Anjali: 00:08

Hi everyone. Thanks for tuning in to today's episode of Money Checkup where we take a deep dive into matters related to money, business and personal finance. I'm your host Anjali Jariwala, CPA and Certified Financial Planner. Last time we talked to Christina Razzi at US Bank about mortgages in the home buying process. Today I wanted to take a step back and talk about how I help clients determine how much home they can really afford. So there's a lot of rules of thumb out there, but rules of thumbs are not the best metrics to use to determine how much home you can afford. Some of the ones that I see out there a lot is having a 28% debt to income ratio, which is what lenders tend to look at. And most lenders will cap out at about 38% debt to income ratio, which is essentially all the monthly debt payments you have divided by your total monthly income. I think that number tends to maybe put people in a position where they're making a mortgage payment that they may not be able to otherwise afford. Uh, the other rule of thumb is three times your income. So you can essentially take out debt that's equivalent to three times your income. So if you make 200,000, you could take out a mortgage of 600,000, which once again is a rule of thumb and not one that I tend to have my clients follow. So when I think about home affordability and help clients go through this process, there's a few factors that I like to look at in order to provide them with a range of how much home they can afford.

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So the first step in the process is to really know your numbers and you have to really do this analysis for yourself before you even think about that home purchase price. So the first number to pull together and sticking it in a spreadsheet, write it down, whatever you need to do to have it front and center is your income. And when I talk about income, I'm specifically talking about your current take home pay. So this is your pay after your taxes, after retirement plan contributions in any other benefits that you may pay into. And if you're dual income, make sure you factor in both of your incomes into this number. Next to you want to list out all of your debt and this debt is going to be not necessarily in total but how much you currently pay on a monthly basis. So if you have student loans or anything like that, what your current monthly payment is cause that's what the lender is going to look at when they're figuring out your debt to income ratio.

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Next I like to look at rental properties of clients, have that and and making sure we know how much income in terms of rental income is coming in for that property and then any expenses. In my experience, a lot of lenders usually viewed this one as a wash, meaning that the income and the expenses will net to zero but that may not always be the case but be prepared cause I that is information that the lender is going to request from you and then the next step which probably will take the longest, is really going through all of your current spending and figuring out how much are you truly spending. On a monthly basis. So when we look at spending for clients that things I look at is how much are their current fixed expenses. Fixed expenses are things like current mortgages, rent, utilities, cell phone bills. So these are expenses that stay consistent and you know what the amounts are on a monthly basis. The other piece of spending is discretionary. Discretionary spending tends to be the one that people have less insight into. And especially if you are used to putting things on a credit card, and this is the one where people are always wondering where did my money go? So it's really good to have a good understanding of what those numbers are. Some ways to do that is to use one of spending trackers, like YNAB or mint.com or just going through year and credit card statement. You know they usually provide a summary as to all your spending in the categories. So once you have all of those numbers you kind of have a good feel as to how much income is coming in on a monthly basis and how much is really going out in expenses. And then what that savings number it looks like on a month.

Anjali: 04:20 The next thing to look at is how much cash do you have. And so when people think about home purchase, they're usually focused on down payment. And so down payment is usually going to be the largest piece, but there are going to be other expenses that you need to have additional cash for. So things like closing costs, which could be another two to 3% as well as meeting reserve. So if you haven't listened to the previous episode I highly recommended, because we talk about reserve requirements, but to provide a quick summary, all lenders will require a certain number of months of reserves, which is essentially the mortgage payment. You can use accounts like retirement accounts to count toward that reserve requirement by retirement accounts are going to count at a lesser percentage than cash accounts would.

Anjali: 05:07 So these are all the things to keep in mind and know when you're thinking through home affordability. So once you gather all of those pieces of information, you should have a pretty good understanding of your current financial situation and probably can put together a net worth statement or balance sheet listing out each of these numbers. So the next piece of it, after you have a good understanding of your current situation is to start picking some numbers for home affordability and running those calculations. So I, I usually suggest a starting price point, something that you think that the price of your, you may pay for a home. And I'll provide a quick example so that it's easy to understand.

