The Massachusetts Homeownership Collaborative

HOMEBUYER COUNSELING CORE CURRICULUM

SECTION II: BUDGETING AND CREDIT

Section Objectives:

- To emphasize the importance of budgeting in the home buying process
- To assist participants in developing a budget and setting financial goals
- To emphasize the need for good credit in purchasing a home
- To assist participants in evaluating and addressing their current credit situation

A. THE ROLE OF BUDGETING AND CREDIT

If you're convinced that you want to buy a house, you need to consider whether you can afford to buy a house. You don't want to be living in a splendid house without a penny to spare for anything else. And you certainly don't want to overextend yourself to the point that you can't keep up your mortgage payments and you risk losing the house.

Many potential homeowners discover that when they add up their total housing costs (the mortgage payment; the costs of moving, settling in and making immediate repairs; and the ongoing costs of taxes, insurance and property management), these costs are higher than the amount they previously paid for rent. If you think this might be true for you, a complete financial assessment is necessary. Do you usually have some money left at the end of each pay period? If not, you will need to alter some of your spending habits before you take on the responsibility of buying a house.

The best way to determine if you can afford to buy a house is to develop a budget.

B. WHAT IS BUDGETING?

- A plan to reach a particular goal
- A guide to help organize finances
- A strategy for spending and saving

Why is a Budget Important?

- It will help you reach your financial goals
- It will help you determine what you can afford
- It will help keep track of where your money is being spent
- It can help you increase savings
- It will help protect you against emergencies

Having a plan is important for everyone. However, no one plan fits every family, couple or individual. Every family is unique in terms of their needs and goals. By following a plan, you'll know where you stand financially. A budget is a plan for spending and saving. It requires you to estimate your income for a particular period and decide how to allocate this income toward your expenses.

C. DEVELOPING A BUDGET

Where are you now?

The first step to developing a budget is to assess your present financial situation. This should include identifying:

- Net Income. Include net income from all sources, including salary, overtime, bonuses, part-time employment, alimony, child support, disability, etc.

  Note: Distinguish between gross income and net income. Gross income is the amount that you and your family earn (this is the amount used in determining your eligibility for a mortgage). Net income is the amount of money that actually shows up in your paycheck, after FICA, federal and state tax deductions, union dues and other deductions. Net income more accurately reflects your available income.

  It's important to remember that lenders evaluate your finances and borrowing capacity based on your gross income (income before taxes). However, homebuyers need to base their homebuying budgets on their net income – that's what you really have to work with.

- Fixed Expenses. Housing costs and other monthly or annual expenses, e.g. car insurance, health and life insurance, bank loans, credit cards, licenses, excise tax, alimony/child support, child care, installment payments (automobile, furniture, appliances, person loans), etc. (These are easy to estimate because they are generally the same each month.)

  This also includes *variable* fixed expenses such as food (meals at home, meals eaten out), household supplies, heat, electricity, gas, telephone, water, clothing (plus laundry and dry cleaning), transportation (gas, automobile maintenance and insurance, public transportation expenses), health care costs not covered by insurance (medical, dental, eye care), savings, etc. (These differ from Fixed Expenses because variable expenses aren't exactly the same each month. Variable expenses are an opportunity to reduce spending because you can comparison shop for the best prices.)

- Discretionary Expenses. For example, entertainment, lottery, vacations, education (tuition, room and board), recreation, beauty care, pet care, tobacco/alcohol, gifts (Christmas, birthdays, graduation, weddings) and charitable donations, dues (union, professional associations), postage, newspapers, dining out, video rental, hobbies, cable, household furniture and appliances, etc.

  Discretionary expenses can be unexpected and thus forgotten to be included in a budget. They're often referred to as "money gobblers" because they eat up income and aren't always anticipated. Some discretionary expenses can also be considered fixed expenses – i.e. education and union dues – because they are regular and predictable.

