



Don't let debt doom your dream home

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Don't let debt doom your dream home. Controlling your credit is key to earning your lender's trust

When you've made up your mind that it's time to start the house-hunting process, don't fall into the trap of putting the cart before the horse, say the experts. Getting your finances in order and managing your debt before you start shopping for homes and mortgage lenders can put you on a faster track to home ownership.

Why is it important to get a handle on your debt early in the process? Because "the mortgage lender will be reviewing how well the prospective home purchaser manages paying their bills on time," says Richard Schram, a manager for Consumer Credit Counseling Service of Central Florida & the Florida Gulf Coast, Inc., Orlando. "A history of payments to other creditors is an indication of how the purchaser will make their payments to the mortgage lender."

"Mortgage lenders are not interested in foreclosing on real estate and then having to sell it to get back their money," says Mike Sumney, co-author of "Weekend Millionaire Mindset: How Ordinary People Can Achieve Extraordinary Success" (McGraw-Hill, 2005). "They want to make loans to people who have demonstrated that they can handle their obligations in a timely fashion and not overextend themselves."

According to Brad Stroh, co-CEO of Bills.com, the amount of debt prospective homebuyers carry affects the three primary variables that determine interest rates on loans they will be offered:

- Your credit score, which ranges from 300 to 850, with higher numbers indicating a greater likelihood of repaying debt. The median U.S. credit score is approximately 725.
- Loan-to-value ratio, which refers to how much of the home's value is being financed by the loan versus how much is paid for in the down payment.

- Debt-to-income ratio, which is the percentage of the borrower's income that goes to pay fixed monthly debts, which includes credit-card debt, auto payments, student loans, etc. The higher the debt, the more risk and the less ability to obtain a lower interest rate. A debt-to-income ratio of higher than 55 percent is frowned upon by lenders, while a ratio below 35 percent is considered excellent.

"Typically, the monthly minimum consumer debt payments of a borrower should not exceed 10 percent of their gross monthly income," says Ron Cahalan, a Gilbert, Ariz.-based mortgage-lending analyst. "The borrower must have a grasp of their debt-to-income ratio, along with what kind of house payments they are comfortable with making."

Sumney says the No. 1 type of debt that lenders scrutinize is consumer debt. Any debt that has to be paid from your salary, with the exception of home mortgage debt, "is an indication that you are living above your means," he says. "All credit-card debt, car loans, boat loans, department-store debt, etc., represent commitments of your future income to pay for something you've already purchased. This negatively affects your future ability to pay a mortgage loan."

Additionally, Schram says, lenders evaluate your capability of obtaining a loan by exploring a variety of indicators, including your monthly income, occupation and length of time with your employer (two or more years is ideal), homeownership status and history, and how often you've moved.

Before initiating the home-shopping process, borrowers "should track all their spending for at least a three-month period," Cahalan says. "Ask yourself if you can cut any of those disposable expenses for luxury or entertainment, or is that a part of your lifestyle that you enjoy [and] don't wish to change? If so, it should be a factor in your budgeting decision on a home payment. Are any of your typical living expenses being paid by credit card, and are you making only minimum payments on those credit cards? If so, those cards will never be paid off."

Diane Weklar, director of marketing for CreditXpert Inc., a Towson, Md.-based credit software company, says there are many things a prospective borrower can do to clean up a credit problem and give lenders a good impression. For starters, "paying bills on time proves responsibility. Also, keeping credit debt at or below 50 percent of the credit limit and/or loan amount on each account generally improves a consumer's credit standing."

Utilizing credit to make purchases and then making on-time payments "demonstrates responsible financial behavior," Weklar says. "After all, if a consumer with credit account never uses them, lenders lack sufficient credit history to judge his or her ability to manage credit."

Likewise, it's crucial to review your credit report carefully and fix any errors or omissions you spot, says Weklar. "Credit reports may lack essential information

or include incorrect information. Furthermore, what one credit report includes, another may omit. Verifying that all data is correct and current builds consistency among all credit reports.”

Under the Fair and Accurate Credit Transactions Act of 2003, all Americans are entitled to a free copy of their credit report once every 12 months from each of the three major credit-reporting agencies: Experian, Equifax and Trans Union. You can obtain your complimentary report by visiting www.annualcreditreport.com, which is the only authorized, official site for consumers to access their credit report online for free, or you can request it by phone at 877.322.8228.

With either method, you’ll be able to order reports from all three credit bureaus at the same time, which offers the advantage of comparing the reports all at once, or at different times throughout the year.

Any account that has been placed in collection is a red flag to lenders that should be resolved prior to applying for a mortgage. “[It] can doom your chances of getting a loan,” says Sumney. “If you have accounts like this on your credit report, you would be wise to focus on clearing them up before even applying.”

Lastly, Weklar recommends never charging more than you can repay on a credit card.

“Only charge what you can pay off when the bill will be due,” she says.