KEYSTONE HOMES

Playing With House Money:

A Detailed Introduction To Home Financing.

Brian Appel & Mark Gilliam

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How Much Is This Going To Cost Me?

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Hi there.

If you're reading this, you're at least curious about what it takes to finance a home when you're not paying cash for the house.

Let me start by saying—buying a home is an emotional process. You might have heard the sayings: "home is where the heart is." "home sweet home." "E.T. phone home." We are programmed to get emotional about where we live. And this is a good thing! We should be happy about where we choose to live. But it's also our responsibility to apply logic to our choice of dwelling, and to make sure the numbers work.

So, with that in mind, let's talk about financing. There are a few things that everyone, and I mean everyone, should consider before buying a new home.

The first thing is:

What is Your Budget?

Yes, a budget! You might be thinking--if it were only four letters, it could be a swear word. But, it is important to understand your spending habits so you know how much you can set aside for your home on a monthly basis while still feeling comfortable. Nobody wants to be "house poor"!

From Urbandictionary.com: **House Poor**- Being relatively broke after purchasing a house or property due to the mortgage payments or other related expenses. Although your total value and worth in assets is increasing by the mere fact that you are owning a property, your monthly liquid assets are fairly tight.

If you're looking for a good place to start, YNAB (you need a budget) has a great app to track your expenses and will walk you through the process of budgeting, even if you never have. It's not free, though. If you're looking for some free budget information, have a look at www.budgetsaresexy.com. This site has advice, random articles about money, but, most importantly for our needs, free budget templates!

How Much Home Can You Afford?

You may already be paying for housing now. If you rent, what are you currently paying per month for rent, utilities, insurance, and parking? If you already own a home, how much are you paying for your mortgage? What about insurance? Property taxes? Utilities? Maintenance? Are you comfortable with current costs?

These will be considerations when deciding your budget for your new home.

> **“New homes come with warranties and tend to have substantially less maintenance costs when compared to older homes.”**

If you’re relocating from one city to another, or one state to another, property taxes and insurance will most likely be different, so you will want to find out by how much.

Also, if you’re in an older home, how much do you currently spend to fix things that break or need replacement? New homes come with warranties and tend to have substantially less maintenance costs when compared to older homes.

How much do you spend on heating and cooling? New homes must meet current model energy code requirements, so you’ll likely see savings on utility bills as well.

Further, a new homes salesperson can help you understand the full costs of a specific new home, so you can compare your current costs to future costs.

Do you have any other debt, particularly high interest consumer debt, and will a mortgage affect your ability to repay the other debt?

Have you saved for a down payment and closing costs?

Do you have money set aside for an emergency? Is it separate from the money you have saved for a down payment and closing costs?

Do you have any known upcoming costs or a foreseeable drop in pay? (i.e. college, retirement, relatives who will need your care as they get older, etc.)

It’s a lot to consider, but it’s best to think about these things before getting started with a mortgage, rather than after you have fallen in love with the home of your dreams…which happens to be well over your budget.

It’s always an option to figure out, manually, how much you can afford. Fortunately, banks have a few ways of figuring out how much you can borrow from them. Typically, banks base your maximum loan amount and whether they will lend you money on a few factors:

- Whether your income is variable or fixed.
- The amount of money owed to banks or lenders.
- Your current credit score.
- How you’ve been doing on your current debt repayments.

Hey, Your Bank Is Checking You Out!

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> **"There is a number that banks use called a debt-to-income ratio, or "DTI", which measures how much of your income goes to debt payments each month. Let's take a look..."**

Banks... The easy way of figuring out how much you can afford. Manually figuring out how much you can afford can be challenging. Fortunately, banks have a few ways of figuring out how much you can borrow from them.

Note: Lenders will sometimes approve you for more than will fit within your budget constraints. If this is the case, you can ask the bank to give you a price range that would get you to your desired payment.

There is a number that banks use called a debt-to-income ratio, or "DTI". Let's take a closer look at this number, and what it measures.

