CLASS

HOME

THE TRUTH OF THE MATTER

There is no aspect more fundamental to the classic notion of the American Dream than homeownership. Ask anyone their definition of the American Dream and I have no doubt that the first thing out of their mouth will be "Home." The postwar boom years of the last century and the rise of suburban life ingrained this notion in us that homeownership is not only something to strive for as an American but very nearly our right. There is no single image that speaks to our security so much as a family home. And there is no greater manifestation of how each successive generation has fared better than the previous one—that very American promise—than the way we've traditionally "traded up" in the area of real estate. And why shouldn't we have come to believe in this? After all, as a general rule, home values have historically risen over time. Your parents or grandparents most likely bought their first house for less than what you might spend today on a new car, and that house probably increased in value dramatically over the years. No

surprise, then, that we grew to expect that you would buy a house that in time would be worth significantly more than what you paid for it, and that house would provide for you and your children. The equity you had in the house would be a safety net, a way to help fund college costs, to bridge a shortfall, to ease some of the anxiety of an underfunded retirement account. And then overnight, everything seemed to change.

The implosion of the housing market has already resulted in more than five million foreclosure notices in 2008 and 2009 and another 2.8 million in 2010, according to RealtyTrac. To be sure, the epic proportions of this disaster were the result of lax lending standards that allowed unqualified borrowers to become homeowners. But also to blame was a kind of entitlement gone wild—the American Dream careening out of control, fueled by greed and recklessness and untethered to a genuine sense of fiscal responsibility. I'm not going to lecture and point fingers—I did that in my 2009 book, *Action Plan;* we all know what went into making that perfect storm and we know all too well that the damage and repercussions are far from over. But I will point out that the housing crisis has ruptured and twisted our view of the American Dream like nothing else in my lifetime.

And the truth is, greed is not the entire story. Many families that didn't overreach during the bubble years are nonetheless suffering as well. As I write, more than six million Americans have been unemployed for more than six months. Nearly one in five of us is either unemployed or working part-time, because we can't find a full-time position. Continuing to make a monthly mortgage payment under those circumstances is proving painfully difficult given those harsh realities and the jobless recovery that we are told is under way. The federal government's mortgage modification program has been a massive disappointment; from its start in the spring of 2009 through late 2010 barely more than one-third of homeowners who were enrolled in the Home Affordable Modification Program (HAMP) were granted permanent modifications. And thousands continue to wait a year or longer to learn their fate.

And let's not forget that millions of people who have dutifully and responsibly made their mortgage payments have been direly

affected as well. Deflated home values have put an end to the prospect of a home as retirement fund or college fund and raised the question of whether homeownership in fact even makes sense anymore. I am shocked by the number of people I talk to who view their home as an albatross, who are underwater, owe more than their home is worth, and regret the day they thought a home purchase was a great idea. It still surprises me to hear so many of you tell me you can't wait until you can unload your house, that you long for the days when you sent your landlord a rent check and slept soundly at night. I guess my surprise is a measure of how ingrained the desire to be a homeowner is in every one of us. Even those of us who know the steep costs and the pitfalls of buying real estate, can't help but feel some sense of betrayal, deep down, that this form of security has been taken from us.

So where does that leave the American Dream? In desperate need of revision, I'll tell you that much. If your home is no longer the rock-solid financial foundation of your net worth, then it is time to rebuild that dream from the ground up. And guess where we start? You got it: by letting go of beliefs and platitudes that may no longer be a part of your reality, looking deep inside, locating your truth, and standing firmly in it.

If we are going to create together a New American Dream that defines us and sets down values that are durable, crystal clear, and unimpeachable, for generations to come, then we need to agree on some fundamental truths at the outset. Interestingly, you'll see that many of these ground rules are ones your grandparents would have embraced—another case of going back to the future. So maybe in the end, we are not rewriting the American Dream so drastically after all; we are just getting back in touch with it in its purest form.

Before we begin this class in earnest, I would like us to walk through some governing principles, to make sure we are in step in our views about real estate:

- **A home is not a stock.** Investing in a home because you think it will rise in value enough to finance other financial goals—your retirement, college tuition, expensive annual vacations—was never

wise. I appreciate that for a decade or so, watching your home's value rise at a double-digit annual pace and being able to tap into those gains with a home equity line of credit was simply too irresistible for many. But we now know where all that financial dishonesty led and we are not going back there.

As I will explain in this class, homeownership is still a viable and smart step for many families. But it must not be viewed exclusively in terms of an investment. It is a place to live, first and foremost, a place to raise your family. That is its primary function. And when purchased with the right financial strategy and expectations it will also be a solid investment. It is a long-term savings vehicle you live in, not a short-term asset you flip to pay for other financial goals.

• **Renting may work best for many Americans.** While the old American Dream was rooted in the notion that it always made sense to buy once you could afford a home, the new dream requires a more complex analysis of what honestly makes sense given your career and family situation.

• **Financing is cheap, but not easy.** As I write this in early 2011, mortgage rates are remarkably low. The fact that you can lock in a 5% interest rate on a 30-year mortgage is an incredibly great deal. But qualifying for that great deal is no easy task as lenders have tightened their standards. To obtain a conventional mortgage you must now come to the lending table with a higher credit score, a higher down payment, proof that you have ample savings to be able to keep paying the mortgage if you are laid off, as well as full documentation of all your income and assets. Refinancing now requires having at least 20 to 30% equity in your home; just a few years ago you could refinance with no equity.

For those of you looking at today's low prices and thinking it may be a smart time to buy, I ask you to stand in the truth of whether it may make more sense for you to rent. For homeowners who are struggling to keep up with a mortgage I ask you to stand in the truth that letting go may be the most honorable way of moving your family forward. And for all of us, we must adapt to the

fact that a home is not a liquid investment whose value will rise at a fast and furious pace. I want to be clear: I still think that homeownership can make great sense for many of you. But you must have a clear-eyed understanding of what a home is and what it isn't. I ask you to read every word of this class carefully and leave your assumptions behind. The work of this class is absolutely critical to shaping our notion of what truly constitutes your New American Dream.

I have organized the Home Class into the following lessons:

- The Truth About Home Values
- When It Makes Sense to Rent
- The New Rules of Buying a Home
- What to Do If You Are Underwater
- How to Reduce Mortgage Costs
- The Dangers of Home Equity Lines of Credit
- Reverse Mortgages
- Investing in Real Estate

LESSON 1. THE TRUTH ABOUT HOME VALUES

If all you know about the housing market is based on what happened during the past 10 years, then the truth is you know very little. The extreme gyrations in the market since 2000 are in fact exceptional. Therefore, this lesson must begin by making sure you understand that recent history was completely disconnected from the longer-term story. Whether you are a renter thinking of buying or an owner deciding whether to stay put, trade up, or trade down, understanding what happened during the housing bubble and its costly aftermath is the foundation of this lesson.

A DECADE OF EXTREMES

From 2000 through the spring of 2006, the S&P/Case-Shiller index of home values in twenty metropolitan areas more than doubled. The average annual gain of 12% during that stretch exceeded the 10% long-term average for stocks. But since that peak, the

same index has shed more than one-third of its value through October 2010.

I am here to tell you that neither double-digit annual gains nor double-digit annual losses is in any way normal. The ride up was fueled by a confluence of unprecedented events we all know are unlikely—I hope—to ever occur again. Lax lending standards allowed otherwise unqualified borrowers to become homeowners, and many more qualified buyers to purchase more house than they could actually afford. And don't get me started on the role of Wall Street and regulators in aiding and abetting the dishonesty.