TIP: For some people, it is easier to look at finances in three month segments, since expenses are different during each season. For example:

Fall is the beginning of the heating season and the start of school
Winter for clothing, holidays and gifts
Spring for taxes, insurance and sports
Summer for vacations

There are many ways to keep a budget. These range from paper and pen (or pencil) and a small notebook to software programs, like Excel or Google Spreadsheets, to free, online budgeting tools available through one's bank. There are also numerous online programs, such as mint.com and creditkarma.com, and some creative ways of saving such as digit.co and acorns.com.

Net Worth

When you apply for a loan, such as a mortgage, one of the criteria that a lender may consider in deciding whether to make the loan is your net worth. Net worth is determined by subtracting what you owe (your liabilities) from what you own (your assets).

The cash assets available in your net worth is a base to determine how much more you need to save for a sufficient down payment and to cover closing costs when purchasing a home.

Where do you want to be?

Once you know your present financial situation, you can more realistically assess:

- Whether current income can cover the costs of homeownership
- What goals to set, e.g. increase savings for a down payment and closing costs

You want your budget to be SMART:

- Specific
- Measurable
- Attainable
- Realistic/revisable

- Time bound

Setting Priorities

Just because a lender approves you for a certain loan amount, doesn't mean that is what you can realistically afford. Think carefully about your budget before buying a house!

Budgeting doesn't end after you move into your house. In fact, it becomes especially important for successful and sustainable homeownership. You can't afford to buy or do everything you want to do at once. This is especially true when you accept the costs associated with owning a home (e.g. maintenance and repair expenses).

Establishing a budget can help you to set priorities:

- It shows you where you are spending your money
- It helps you watch your spending
- It shows you areas where you can save money
- It helps you plan.

Now is the time to start.

Summary:

- Establish a budget for the next three months – know what's coming in and what's going out.
- If you have to reach into your wallet, it's coming out of your budget.
- Set realistic goals. Don't try to change your spending habits all at once.
- Include all family members. If everyone takes a role in setting the goals and the budget, they will be more apt to follow it.
- Don't get discouraged. If the budget isn't working, make adjustments for the next three months.
- You control your money. Don't let it control you!!

D. BUDGETING AS A RENTER VS. BUDGETING AS A HOMEOWNER

This section is meant to alert participants to the differences in financial responsibilities between being a renter and being a homeowner. These issues are covered in more detail in the section on Successful Homeownership.

The expenses involved in being a homeowner are different from those of being a renter.

Costs of Homeownership

You should anticipate the expenses involved in *being* a homeowner well before you make a commitment to buy a house. Developing a homeowner's budget can help you decide how much you can afford to pay for a house, identify questions to ask about houses you will look at and help you to determine whether you can meet the monthly expenses (utilities, taxes, insurance, etc.) for a particular house.

How are Expenses Different as a Homeowner?

As a homeowner, you take on certain responsibilities that you did not have when you were renting an apartment. Who pays the water and electric bills? Who pays the property taxes? Who fixes all appliances and makes sure all systems (heating, water, electrical) are in good working order? Who repairs a failed septic system? Who is responsible for painting the house? Who fixes or replaces storm windows and doors? The answer to all these questions is the same: the homeowner – YOU.

These expenses, along with mortgage payments, taxes and your regular family expenses need to be included in your homeowner's budget. The penalties involved in not paying or late paying homeownership expenses can be quite severe. For example:

- As a homeowner, you will be charged late fees if your mortgage payment is late. Lenders usually will not accept partial payments; you must pay the full amount due plus any late fees. Many lenders will consider the loan in default if full payment is not received by the due date of the third monthly payment, and will begin foreclosure proceedings.

- If you do not pay a credit card bill, the company will follow up with constant letters and phone calls. Lenders, on the other hand, may only send out a few letters notifying you that you are delinquent before starting foreclosure proceedings.

- As a homeowner, not paying your water, sewer or trash bills or your property insurance can result in a tax lien on your property. The lender will pay the tax lien and then increase the monthly mortgage payment to recover the amount they paid on the lien, plus interest.

