or a low debt-to-income ratio can sometimes qualify with a lower credit score. Your debt-to-income ratio compares your gross monthly income with the total of your monthly debts (e.g., housing, student loan and credit card payments). Borrowers with a score of 740 or higher pay the lowest interest rates on conventional loans.

"A loan officer can talk about available loan programs and down payment resources that could impact how much you need to save," said Henry Brandt, branch manager of Planet Home Lending. "You also need to learn about the cash you'll need for closing costs and to get an estimate of your insurance and taxes."

Math for buyers. A lender can estimate the amount you qualify to borrow, but your comfort level with a monthly payment is more important than maxing out your borrowing power.

"Your debt-to-income ratio must be 50 percent or less, although sometimes there are exceptions, and it can be higher," Brandt said. "But it's important to stress that this formula uses your gross income, not your take-home pay. You're better off with a much lower debt-to-income

ratio."

Brandt recommends saving the difference between your rent and your estimated mortgage payment to see if you can live comfortably with the higher payment.

What your down payment looks like. How big your down payment needs to be depends on the home price and loan program. Most lenders have special loan programs for first-time buyers. Some with income qualifications have low down payment requirements and don't require mortgage insurance.

Veterans may qualify for a VA loan with zero down payment needed. Buyers purchasing a home in a rural area may qualify for the Agriculture Department's rural development mortgage. Conventional loans are available with down payment minimums as low as 3 percent. Federal Housing Administration loans require a 3.5 percent down payment.

"There are numerous down-payment assistance programs available on the state and county levels that many people can use to get into a home with far less cash than they think," Smalley said.

A NeighborWorks survey found that 73 percent of all consumers were not aware of down payment assistance programs in their area for middle-income buyers, yet most states have these programs.

Downpaymentresource.com provides a searchable database of them.

While savings were the primary source of down payment funds for first-time buyers in 2017, according to NAR, 25 percent of buyers used a gift from a family member for some or all of their down payment.

Gifts from one individual to another are tax-free up to $15,000, so a married couple could receive $30,000 from one person without owing taxes. Lenders require a letter verifying the funds are a gift.

Benner says it may be wiser to use the cash to pay down debt because your debt-to-income ratio would be reduced if you can lower your monthly credit card payment or eliminate a car loan.

Another potential down payment source is your 401(k), says Benner. You can borrow 50 percent of your vested funds or $50,000. Typically, you need to repay the loan through payroll withdrawals. The repayment period varies by company.

"Some companies have special provisions about how you can borrow from your retirement account, so it's best to call your human resources department to find out the rules and how they could impact you," Smalley said. "You can't borrow from an IRA, but you can cash it in. However, you'll face tax implications that could mean it's not worth taking out the cash."

Brandt says he's not a fan of retirement account withdrawals because you're losing out on market gains and the long-term benefit of retirement savings that could hurt you in the future.

"If you don't have to borrow too much and you can repay it quickly, it's certainly an option," he says.

Don't forget you'll also need cash for closing costs, an emergency fund and moving expenses. You can ask sellers to help you with closing costs, although they may be less willing to do so in a competitive market, Brandt said.

“Deciding to save $10,000 in the bank rather than use if for a down payment will only cause your mortgage payment to be $50 or $60 higher, but you’ll be much better off financially with cash for emergencies,” Smalley said.

A home is the most expensive purchase most people will make in their lives. With a bit of planning, you can avoid the anxiety that can plague these transactions.