Anjali: 05:48 So let's say you, you picked a price point of 500,000 that's what you think you can afford. So if you are purchasing a $500,000 home and you're putting 20% down, the down payment on that is 100,000 so that's the first number you need to keep in the back of your mind. If you're putting anything less than 20% that's fine. You just have to then take into account other things. I may come up in the mortgage process that'll talk about in a bit. And so let's say if you are putting 20% down the mortgage on that $500,000 home will now be 400,000 because 100,000 of it has been paid in cash at the down payment. Mortgage rates do vary based on the type of mortgage that you're looking at. And you know, once again check out the previous episode where we talk through the different types and what may make sense for your current situation. But let's assume you're going with a 30 year fixed, which is essentially a fixed rate for 30 years. And let's assume that rate is four and a half percent. So if you have a $400,000 mortgage at four and a half percent, your mortgage payment is actually going to be $2027 per month.

Anjali: 06:57 So this is just principal and interest. And when I talk about principal and interest, that's essentially just the principal that you're paying down as well as the interest, which is the four and a half percent. So that's only one piece of your monthly payment. You have to also keep in mind that there's going to be other additional expenses that are going to come up on a monthly basis that you need to take into account when you're really trying to determine home affordability. So some of those other expenses are property tax. So if you currently rent property tax is something that you're not paying for. So that's going to be an added cost and depending where you live, that can be fairly sizable. The other thing is homeowners insurance. Usually depending on the type of home you buy and where you're purchasing, you may see your insurance costs going up once you own a home.

Anjali: 07:42 Other things that come up, especially if you're going to purchase a Condo, which is very common in a city, our HOA. So HOA ways do vary. Sometimes they're minimal. I'm originally from Chicago and the HOA is on Condo buildings can be as much as a mortgage payment. So those are all things that you need to keep in mind. The other pieces, Mello Roos. So Mello Roos is something that I actually didn't come across until I moved to California. And it's in certain neighborhoods where you pay an additional tax on top of property tax and it's usually there to fund things like the school. And then the last one that I usually like to look at is PMI, which is mortgage insurance. So if you're putting anything less than 20% down, you may be subject to mortgage insurance. There are lenders who will waive the mortgage insurance requirements based on the type of loan. So I'm in the last episode we talked about Doctor Loan. So usually if you're under a doctor loan program you can put less than 20% down and you won't get hit with PMI, which is a nice benefit.

Anjali: 08:43 So once you figure out all of those other numbers, then kind of calculate what that total payment is going to be all in per month. And then what you need to do next is see how much of your income is essentially being eaten up by that payment. I like my clients to kind of stay up at a range of 30% or less of take home pay. So you can get that monthly payment, dividing it by your total net, take home pay, how, what's that percentage look like if it's 30% or less than usually that's a a good comfortable range for most people. But it may not be based on your individual circumstance.

Anjali: 09:18 So the 30% income threshold is Nice, but it may not always work, especially for people who live in high cost of living areas. I'll take myself as an example. I live in southern California. Housing is very, very expensive here. So for many people trying to follow that 30% rule of thumb may not be a realistic and it may not be something that would really be suitable in their situation. So the other factor that I look at when we think about home affordability is really how much of your savings is getting eaten up by that new payment amount. So if you recall the numbers that I mentioned running earlier, you know, what's the total take home pay, how much of your pay is getting used up by fixed expenses and discretionary, and then what's that monthly savings, right? So how much is that current monthly savings rate and then what happens to them monthly savings rate once you purchase a home.

Anjali: 10:19 So if you're currently saving, let's say $2,000 a month and you're renting and then you decide you may want to purchase a home and you run all of these numbers and now your savings rate is going to drop to a thousand dollars a month, is that a savings rate that you are comfortable with? Is that enough to fund other goals that you may have in the future? You know, other goals can be things like a future car purchase, future children, current children maybe increase in childcare costs, things like that. So it's really a personal decision as to what you're comfortable with and what works. When I run home affordability, I provide a pretty wide range to show clients how much of their savings is getting eaten up at each increment that we're looking at. So in some situations the home purchase may put that person in a negative cash situation when all of these factors are taken into account. If that happened after you run your numbers, then you know that that's probably not a price point that you can afford currently. And consider going down in your price point in order to make those numbers work.

Anjali: 11:24 And then the, the other thing I always like to tell my clients is that you don't want to completely deplete your savings if possible after the home purchase. Because almost always there's going to be unexpected costs that come up when you own a home. So things that come up, maybe you're moving to a larger place, utility costs may go up if few own a single family home. You may need to pay for landscape or someone to plow your driveway, which may not have been an issue if you were renting a place and now is taking care of. So you want to have a fudge factor in your numbers to account for potential increase in expenses, which is why when you're looking at that savings rate, we don't want to have a savings rate that goes down to zero after the home purchase because you may end up being in a really, really tight, uncomfortable situation or a negative cash flow situation, which is very hard to recover from the saying. You don't really want to be home rich and cash poor, so that that really does hold true in home affordability.