The ride down of the past three years is the painful process of coming back to the truth. That truth, over many decades, is that home values rise at an average annual rate that matches or slightly exceeds the long-term average annual 3.5–4% rate of inflation. For all the pain of the bubble bursting I find it so interesting that the same housing index today is 43% above where it stood in 2000. That works out to about a 3.3% annualized rate. Not too far off the long-term rate, is it?

Of course, national averages do not tell the real story of what is happening in your area. In the regions that had the biggest boom, the bust has been the most painful, and it may be a few more years before we see prices stabilize in those areas, since the backlog of foreclosures must be winnowed down. But the point here is that whatever has happened to your market, whenever it reaches its bottom, I want you to know what you can rationally expect to happen going forward. And that is why I want you to focus on a rate of 3.5% or so, on average.

STAND IN THE TRUTH

That brings us to our central stand-in-the-truth moment for the Home Class: Be realistic about what your home is worth today and be realistic about what it may be worth five, 10, 20 years from now. A $300,000 home in 2006 that is now worth $200,000 might "get back" to $300,000 in about 12 years, assuming an average price gain of 3.5%. Even at a very strong 6% rate it would take more than six years to get back to 2006 levels.

The decisions you need to make—the housing dream you are in charge of re-creating—must be grounded in your personal truth of what you have today, not what you had at the peak of the housing bubble in 2006. And I am asking you to look toward the future with an expectation that housing prices will, at best, post gains that are more in line with their long-term historical trend of keeping pace with inflation. This brings me back to a point I introduced at the outset of this class:

A HOME IS A SAVINGS ACCOUNT, NOT A HOT STOCK

Even though a home can still be a very solid investment that over time should grow in value, it is never ever to be mistaken for a liquid investment. Your emergency fund at your bank or credit union is liquid; you have access to it 24/7 and you know exactly what it is worth. A stock or bond investment is also fairly liquid; you can sell it five days a week and have the money in your account typically within a few days.

Your home, on the other hand, is an illiquid investment. If you wake up tomorrow and decide to sell, the best-case scenario is that you might have the cash deposited in your bank account in sixty days, and that's me being highly optimistic. In late 2010 the average time it takes to sell a home is three to six months in many markets. That's a long time to wait for your money.

What about a home equity line of credit (HELOC)? As far as I am concerned the rise of the HELOC is one of the most costly tricks the financial services industry played on willing homeowners. I never advocated turning your home equity into an ATM you could tap at any time. And as I explain later in this chapter, I think HELOCs could be especially dangerous in the coming years.

So do I think owning a home is still a viable dream given my insistence on expecting moderate appreciation going forward? Absolutely. But so too is renting. Remember what I explained in the very first chapter of this book: The way you create lasting security for you and your family is to focus on creating entirely personal dreams that reflect what is right and honest for you and you alone.

LESSON 2. WHEN IT MAKES SENSE TO RENT

It used to be, not all that long ago, that renting was something you settled for if you couldn't afford to buy a home. Renting was a way station en route to buying, a rite of passage. My, how times have changed.

These days, in my opinion, renting can be the end in itself, a far better move, depending on your personal circumstances.

To those of you currently renting who are wondering if now is a smart time to buy because you can get a good deal on a house, I want you to first make sure you can answer yes to every item in my checklist:

- Do you intend to live in your home for a minimum of five to seven years?
- If you lost your job—or wanted a new job to advance your career—could you reasonably expect to find a comparable job locally (i.e., one that would not require that you relocate)?
- Can you afford a 20% down payment?
- Do you place a high value on knowing you don't have to answer to the whims of a landlord?

My 5-to-7-year rule is to help you avoid the likelihood that you would someday sell your home and have less in your pocket than what you paid. What you must realize is that when you go to sell you will need to spend about 8% to 10% on settling all your selling costs. The way the real estate system works, the seller pays all of the agents' fees; typically that is 6%. On top of that you may have to pay a transfer tax to your state or county that might be 1% or more of the sale price. If you live in a condominium, cooperative, or other development that has a homeowners' association, you could even encounter a fee when you sell; this practice has become more common as a way to discourage investors who buy with the intention of flipping a property. Then there is the cost of moving. Add it all up and you can see why I say you need to plan on giving up 8% to 10% of your sales price to make the move. Given that we may still have a few years ahead of us before the

market stabilizes, I think buying today with anything less than a 5-year to 7-year time horizon is risky. Over a shorter period we can't confidently assume you will get anywhere near enough price appreciation to cover the 8% to 10% cost of selling.

Your job outlook is another important factor as well. If you have any reason to expect you might need or want to relocate within the next five to seven years, then renting can in fact be the far better option for now.

I also think renting is smart if you have yet to save up a 20% down payment. I am well aware that loans insured by the Federal Housing Administration (FHA) come with very low down payments. But as I explain later in this chapter, your housing dream will be more sustainable if you can make a 20% down payment.

Another important consideration is whether you really, truly, deep down yearn to be a homeowner. Don't listen to anyone else. Do not feel like it is something you should do. Your new dreams must be as firmly rooted in emotional truths as in financial truths. If you are scared of buying, then embrace the truth that you are meant to rent. If you don't really care that you can't renovate the kitchen or that you might have to move in a few years if the landlord raises your rent too high, then renting is right for you. Respect your feelings; they have as much sway here as your finances.

THE MATH OF RENT VS. BUY

There are of course many factors that come into play when deciding whether it makes financial sense to buy or rent. At the top of the list is what it would cost you to rent a comparable home that you are considering buying. Then you need to factor in the purchase costs (closing costs on your mortgage can equal 5% or more of your purchase price) and the eventual cost of selling as well. While you are an owner you will have the benefit of some tax breaks, as well as full responsibility for maintenance and property tax.

At the same time, I want to make sure that renting is not overplayed as the "best" solution. As with all financial decisions there are trade-offs. And with renting you must prepare—and budget—

for the possibility that the landlord will raise your rent, or decide to sell the home, and the new owner imposes a big rate hike at the next renewal. And you must put a personal price on how important or unimportant it may be to you to know you can stay put and renovate the home to your choosing.

The Best Buy vs. Rent Calculator: *The New York Times* has a free online calculator that allows you to build a very customized calculation based on your personal circumstances. The calculator will show you an expected break-even date where the cost of buying (and eventually selling) makes more sense than renting. No calculator can perfectly capture every nuance of each individual situation, but this calculator does an excellent job of making sure key costs are accounted for. Give it a spin and see how long you would have to stay put before the cost of buying would be worthwhile. Go to www.nytimes.com/interactive/business/buy-rent-calculator.html.

Tips for Using the Calculator

- Base your purchase information on making a 20% down payment.
- Plug in the current rate for a 30-year fixed-rate mortgage.
- Check your local newspaper or ask a real estate agent for an estimate of what comparable homes rent for in your area.
- Assume that both home prices and rents will rise at either 3% or 4% a year.
- If you are considering buying a condo, please click the "Advanced" settings button so you can input the fees you may likely pay.

ADVICE FOR OWNERS WHO NOW WANT TO RENT

I know that many of you who own a home are questioning whether it makes sense to sell and go back to renting. In the "What to Do if You Are Underwater" lesson later in the chapter I share strategies for homeowners who now have a mortgage that exceeds

the current value of their home. But I also want to address those of you who have equity in your home but are now wondering if it makes more sense to sell and rent. Again, I am going to come back to the fact that you must shape and follow your own personal dream. If you are considering a move because of a life change—the kids moving out, you're ready to retire and downsize, or you recently ended a relationship—then by all means it makes sense to run the numbers and see if renting is right for you. But do not gloss over the potential drawbacks of renting as well. Think through the trade-offs and make an informed choice.