- As a homeowner, if you cannot pay your homeowner's insurance, the lender will purchase insurance for you. Known as "forced-placed" insurance, the policy will often cost much more than if you purchased the insurance on your own. You will be required to make the increased payment, or risk losing your home.

E. THE IMPORTANCE OF GOOD CREDIT

Good credit is the most important element in obtaining a mortgage. While it is important to be able to demonstrate a good credit history, few people have perfect credit.

If you have ever used a major credit card or financed an expensive purchase such as a car, you probably have a record at a credit reporting agency. This record of your credit history allows lenders to check your payment habits before they approve you for a mortgage, and it often helps to predict whether you are likely to be a good credit risk.

Lenders look at your financial ability to pay and at whether you have paid your bills on time. All this information is kept on file at three major reporting agencies, Equifax Credit Information Services, Trans Union Corporation and Experian. To obtain your complete credit history, all three agencies must be contacted because creditors do not all report to the same agencies.

You are entitled to 3 free credit reports each year. You can get your free credit report from annualcreditreport.com.

TIP: Credit reports should be ordered for all participants or participants should be encouraged to order their own reports. If you have a lender speak to the group, s/he may provide the service free of charge.

F. CREDIT REPORTS

What does a Credit Report Cover?

A credit report is based on information supplied over time by your

creditors. It includes:

- Identification and employment information. Your name, address, birth date, Social Security number, employer and spouse's name are routinely noted. The bureau may also provide other information, such as your employment history, whether you own a home, income and previous address if a creditor requests it.

- Payment history. Your account record with different creditors is listed, showing how much credit has been extended, and how you have repaid it. Related events, such as referral of an overdue account to a collection agency, may be noted as well.

- Inquiries. Credit bureaus are required to maintain a record of all creditors who have requested your credit history within the two years.

- Public record information. Events that are a matter of public record and are related to your creditworthiness, such as bankruptcies, foreclosures, or tax liens, also may appear in your report.

Credit Scores

The credit score is an indicator of how well a borrower manages debt. Using a mathematical model, the data regarding each item on the credit report is used to produce a number between 350 and 850, known as the credit score. Higher scores represent those with less risk. When lenders refer to a representative credit score, they are referring to the median score. When multiple borrowers are involved typically the borrower with lowest median score is the one that is considered as the representative credit score. Other loan programs may consider the person who earns the most money, also known as the primary wage earner, as having the representative credit score. On many loan programs there are minimum score guidelines.

How to Read Your Credit Report

- **Types of Accounts.** There are two types of accounts listed on a credit report: individual and joint. The individual account indicates that the person named on the file has sole use and responsibility for payment of the account. A joint account means that two persons use the account and each is liable for payment.   This is true even if a divorce decree makes one spouse responsible for paying off the joint account (since creditors are not a party to the divorce decree).

- **Terms.** The terms "Automated" or "Manual" refer to the type of data source used by the creditor. In an actual report, the initials "A" or "M" would be used.

- **Types of Accounts.** There are generally three types of accounts typically used by credit grantors:

Installment credit agreements, in which a consumer signs a contract to repay a fixed amount of credit in equal payments over a specific period of time. Automobiles, furniture and major appliances are often purchased on an installment plan. Personal loans are usually repaid in installments as well.

Revolving credit agreements, in which a consumer has the option of paying in full each month or of making a minimum payment based on the amount of the balance outstanding. Department stores, gas and oil companies, and banks typically issue credit cards based on a revolving credit plan.

Open 30-day agreements, in which a consumer promises to repay the full balance owed each month. Travel and entertainment charge cards and charge accounts with local businesses often require repayment on this basis.

In an actual report, the initials "I," "R," or "O" would be used to identify the type of account.

How to Correct a Credit Report

The creditor who reported the information is the only person who can remove negative information contained in your credit history. If the negative information is correct, creditors rarely agree to remove it. You should be very wary of organizations that state that they can "clean up" your credit history.

If the negative information is true, you can:

- Pay any balances so that creditors can update file reports which show the account is paid. However, negative information will remain until deleted.

