

# Chapter 2

## How Much House Can You Afford?

### In This Chapter

- ◆ Calculating your total income and monthly expenses
- ◆ Finding your appropriate price range or knowing how much you can borrow
- ◆ Understanding lender ratios
- ◆ Getting prequalified or preapproved for a loan
- ◆ Checking your credit history

If you had enough money to pay cash for your home, buying a home would be easy—simply write a check. Unfortunately, few people can pay cash for a home. Around 99 percent of home buyers borrow money to buy their home, and you probably fall into this 99 percent. Even if you did have enough money to purchase a home outright, you might not want to do so because of the tax benefits.

The critical question is *how much can you afford to borrow?*

## 16 Part I: Getting Started

All lenders are going to take a close look at your financial situation. This chapter covers the upfront costs of buying a home and then helps you take a close, perhaps painful, look at your financial and credit situation.

### How Much You Make and How Much You Spend

Before lenders will give you a loan, they will carefully review the money you make and the money you spend. The first thing you should do in figuring out how much money you can spend on a home is to determine your yearly and monthly gross income.



#### Real Estate Terms

What's the difference between net and gross income? **Gross income** is the amount you earn before taxes; **net income** is the amount you make after taxes and other expenses.

Your monthly *gross income* is the amount you earn each month *before* taxes. For example, if you earn 36,000 dollars per year, you gross 3,000 dollars each month ( $36 \div 12 = 3$ ). If you and your partner's combined gross income is 60,000 dollars per year, you gross 5,000 dollars each month ( $60 \div 12 = 5$ ). Your *net income* is a completely different story. Your net income is what you have left of your gross income after you pay your taxes and your monthly bills. This section explains how to gather the information you need and then how to calculate gross and net income.

### Gathering Income Information

To start, gather all your paycheck stubs and income information from your current job. If you plan to buy a home with a partner, gather income information for this person as well. Make sure you also locate past income tax forms; you can expect to show them when requesting a loan from the bank.

Most lenders will consider only income that can be verified—from your employer or past tax returns. If you have other income from freelance work or the sale of furniture that you make in your woodshop, gather that information also. Make sure that this additional income is money that you have paid taxes on; otherwise, the lender will not consider it.

If you have other income from bonuses, know that bonuses don't always count. This is because bonus money is not always guaranteed. If you want to have your bonus

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money considered as part of your gross salary, you need to prove that bonuses are a regular part of your pay. You must show a track record of receiving bonuses for two years. Another way to include bonuses in your total is to have your employer write a letter saying that the bonus is dependable income.

If you receive alimony or child support, you can include this money in your total if you want. You must show that this is a dependable source of income and will be continuing for a minimum of three years. You may need a settlement statement from your divorce that states the amount you receive. Keep in mind that lenders will look for an average income. They will want to evaluate your income from the past two years to make sure it has been steady, and they will take into consideration any seasonal jumps. Usually two years of continuous employment proves to lenders that you have a steady income. If you have had multiple jobs in the past two years, lenders may require that you write a letter as to why you have switched jobs often. In addition, if you're recently out of college, lenders may take into consideration your future earning power.

### Figuring Income for the Self-Employed

Banks used to look somewhat unfavorably at people who were considered “self-employed.” They were considered a risk and had no guarantee of getting approved for a loan. Nowadays, consultants and small businesses are popping up all over, and self-employed people (like writers!) are treated almost like people with “real jobs.”

If you're self-employed, the lender will usually consider as gross income the amount of money on which you paid taxes. For instance, if your business grossed 100,000 dollars, but you paid taxes on only 35,000 dollars, the lender will consider 35,000 dollars as your gross annual income. You will have to show two years of tax returns for your business to verify your income.

If your self-employed income fluctuates from year to year, you might be asked to provide a letter as to why your income went down from one year to the next. Of course, no letter is necessary if your income goes up. Lenders like consistency—although they don't have a problem if your income keeps going up. Also note that if you grossed 50,000 dollars one year and 100,000 dollars the next year, the bank will average the two years to come up with an average gross income of 75,000 dollars.



