**CHAPTER 1**

# Calculate How Much You Need to Buy a House and Set Your Goals

"What's your price range?" is one of the many loaded questions you'll face as a prospective homebuyer. As you sit across the table from your mortgage lender one day in the future, you should be confident in your response. That's right, you can—and should—do some major budgeting legwork before a lender ever looks at your finances.

It starts with setting financial goals that will support your decision to buy a house, which is both an immediate expense and long-term commitment. With specific milestones in mind, you won't buy a house before you're ready or go into the process blind to the costs of homeownership.

"Buying a home is one of the most stressful things that anyone will go through and will probably be the most expensive thing you'll buy in your life," says Deborah Smith, a top real estate agent who ranks in the top 5% of agents in Southfield, Michigan.

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**DEBORAH SMITH**

TOP 5% REAL ESTATE AGENT IN SOUTHFIELD, MICHIGAN

Before her buyers go all in, she reminds them of how big of a financial commitment a home purchase is.

"I educate my buyers on being realistic about owning a home and what the cost will be like," she says. For such a momentous purchase, you'll want to make sure that you do it right.

Let's walk through how to:

- Figure out how much you can spend on a mortgage every month
- Calculate what you'll need for a down payment
- Budget for closing costs
- Improve your credit score
- Plan for recurring expenses like taxes, maintenance, and insurance
- Protect your emergency fund

We'll take it slow, step by step.

## How to determine your maximum monthly mortgage payment

When you get preapproved for a mortgage, a lender will look at many factors (your credit history and overall financial profile) to determine how big of loan you qualify for. The underwriting process is complex, but generally lenders prefer that when you take on a mortgage, your debt-to-income ratio doesn't exceed 43%.

That means the slice of your gross monthly income you put toward any kind of debt, whether it be a mortgage, car payment, or student loans, likely will get capped at 43% of your pre-tax income when you go to buy a house.

**DTI:**
debt-to-income ratio

It's a good standard to be aware of. However, depending on your circumstances, the 43% mark can actually put you out of your comfort zone financially. A lender won't factor in, for example, how much you spend on daycare every month or whether you're helping your younger sister pay for college textbooks, notes millennial-focused magazine Mental Floss. On the other hand, without a ton of extra expenses, a 43% DTI could be just fine.

As far as what a middle-of-the-road buyer pays, Americans on average spent $1,443 on monthly housing costs such as their mortgage in 2018, according to a study by NerdWallet. Moreover, the Bureau of Labor Statistics found that Americans typically put 37% of their budget toward housing costs.

As of April 2019, the average listing price for homes in the U.S. is close to $300,000, which translates to an average $1,383 in mortgage payments (for 20% down and a fixed 30-year loan term). Every market is different—median home prices hit $1.7 million in San Francisco, CA, whereas listing prices in Omaha, Nebraska average $235,000.

Wherever you settle down, a home is a huge financial commitment that sticks with you. The most common mortgage terms are 15 and 30 years, and people tend to stay in their homes for 13.3 years on average. Meanwhile, 88% of recent buyers financed on average 87% of their home purchase, suggesting that many Americans plan to pay off their homes over the long term.

It's the biggest and longest IOU you may ever take on. Regardless of national averages and whatever your friend paid for a house, figure out a budget that works for you.

## How much can you spend on a house each month?

Many first-time home buyers fail to consider what comes after the initial down payment on a house. Your mortgage bill and its related costs will arrive like clockwork in your mailbox each month and you don't want to panic about how to make ends meet.

Follow this step by step to calculate a comfortable monthly mortgage payment:

### 1. Add up your income streams

First, add up every source of income that goes into your bank account. Include what you bring home, what your partner earns, and other steady sources of money.

**30% Standard:**

home affordability rule that states your housing costs should account for no more than 30% of your gross income

Next, you'll need to figure out how much of your budget you'd like to allocate to housing costs every month. The "30% standard" is one home affordability rule that's stood the test of time. It states that your housing costs, including taxes and insurance, should account for no more than 30% of your gross income (meaning, your income before taxes).

The Joint Center for Housing Studies traced this rule back to the 80s when federal legislation increased the affordability standard to 30% for most federal housing assistance programs. The Research Center concluded that although the 30% rule is simplistic and should be taken in the context of an individual's cost burdens and income level, as of 2018, the 30% standard remains valid as a general guideline.