If your issue is that you just feel overwhelmed by the cost of the mortgage and maintenance and you know you can indeed save more by renting, then you are absolutely to stand in that truth. There is nothing wrong with changing your mind; if your new dream is to rent rather than own, then that is the right dream for you. Just promise me you will factor in the 8% to 10% cost of moving. That is not a reason to stay put, but if it adds up to more than you can cover from the gain on the sale, I want you to plan for how you will cover the costs. You may need to head back to chapter 2 to find ways to boost your savings for the next six months or year so you can cover the cost of the move.

LESSON 3. THE NEW RULES OF BUYING A HOME

For renters who are eager to buy now that prices have come down, and for owners who are looking to make a move, I have rules I want you to follow so your new housing dream will give you security, not stress.

SET A BUDGET THAT SATISFIES YOUR NEEDS

Remember the credo of chapter 2? *Live below your means but within your needs.* Now is the time to embrace that phrase and make it a governing principle of your life. I do not want you listening to a mortgage lender who tells you what you will be allowed to borrow, nor do I want you to follow the advice of a real

estate agent who insists the bigger, more expensive house is a better value. Listen only to yourself. This is your dream, and so it must be rooted in what makes sense for you. I want you to seriously think through how much space you need. The size of new homes has increased about 35% over the past three decades, yet household size has declined. I want you to be comfortable, I want you to enjoy your house. But a smaller home that fits your needs means a more manageable mortgage, a lower property tax bill, lower utility costs, and likely less time and effort to maintain. And lower housing costs leave more income for your other important dreams, including funding your retirement or saving for a child's college education.

KNOW YOUR INCOME LIMITS

Lenders are now back to calculating how big a loan they will offer you based on your income, a practice all but abandoned during the housing bubble. The two standard calculations are:

- Your mortgage, property tax, and insurance (called PITI) should not exceed 25% of your gross (pre-tax) monthly income.
- Your PITI and all other debts should not exceed 36% of your gross monthly income.

There is leeway in those numbers; if you have other assets or make a big down payment you may be able to run past those limits. And in high-cost areas, the 36% debt-income ratio often is stretched past 40%.

My recommendation is that you never exceed the 25/36 rule. If you think that's impossible, then I ask you to return to another tenet from an earlier lesson: *Sometimes when we feel stuck we must change our perspective.* If 25/36 seems out of your reach then you have two choices: Hold off purchasing until your finances make 25/36 doable, or shop for a less expensive home. The quickest way to buy an affordable home that meets the 25/36 test is to lower the price tag. That is the essence of living below your means but within your needs.

First-time homebuyer alert: Please do not think that you can afford a monthly mortgage that is equal to your current rent. There are many additional costs that come with homeownership that can add 30% or more to your monthly base mortgage rate. In The Classroom at my website you will find information on how to figure out the true cost of homeownership and how to test whether you can honestly afford to buy. Go to www.suzeorman.com.

AIM TO MAKE A 20% DOWN PAYMENT

Are you thinking that sounds crazy given that we all know you can get an FHA-insured loan with a 3.5% down payment? So why, you are wondering, should your dream of homeownership be delayed by that 20% obstacle? I know all about the FHA program. I am well aware of what you can get these days. My job is to teach you what I think is best for your long-term security. In my opinion, if you cannot afford a 20% down payment, you cannot honestly afford to buy a home. During the 2000–2006 stretch, if sizable down payments had been required we would not have had such an inflated bubble and its painful deflation. Down payments below 20% also mean you must purchase mortgage insurance; whether through the FHA-insured program or private mortgage insurance, this adds to your housing costs.

A SPECIAL NOTE ABOUT FHA-INSURED LOANS

Before the financial crisis, mortgages insured by the FHA accounted for about 5% of the new loans doled out in any given year. In 2010 the FHA insurance program accounted for about 30% of loans for home purchases. How come? Well, lenders are making it tougher to qualify for a conventional mortgage and are all too happy to steer clients into FHA-insured loans given the fact that the federal government is in fact *insuring* that it will pay off the loan if the borrower runs into trouble.

I have to say that I am not a huge fan of FHA-insured loans.

The fact is, they perpetuate many of the problems that got us into this housing mess. For starters, until 2010, the FHA didn't require a minimum FICO credit score to be eligible for a mortgage. And it wasn't until last year that it set a FICO credit score floor. But that floor is a score of 500! If you can make a down payment of at least 10% and your FICO credit score is between 500 and 580, that's good enough for the FHA. And if you have a score above 580 you are eligible for an FHA-insured mortgage that requires just a 3.5% down payment. That said, many lenders that offer FHA-insured mortgages are applying their own FICO score rules, and require a FICO score of at least 620–640. But any FICO credit score below 700 is in fact a sign that you have some financial issues to address. Yet 40% of FHA-insured loans in 2010 were given to borrowers with FICO scores below 680. Consider that for a regular conventional mortgage, most lenders these days won't give you the time of day if you have a FICO credit score that low.

At the same time, a 3.5% down payment just strikes me as dangerously low. When you put down 10% or 20% the simple truth is that you will think longer and harder about what you are doing. Putting so much of your own money on the line forces you to stand more solidly in your truth. And that large down payment gives you downside protection if, God forbid, anything were to happen and you needed to sell the home at potentially less than your current mortgage balance. Let's say you made a 20% down payment and values are 5% lower when you go to sell. Well, you still walk away with 15% equity; that's more than enough to cover your closing costs and the agent's fee. But if you put down just 3.5% to 5%, you will find yourself owing the bank money to move, or face the foreclosure or short-sale process. As I explain below, that's not a scenario you want to find yourself in.

I also want potential borrowers to understand the cost of an FHA-insured loan. At the time of the loan you will owe an up-front insurance fee equal to 1% of the loan amount, and then there is an ongoing annual insurance premium equal to 0.90% of your loan amount. You owe that ongoing fee until your equity in the home reaches 22%. As we discussed earlier, that could be many

years, given that appreciation rates over the long term will likely be modest.

So am I against FHA-insured loans? It depends. If you are considering an FHA-insured loan because your FICO credit score is low due to your own self-induced overspending or poor payment habits, then I absolutely will not condone buying a home with an FHA-insured mortgage. Just because you can do something does not mean you should. And please don't hide behind the notion that because the federal government says it is okay, it is. Look, the federal government has its own agenda: By expanding the FHA-insured loan program, it is trying to keep the battered housing market from bigger losses. But your agenda is to stand in your truth and make financially sound decisions. If you can't get a conventional mortgage because of your own poor choices, then the only honest action to take is to wait until you repair your credit score, or save up enough for a bigger down payment so you can in fact qualify for a regular loan.

Now, that said, I think the FHA-insured mortgage can be a viable option for those of you who are rebuilding your life after divorce, or a financial setback such as a long layoff. Those are circumstances where a poor FICO credit score is not a sign of a lack of financial responsibility, but rather an indication that you have undergone a disruptive life event beyond your control. But even here I ask you to stand in your truth. I would feel so much better if you waited until you had the money to make a down payment of 10 to 20%. Being able to save that much is a sign that you have the strength and tenacity to make the right financial choices. And with a more sizable down payment you will be that much closer to the 22% home equity you need to have the 0.90% insurance fee dropped from your payment.