#### Real Deal

If you don't have two or more years of tax returns and your business is mainly freelance or contract work, it can help to show the lender copies of contracts you have for current and future work.

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### Keeping Track of Your Income

Use the following worksheet to record your yearly gross income. To calculate your monthly gross income, divide this figure by 12.

*Calculate your gross income.*

<b>Income (yearly)</b>	<b>You</b>	<b>Co-Purchaser</b>
Gross Salary	\$ _____	\$ _____
Bonuses	\$ _____	\$ _____
Interest	\$ _____	\$ _____
Dividends	\$ _____	\$ _____
Social Security/Pension	\$ _____	\$ _____
Child Support	\$ _____	\$ _____
Other _____	\$ _____	\$ _____
<b>Sub Total</b> (add above lines)	\$ _____	\$ _____
<b>Yearly Gross Income</b> (add Columns)	\$ _____	
<b>Monthly Gross Income</b> (divide by 12)	\$ _____	

You now know how much money you and your partner make each year and each month. You will use these figures along with your monthly expenses to calculate how much you can borrow in the section, “What’s Your Ratio?”

### Keeping Track of Your Expenses

You know the money that is coming in. Now you need to figure the total money that is going out. Lenders consider this total as your monthly expenses. You might be surprised to find out how much money you have (or don’t have) left over at the end of the month after paying all your bills.



#### Real Deal

If you have fewer than 10 months left on an installment loan, don’t include it in your total monthly debt payments. If you’re close to 10 months, consider paying off the loan enough to bring it under the 10-month mark. Then you don’t have to count it.

You need to collect all your required monthly payments. This includes car loans or leases, student loans, minimum monthly payments on any and all credit cards, and so on. After you have all of the monthly payments, you can total them. Use the following worksheet to record your monthly expenses. Adjust the categories as needed to suit your particular expenses.

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Make a note of your total expenses; you will use this total in the next section to compare some lending ratios.

<b>Expenses (monthly)</b>	<b>You</b>	<b>Co-Purchaser</b>
Car Payment	\$ _____	\$ _____
Student Loan	\$ _____	\$ _____
Credit Card #1	\$ _____	\$ _____
Credit Card #2	\$ _____	\$ _____
Credit Card #3	\$ _____	\$ _____
Other Loan	\$ _____	\$ _____
Child Support	\$ _____	\$ _____
Alimony	\$ _____	\$ _____
Other _____	\$ _____	\$ _____
<b>Sub Total</b> (add above lines)	\$ _____	\$ _____
<b>Monthly Expense</b> (add columns)	\$ _____	

*Calculate your monthly expenses.*

## How Much Money Can You Borrow?

The first part of the loan equation is complete: you know how much you make and how much you spend. The next step is to figure out how much you can borrow.

If you're getting tired of all the number crunching, you can use a ballpark method for figuring out how much you can borrow. Roughly, you can borrow up to 2 to 2½ times your annual gross salary (sometimes more). If you and your partner make 50,000 dollars, you might be able to buy a home in the 100,000- to 125,000-dollar price range.

Lenders and agents are a little leery of the ballpark method. For one thing, this method is too easy, and if they allow things to look too easy, you may figure out you don't need them. More important, rough estimates can't take into consideration individual circumstances. For example, if one couple with a 50,000-dollar income has 20,000 dollars in savings and no car payment, they may be able to afford an even more expensive home than a ballpark figure would indicate. If another couple with a 50,000-dollar income has two car payments, maxed-out credit cards, and intend to get their down payment by winning the lottery, they might not qualify for a home in any price range.

