Andrew 0:05

Hello, and welcome to the JGUA Financial Commentary podcast. I'm your host, Andrew Baron and in this episode I speak with William Post about the five "C's" of buying a home. But first, a short disclaimer:

The contents of this podcast are strictly for informational purposes only and nothing said shall be taken as investment, tax, or legal advice. Any strategies discussed may not be suitable for the listener specifically. And JGUA encourages consulting with your advisor before implementing any strategies to ensure they meet your individual objectives.

And with that, welcome, William.

William 0:43

Thanks, Andrew. How are you?

Andrew 0:45

I'm good.

Will, can you give us a little bit of your background, maybe why you have some expertise and guidance in this area?

William 0:53

Yeah, thanks, Andrew. So before joining John Ullman and Associates, I was a branch manager. Specifically for a local bank and then a local credit union. And during my time there, I was a lender as well, where I would help customers with a commercial and consumer needs. And one of my favorite things to work with was first time homebuyers, and assisting those that had thin or poor credit, become homeowners for the first time. I used to do a lot of credit counseling and for first time homebuyers, I came up with a program we called it the five "C's." Those five "C's" are understanding Credit, understanding your Capacity, Cash, Collateral, and then miscellaneous Costs. Currently, with the firm, I'm a relationship development rep where I help connect people in the community and organizations in the community with our firm and our advisory team. I am not an advisor. I help connect people the right fit person here at the firm.

Andrew 1:52

This conversation might get a little bit into detail. So if you want to get a pen and paper out, it actually might be a good idea. Will, in your introduction, you kind of mentioned the first "C" of the five C's—with credit and how you liked helping former clients. You want to talk about that a little bit?

William Post 2:10

Sure. So the first "C" is credit. And for most programs, you have to meet a certain threshold when it comes to credit. For many first time homebuyers, particularly with government loans, like FHA, VA, USDA, you need to have at least a 580 to 620 credit score, and that changes depending on the circumstances. For other programs like Freddie Mac, or Fannie Mae, you need at least a 680 credit.

So what is credit? Credit, most of you heard as your FICO your FICO score outside your banker will typically call it and that's what I'm talking about with your score. On your credit, there has to be a couple of criteria. You have to have enough payment history of specific debts. You need at least 12 months recorded history of installment payments, installment payments being like car loans, school loans, personal loans, you also need at least 12 months history of revolving debt. And that's like credit cards, line of credits and things of that nature. You typically need at least 12 months of each in order to qualify for the bare minimum. Now, if you don't have a credit score in those ranges, or you don't have any history of payments on your credit report, you can get a cosigner. There's a misunderstanding about what the cosigners role is with the loan, and how they get approved. A cosigner will sign on a loan with you. But that's not the free all they're not just offering their credit, they need to show that they can meet the five C's individually as well. This is basically they're loan and you're along for the ride. We need to understand that. On the flip side when they also underwrite someone, they also have to make sure that your five C's are being met as well. So it's kind of a dual process if you're requiring a cosigner. So if you're considering being a cosigner know that this debt is fully yours.

Andrew 3:55

The next “C” in our five “C's” is capacity. And I believe this speaks to the amount of home you can purchase, correct?

William Post 4:03

Yes, so if you are getting pre-approved for a loan of any type, you're going to hear your lender use a term called debt to income, and that's what capacity is. It's a measurement of how much one can afford before they take on a loan. Now what the debt to income is going to tell you how it's calculated. It sounds pretty obvious but it’s a little bit more detailed. It's your total debt over your total income on a monthly basis. Now let's break that apart to see what that actually entails. So your total debt that's going to pull over all of your minimum monthly payments from your credit report as a starting point. Keep in mind, if you have a credit card that you pay off at the end of the month, let's say you pay it off, its 1000 bucks at the end of every month, but only has a $35 minimum payment. On the pre-approval. It's only accounting for that $35. So that's the part that you’re contractually obligated to the minimum payments. Same goes for your vehicle if you've got a $400 vehicle payment, but you throw $600 at it on their credit report, it says 400, that's what they're using.

Additional things that get added to the monthly debt are going to be the proposed loan amount, that's your principal and interest. If you need PMI, which we'll discuss later, also includes homeowners insurance, and real estate taxes. And then additional things that could be added are things like let's say child support, or if you are paying off an obligation to your parents that's off the table, they gave you money for school, and you're paying them back or something like that, that gets added to that, because that's an obligation. Plus, maybe you have business ventures, business ventures are not included on your credit report. And that payment needs to be calculated for in your total monthly obligations. Things that it doesn't include is going to be like utilities. Now your income, your income is calculated, typically, it's going to be your regular income over the past two years, plus, you're going to have to supply at least two months’ worth of pay stubs

Andrew 5:59

That can change for self-employed.

William Post 6:01

Yep, it can, it can change for self-employed, I'll address that in a second. That's a good point.

And what the lender will do, they're going to take a monthly total, over the past two years, plus whatever the year, two months total is. And that's going to be the total gross income they use, they typically don't use commissions or bonuses, unless it is a recurring, rather predictable amount, you have two years of history that they'll include it. If not, don't expect them to include that. For business owners what they'll do, they will take your net income, and they'll typically add back interest paid, plus depreciation. Now, here's the kicker: most of the time, with most programs, they're going to approve a ceiling up to 40%. Sometimes over 40% window, depending on your circumstances, maybe you have liquid assets, or you know, you have more than enough discretionary income, sometimes I'll approve over 40%. But for the most part, it's 40% or less.