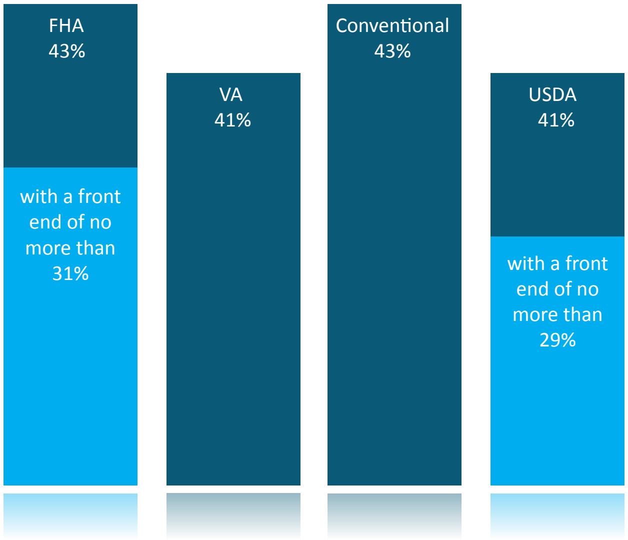
A debt-to-income ratio is broken down into two parts: front-end and back-end debt-to-income ratios.

A front-end debt-to-income ratio looks at how much of a borrower's income will be going towards housing costs. As an example, let's say that a borrower makes $6000 in gross income each month. Their mortgage is estimated at $1200 per month. That puts the borrower's front-end debt-to-income ratio at 20%.

But the front-end ratio is only a starting point. The lender also wants to see what the borrower's overall debt would be, as a percentage of their income. A back-end debt-to-income ratio is used to calculate this percentage. It is calculated by adding up all of the borrower's monthly debt-related payments, including the mortgage, and then dividing the total by the borrower's gross income.

So, using the example above, if the borrower is making $6000 per month, and their mortgage payment would be $1200 per month, and their other debt obligations are $1000 per month, then their back-end debt-to-income ratio would be $2200/$6000, or 36.7%.

Typically, when lenders talk about maximum allowable DTI, they are referring to the back-end debt-to-income ratio. Historically, the maximum allowable DTI was 36%, with a maximum front-end DTI of 28%. But guidelines frequently change. At the time of this writing, the maximum DTI amounts for different loan types are:



You'll notice that in the earlier example where the borrower had a front-end DTI of 20% and a back-end DTI of 36.7%, the buyer would have met the maximum DTI requirements of each of the basic loan types.

The maximum DTI ratios listed above are guidelines, and lenders sometimes make exceptions for compensating factors that make a lender more confident in a borrower's ability to repay the loan. Two examples of compensating factors are if the borrower has an excellent credit history, or if the borrower is putting down a larger down payment.

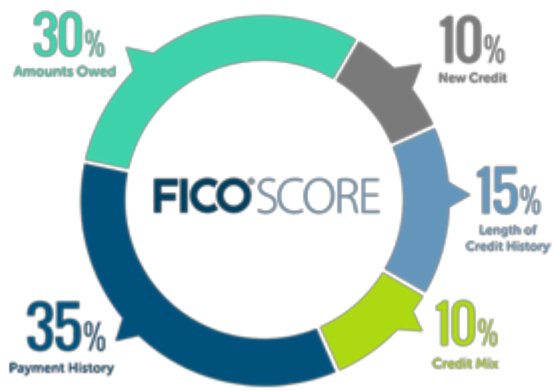
Lenders also want to know that you've been at your job for a while, in your industry for a while, and, if you are self-employed, they want to see at least two years' worth of income. So, if you've recently become self-employed, you may have to work for up to two years before you can obtain a mortgage loan.

The **Co-Borrower**: If a borrower is having a hard time getting a loan because of a low credit score or an unfavorable DTI, a co-borrower can make it easier to get a loan. That borrower would just need someone with a strong credit score and a low debt to income ratio that is willing to cosign on the loan. But there's a catch: if they sign on as a co-borrower, they have to trust that the borrower will make the payments, or they will be on the hook for paying the mortgage. Similarly, if you are already a co-borrower on someone else's loan, that could affect your DTI and your ability to get a mortgage loan.

Being a co-borrower is a big commitment. It lasts until the loan is paid off. For this reason, typically co-borrowers are related: parent-child or spouse-spouse, although there are exceptions. But depending on circumstances, it may be the only good option for a borrower to get a home loan.

Credit Score: The All-Important Stat

You've probably heard this term. A lot. Lenders check your credit upon opening any line of credit, setting up utilities, and even when purchasing some services with a recurring payment, such as a cell phone agreement. A credit score is designed to be an indicator of a person's likelihood to repay a loan. It's based on five factors: payment history, the amounts owed, length of credit history, new credit, and mix of credit. Myfico.com has the following image, below, which breaks down the factors determining how credit scores are weighted:



Credit scores range between 300 and 850 and the minimum required credit score varies based on loan type. There are certain types of loans that require a higher credit score, and on some loan types, the higher your score, the better your interest rates. So, while it's necessary to meet the minimum requirements, it can be beneficial if you've established a high credit score for yourself over the years. As of this writing, a 580-620 are the minimum credit score requirements for some of the common loan types.