## 20 Part I: Getting Started

# Understanding Lender Ratios

Lenders compare your income and monthly payments to certain qualifying ratios—the most common of which is the debt-to-income ratio. If you have a particular lender in mind, call the lender and ask what ratios it uses. You will see these ratios expressed like this:

- ◆ 28/36 (the ratios most often used for conventional loans)
- ◆ 29/41 (ratios used for FHA loans)



### Real Estate Terms

The **housing expense ratio** (front-end) is the percentage of gross monthly income that goes toward paying a mortgage or rent on a home. The **overall debt ratio** (back-end) is your total monthly expenses, including housing, credit cards, loans, and all other debt. If your housing expense ratio is high, you may be considered “house poor.” That is, much of your income is taken up by your house payment.

The first number, sometimes called the front-end ratio or *housing expense ratio*, is the percentage of your income that you can spend on housing. For example, most lenders say your monthly house payment (including loan payment, property taxes, and insurance) shouldn't total more than 28 percent of your gross monthly income (that is, your gross annual income divided by 12). The ratio used depends on the amount of money you put down on the home as your down payment.

The second number, the back-end or *overall debt ratio*, totals your housing expenses plus your long-term monthly debt, then figures this total as a percentage of your monthly gross income. For example, most lenders say your housing expenses plus your monthly debt should not be more than 36 percent of your monthly income.

How do lenders come up with these ratios? Lenders don't like guesses, but that's basically what the ratios are. The lenders feel if they follow these guidelines, homeowners will be able to pay off their loans. The ratios are arbitrary, though, and are based on studies done in the 1930s and 1940s by the Federal Housing Administration. Most lenders sell the loans to a secondary market, and, therefore, follow the guidelines set by the agencies that purchase the loans. The ratios will vary depending on the area. Also, the bigger your down payment, the less significant the ratios become.

## What's Your Housing Ratio (a.k.a. Maximum Mortgage Payment)?

To figure out your housing ratio (maximum mortgage payment), use the following worksheet and these steps:

1. Enter your monthly gross income.
2. Multiply this amount by 28 percent (.28). The resulting figure is what you can conservatively afford for a monthly mortgage payment.

<b>Monthly Gross Income</b>	\$ _____
	X .28
<b>Maximum Mortgage Payment</b>	\$ _____

*Calculating your maximum mortgage payment housing ratio.*

To figure out your overall debt ratio (maximum mortgage payment), use the worksheet and follow these steps:

1. Enter your monthly gross income.
2. Multiply this amount by 36 percent (.36). This figure is the total amount of money you can spend on all debts—housing and other.
3. Write in your present monthly debts.
4. Subtract your present debt from your maximum monthly debt to find out how much you have left over for your mortgage payment.

Translating this monthly payment into a loan amount can be tricky. Your housing expenses include what is known as PITI (principal, interest, taxes, and insurance—pronounced “pity”).

The principal and interest will vary depending on the amount of the loan, type of loan, and interest rate. You can use the tables in Appendix C to look up the principal and interest amount for different loans and interest rates.



### Real Deal

If you don't want to wade through all the worksheets in this chapter, you can ask your agent or lender to give you an estimate of how much home you can afford. You'll still have to provide reliable information. See the later sections in this chapter on getting prequalified and preapproved.

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*Calculating your maximum mortgage payment overall debt ratio.*

<b>Monthly Gross Income</b>	\$ _____
	X .36
<b>Maximum Monthly Debt</b>	\$ _____
<b>Present Monthly Debt</b>	\$ _____
<b>Maximum Mortgage Payment</b>	\$ _____
<b>Overall Debt</b>	\$ _____

### Don't Forget Taxes and Insurance!

Just because a lender says you can afford house payments of 1,200 dollars doesn't mean you actually can. On top of the principal and interest, you need to add taxes and insurance. Taxes will vary depending on where you live, and insurance will vary depending on the policy you purchase.

You can ask your real estate agent to give you estimates of these payments. Also, when you look at homes, the home information sheet usually includes the tax information for that property. Keep in mind that property taxes can vary widely by area, so it's one thing to consider when selecting a home you can afford.