- Wait for negative information to be taken off.

Credit bureaus must automatically delete most information that is more than seven years old. Most bankruptcy declarations are deleted after ten years.

Credit reports can include inaccurate information and/or errors in reporting.

Some errors that frequently occur on credit reports are:

- Debts that belong to someone else
- Current account reported as past due
- Mathematical errors
- An outstanding balance which was paid but remains listed as unpaid
- A portion of a bill which was an overcharge and was not paid
- A charge-off reported on an account that was paid prior to initiating a charge-off
- Information more than seven years old

If the information is incorrect, you can:

- Fill out a dispute form or write your own request for an investigation of any inaccurate information. These forms are available from, and should be returned to, the credit bureau.

- Within 30 days, the credit bureau must verify the information and correct or delete the information or report to you why the information is correct.

If you dispute the information in your credit history, credit bureaus may include in your file a statement from you of 100 words or less that explains why you disagree with the outcome of the dispute.

If any deletion or notation is made regarding the information, you may request that the new information be sent to any potential employer who has received a credit report during the past two years and, in addition, anyone else who has requested credit information in the previous six months.

If you are denied credit, the creditor must identify the credit agency involved. You have the right to contact the credit bureau and request a copy of the contents of your file. If you act within 30 days of being turned down, there is no charge for the copy of the report. Reasons for denial can include length of employment, length of time at current residence or other minimum requirements determined by the creditor. Because credit bureaus record each inquiry, some creditors may deny your application if they think you are trying to open too many new accounts too quickly.

Even if you are up-to-date on all your accounts but had instances of being past due on accounts, you may be asked to explain this (in writing) when you apply for a mortgage loan. Requests for such an explanation are standard practice. In most cases, if you can document a reasonable explanation (e.g. illness, unemployment, you moved and the bill did not get to you on time), the lending institution is likely to continue the mortgage process. You want to show that (1) this is not a pattern for you, (2) you have maintained a good credit history since that time, and (3) the cause of the problem has been eliminated. The exception to this might be if your delinquency on the account still exists, as in the case of an unpaid charge-off. Payment in full cannot change yesterday's report of delinquency history. It does, however, demonstrate a willingness to take responsibility for your debts today.

Too Much Credit?

Credit card balances today are much larger than in the past. New offers arrive in the mail every day, giving us the opportunity to purchase items we want but might not need. Some people have five or six credit cards. Some are already at the maximum they can charge. Payment minimums may be $20 to $50 per month or more, with most of the payment being applied to interest and not principal. Other people have many credit cards with open lines of credit still available. Even though they may not have a balance, the potential for a great amount of debt is there.

In qualifying to buy a new home, lenders sometimes total the amount still available on all those credit cards as if you had spent it. For example, you have a Visa card with $5,000 worth of credit on which you owe only $1,000 and still have $4,000 worth of credit you can use. A lender looking at your credit report would add in the additional $4,000 to your potential debt ratio. **If you have too much access to credit, you could potentially be denied a loan. Having too much credit can make it almost as difficult to purchase a house as having no credit at all.**

G. BUILDING A CREDIT HISTORY

Building a good credit history is important. If you have no reported credit history, it may take time to establish your first credit account. This may be a problem for both young and older people who have never used credit, divorced or widowed persons who shared credit accounts that were reported only in their spouse's name, and people who have recently immigrated to this country.

There are steps you can take to build a credit history:

- **Open a checking account** and make sure it remains in good standing. Do not overdraw the account.
- **Start a savings account and make regular deposits.** If the institution

allows, use your savings as collateral to secure a small loan. Repay the loan as agreed to build a credit history.

- **Apply for a department store or gasoline company credit card.** If you use and repay accounts consistently and on time, you will help build a positive credit record.

- **Apply for a secured credit card.** This type of card requires a deposit. You borrow against the deposit. Interest rates and fees on this type of credit may be higher than on unsecured credit cards. Be sure to shop around for secured credit cards as you would any other card.