Here's how you can incorporate the 30% rule into your home budgeting plan:

> Say you and your spouse take home a combined **$4,200** every month before taxes. If you **multiply 30% by this number** (plug in 0.30 × 4,200 in your calculator), you'll get **$1,260**. You know then that **your monthly mortgage and housing expenses should not exceed $1,260.**

That $1,260 should cover:

- Mortgage principal and interest
- Property taxes
- Homeowners insurance
- Mortgage insurance (if applicable)
- Homeowners association fees (if applicable)

Note: Some real estate listing sites will show you how much the mortgage payments will total on different homes for sale online, giving you hope that what you pay now toward rent will translate to an attractive house budget. Beware: fail to factor in taxes and insurance, and you'll overblow your budget, big time. Property taxes vary widely across the country, but the average American household spends $2,279, every year ($190 per month) on taxes for their home. Meanwhile the average homeowners insurance

premium, which protects you in cases such as fires and theft, ranges from $600-$2,000 per year. These are no small expenses.

Additionally, if your down payment is less than 20%, and you're taking out a conventional loan, then you'll likely need to factor in private mortgage insurance. Homes in a private community, like a condominium, may also tack on HOA fees for those extra amenities and services.

### 2. Factor in your existing debts

*If you're taking out a conventional loan, any down payment that dips below 20% of the home's value must be coupled with private mortgage insurance (PMI), an extra cost bundled into your mortgage payments every month.*

Remember, most lenders recommend a maximum debt-to-income ratio of 43%. So from here, you'll need to add up the amount you pay toward existing debts (like student loans and credit card balances), and divide that by your pre-tax income ($4,200 in our case).

Using the above example, you'd need to run the numbers like so:

**$4,200** (income) × **43%** (DTI max) = **$1,806**

With an income of $4,200, **your total debt should not exceed $1,806.**

If you put 30%, or $1,260, of your income toward housing costs, that leaves $546 leftover to put toward other debts. If together your monthly debt payments exceed that cap, you'll need to lower your monthly housing budget accordingly.

### 3. Aim high on your down payment (within reason)

Your down payment is what you pay out-of-pocket from your own savings at closing, and there's a reason the phrase "20% down" rings in your head like an earworm: If you're taking out a conventional loan, any down payment that dips below 20% of the home's value must be coupled with private mortgage insurance (PMI), an extra cost bundled into your mortgage payments every month. PMI protects the lender if you miss your mortgage payments, though it does not protect you as the buyer from foreclosure.

However, 20% down isn't the only route at your disposal. According to a study by Country Financial, a reputable insurance company established in 1925 that serves more than a million U.S. homes, more than half of buyers surveyed in 2019 put down 10% or less, while one-third put down short of 5%.

What you put down depends on what you're financially capable of, and the requirements vary based on the type of loan. For example:

- **FHA Loans**, backed by the government: Minimum of 3.5% down payment required
- **VA Loans**, backed by U.S. Department of Veteran Affairs: 0% down payment required
- **Conventional Loans (with PMI)**: Minimum 3% down payment
- **Conventional Loans (without PMI)**: Minimum 20% down payment
- **Jumbo Loans**: 10% down payment

*"Anytime you trade time for money, you're going to pay more for whatever you're buying."*

**MARK SQUIRES**

FINANCIAL EXPERT & CEO OF WISE CHOICES FINANCIAL

Dave Ramsey, one of the most well-respected personal finance experts in the industry, says that if you want debt-free homeownership, a 20% down payment is your best bet. For one, you can likely kick the PMI to the curb on a conventional loan with 20% down. (There are exceptions to this; for example, if you were to offset the down payment costs with a "piggyback" second mortgage which acts as a home equity line of credit, PMI may still apply. Government-backed programs may also include their own form of mortgage insurance.)

In addition, a higher down payment will likely qualify you for a lower interest rate* (depending on other factors within your larger financial profile), which can mean big savings over time.

For example:

> If you decide to buy a home for $250,000, with a **20% down payment**, 3.5% interest rate on a 30-year fixed term, your monthly payments come out to around **$1,231** give or take a few factors.
>
> With a **10% down payment**, that number jumps to **$1,399**.

You might think that $168 difference isn't much. But, multiply that by 12 months in a year, that's an extra $2,016 a year in payments. Two grand for 30 years? Add a whopping $60,480!

"All you're doing is trading time for money and anytime you trade time for money, you're going to pay more for whatever you're buying," says Mark Squires, financial expert and CEO of Wise Choices Financial.

He also explains that while the down payment is important, buyers need to stay on top of

*If you're set on putting down 20% but the idea of it makes you feel shaky with any particular property, the solution is simple: Buy a cheaper house.*

every mortgage payment. Don't push it to the limit with your down payment to the point where you're left with barely any savings leftover. Stay within your means.

If you're set on putting down 20% but the idea of it makes you feel shaky with any particular property, the solution is simple: Buy a cheaper house.