#### Buyer Beware

If you buy a newly constructed home, the taxes are often calculated a year after you have lived in the home. You may owe money and your monthly payment may change because you don't really know what the tax will be until an assessment is done. After this assessment, you often have to pay any taxes owed on the first year as well as pay adjusted taxes for the current year.

In addition to taxes and insurance, you might also be responsible for an association fee, which is a fee you pay toward the maintenance of common areas in your neighborhood, like a playground, trees and grass, and athletic courts.

### Use This Example to "Get" This Concept

The following shows the yearly gross income and monthly payments for our sample couple, Dick and Jane Smith. The combined income of the couple totals 55,250 dollars. Their monthly gross income, then, is 4,604 dollars.

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<u>Income (yearly)</u>	<u>Sid</u>	<u>Nancy</u>
Gross Salary	\$ _____ 30,000	\$ _____ 25,000
Bonuses	\$ _____	\$ _____
Interest	\$ _____	\$ _____
Dividends	\$ _____	\$ _____ 250
Social Security/Pension	\$ _____	\$ _____
Child Support	\$ _____	\$ _____
Other _____	\$ _____	\$ _____
<b>Sub Total</b> (add above lines)	\$ _____ 30,000	\$ _____ 25,250
<b>Yearly Gross Income</b> (add columns)	\$ _____ 55,250	
<b>Monthly Gross Income</b> (divide by 12)	\$ _____ 4,604	

*Gross income.*

If you apply the first ratio (housing expense), you can see that the Smith family can afford a maximum payment of 1,289 dollars.

<u>Expenses (monthly)</u>	<u>Sid</u>	<u>Nancy</u>
Car Payment	\$ _____ 240	\$ _____ 325
Student Loan	\$ _____ 85	\$ _____
Credit Card #1	\$ _____	\$ _____ 25
Credit Card #2	\$ _____	\$ _____
Credit Card #3	\$ _____	\$ _____
Other Loan	\$ _____	\$ _____
Child Support	\$ _____	\$ _____
Alimony	\$ _____	\$ _____
Other _____	\$ _____	\$ _____
<b>Sub Total</b> (add above lines)	\$ _____ 325	\$ _____ 350
<b>Monthly Expense</b> (add columns)	\$ _____ 675	

*Monthly expenses.*

<b>Monthly Gross Income</b>	\$ _____ 4,604
	X .28
<b>Maximum Mortgage Payment</b>	\$ _____ 1,289

*A maximum mortgage payment housing ratio.*

If you use the second ratio (overall debt), you can see that the Smith family can afford a maximum payment of 983 dollars. The lender will use the lowest figure, which is 983 dollars, when qualifying the loan.

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*A maximum mortgage payment overall debt ratio.*

<b>Monthly Gross Income</b>	\$ _____ 4,604
	X .36
<b>Maximum Monthly Debt</b>	\$ _____ 1,658
<b>Present Monthly Debt</b>	\$ _____ (675)
<b>Maximum Mortgage Payment</b>	\$ _____ 983

## Prequalifying for a Loan

If you have followed all the worksheets in this chapter, you should feel pretty confident about what you can afford, and you should know your financial situation.

If you choose not to do the worksheets, you may want to have a lender prequalify you. (You also may want to do this in addition to qualifying yourself so you're sure your figures are accurate.)

## What Do You Need to Prequalify?

After you find a company to qualify you, you can either schedule an appointment or sometimes be qualified right over the phone (or via the Internet). You will be asked to provide the following:

- ◆ **Social Security number.** Lenders will use this to pull your credit report, which will give them a synopsis of your credit history (if you have any) and a credit score. The credit history will contain any and all credit cards (yes, even the Gap card), bank or car loans, and any type of credit you have had within the past seven years or that you currently have.