> **"A credit score is designed to be an indicator of a person's likelihood to repay a loan. It's based on five factors: payment history, the amounts owed, length of credit history, new credit, and mix of credit."**

If you're wondering where your credit score places you, see the chart below taken from Experian.

Down Payment: The Largest Sum of Up-Front Cash Required to Buy a Home:

Let's get this out of the way: the type of loan can dramatically affect the amount of cash required to purchase a home. One can, with the right loan type and agreement with the lender and/or seller, drastically minimize or even eliminate out of pocket costs at closing. So, what are the options? Well, that depends on you.

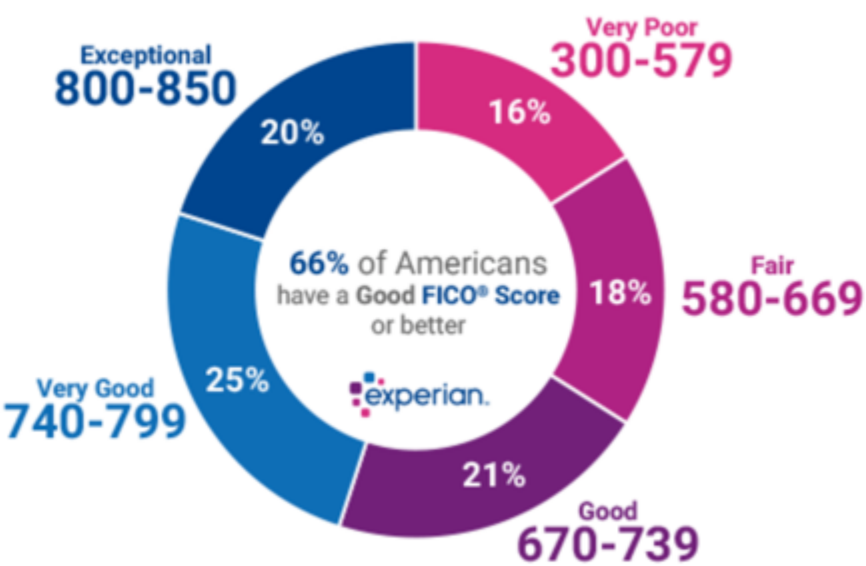
Do you have money set aside for a down payment? Do you prefer to keep money in your bank account rather than in equity (the difference between the value of a home and what a borrower owes on the home loan)?

Or, do you prefer to pay a larger portion of the home out of pocket, to save yourself interest over the life of the loan, reduce the monthly mortgage payment, and possibly avoid private mortgage insurance?

A word on **Private Mortgage Insurance (PMI)**: Because of the possibility of not making required payments on a home loan (defaulting), PMI is required on most loans with above an 80% loan-to-value ratio. PMI is an insurance that protects the bank from loss during a borrower default. If a borrower defaults on a home loan, the mortgage allows the bank to sell the home to pay back the borrowed money. To the extent that the selling of the home does not pay off the mortgage, PMI will make up the difference.

Fortunately, with the exception of the FHA loan type, which you'll learn about later, PMI automatically drops off after the loan-to-value of a home drops below 78%. So, just paying down the amount owed on the home (principal), will eventually cause the PMI payments to go away.

Mortgage default, eviction, and forced sale of a home are terrible situations. Nevertheless, the reality is, if a bank loans money and can't get the money back, it will get it back through the sale of the borrower's home. This is why having a budget is so important.



Money Matchmaking: Which Loan Type Is YOUR Type?

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There are a few common types of mortgage loans. I will list them below, by their maximum loan to value (LTV) percentages:

1. Veteran's Administration (VA) Loans:

Up to 100% financing with no down payment. This loan type is available to veterans of the United States military. You must have a certificate of eligibility (CoE) to use this loan product. Details about eligibility are HERE. If you are eligible, this loan may have favorable interest rates and low built in fees, and is one of the only loan products that allows 100% financing.

2. United States Department of Agriculture Rural Development (USDA) Loans:

Up to 100% financing, so no down payment. A home must be located within the USDA eligibility area, which will generally limit eligibility to rural areas (see the eligibility map here), and the borrower's household must be under the maximum income limits (listed here). USDA loans traditionally had low fees, but fees have increased since the most recent recession.