There's another layer to this that's important to note: For some buyers who live in markets where housing costs keep rising at a fast pace, it may make more financial sense to pull the trigger on a home purchase rather than spend more time saving to reach a certain down payment benchmark. Let's say you spent 5 years saving up to put 20% down, but you live in Oakland, California, where home prices rose 5% year over year in June 2019. Home prices here could outpace the rate at which you save, and before you know it, you're back to square one for the same house, but at a more expensive price.

## Leave room for emergency funds

Financial advisors also recommend that you save 3 to 6 months of living expenses for an emergency fund, so that if doomsday does arrive in the form of a lay off or stock market crash, you can stay above water.

As an example, let's stick to our monthly income of $4,200. Let's say you use 50% of your income to pay for your living expenses. Three to six months of living expenses for your emergency funds would range from $6,300 to $12,600 in the bank.

## Anticipate maintenance costs

Finally, don't neglect your home maintenance budget. 44% of homeowners regret their home purchases, stating that home maintenance and other costs were much more expensive than expected. Bankrate.com, a top-rated online finance site, found in a survey that the average homeowner pays $2,000 every year on maintenance. This includes anything from faulty plumbing to landscape fixes that require upkeep.

Allocate at least 1%-2% of your home's value toward home maintenance and repairs, so that you don't empty your bank account to fix up a leaky roof after a rainstorm.

## Don't forget about closing costs

On top of the down payment, buyers are on the hook to pay closing costs.

Here's an idea of the types of fees you can expect to be included in the final closing costs. (There are many more, and this is just a sampling. For a full list, review Eave by HomeLight's comprehensive guide to closing costs and third-party fees for buyers.)

*In total, buyer closing costs average anywhere from 2% to 5% of the final purchase price of your home.*

- **Loan application fees**: Most banks and lenders charge buyers for the processing a new loan requests, which include credit checks and smaller administrative fees.
- **Loan Origination fee**: Most lenders charge buyers for the evaluation and preparation of your loan. Buyers can expect to pay around 1 to 2% of the loan amount, but this fee can go all the way up to 3%. So a $200,000 loan may require a $4,000 loan origination fee.
- **Transfer taxes**: You pay transfer taxes when the property changes hands from the seller to you. Transfer taxes are set by your state or local government, so what you end up paying depends on your city. Generally, you can expect transfer taxes to be a percentage of the sales price.
- **Recording fee**: The government charges recording fees for the registration and recording of your real estate purchase into public record. Recording fees vary from city to city, so the cost depends on the rate your government charges. Expect to pay anywhere between $100 to a few thousand dollars.
- **Property taxes**: Property taxes are location-specific and buyers normally pay the taxes due after closing. But if the seller has already paid for the entire year, buyers will have to pay their prorated amount.

You'll also need to account for fees for the home appraisal and home inspections, which can either be paid upfront/per appointment or all at once at closing.

In total, buyer closing costs average anywhere from 2% to 5% of the final purchase price of your home. On the $250,000 house you want, you'll likely pay an additional $5,000 to $12,500 for closing costs.

# Set the right goals toward achieving homeownership

Now that you've done some important math, grab a pen and paper or your laptop (you'll be 42% more likely to achieve your goals if you write them down). You and you alone are in the best position to know your life plans and financial situation.

Write down your North Star based on your calculations

As you save up for a home, you'll need to be intentional about your end game.

This is what your setup may look like if you decide to put 20% down on a $250,000 house:

- $50,000 for a 20% down payment goal +
- $10,000, for ~4% closing costs +
- $6,300 for emergency funds (three months of living expenses)

Added together, your bare minimum North Star amount should total $66,300. Let's say you already have $10,000 in the bank. That lowers your savings goal to $56,300.

## Work toward a higher credit score no lower than 580

Let's start with the good news: You don't need a perfect credit score to buy a house.

"Most of the time people think they need very high credit scores, a 700 or better. They don't," says Chris Zinn, a top real estate agent in Tulsa, Oklahoma. "There's all kinds of loan programs out there for people with scores even in the high 500s."

*"Most of the time people think they need very high credit scores, a 700 or better. They don't."*

**CHRIS ZINN**

TOP REAL ESTATE AGENT IN TULSA, OKLAHOMA

If you're strapped for time, you may still qualify for FHA loans with a credit score as low as 580, but you'll need to commit to at least a 10% down payment.