### Real Deal

One of the advantages of working with a real estate agent when purchasing a home is he or she can prequalify you. Your agent also will likely know current interest rates and have connections with different lenders. The agent can also help you decide whether you should, depending on the real estate market, get prequalified or preapproved.

- ◆ **Name and addresses for the past three years.** Lenders will use this information to determine how “stable” you are. Do you move from place to place often? Or have you lived in the same location for a while?
- ◆ **Employment history.** This shows whether you have a track record for working with a company for only a short period of time, or if you have worked for the same company for many years.

- ◆ **Current income.** This is how much money you make on a monthly basis. You can also expect to answer additional questions about your income. For instance, are you paid weekly, bimonthly, or monthly? Are you paid a salary or do you work on a commission basis? Are you self-employed?
- ◆ **Current expenses.** Lenders will look at how much money you spend each month on a regular basis—for example, your monthly car payment and monthly credit card payments.
- ◆ **Current bank account balances.** Lenders also want to know how much money you have in the bank. Do you have a savings account? Any investments? If you have \$12.53 in your checking account, how do you think it looks compared to having \$12,530 in your savings account?

You can prequalify informally, or you can go one step further and actually get pre-approved for a mortgage.

## Advantages and Drawbacks of Prequalifying

When you prequalify informally, you don't pay a fee. You usually spend 20 to 30 minutes on the phone with a lender. The lender will ask you questions about your income and monthly debt (similar to the earnings and expenses covered in this chapter). Then the lender will do some quick calculations to let you know how much you can finance. This type of prequalifying is good when you want a very rough estimate.

Keep in mind that the lender is not guaranteeing you a loan; you will still have to go through a formal qualification. Also, lenders base their estimate on what you tell them. If you exaggerate your income, make up an amount because you don't know, or forget about monthly payments, you won't get an accurate figure.

Sellers like to know that when you make an offer, you can actually get a loan for the home. If you have informally prequalified, you don't really have any advantage in the negotiating. If you are preapproved (covered in the next section), sellers may look more favorably on your offer because they know you have a secure bid. Compared to other bids that might not be secure, your offer may look better.

Keep in mind that if you ask your lender to estimate how much home you can afford, that person will tell you exactly how much you can afford, but that might not be the amount you want to spend. For instance, although you might actually be able to afford a 300,000-dollar home, that doesn't mean you need to or have to spend that much.

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Also, be sure your real estate agent understands the price range you want to stay within. If agents start to show you homes out of the range you feel comfortable with, remind them of the range you are seeking (unless it's simply unrealistic within the market, in which case the agent should simply tell you this). Remember that agents usually make a commission based on the price of the home you purchase.

### Getting Preapproved for a Loan

The preapproval process is one step further than prequalification. If you are pre-approved, it means that the lender has verified your credit, reviewed your tax returns, and verified your employment, earnings, and assets. You have to submit this paperwork; a verbal approval without submitting this information isn't a true preapproval. The lender will then give you a letter stating that it is willing to grant you a mortgage for a specified amount within a certain time period (usually 60 days).

It will also state the maximum loan amount and any stipulations regarding the loan (for example, you have to sell or rent your current home first). This documentation proves that you have been approved for that loan and that an underwriter has checked and guaranteed the loan.



#### Real Deal

A preapproval letter can make quite an impact with sellers if they know you are pre-approved and are extending an offer on their home. If you had two offers on your home for sale, one that is preapproved and one that is not, who would you think has the logical advantage?

Sellers like buyers who have been formally pre-approved because they know that the buyer will not (or should not) have problems purchasing their home.

Keep in mind that when you get preapproved by a lender, you're guaranteed a loan with that particular lender. Another lender may offer better terms (for example, fewer fees or a better mortgage product), and if you want to use that lender, you will have to go through getting approved with them. As you learn in Chapter 5, you will probably want to shop around and select a lender with the most favorable terms.