Special Buying Rules for Condos and Co-ops

If you are considering buying a condominium or cooperative, please be very very careful. In some of the most overdeveloped

markets that have been hardest hit, condo prices can, at first glance, look like an incredible steal. But when you purchase a condo or co-op you are purchasing more than four walls; you are buying a piece of an entire development, and that means you have to make sure the development itself is a good investment. Here are the questions to ask:

- **What percentage of the units are owner-occupied as a primary residence?** Lenders and the FHA are becoming increasingly cautious about offering mortgages for properties that are in developments full of vacation or investment-property owners. And if a development is full of renters, that can impact your future resale value as well; unless it is a hot market for investment properties, you might have a hard time selling at a top price when everyone else around you is renting out their units. My advice: Stick with developments that are at least 90% owner-occupied.

- **How many units have been foreclosed on in the past three years?** If the answer is more than 3%, that is a sign of potential trouble, if you ask me; if there are more foreclosures you will likely see your home's value drop.

- **What is the homeowners' association or condo fee for each of the past five years?** You do know that in addition to your mortgage payment, you also will owe a monthly maintenance or common charges fee, right? I am asking because I am surprised at how many people come up to me so excited about a great condo deal, and then when I ask about the common charges they give me a blank stare. These monthly fees go toward paying the general maintenance costs of the development or building—landscaping, security, etc. And a portion of your monthly fee should also be set aside in a longer-term reserve fund that is tapped when the development needs to make an assessment for a major repair or upgrade, such as a new roof. I would be very wary of any development whose association fees have increased more than the general rate of inflation—

about 3.5% or so. That's a sign that the development doesn't have a good grip on its costs, which would likely mean more big adjustments going forward. I also think you need to be extremely careful about buying into a development with many unoccupied units; if those units aren't sold or rented quickly it's likely the existing owners will be stuck with higher monthly fees.

- **What percentage of current owners have not made their monthly condo/association fee payments in the past three months?** If it is more than 3% take that as a warning sign that everyone else—including you—may be asked to make up the shortfall.

- **How large is the reserve fund?** All the owners, collectively, are on the hook for any big-ticket repairs or upgrades to the development. Ideally, you want to hear that the condo's roof is 15 months old, not 15 years! You must insist on reviewing the financial statements for the development, including how much money is currently set aside in the reserve fund. At a minimum, at least 10 percent of a condo association's annual operating budget should be set aside for the reserve fund. For older developments that are more likely to need maintenance, it would be great to see even more dedicated to the reserve fund. It's obviously your best bet to focus your sights on developments in good physical shape, but if you have your heart set on a unit in a building that will likely need a new roof or other capital repairs in the next few years, be sure the reserve fund can handle that cost. Otherwise you could be hit with budget-busting special assessments that can cost you thousands of dollars.

Now, if all of that checks out, I then want you to do a full 360-degree inspection of your unit. Look, you are going to be living with neighbors quite near. So you better make sure you will be content amid all that closeness. Spend some time walking around the development and talk up as many residents as possible; are they effusive or complaining? You also want to do a noise check: If

it's a multilevel unit, I would ask to have someone walk around the unit above you; I personally would never go near a place where I could hear my neighbor's every move. Same goes for any attached units nearby. Are the walls soundproof? And if you are highly sensitive to cigarette or cigar smoke, try to find out if neighbors you will be sharing ventilation systems with are smokers; in many buildings that smoke could end up wafting into your unit. And be sure to visit at a few different times, especially a weekend night. If you enjoy peace and quiet, it is better to know now if your neighbors tend to be more outgoing—and noisy—party types.

WHERE TO COME UP WITH THE DOWN PAYMENT

As discussed in "Stand in Your Truth," the way to save for capital purchases is to create automated savings accounts so you can add to your dream funds every month. Set up a separate account for your down payment. The money should be kept in a stable bank or credit union account; money you expect to need within 10 years should never be invested in stocks.

DO NOT TOUCH YOUR RETIREMENT SAVINGS

In the past I have given first-time buyers the option of taking money out of their retirement savings for a home down payment. There is indeed a special rule that allows first-time buyers to withdraw up to $10,000 from a traditional IRA for a down payment, and be exempt from the 10% early withdrawal penalty levied when you are younger than 59½. (Though you still will owe income tax on the withdrawal.) Roth IRAs are another down payment source; you can always access money you contributed to a Roth without any tax or penalty, and first-time buyers can take $10,000 of earnings without paying the early withdrawal penalty. Income tax is only charged if the account is less than five years old.

However, I do not subscribe to that advice anymore. Given the struggles so many of you are having saving for retirement I am going to insist that you leave every penny of your retirement

money invested for retirement. If that means you need to spend a year or two saving up for a down payment, that's the truth I am asking you to stand in. Remember, the New American Dream is not just about sensible homeownership, but about retiring with security as well.

I also do not advocate borrowing large sums from your family for the down payment. This is primarily a lesson in personal accountability. I want you to be responsible for what likely will be your single biggest investment ever. For a 20% down payment I do not want your family chipping in more than one-quarter of that amount, or 5%. And it is your responsibility to make sure your family members are standing in their truth. They must never give you money if it compromises their own financial security.

MAINTAIN AN EIGHT-MONTH EMERGENCY SAVINGS FUND

In late 2010, more than 40% of unemployed Americans had been out of work for at least six months. That statistic alone should make it obvious why I insist you have ample savings set aside so you can continue to cover your mortgage and other housing costs in the event of a layoff or furlough. In fact, mortgage lenders will be looking at your savings when evaluating your application. Without at least four or five months' worth of mortgage payments saved up you may find it hard to land a deal.

OPT FOR A 30-YEAR FIXED-RATE MORTGAGE

As I write this in early 2011, a 30-year fixed-rate mortgage for a well-qualified buyer is below 5%. I can't tell you how seriously great that is. When you can lock in a low rate and you never have to worry about it changing, you must grab that deal. Yes, I know five-year and seven-year adjustable rate mortgages have even lower rates, but they also come with risk as well. Haven't we all learned the risks that come with adjustable-rate mortgages? Many of today's foreclosures came about because people took out adjustable mortgages during the bubble that they assumed they

would be able to refinance out of before the rate adjusted. When that didn't pan out as expected the troubles began. And given that interest rates are currently at historic lows, the trend going forward is for rates to rise, not fall. All the more reason to lock in a safe-not-sorry 30-year fixed-rate mortgage.

TIP: Consider a 15-year mortgage if you are at least 45 years old. As I explain in the retirement chapter, I think one of the best retirement strategies is to get your mortgage paid off before you retire. So if you are purchasing a house today that you anticipate you will retire in, and retirement is within 15 to 20 years, I want you to consider taking out a 15-year mortgage. Yes, that means your monthly payments will indeed be higher, but at today's super low interest rate—4.0% as of early 2011—a 15-year is incredibly affordable. If you have the income and savings to be able to handle the higher monthly payments you will save tens of thousands of dollars in total interest payments as well as arrive at retirement mortgage-free.

And if you are confident you can afford the higher required payments with the 15-year loan, it is the better strategy than just settling for a 30-year mortgage that you intend to pay off in 15 years. The interest rate on a 15-year mortgage is typically about a half a percentage point lower than the rate on a 30-year loan. That helps keep your overall interest costs lower. The website Bankrate.com has a calculator that will walk you through the math of a 15-year vs. 30-year mortgage.

UNDERSTAND THE RISK OF DISTRESSED PROPERTY

In most parts of the country, foreclosed homes and homes that are listed as short sales account for one-quarter or more of the homes for sale. These so-called distressed properties often sell for below-market rates, but you need to be extra careful if you are considering bidding on either type.