Best case scenario, if you can set long-term goals, you can work to improve your credit score as you save up money for the down payment. Most lenders prefer home buyers with higher scores, which sets you up for better mortgage terms and lower interest rates.*

Here's how you can try to raise your credit score:

**1. Monitor your credit score for free.**

Various online platforms will give you an estimate based on how well you pay off your debts. This doesn't hurt your score either since you aren't conducting a full-on investigation and background check into your financial history. Check out these platforms (which all come with mobile apps so you can check your credit on the go):

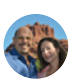
*Credit Sesame and Credit Karma are great tools for helping you keep track of your credit as you save for a home.*

- **Credit Sesame**: A strong option thanks to the company's partnership with TransUnion, a highly reputable credit service with over 200 million users and 65,000 businesses. You get alerts every month that show you your progress and the service provides identity-theft insurance of up to $50,000.
- **Credit Karma**: With Credit Karma, which is partnered with TransUnion and Equifax, a credit agency with more than 800 million users, you can monitor your credit score and analyze what's affecting it, such as outstanding debt and too many hard inquiries. When the platform pulls your credit score, it also identifies areas for you to save money.

These tools are great for helping you track your credit as you save for a home. But remember, they are offering estimates, so the numbers they provide can't be taken as gospel. When it comes time to take out your mortgage, it's important to know your official credit score, as that's the number lenders will look at.

**2. Student debt? Car loans? Credit card bills? Pay. Them. Off.**

*"If you're looking to buy a home, get that debt situation under control and pay it off."*



**DAMIAN & DANIELLE BRUNO**
TOP 1% REAL ESTATE AGENTS IN SEDONA, ARIZONA

Damian & Danielle Bruno, real estate power couple who are in the top 1% of agents in Sedona, Arizona, advise buyers to tackle debt head on.

"If you're looking to buy a home, get that debt situation under control and pay it off," says Damian. "Saving money while having debt is really counterproductive."

Nobody expects aspiring homeowners to be debt-free in order to buy a home, but you should try your best to work toward that goal. Most lenders advise their clients to keep their debt-to-income ratio below 43%. If you have a higher ratio than 43% (more debt than income), lenders are less likely to approve you for a loan.

We'll get into strategies on how to trim your debt in Chapter 3, but here are some tips to get started:

- Live within your means: track your expenses and budget what you would spend every month.
- Pay off your credit card bills in full and find a method for the rest of your larger debts, like medical bills or student loans.
- Stay on top of your monthly dues and when you can, make extra payments to shave off time and interest.

**3. Avoid opening new accounts, lines of credit, or buying big items like a car.**

These decisions prompt lenders to conduct a thorough background check on you. This will lower your credit score! With excessive payments and loans, you prove to lenders that you're a credit risk.

## Set a deadline for your savings

The best goals are measurable and time-specific. If your goal is to purchase a home, you should know how much you'd like to have in the bank when you get a mortgage. Then, set a hard deadline that will keep you accountable.

*The best goals are measurable and time-specific.*

> Let's say you already have **$10,000 in savings.** Then in total, you'll need to save up **$56,300** to afford the cost of the **$250,000 home.**

If you set yourself a deadline of 3 years and put your savings in an account with a 2% interest rate, you'll need to save at least $1,502 every month to meet that goal. When you break it down like that, you don't have to climb Mount Everest all at once. You can take it day by day, one step at a time.

# Use HomeLight's home affordability calculator to connect the dots

To get a clearer picture of what your payments and debt will look like with a home purchase, play around with HomeLight's Home Affordability calculator. It takes into account factors such as your down payment, average interest rates* and different loan terms (the most common being the 15-year or 30-year mortgage).

Let's run through a calculation using the HomeLight Home Affordability Calculator and our example from above:

- First tell us your location. For illustrative purposes, let's say you're in a mid-tier housing market like Dallas, Texas. Not the cheapest, but not the most expensive, either.
- Enter into the calculator what you'd earn annually (that's $4,200 * 12 months), or $50,400.
- Then, plug in your savings goal, in this case $66,300.
- Next input how much of your savings you'd be willing to allocate toward the down payment (we'll use 20%) and closing costs. To preserve your $6,300 safety cushion, you'd be able to put allocate $60,000. Type in your monthly obligations, such as student loans and car debts. For this example we put in $450, since it's below that 43% DTI cap.
- With an interest rate of 4% and a 30-year loan term, the home affordability calculator shows you that you're able to buy a $251,502 home. Your monthly mortgage payments shake out to $1,356 including taxes and insurance.
- Think back to our original 30% rule: you were trying to stay below $1,260 for your total housing costs. The calculator shows you you'd pay a smidge above that in this scenario. However, you can adjust your price range up or down from the calculator results based on your individual budget boundaries.

Phew, that was a lot of information at once! Are you still with us?