### Checking Your Credit

When you qualify for a loan, the lender will check your credit to ensure that you don't have any credit problems. If you have had a history of credit problems, you will probably want to get your credit report and be prepared to respond to any questions or problems on the report.

If you haven't been late or missed any payments, you probably don't have to worry about getting a bad credit report. But mistakes do happen, and sometimes your report may include something that is wrong or a problem that has been resolved. You may want to get a copy of your credit report just to double-check.

## Getting a Credit Report

Federal law requires that you have access to any information in your credit files, and you are entitled to a free report each year. You can obtain a credit report from a local credit report agency or a national credit bureau. Three of the best-known credit bureaus are Equifax, Experian, and TransUnion.

The fee for a report is roughly 10 dollars; you can also get a set of three reports from all three major credit bureaus for around \$35. Check the credit bureau sites for current pricing information. You must send the credit bureau a letter that includes your full name, date of birth, Social Security number, and present and past addresses. You may also need to send a copy of your driver's license or a phone or utility bill to verify your current address. Don't forget to personally sign the request letter, because your signature is a requirement to obtain the credit report.

### **Equifax**

1-800-685-1111

[www.equifax.com](http://www.equifax.com)

### **Experian**

1-888-397-3742

[www.experian.com](http://www.experian.com)

### **TransUnion**

1-800-888-4213

[www.transunion.com](http://www.transunion.com)

### **Bet You Didn't Know**

The Internet includes many financial sources, including numerous mortgage companies (for example, [www.mortgage.com](http://www.mortgage.com)). You can visit sites not only to get information about the financing process, but also to prequalify and get a rough estimate of how much you can borrow. (Make sure you understand whether you are prequalifying or getting preapproved. Remember, there's a difference!)

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You can also request your spouse or partner's report at the same time, but you must supply all the same information and include both your signatures.

Get the report two to three months before you apply for the loan so you'll have time to resolve any problems that turn up.

If you have been turned down for credit, the creditor must furnish you a copy of the declination letter (why you were declined) and a copy of the credit report (free of charge, if you ask for it).

### What's on Your Credit Report?

After you receive your credit report, you might be curious as to what all of the information means. Each of the credit reporting bureaus use different codes and a different format for a typical consumer credit report, but the following information will be on all of the reports:

- ◆ **Identifying information.** This includes your name, any former names (maiden or married names), current and previous addresses, Social Security number, date of birth, and current and previous employer information. All of this information is tracked from any credit applications you have ever had to fill out. So make sure you fill out credit forms completely, accurately, and consistently each time.
- ◆ **Credit information.** This includes any and all information about credit accounts opened, the assigned credit limit, loan amounts, current balances, monthly payments, and the pattern that you have paid your credit for the past years. In addition, any names of individuals who are on your accounts (for example, a spouse or even ex-spouse or co-signer) will be listed. The companies that you do business with provide this information.
- ◆ **Public record information.** This includes federal district bankruptcy records, state and county court records, tax liens and monetary judgments, and in some states, overdue child support payments. This information comes from public records.
- ◆ **Inquiries.** This includes the names of those who have obtained a copy of your credit report for any reason. For example, if you ever receive credit card offers in the mail, those companies will most likely be listed on your report, because they obtained your credit information. This information comes from the credit-reporting agency, and it remains available for as long as two years, according to federal law.

All this information is used to calculate a FICO score—a scoring system derived in part from your past credit history. This score is calculated each time the credit report is requested.

## What's a FICO Credit Score?

The FICO score is a number between 300 and 800. Most lenders will tell you that a score higher than 660 is considered “good.” If your score falls between 620 and 660, you will probably have to write more explanation letters and work harder to convince a lender to give you a loan. You also might be looking at a higher interest rate on the loan right out of the gate.