A **short sale** is when a lender agrees to let a homeowner sell a home for less than the current balance left on the mortgage. The lender is essentially agreeing to take a loss on that shortfall. As a

buyer you must understand that you have two sellers in a short sale: the homeowner who is listing the home, and the lender. When you make a bid, even if the seller accepts, you then must wait to hear if the lender agrees to the terms. That can take months. And if the seller has a second mortgage on the home the process becomes even more difficult; the sale can't go through without the approval of the second-mortgage lender, and that is not something that happens easily or quickly.

A **foreclosure** is when a lender has already taken back possession of a home from a borrower. Sales of foreclosed homes can move much more quickly; once the bank puts the property on the market it is eager to make a deal. But I don't have to tell you about all the problems rocking the foreclosure market; as I write this in early 2011 we are dealing with revelations that many lenders may have foreclosed on homes without going through the proper steps. More troubling is the concern that many lenders lack the proper documentation to prove they in fact have title (ownership) of the home. What seems most likely is that this will clog the foreclosure process for months as banks—prodded by regulations and lawsuits—will have to scramble to prove their paperwork is in place. Given the turmoil in the foreclosure market I advise you to think very long and hard and ask yourself if you are up for navigating your way through the maze. It can take months. And you must work with a real estate agent with experience in foreclosures, as well as a real estate lawyer well equipped to review all documents. You need legal proof that a title search has been conducted and that you will indeed have free and clear title to the property.

TIP: Title Insurance on Foreclosed Homes. If you are purchasing a foreclosed home and you anticipate making sizable renovations to the property, ask your title insurer for a policy that includes a special rider that would cover not just your purchase price, but also the future value after renovations as well. In the event the foreclosure documentation mess escalates and your ownership is questioned in the future, you want to know at the very least that your title insurance policy will provide ample reimbursement for the renovated value of your home.

I recognize that there are some seriously great prices available on foreclosed properties, but I want you to be very careful if you decide to focus on foreclosed property. The buying process can be lengthy and full of pitfalls, and the current legal issues swirling around add a dose of uncertainty. Please stand in your truth: Maybe paying a slightly higher price for a home that is not a foreclosure is in fact the better deal for your family.

LESSON 4. WHAT TO DO IF YOU ARE UNDERWATER

The steep fall in home prices in many parts of the country means that many homeowners who purchased a home during the bubble—often with little or no down payment cushion—currently have a mortgage that is higher than the market value of their home. According to housing data firm CoreLogic, more than 20% of homes with a mortgage in the third quarter of 2010 were underwater. Arizona, California, Florida, Michigan, and Nevada have the highest concentrations of underwater homeowners.

In this lesson I want to address separate strategies for two very different types of underwater households: those that can't afford their mortgage and those that can. If you can't afford your mortgage and you are in fact underwater, I want you to stand in the truth that walking away may in fact be the right and honest move for you and your family.

If you are underwater and can still afford your home, the math and the ethical questions require a different strategy.

IF YOU ARE UNDERWATER AND CANNOT AFFORD YOUR MORTGAGE

I need to start this lesson by telling you what I absolutely do not want you to do, ever: You are never to touch your retirement savings to keep up with a mortgage you can no longer afford. You must respect your retirement truth as much as your housing dream: You will need to have savings to support yourself in retire-

ment. Using that money today to cover your housing costs raises the risk you will permanently doom your retirement dream.

I know this is such a painful truth to face, but it is the right truth. Please try to step back for a moment and think through the outcome of using retirement funds to cover a mortgage payment: All money withdrawn from a traditional 401(k) or IRA will be taxable, and there may be a 10% early withdrawal penalty as well. That reduces what you will have to put toward your housing costs. And whether the tapped funds are taxed or not, the more important issue is that they are being used at all. What's most upsetting for me is when families withdraw money from their retirement funds to cover a mortgage, and then when those savings are used up they still can't afford the mortgage. They depleted their retirement savings to do nothing more than delay the inevitable: They can't afford that mortgage, period.

And as I explain on page 182 in the retirement chapter, I do not recommend you ever take out a 401(k) loan. So please read that advice before you make this costly mistake.

That brings us to the right strategies to pursue if you have a mortgage you can no longer afford. I am not going to sugarcoat anything here. The very sad truth is that banks have, on the whole, been incredibly unresponsive in working with homeowners who cannot afford their mortgages. The help that was promised, I'm sorry to say, did not materialize for so many of you. The federal government's programs have proven to be woefully ineffective, in large part because lenders are asked—asked, but not mandated—to participate. So far, banks haven't shown much enthusiasm for helping. I mention all of this to make sure you understand the resolve and tenacity that is required to try to negotiate a deal with a lender.

There are four basic options for dealing with your predicament; I list them here in order of their appeal for distressed homeowners.

- **Loan Modification:** Your lender agrees to reduce your payments to an affordable level.

- **Short Sale:** The lender agrees that you will sell your home for whatever it can get in today's market. If the sale price is less than the outstanding balance of your mortgage, the lender will forgive that amount.
- **Deed in Lieu of Foreclosure:** You hand the house back to the lender, and the lender agrees to not go through the foreclosure process. A lender will typically require you to attempt a short sale before considering a deed in lieu of foreclosure.
- **Foreclosure:** The lender takes back your house and sells it. Depending on your state the lender may be able to sue you for any loss it incurs if the sale price is less than the outstanding mortgage balance.

Please understand that the lender, not you, is in the driver's seat here. What you want is irrelevant; this is all about what a lender is willing to offer you. Let's walk through each option in detail.

Loan Modification

If you can prove you have financial hardship, a lender may be willing to reduce your current monthly payment to a more affordable level. I want to stress that this does not mean your principal balance will be reduced. While that is possible, banks have been loath to offer this relief. What is more likely—if you can even win a modification—is that your interest rate will be reduced to lower your payment.

The federal Home Affordable Modification Program (HAMP) offers lenders incentives to reduce the mortgage payments for qualified borrowers. Some lenders may have their own modification programs as well. The bottom line is that you want to start working with your lender as soon as you have any inkling you are headed for trouble. You do not need to be behind on your payments to qualify for the HAMP program; if you can prove financial hardship, such as a drop in your income due to a layoff, or the fact that your mortgage payment is adjusting to a new, higher cost that will make it hard to pay the loan, you may be able to win a reduction.

HAMP Basics

To be eligible for HAMP:

- The mortgage must be for a primary residence that was obtained before January 1, 2009. Vacation homes and investment properties are not eligible.
- The mortgage amount must be $729,750 or less.
- You must be able to prove financial hardship: Either your mortgage has increased or your income has decreased.
- Your monthly mortgage payment (including property tax, insurance, and homeowners' association fees if applicable) must be more than 31% of your current gross income.

TIP: In the summer of 2010 the Treasury Department, which oversees HAMP, introduced a new variation specifically for households in which a layoff has made it hard to keep up with the mortgage payment. The Home Affordable Unemployment Program (HAUP) offers a reduced payment for a short period while the household looks for reemployment. As with all of these programs, lenders are not required to participate, and so far it does not seem to be widely adopted. But please check with your lender to see if it may be willing to use HAUP to give you a temporary reduction in your mortgage cost.

If you meet all those criteria you may be able to win a mortgage reduction that brings your monthly payment down to 31% of your gross income. The HAMP website has a calculator that will show you an estimate of what your monthly payment could be if you win a modification: www.makinghomeaffordable.gov.