Anjali: 12:29 Once you have a good idea, you can probably set a range for yourself. I like clients to have a range because usually a small increase in purchase price is, is a fairly small increase in the monthly mortgage payment because it's being financed over 30 years and that's not to push people to go over their budget, but you may be in a situation where maybe there's another offer that's come in as well, and so you may need to just go up a little bit more in order to get the home. So you want to have your range and know what those increments look like so that you feel comfortable if you need to make that quick decision with your realtor and go up in the purchase price to get the home that you want.

Anjali: 13:09 So you know, I always tell people that the process is not an exact science, unfortunately it's more of an art. So the best way to make the decision is to really know your numbers and then to run all the numbers on the other side of things. If you're looking at MLS listings, it's going to list out all of these expenses like property tax, HOA, Mello Roos, etc. So you should have pretty much all the information you need and hopefully you've already gone through the process of speaking with a few lenders. You have a current idea what mortgage rates will look like, or you can also Google it and find out.

Anjali: 13:42 So the, the next piece that I haven't talked about yet, but I would like to spend a few minutes discussing is tax savings on a home purchase. So I wanted to first talk about the tax law changes that happened last year with the new tax law that went into effect in 2018 because there were some material changes that impact home purchase and property tax deductibility.

Anjali: 14:05 So the first change was that the mortgage interest deduction, which is an itemized deduction on schedule a, the old law would allow you to deduct up to $1 million of mortgage interest. Unfortunately, the new tax law kept that interest deductibility two mortgages up to 750,000 so if your home purchase prices, the mortgage is going to be seven or 50 or less, you're still going to get the full interest deductibility. If you itemize by people who are looking above that price point, they're going to see their deduction limited up to that 750,000 the next piece is property tax. So in the old tax law, property tax used to be completely deductible if you were to itemize the new tax law has put a cap on that as so now state taxes are capped at $10,000 per year, whether you're an individual or a family. So what do I mean by state tax?

Anjali: 15:00 So state tax essentially includes all income taxes you pay as well as property tax. So this actually is a pretty material impact for people who live in high cost of living areas such as California or New York or you know even Pennsylvania where the income tax rate is high and then property taxes can also be high so that overall deductibility is now only 10,000 so those are a few things to keep in mind when you're kind of thinking through tax impact of home purchase, since this is a tax benefit that you recognize on your tax return. I don't usually incorporate this number into the analysis from my clients. And the reason why is there is a benefit for tax purposes for a home purchase, but you're not going to see that benefit usually on a monthly cash flow basis and you're really just going to see that benefit when you file your tax return. So I try to very much keep it to what the impact is going to be on monthly cashflow because that's really going to be the deciding factor in terms of what you can and cannot afford.

Anjali: 16:05 The other thing to consider when you're thinking through home affordability is whether you want to leave some cash left over after all costs are said and done. And the reason why is many people that I work with, usually when they're purchasing a home, it's an upgrade from the place that they're currently in in terms of maybe size, location, whatever the case may be. And because of that they usually want to furnish it, which is very common and you know, furnishing an entire home. If you're planning to do that can be very expensive. If you're planning to use a designer, that's a cost as well. So if you are thinking about home affordability and, those are things you really would like to be able to do after you purchase a home. Then make sure that you're setting a price point and make sure that the down payment is such that you're still gonna have cash left over to be able to do those things. And if that's not a priority and that's something you just want to save for after you move into the home, then the focus should be on the savings rate and how much is going to be left over after home purchase to be able to do something like that in save for it.

Anjali: 17:04 So I wanted to go through some pitfalls to avoid when you're thinking about home affordability and purchasing a home. So the one main one is trying to anticipate future increases in expenses and make sure that your mortgage payments still aligns with that. So a few examples are, one is student loan payments. So if you are on any sort of income based repayment, the way those payments work is that as your income goes up, the student loan payment will go up as well.

Anjali: 17:34 So I have a lot of clients that are on income based repayment. We actually will calculate what that payment is going to look like in the next two five 10 years to make sure that the mortgage payment that they're going to have is still going to work with that future increase in the student loan payment. So that's one of them. The next cost to consider is if you have a child or planning to have more children, what the cost of an increasing family looks like for you. Once again, you don't want to have the numbers be so tight that if some sort of unexpected life change occurs like a new addition to the family, which can be very common, that there's some buffer in there so that you can account for that and still be comfortable with the mortgage payment. And then the last one is along the lines with kind of an increasing family is is there going to be an increase in cost of childcare? That's usually the biggest expense I see for people who are starting a family is that childcare costs. I met in school costs, preschool, private school, whatever the case may be. And there may be other types of future expenses that may be pertinent to your specific situation. So I highly recommend thinking through that and incorporate that into your numbers. Once again, you don't want to put yourself in a situation where the numbers are are too tight and you're not comfortable on a monthly basis. That means that you probably bought too much home and it was a price point that you couldn't afford.