Your FICO credit score is influenced by five characteristics that help lenders determine your credit risk. Each of the following is taken into account, in descending order of importance:

- ◆ **Past delinquencies.** If you have made late payments in the past, you are more likely to repeat this in the future, and you are more of a risk. See the next section, “Are You a Risky Creditor?”, for examples.
- ◆ **Use of credit.** If you max out your credit cards or keep them close to the limit, you are more of a risk because of your spending habits.
- ◆ **Credit file length.** If you have a short credit history, the FICO system assumes you are more of a risk because you are inexperienced with handling credit.
- ◆ **Number of times asked for credit.** If you initiate multiple requests for credit cards, loans, or other debt instruments in a short period of time, you are more of a risk.
- ◆ **Mix of credit.** If you only have credit cards (revolving loans), you are considered more of a risk than someone who has a combination of installment (for example, car loans) and revolving loans. On an installment loan, money is borrowed once and fixed payments are made until the balance is gone; revolving credit has borrowers making regular payments, which frees up the access to more money.



### Real Deal

Note that there isn't a big difference between “good credit” and “great credit.” If you have a great credit score, in the 700+ range, you might be able to qualify for specific loan opportunities that lenders offer. But don't be disappointed when your interest rates aren't much better than those that would be offered to individuals with good credit.

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The FICO system also looks for patterns and whether any problems appear to be ongoing. If your score falls below 620, you have a chance of getting a loan, but you will really have to work for it and will definitely pay for it in your loan interest rate (refer to the section “Loans for Those with Blemished Credit” in Chapter 15). In recent years, more of these types of loans have been granted, and certain lenders specialize in dealing with individuals who have this type of credit rating.

### Are You a Risky Creditor?

You will be considered a higher credit risk if your credit report shows that you have more late payments and slow payments than listed for the following types of credit:

- ◆ **Housing debt.** An example of this type of credit is your current mortgage or rent. You should have no payments past due.
- ◆ **Installment credit.** An example of this type of credit is a car loan. You should have no payments that are 60 days or more past due and no more than two payments that are 30 days past due.



#### Real Estate Terms

A *subprime* borrower has either missed payments on a debt or has been late with payments. Lenders will charge a higher interest rate to compensate for the potential losses from customers who may run into trouble or default on the loan.

- ◆ **Revolving credit.** An example of this type of credit is a credit card. You should have no payments that are 60 days or more past due and no more than two payments that are 30 days past due.

If you have some of these types of risk, you might be considered a *subprime* borrower. This is a person with a less-than-perfect credit report. Again, it doesn't mean you will never find a lender, it just means that you will have to work a little harder to find a match.



#### Buyer Beware

One common scam for handling bad credit is working with a “credit doctor.” These services promise to clean up your credit report, but that's not a promise they can keep. If your report includes a mistake, you'll have to correct it (covered next). And if there is an error, the company will correct it without charging any fee. Also, if you have a bad credit history, the “credit doctor” can't do anything about that.

If you receive any offers for credit doctoring, you can forward it to the Federal Trade Commission ([uce@ftc.gov](mailto:uce@ftc.gov)).

## Correcting a Mistake or Responding to Problems

If your credit report doesn't show any problems, you can rest assured that your loan won't be turned down because of your credit report. If your report does include a problem, you should correct it (if it is in error) or resolve it. A mortgage lender can also get an agent from a credit bureau to help correct any errors.

If you have any outstanding debt, resolve it by contacting the creditor. Be sure to send a letter to the creditor requesting they notify you and all three reporting services that the problem has been fixed. Lenders often request reports from multiple sources; differing reports raise a red flag to lenders.

If you cannot resolve the problem, document your explanation. The credit agency must include your explanation of the problem in the credit report.

If you pay your bills, but pay them late, you may think that you don't have a bad record. Slow pays (late payments) are almost as bad as no pays, and they reflect poorly on your credit record. You should document or explain any late payments, especially any late rent or mortgage payments. Perhaps you moved or got a divorce and the bill arrived too late.