- **Join a credit union.** All credit unions offer savings ("share") accounts, and most offer interest-bearing checking ("share draft") accounts. Many have full-service loan departments, including credit cards, with very competitive interest rates designed to assist members in establishing credit. While a credit union often offers lower lending rates, it may not report to local credit bureaus.

- If you are turned down for credit, **find someone with a good credit history to co-sign for you.** Keep in mind that the person who co-signs is responsible for making payments if you do not, and that payment history on the account will become part of the co-signer's credit report. (Remember this information if you are ever asked to co-sign a loan or credit card.)

<u>Buying a Home if You Have No Credit History</u>

Lenders like you to have three established forms of credit. If you have no history of credit cards, some lenders will accept alternate forms of credit, such as:

- **Rent payment receipts**

- **Letters and payment receipts from the telephone, cable TV, electric or gas companies showing payment history.** (Note: If a home buyer had gas in his/her old apartment and didn't pay it because s/he now has oil, the debt remains outstanding and will affect his/her ability to purchase a home.)

- **Car insurance payment history**

- **Money order receipts**

H. SIGNS OF A CREDIT PROBLEM

If you say "YES" to any of the following five questions, this indicates that you *may* need to re-examine the way you use credit:

1. Are you near or at the limit of your lines of credit?
2. Do you make only the minimum payments on your revolving charge accounts?
3. Do you not have any money saved for unforeseen circumstances?
4. Are you unaware of the total amount of your debt?
5. Is 15% or more of your take-home pay used for debt payments?

If you say "YES" to any of the next five questions, you are in financial danger and *must* re-examine the way you use credit.

1. Are you borrowing to pay for items that you should buy with cash, such as groceries?
2. Do bill collectors call you or are you receiving overdue notices?
3. Are you behind on the basics, such as rent or utilities?
4. Do you ever skip some bill payments to make others?
5. Do you make some bill payments by either taking out a new line of credit or by using your unused lines of credit?

I. REPAIRING CREDIT

There are some general steps you can take to gain control of your credit, whether you are in a financial bind now or anticipate some repayment difficulties in the near future:

- The first step is to cut up your credit cards and/or write to creditors asking to have your accounts canceled or frozen.

- The next step is to renegotiate your payment plan to avoid default. Before picking up the phone to call your creditor, determine how much you can afford to pay each month. (Look at your budget, determine how much you need to cover your basic needs, and then decide how much you can pay to other creditors.) This is a very difficult step so many people simply stop paying and hope that the problem will disappear. It will not.

- Contact creditors and tell them about your financial condition (your bills exceed your income) and present the new payment amount to each creditor. Emphasize that you want to handle your account responsibly, that you would like to repay your debt, and that this is the only way you can show good faith given your financial situation. Make sure you get the name and mailing address of the person with whom you are speaking. If the person is not helpful, ask to speak to a manager until you reach someone who can authorize your new repayment plan. Even if you cannot reach a repayment agreement during that phone call, write a letter when you hang up the phone documenting that the conversation occurred and send it to your creditor (keep a copy for your files).

- Write to all creditors detailing the agreed upon payment plans. Always keep copies of your correspondence for your personal records, as well as any correspondence regarding the agreement sent to you by the creditors.

- Make all agreed upon payments on time. If you cannot make a scheduled payment, call and let the creditor know. (Do not miss a rent/mortgage or utility payment to pay your credit card bills!) Follow-up with a written note.

- Save all rent receipts and utility receipts (be sure to pay these on time – and before you pay your credit card bills). This will show that you are keeping up-to date on your other obligations.

- Save the paid credit statements that show no overdue payments, and be sure the creditors report the repayment agreements to the credit reporting agency.

If you need assistance in budgeting and/or debt counseling, contact your local Consumer Credit Counseling Service (CCCS) office (CCCS has 16 locations throughout Massachusetts. Their toll free number is 800-208-2227 and their website address is www.creditcounseling.org).

Do not send money to "credit repair" agencies. They charge a lot of money and generally do not do anything you cannot do on your own or with the help of a non-profit agency such as CCCS.