Anjali: 19:01 And then the last thing I want to go through his things that you should do to prepare your credit if you're going to start the home buying and mortgage process. So the first thing I like to recommend to my clients is to see where we're starting from, right? What's your current credit score? So you can obtain this information by paying for it through one of the credit bureaus, or you can sign up for a free credit service like Credit Karma. So either one of those services will give you what your current credit score is so you have something to work off of. Most lenders have a base of what the credit score needs to be in order to qualify for the best rate. So you really want to know what that number is because that can make a difference if your mortgage rates and up being half a percent to a percentage higher cause that's the number you should know ahead of time while you're running your calculations. The next piece is to pull your credit report from all three of the agencies and review them. You can pull this for free, I believe annual credit report and I suggest doing it from all three agencies because I have seen many situations where there's discrepancies between the bureaus in terms of what they're reporting. So you want to review it for accuracy and you want to make sure that everything reflected in there is true to you. And if there's any mistakes to get those addressed, if you can before you start the whole mortgage process. And the thing to keep in mind is that when you're looking to get a loan from a lender and they're going to take the average of all three. So even if one bureau is reporting a higher credit score than the other two, they're not going to take the highest one. They're going to take an average. So you want to make sure all three are up to a number that is as high as possible for you. The next piece is paying off that low hanging debt. And when I mean by that is really credit card balances. So if you can pay off those credit card balances before a lender pulls your credit, that's ideal mainly because if you have large unpaid balances that's going to impact your credit score and the lender's going to have to use the credit score and on that day that they pulled it. So if you know they're going to pull it on a certain day, pay off that balance a few days before just so once again year, hopefully getting the best credit score number you possibly can.

Anjali: 21:12 And then the next piece is to really shop around for mortgage rates. Lenders have a lot of different types of programs based on profession, based on the type of mortgage you want to get. So it's a good idea to do your diligence and to compare a few lenders just to make sure you're getting the best rate for your situation. I usually have clients ask me will this impact their credit score negatively if they're getting credit inquiries from various lenders and usually the way it works is that the credit bureaus know that when you're purchasing a home that you are going to want to look at various rates, so they usually will only count multiple credit hits as one for purposes of a mortgage and as long as it's done within a certain period of time from each other. So worrying about the credit score hitch and be a factor to nod at least shop for rates because it should be a small impact, your overall credit score. And then the next piece is to find a good real estate agent who can guide you through the home buying process and really be your advocate. There's a lot of variance in in the real estate space, very similar to the financial planning space. So you really want to find someone that you can trust who's going to be your advocate, who really knows the market and can put you in a position to get the best deal for yourself or to get that home you really want. So there's a lot of referral type programs. If you have a referral from a friend, things like that where you can get a direct referral I think is always more beneficial than having to use someone that dropped a postcard in your mailbox more or less. And if you aren't sure. Another good option, which is what I used when I was helping my parents find an agent to sell their home is in addition to getting a few referrals, was looking at who the top agents were in their neighborhood and interviewing a few of them just to see how their process works to see what they do. And usually if they're one of the number one agents and the you have a little bit of assurance that they are good at their job and what they do.

Anjali: 23:07 And finally the last piece of advice is to really be prepared to walk away from an offer if the price is driven up that that tends to happen in, in competitive markets and you don't want to get in a competitive bidding situation and at a price point that you just can't truly afford. So you have to really go in with the mindset that it's okay if you don't get it and to walk away. And this is very much human nature. We find a home, we fall in love with it and we really don't want to lose it. And due to that, if it's a competitive market, we may end up offering more than we thought we could afford. And then we put ourselves in a more financial situation, which is not ideal. Better to walk away and to keep looking and to find that house that's right in your price range.

Anjali: 23:52 So those are, those are all my tips for home affordability. I know there was a lot of information in there, so if you want to recap, you know, please visit the show notes, which I'll have a summary of the key points that we went through today.

Anjali: 24:07 Thanks for tuning in today. If you're interested in making better financial decisions and are considering working with the professional, please visit us www.fitadvisors.com to schedule a free initial consultation.