### Real Deal

If you find that your credit is in a lot worse shape than you anticipated, you can contact one of the personal credit counseling organizations for help. They might be able to help you sort out your credit problems for a small fee or possibly even at no charge.

Beware of so-called "non-profit" credit counseling agencies that require you to pay large sums of money or make promises that seem unrealistic. Recently there have been scams involving this type of service. If you want to use a service, check out the credit counseling company's background. Bottom line: always be cautious about any deals that sound too good to be true.

If your report has a mistake, you need to get *each* reporting agency to correct it. This is harder than actually clearing an outstanding debt! Write a complaint letter; call the local office. If you can't get resolution, call the bureau manager. If you write in, include the questions you have about your credit report and the actions you would like to take. Then include your name, address for the past five years, Social Security number, date of birth, current employer, phone number, and signature.

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### Strengthening Your Credit

If you know you have a low score due to slow pays or because you haven't established credit in your name, you have some options for strengthening your credit.

For instance, you may find out that you don't have a credit history. Many married baby boomers have been taking care of their family for years, only to find out that their credit cards and credit history are actually established in their spouse's name only. Because of their lack of employment history and being the secondary person on bank accounts, they haven't established a credit history.

Even if your name is on all the accounts, it doesn't mean that you have established credit. Apply for a department store card or gas card in your name (because they are relatively easy to apply for) and pay the bills on time, of course. Another option might be to open a bank account with your name as the primary person on the account and then secure a credit card against the deposit amount. These are a couple surefire ways to build or perhaps rebuild your credit.

If you have had bad credit, work to build new, positive credit references. Create a budget and stick to it. Pay off any past due debt. And again, know what your credit report says so that you aren't broadsided.

### Dealing with a Bad Credit Report

How long will you be haunted by bad debt? Suppose that in the past you had some credit problems, but now they are all resolved. How long does bad debt stay on your record? Seven years. After that time, the unfavorable credit information should be dropped from your file. If you file for bankruptcy, this information stays on your record for 10 years. Lenders really only look at the last two years, though.



#### Real Deal

If you have several credit cards, get rid of most of them before you apply for a loan. Having too many credit cards may be looked on unfavorably by lenders. With easy access to credit, you could get yourself into trouble.

If you have a bad credit report, does that mean that you will never own a home? No. It may mean that you have to search harder to find a lender, and you may pay a higher rate for the loan. Lenders will work with you, and you can always refinance the loan to get a better rate after you have established a better credit report.

Another option to consider is looking for homes where the sellers are willing to carry some or all of the loan. When this happens, the seller serves as the

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mortgage company or bank, and you make payments directly to the seller. This way, if you cannot make the payments and the home must be foreclosed upon, the home-ownership goes right back to the seller. To some sellers, this is worth the trouble of carrying the loan. But if you keep making the payments without any problems, the home is yours.

### The Least You Need to Know

- ◆ Lenders look at two ratios when deciding whether you qualify for a loan. The front-end or housing expense ratio requires that your mortgage payment not exceed a certain percentage (usually 28 percent) of your monthly income. The back-end or debt-to-income ratio requires that your mortgage payment plus your debt payments do not exceed a certain percentage (usually 36 percent) of your monthly income.
- ◆ Mortgage payments consist of the principal, interest, taxes, and insurance. You will see this abbreviated as PITI.
- ◆ To find out how much you can borrow, do a rough prequalification by dividing your gross yearly income by 12 to get your gross monthly income and then subtract your total monthly payments. You can also talk with a lender and prequalify either formally or informally.
- ◆ You may be able to get preapproved by documenting all of your income and debt with a lender. Prequalifying is useful as a guide, but is meaningless to the seller. Preapproval, because the loan is guaranteed, does mean something to the seller: it means you can have the resources to purchase the home.
- ◆ It's a good idea to check your credit record to ensure that you don't have any credit problems. If you do, resolve the problem or have your record corrected before you apply for a loan.