I need to be very honest here: To date this program has been a huge disappointment. Through the summer of 2010 only one-third of applicants who were given a "trial" modification were able to win a permanent modification. One of the issues was that the program initially enrolled participants before verifying their eligibility. In many instances lenders disqualified people during the trial period if they could not document financial hardship or their payments did not exceed 31% of gross income. A change in

the program—effective in June 2010—requires verification of eligibility before a trial modification begins. What this means is that you will know early on if you are a bona fide candidate for a modification. However, the reality has been that many eligible homeowners are often being strung along for months—the average modification trial period in 2010 was about fourteen months—only to be turned down for claims of faulty paperwork.

And what is particularly upsetting is that when you go into a trial modification you could be making matters worse, as you'll soon see.

The Risks of Asking for a Trial Modification

When a lender offers you a trial modification, your monthly payment will be reduced. That's the good news. The bad news is that this will have a negative impact on your credit score. Why is this? Because even though the bank agrees to lower the payment, it must still report the fact that you are no longer paying the full amount due. So if you have been current on your mortgage and other payments, and you enter into a trial modification, be aware that your credit score is going to take a tumble. The hit your score takes will depend on your score prior to the modification. Unfair as it may be, a high score will actually fall more—possibly 100 points or so—while a lower score will not see as much impact.

The second risk is what happens if you are turned down for a permanent modification, a fact of life for more than two-thirds of borrowers who had gone through HAMP as of the summer of 2010. If you are deemed ineligible for a permanent modification, the lender can turn around and demand repayment for the difference between your regular payment and the trial payment.

Here's an example: Let's say you had a $2,000 monthly mortgage payment that was reduced to $1,500 during a 10-month trial period. Then the lender decides you do not qualify for the permanent modification. It can then demand that you repay the $500 monthly reduction you had for the 10 months. Suddenly you find yourself back at owing $2,000 to cover the monthly mortgage *and* you have a $5,000 balloon payment you must pay pronto. If you

can't handle both of those costs, the bank then starts the foreclosure process. In late 2010 the Treasury Department said it was looking into the balloon payment issue.

In the meantime, I want anyone considering a modification to be very aware of what they may be walking into. Before you agree to a trial modification I recommend you get the lender to answer—in writing—the following questions:

- Do I meet the financial requirements to be eligible for a permanent modification?
- When will you decide on making my modification permanent? (It is supposed to be three months, but the average wait time has been four times as long.)
- If I am denied a permanent modification, will I owe any balloon payment? If so, how fast must I pay back that balloon payment?

I then want you to stand in the truth. Given the sorry statistics on how many homeowners in trial modifications are turned down for a permanent modification, I want you to ask yourself whether the better move—the one that allows your family to in fact move forward—is to walk away from the house.

TIP: Tax Break for Short Sales and Foreclosures Before January 1, 2013. Before the financial crisis, if you walked away from a mortgage and your lender forgave you the difference between the sale price and the mortgage balance, you still had a potential federal tax bill. The amount of the forgiven amount was reported as "income" given to you and you would owe tax on that income. But a special law passed in 2008—the Mortgage Debt Relief Act—temporarily does away with this tax bill. Through December 31, 2012, any short sale or foreclosure in which the lender forgives any unpaid portion of your mortgage not covered by the sale price is exempt from the tax. The mortgage must have been taken out before January 1, 2009, for a primary residence, and the maximum loan amount covered is $2 million. For those of you who are considering a loan modification, I want you to be aware of the expiration date for this tax break. If you have any doubt whether you

will qualify for a permanent modification, or whether even with the modification you will be able to hold on to the home, the wise move may be to let go of the home and have it sold/foreclosed before the end of 2012. If you wait longer and you ultimately need to give up the home, you may not be able to take advantage of this important debt forgiveness regulation.

Short Sale

In a short sale your lender agrees to let you sell your home for a price that is less than the outstanding balance on your mortgage, and the lender will not require you to pay the difference. Lenders know they are likely to get a higher sale price through a short sale than if they have to foreclose on a home and incur all the costs of that process, including selling the house. That's their incentive for considering a short sale. But a lender will not extend a short sale option to anyone who merely doesn't want to pay their mortgage. Please respect the truth that your mortgage is a legal obligation; you promised to make a payment. If you no longer want to make the payment that is not nearly a good enough reason for the lender to agree to a short sale. You must exhibit a financial need for the short sale, such as a change in your household income, or an adjustable mortgage that has adjusted to the point of being unaffordable.

If your lender agrees to a short sale it will have the final say on accepting a buyer's offer. That is, the lender can turn down a buyer's offer if it decides it is too low, even if that means the lender will then start the foreclosure process on your home.

Deed in Lieu of Foreclosure

In some instances, lenders may be willing to work out a deal for you to hand over ownership of the home to the lender without having to go through the formal foreclosure process. It is entirely up to a lender whether it wants to go this route, and typically this will be offered only if a short sale was not successful.

Foreclosure

This should be your last-resort option if you must walk away from a home and you have been unable to work out a modification, short sale, or deed in lieu of foreclosure with your lender.

In a foreclosure the lender takes back ownership of the home and assumes responsibility for selling the property. In twenty-three states this process must go through the court system; in all other states there is no requirement for judicial review. In early 2011 we are in the midst of the latest twist in the housing fiasco: lenders pushing through foreclosures while cutting corners in documenting the process. As noted above, in the most extreme cases there are now questions as to whether lenders can prove they in fact have title to these properties.

The behavior of the banks and mortgage servicing companies has been awful. That is not to be debated. But I do not want any of you who are in foreclosure because you have not been able to pay your mortgage to think that this is some sort of reprieve and you will be able to win back your home. If you cannot afford your home, you cannot afford your home, regardless of the paperwork mess. That said, you may be able to use the debacle to your advantage; to the extent it slows down the foreclosure process that gives you more time to think through your next step. The healthiest move is to move out as soon as possible, but if you are not paying the mortgage, staying put while the foreclosure process plays out can give you a few more months—maybe even a year or more—to save money so you can secure a rental once you do move out. The fact that you are in foreclosure means your credit score has already taken a hit; so having more money to make a larger security deposit on a rental may be necessary to convince a landlord to rent to you.

Now, I am not blind to the controversy in suggesting that strategy. But if you have in fact done your very best to work out a solution—and despite your good-faith efforts (see the modification problems I just detailed above) you are still tossed into the foreclosure process—I have no problem suggesting you use the time it

takes for the bank to formalize the foreclosure to save as much as you can.

Tax Breaks on Foreclosures

As I mentioned above, through 2012 any foreclosures or short sales of a primary residence that result in a home being sold for less than the mortgage balance are eligible for an important tax break: The amount of the shortfall, which typically is treated as taxable income by the IRS, will not be taxed.

But that does not mean you are free and clear of all obligations.

In certain states, under certain circumstances, a lender or a collection agency can seek a "deficiency judgment" that would require you to repay the difference between the mortgage balance at the time of the foreclosure and the market value of the home. Please understand that just because you "walk away" from the home through a foreclosure, you could indeed still be on the hook for at least a portion of the unpaid balance of the loan. And depending on the state, you could be hit with a deficiency judgment four or five years after the foreclosure! What you may be liable for depends on what type of mortgage you have, and your state. If you have what is called a *recourse* loan, that means the lender, in certain circumstances and in certain states, may have the right (recourse) to sue you for the unpaid portion of the mortgage. If your mortgage is nonrecourse that means the lender doesn't have the right to seek payment for the unpaid balance.