3. Federal Housing Administration (FHA) Loans:

Up to 96.5% financing, so a 3.5% down payment. FHA loans are fee-heavy and have a built in PMI premium payment for the life of the loan. It is not the ideal loan type for people who have great credit and money to put down, but it might be the only option for people looking to get a home that have lower credit scores and less cash to put down, and don't have access to a VA or USDA loan.

4. Conventional Loans:

Typically, the maximum financed will be 95%, so 5% down. There are even some programs for buyers such as doctors, and buyers with very high credit scores, that offer lower down payments or no PMI. Fees tend to be lower on conventional loans. For this reason, if you qualifiy for this type of loan, it is generally the best loan type a buyer can obtain.

A term is the maximum length of time that the mortgage will exist before it is paid off. Generally, the loan types above are available as either 15 or 30-year fixed rate mortgages. A 30-year mortgage at the same interest rate as a 15-year term mortgage will have lower payments. The benefits of a 15-year mortgage is that less interest will be paid over the life of the loan.

Other ways to finance a home are by using an adjustable rate mortgage (ARM) or balloon payment mortgage. If you consider these types of loans, be sure to know the benefits and drawbacks, and read the fine print.

If you made it this far, you must be serious about getting a handle on your house money! Alright, good! Time for some good information that will make your friends jealous and your enemies run in fear!

Did I oversell it?

Okay, so we talked about the mortgage itself, which includes principal, interest, and private mortgage insurance. But most mortgage payments include other items, too. These items are home insurance and taxes, which are paid out of what is called an "escrow account".

> **"Fees tend to be lower on conventional loans. For this reason, if you qualify for this type of loan, it is generally the best loan type a buyer can obtain."**

The Exciting Details About Escrow Accounts!

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Escrow Account

Without a bank paying your escrow for you, you would be responsible for paying the local city or county your property taxes on your real estate property. You would also be responsible for paying your home hazard insurance each year. To make things simple, and also to make sure you make the payments, the bank collects an estimated amount of money from you each year and keeps it in an escrow account (a fancy way of saying a trusted account that's separate from the bank's day-to-day funds), and pays the insurance and taxes on your behalf each year.

From time to time you'll get a letter. It will say words to the effect of: "Your escrow is low and now you must pay more!" - Your Bank

Why do you get this letter? When home values rise, property taxes and insurance generally rise as well.

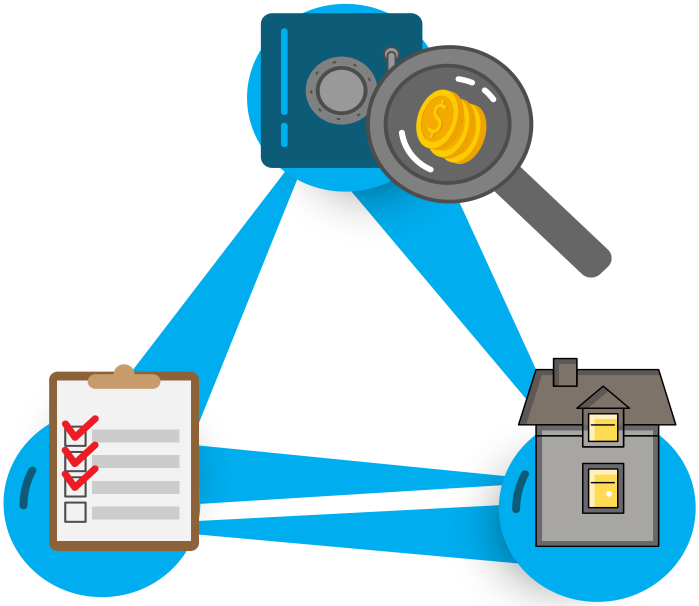
But the bank doesn't realize this until it's exhausted your escrow account and has to pay more in taxes and/or insurance than it has set aside from your payments. So, they make the payment, and then bill you.

They will usually offer two options: pay them the difference now, or increase your payments for a time, until the difference is made up.

So those are the escrow items. All together, your monthly mortgage payment includes principal (an amount that goes towards the overall amount owed on the loan), interest (your charge for the money borrowed), property taxes, and hazard insurance.

Collectively, this payment is called a PITI (principal, interest, taxes, and insurance) payment. So if you're getting preapproved for an amount, make sure to ask your bank what the total PITI payment is estimated to be, so you aren't surprised by a mortgage payment that's much higher, once escrow items are added in.

> "...the bank collects an estimated amount of money from you each year and keeps it in an escrow account (a fancy way of saying a trusted account that's separate from the bank's day-to-day funds), and pays the insurance and taxes on your behalf each year."