The best investment you can make at this juncture is to talk to a real estate attorney with foreclosure experience so you can understand what may happen to you *after* the foreclosure. Please don't assume that just because you live in one of the nonrecourse states, your loan or the specific nature of your mortgage protects you from a deficiency judgment. (Nonrecourse states that prohibit deficiency for most home mortgages are Alaska, Arizona, California, Minnesota, Montana, North Carolina, North Dakota, Oklahoma, Oregon, and Washington. Please note, other states impose

restrictions on lenders' ability to seek deficiency judgments. As I said, retaining a lawyer well versed in your state's foreclosure laws is very important.) While nonrecourse means that you are generally protected from any deficiency judgments, you need to know if your actual mortgage is recourse or nonrecourse. And even if it is nonrecourse you could under some circumstances still be liable for a deficiency judgment. For example, only mortgages for a primary residence are generally protected. Any foreclosure on an investment property or HELOC loans is not protected from a deficiency judgment. And in some nonrecourse states, if the lender was granted the foreclosure through a judicial proceeding it can then seek a deficiency judgment.

I can't emphasize enough how important it is to sit down with a real estate attorney who can spell out the rules and regulations in your state. I want you to go into the process with eyes wide open. Sadly, some people who "walked away" are now finding they must declare bankruptcy after the fact to deal with a deficiency judgment they can't afford.

UNDERWATER BUT YOU CAN AFFORD THE MORTGAGE

For those of you who are underwater on a mortgage but can still afford the payment, your decision involves more than financial issues.

I want to be absolutely clear about what I believe is the right thing to do. If you are 5%, 10%, even 20% underwater, and you can afford the mortgage, I cannot condone walking away. I don't care if rents are cheaper. That mortgage is a legal document; you do not walk away from it out of convenience. If you want out, then sell the home and use your savings to make up any difference between the sale price and your remaining balance. That is what I call being financially responsible.

I also hope that if you are only marginally underwater, you retain the perspective on what your home is. If your family loves that house, if it is the refuge and centerpiece of your family, and you can afford the mortgage, then don't get caught up in its current

value. We are most likely through the worst of home price losses. Enjoy your home for the shelter it provides today, and over time—it might take ten or more years—you will likely see its value rebound.

Now, that said, I do indeed respect that some of you who bought at the peak of the bubble in the most inflated markets—Florida, Arizona, and Nevada among them—may now be 50% or more underwater. And in those instances I understand the rationale of walking away. For example, I have a dear friend who made a $140,000 down payment on a $700,000 home in Tampa, Florida, in 2007. She certainly met my stand-in-the-truth test of a 20% down payment. But since then, not only has the value of her home sunk to $150,000—that is what identical homes are selling for—but also her association fees have gone through the roof because so many of her neighbors have stopped their payments, or have already foreclosed. And she's actually lucky; at least her neighborhood remains safe; I know so many of you who are deeply underwater are now surrounded by empty homes. That's not just spooky, it is easy pickings for burglars. So I get it. My friend ended up walking away and having to declare bankruptcy—she had a recourse loan. There was no triumph in this. But there was relief from an awful situation where no one would work with her to come up with a modification.

The hard truth my friend stood in, and the hard truth some of you must face, is that it could be decades, if ever, until you will see home values return to their pre-crash levels in these hardest-hit areas, especially if your neighborhood and region is currently overwhelmed with foreclosures. In those instances you must dig deep and decide what is the right financial move for you.

HOW LOAN MODIFICATIONS, FORECLOSURES, SHORT SALES, AND DEEDS IN LIEU OF FORECLOSURE AFFECT YOUR ABILITY TO GET A MORTGAGE IN THE FUTURE

When you do not fulfill your obligation to repay your original mortgage in full—even if the lender has agreed to a workout—

your credit report will note the underpayment. According to FICO, the leading resource for credit scores derived from your credit report, a loan modification, short sale, deed in lieu of foreclosure, and foreclosure are all treated the same in terms of your credit score. One is no better, or worse, than the other. Once the underpayment shows up on your credit report it will remain there for seven years. How much it will hurt your score varies; if you had a high score before, it will have a larger impact; if your score was already low, it will have a smaller impact. The impact of this demerit declines over time; it will have less impact six months from now than it does today, and its impact three years from now will be less than two years from now. If you focus on the steps that help your credit profile—on-time payments, for example, and keeping your debt level low relative to your available credit—you can in fact repair a lot of the damage in less than seven years.

While FICO does not differentiate between the various types of loan workouts, mortgage lenders do. I know this might sound a bit crazy when we are talking about walking away from your house, but it is important to understand how your ability to buy another house in the future will be impacted by how you walk away from your current home.

As I write this in early 2011, the vast majority of lenders follow the rules laid down by Fannie Mae and Freddie Mac. These two agencies either guarantee or buy up most of the mortgages that lenders make; thus lenders are careful to make sure they follow the guidelines for what qualifies to be bought or guaranteed by either government agency.

If you go through a formal foreclosure, you may need to wait five years to qualify for a new mortgage that is backed by Fannie Mae. The wait can be less if you can document that the foreclosure was due to an "extenuating circumstance," such as a divorce or losing a job. But if you walk away through a short sale or deed in lieu of foreclosure, you may be eligible for a Fannie Mae–backed mortgage in just two years if you have a 20% down payment, or four years for a 10% down payment. This rule presumes you are able to meet all other credit and income qualifications for the mortgage.

LESSON 5. HOW TO REDUCE MORTGAGE COSTS

Despite all the headlines this rash of foreclosures is getting, the truth is that the vast majority of homeowners can in fact afford to stay in their homes—and want to stay in their homes. But those of you who are in this category have a new dream to consider as well. Whereas borrowing as much as possible to buy the biggest home possible was a centerpiece of the old American Dream, for many of you, your new home dream is to get your mortgage paid off as quickly as possible, or to take advantage of the current low mortgage rates and refinance into a less costly loan.

WHEN IT MAKES SENSE TO PAY OFF A LOAN AHEAD OF SCHEDULE

As I explain in great depth in the class about planning for retirement in your 40s and 50s, I think one of the best retirement strategies to put in place is to have your mortgage paid off before you retire. So for anyone who is at least 50 years old and is absolutely sure they will stay in their home through retirement, I am all for accelerating your loan payments so you get the mortgage paid off. If you want to learn more about my reasoning and my recommendations for how to accomplish this, please see pages 194–203.

THE NEW REALITIES OF REFINANCING

For those of you eager to reduce your mortgage costs, today's record low mortgage rates offer an incredible deal. As of early 2011, the 30-year fixed-rate mortgage has an average interest rate below 5%; creditworthy borrowers may be able to grab a rate as low as 4.8%. And a 15-year mortgage has a 4.1% rate.

But to be able to refinance you will likely need to have at least 20% equity in your home. If you don't have that much equity, you will need to bring cash to the deal to reduce your loan amount to the magic 20% level. This is what is known as a cash-in refinance, and in 2010 it accounted for about one-quarter of all refinancings.

I think a cash-in that helps you lock in a lower rate can make tremendous sense if you have the savings to bring to the closing. I do not want you tapping your emergency savings fund for this, nor are you to touch your retirement savings. If you want to do a cash-in, you must have extra savings you can use to pay down your loan to the 80% level.

Whether you are doing a straight refinance or a cash-in refinance, please heed the following.

REFINANCING RULES

Never Extend Your Loan Term

If you have 20 years left on a 30-year mortgage, you are never to take out a new 30-year loan. That will extend your total loan term to 40 years. The goal should always be to maintain or reduce your total loan term when you add the time you have already paid on your current mortgage to the length of the new mortgage. So if you are 10 years into a 30-year mortgage, your refinanced mortgage should be for no more than 20 years. In fact, as I explained earlier, I would root you on if you could handle refinancing into a 15-year mortgage. The whole point is to get the mortgage paid off sooner rather than later.

Calculate the Cost of the Refinancing

There are fees to pay when you refinance. Those can be 1% to 2% or more of the loan amount. Ideally you will pay the fees in cash up front. But if you can't swing that right now, then go ahead and roll the refinancing fees into the new mortgage; yes, your monthly costs will be slightly higher, but if this move does indeed ensure you can get the home paid off faster, and ahead of your retirement, then that's the big-picture goal we need to focus on here. However, you need to understand how long it will take for the lower cost of the new mortgage to offset the fees you paid for the refinance. At Bankrate.com you can use a calculator to compute how many months it will take you to recoup your costs. If you anticipate you might move before then, think twice about the refinance.

Consider a 15-Year Mortgage

The interest rate on a 15-year fixed-rate loan is typically about 0.5% less than the rate on a 30-year. In early 2011 the spread was even greater, about 0.7%. If you are refinancing a mortgage with 20 or more years left, run the numbers to see if you can afford to go with a 15-year mortgage. The 15-year will always have a higher monthly payment than a longer-term loan, but you will spend thousands less in interest payments, and you also have the satisfaction and security of getting the loan paid off sooner rather than later. But don't overstretch to make a 15-year work. This only makes sense if you have the available cash each month to easily handle the payments. And you must still continue to contribute to your retirement savings. If you are in your 30s and 40s I don't think paying off your mortgage should be your highest priority just yet; focus on retirement savings, your emergency fund, and if you want, putting away some money for the kids' college education.

For those of you in your 50s, here's an example of how the 15-year can pay off:

Let's say you took out a $300,000 30-year fixed-rate loan in 2003 at 6.5%. The monthly cost is about $1,900. Now you want to refinance to take advantage of lower interest rates. After eight years you would have a balance of about $265,000 to pay off. If you choose a 22-year loan term (to keep your total payment period at 30 years), your loan payment assuming a 4.8% fixed rate would be about $1,625 a month. So you lower your monthly costs by $275 a month. Pretty good.

Now let's consider choosing the 15-year mortgage instead. At a 4.1% interest rate your monthly payment would actually rise, to about $1,965. That's just $75 more than you are currently paying on your existing mortgage, though of course it is $350 more than if you refinanced into a new 22-year mortgage. But remember, with the longer loan you would be paying that $1,600 a month—$19,200 a year—for seven years longer than your payments on the 15-year loan. If your goal is to get your debt paid off sooner, not

later, it seems to me that paying $75 more a month than you currently owe is the smarter strategy than locking in a lower mortgage that will take a full seven years longer to pay off.

As we discussed in "The New American Dream," delayed gratification is often the route to realizing our dreams. And in fact the 15-year mortgage definitely pays off for those who are patient. You will not only have the loan paid off seven years faster, which can be a huge boost come retirement, but also your total interest payments with the 15-year loan will be about $90,000, compared to $165,000 for the 22-year loan. That's a savings of $75,000.

LOWER YOUR MORTGAGE COSTS WITHOUT A REFINANCE

If you determine a refinance doesn't make sense for you—maybe you lack the equity, don't have the money for a cash-in refinance, or your credit score won't qualify for a great rate—you can still get ahead on your mortgage. Simply add extra money to your monthly payment. All you need to do is verify with your loan servicing company that the money is to be applied to paying down your principal. This is in fact my recommended strategy if you have any doubt about your job security, or if you do not want to lock in the responsibility of higher payments on a 15-year loan. By sticking with your existing mortgage and just making optional extra payments you have the flexibility to stop those extra payments if the need arises. A table on page 198 in the class on retirement strategies in your 40s and 50s illustrates the advantages of this very clearly.

TIP: Lenders usually have programs that offer to help you speed up your payment process. But there are often fees charged to enroll in such a program, and in my opinion they are a complete waste of your money. The fact is, you can pay off your mortgage ahead of schedule without incurring any monthly fees, by simply sending in a larger payment than is due each month. Ignore those bank come-ons and use common sense.

LESSON 6. THE DANGERS OF HOME EQUITY LINES OF CREDIT

Those of you who have been following my advice for years know that I have never liked borrowing against the equity in your home, especially for expenses that don't qualify as needs. Given that I have asked you to embrace the concept of living below your means but within your needs, I hope it is patently clear why I think it is frankly dishonest to borrow against your home equity. It is often an indication that you are in fact trying to live above your means.

In the immediate wake of the financial crisis, lenders were reducing or terminating outstanding home equity lines of credit (HELOCs). But I bet those of you with ample equity and good credit have recently started receiving new offers to open a HELOC. With the eye of the storm past, lenders are looking for ways to generate revenue, and homeowners with strong financials are a likely target.

And the timing could not be worse. While I have always advised against HELOCs, there is a looming risk tied to what is going on in our economy that makes HELOCs especially dangerous right now.

The vast majority of HELOCs are variable-rate loans. The rate is tied to a financial benchmark, such as the federal prime rate. The prime rate is typically 3 percentage points higher than the federal funds rate that you hear about so often in news reports. As I write this in early 2011, the federal funds rate is right about 0.25%, and thus the prime rate is 3.25%. When the prime rate moves up or down, so too does the interest rate charged on a HELOC. Lenders will charge a premium above the prime rate—called the margin—that can add 0.50 to 1.0 percentage point or more to the prime rate. For example, in the fall of 2010 some lenders were offering borrowers with good credit a HELOC at 3.75% (prime + 0.5%). That 3.75 sounds so enticing. In fact, lenders are quick to point out how smart it is to take out a low-rate HELOC and pay off your high-rate debt, such as credit card debt or a car loan. Or to finance a car purchase with a HELOC.

Here's what the lender might not be so quick to explain to you:

Interest rates are going to rise, and when that happens your HELOC payments will go up. In the coming months and years we will see short-term interest rates controlled by the Federal Reserve rise. It may not happen this year, but sooner or later rates must rise off their historic lows. That makes HELOCs risky; with the future direction of the prime rate up, not down, you will likely encounter higher payments. Consider what happened just a few years ago: In May 2004 the prime rate was 4%; by the end of 2005 it was 5%. A year later it was at 7% and by December 2006 it had shot up to 8.25%. Homeowners who had HELOCs tied to the prime rate saw their rate more than double! Take out—and use—a large HELOC and in a few years you may well find yourself stuck paying the line back at a much higher interest rate.

If you fall behind on a HELOC the lender can foreclose on your house. A HELOC is what is known as a secured loan, meaning it has collateral. And that collateral is your home's equity. If you were to get in so much trouble you could not keep up with your HELOC repayments, the lender could foreclose on your home to use the equity to settle your balance due. That is why it never—and I mean absolutely *never*—makes sense to use a HELOC to pay off credit card debt or to pay for a car. Credit card debt is unsecured; if you can't pay it off no one can come take your house from you. But if you transfer the credit card debt to a HELOC you have put your home at risk if you don't keep up with the payments. I also don't think it ever makes sense to use your home to pay for a car; I'd rather you use a regular car loan. In the event you fall behind on a car loan, you risk losing just the car, not your house.

HOME EQUITY LOANS

I also have to say that I am not a fan of a home equity loan (HEL) either. A HEL typically has a fixed interest rate. That indeed will make it more appealing than a HELOC in a rising-rate environment. But the more pressing issue is why you are tapping into your home equity at all. It is a clear signal, in the majority of instances, that you are trying to live beyond your means. My bottom line is

that if you are tempted to use a HELOC or a HEL, take that as a warning signal that perhaps you are not standing in the truth of living below your means but within your needs.