Out Of Pocket: Down Payment And Closing Costs Explained.

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"Most people think of the down payment when they think of the money due at closing, but that's only part of the picture."

But let's back up. Before you even begin paying your mortgage, you have to actually buy the home. You have to close on it. And to close on it, a certain amount of money needs to be paid.

Most people think of the down payment when they think of the money due at closing, but that's only part of the picture. Let's look at all of it:

Down Payment:

This amount depends on your loan, and it will be your initial equity in the home. The minimum down payment is determined by the type of loan you get. Earlier we talked about some of the different LTV ratios associated with different loans. A 100% USDA or VA loan would require $0 in down payment (unless an appraisal comes up short), an FHA loan would require 3.5% down, and a conventional typically requires 5% or more down.

But that's just your initial down payment. What else might you have to pay for, when you close? I'll give you a moment to guess...

If you said closing costs and prepaid items, you've probably been doing some research. Nice! So let's talk about closing costs.

Closing Costs:

There are people other than the buyer and seller that do work in the process of real estate exchange. Who do you think might need to be paid?

Did you guess that the bank needs to be paid? CORRECT! They always get their share. Who else might need to be paid? The attorney? Well, yes. And the surveyor. And the appraiser. Heck, let's go ahead and list it all:

Bank:

Origination charges (for originating your loan). These include:

- Document review fees
- Origination fees
- Processing fees
- Underwriting fees

Appraisal fee: The appraiser makes sure the current market value supports the price of the home, to protect the lender and the buyer.

Flood certification fee: to determine whether you need flood insurance.

Closing Attorney:

For services related to changing ownership and handling money for the buyer and seller. These fees include:

- Preparation of deeds (title), mortgage, notes payable, etc.
- A courier fee, for gopher (go for this, go for that) services.
- A settlement fee, for closing the home
- A wire transfer fee, to wire the money from the bank to the seller
- Title search
- Recording fees, because the government doesn't do helpful paperwork for free.

A Note on Title Insurance:

First, let's define title, as it pertains to real estate. A title is the group of legal rights to a property. Title insurance is unlike other insurances in that it is used to proactively establish a chain of records of title to protect the owner from adverse interests or errors and omissions that could result in the owner's loss of title. The best part: You pay it only once, upon buying a home.

Lender's Title Insurance:

This protects the lender in the event there is a problem with a title after closing. Title problems after closing are extremely rare, but when they happen, they are bad. The lender doesn't want this risk, so they require the borrowers to obtain title insurance on the bank's behalf.

Owner's Title Insurance:

It'd be nice if the lender's title insurance protected your interest in the property, right? If only. It just covers the amount that you borrowed on the property. So if you want your initial or future equity covered by insurance, you'll need to pick up a separate owner's title insurance policy.

That covers a lot of what you'll see in closing costs. It seems like a lot, but that's the reason that a rule of thumb for closing costs is that they will generally be between three to four percent of the purchase price, when financing the home. Closing costs can be much lower when a bank is not involved, but most transactions today involve a bank.

Prepaid Items:

Alright, you paid the other parties involved. Now you have to "prepay" your property taxes for a year.

You will also prepay interest and mortgage insurance premiums on your loan for each day through the end of the month in which you close. Think of this as a partial interest-only mortgage payment that gets you through part of a month before your first "real" payment is due the first day of the month following the first full calendar month after you've closed on your home.You also have to prepay your homeowner insurance, typically a year in advance. You'll also pay a certain amount into your escrow account as a cushion, typically two to three months' worth, for future home insurance, and property taxes.

The GOOD News:

Many sellers, especially homebuilders, recognize that there are a lot of costs associated with buying a home, and even though they pay for the agents to sell the home (typically five to seven percent of the purchase price, depending on the area), they may still offer to pay some of the closing costs on your behalf. This assistance with closing costs and prepaid items can make it much easier to get started owning a home.

Whew! Sorry--that was some dry material, but it covers the nitty-gritty of what you need to know when you're looking to finance a home. In a future article, we'll take a look at the benefits homeownership offers as an investment, and how to compare that investment to other housing options, such as renting.

About Keystone Homes

Keystone Homes is an experienced home builder that makes it simple and easy for our customers to enjoy their personalized, new home.

As a family-owned business, we value the preferences of each of our customers. We provide a sustainable, streamlined building process that gets our customers into their new home in as little as 90 days.

Because homebuyers are often looking for more than just a place to hang their hats, our homes are built to professional quality standards and embody what it means to enjoy classic American living. After all, there's no greater feeling for a family than having a place to call their own.

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