Now, the thing I want to hit pause on is 40% a lot of money, and this is your gross income. This is before taxes. So if you are a W-2 earner, and you know what your paycheck looks like your take home versus your gross, we all wish we got our gross as our net, right, but we don't usually, like 70%. It doesn't take into account your health insurance, it doesn't take into account taxes, it doesn't take into account retirement contributions.

So our take home may only be 70% of our gross, yet we're being approved on 40% of our gross. This is where I would have the conversation with all of my borrowers. I can probably approve you for more than you're comfortable with. You need to understand how much you can afford because it is very likely you can get approved for much more than you're willing to take on. A practice that I would do is, I would show my borrowers how much they can get approved for. Let’s say it's an additional $2,000 a month just for the sake of a number. And before they actually went shopping, I would say we're going to open up a savings account and I want you to pay yourself $2,000 a month, and don't touch that money. It’s your money, you're going to build savings, but I want to see if you can actually afford this payment like I can approve you for. And in a lot of cases it was more than they wanted to take on. If you're currently paying rent. And it's not as much as what you can get approved for let’s say you're paying $600 a month for rent, but you're getting approved for a $2,000 loan, well then take your 2000 less the rent and put that difference aside into a savings account just to get into practice of you not having the money anymore. So if you're not used to making a housing payment, that's that aggressive that's one nice practice that one can do, just to try a payment on for size. Once you sign that dotted line on the mortgage, that's a 30 year obligation. And it doesn't matter how you feel about the payment, it's a done deal. You have to learn what you can actually take on. You, as a borrower have to understand, “Okay, I know I can get approved for X amount, but I'm only comfortable with this number.” And then with that number, you work backwards to figure out what your loan amount should be in your shop from inside that window.

Andrew 9:09

I think you did a good job of giving that banker perspective. But for the audience, I think that reverse engineering, that backwards 40% might be… and translating that to a dollar amount for home might be a little complicated.

William Post 9:23

So let's say you make $120,000 a year. Okay, if you were to divide that over 12 months that is $10,000 a month of gross income. A banker is going to see that amount and be like okay, I can lend up to 40% of that monthly income. So now you take the 10,000 and times it by point four and now you're at $4,000 a month of available payment monies that you can put towards debt. So now you have that $4,000 now start subtracting out things that you would find on your credit report. Things like your credit card payments, your car payment. Now you want to subtract out potential taxes. Now you want to subtract out potential homeowners any other monthly obligation you have whatever that bottom line differences. That's technically how much you could get approved for, for a monthly principal and interest payment for a mortgage. Look at that number, you're like, yeah, I can do that. Or you look at that number, you're like, nope. But you don't want to be maxed out, right? You want to be able to go out with your family to dinner, you want to be able to make home improvement projects, potentially, in the future, and you want to be able to get that second or third vehicle. If you tap out with your mortgage. This assumes your income stays flat. You know, we should never assume we're always going to get paid more, make decisions based off of where you're at now, because we can't control what things are going to look like later.

Andrew 10:50

The next thing is cash. Good to have! Plan on it! What can you tell us about cash?

William Post 10:55

Absolutely, you can never have enough cash. I'm talking about down payment and the ability to cover the purchase cost with the home. So there's a number of loan programs out there. Before we get into the cash, I want to talk about the percentage of which banks typically lend against. So when a banker looks at a home, right off the bat, they can approve up to 80% of that purchase. That means typically, the borrower has to come up with 20% for the down payment. Now, as housing prices have increased, it has become more and more difficult to buy homes. So this new creature came out called PMI—Primary Mortgage Insurance. And what that does is it allows the bank could provide additional down payment coverage for that 20% difference there. So then it becomes more affordable for the borrower, they don't have to come up with 20%, they have to come up with say, if you're getting an FHA loan, now you can get a 97% approved loan to value, it's called LTV, loan to value. And then you as the borrower only have to come up with 3%. Now with VA and USDA, you can lend up to 100% of the home's value, sometimes even more of that of the sale price. And so it just depends what type of program you're looking at. But PMI is on most government loans and is available for in house products from the bank as well.

Now, that means you have to have at least typically a certain amount down. Let's just say 3% with the FHA example, they're becoming more and more popular. So let's discuss that. You have to have at least 3% cash. What does that mean? Well, it has to be verifiable cash. It has to show up and exist on a statement for at least two months prior to the loan application. So if you are like some where they actually put the money in cash form, put it in envelope, and keep it in a safe. It's not going to cut it if you're expecting to go through an underwriting process. Take that cash, you have to put it in a bank, it has to be verifiable. A little bit of planning here. If it's in an investment account or a retirement account, that's fine, it has to show up on a statement. Now if it's a gift, say you don't have cash and it's a gift. Your parents and grandparents want to gift you money. That's fine. A gift letter will be generated but they have to provide statements as well. So it has to be verifiable on a statement from them.

Additional cash that's needed. Banks typically want to see at least two months' worth of the loan payment in reserves, in addition to the down payment monies. They want to see that there's some sort of savings habits there to be able to cover the monthly payment going forward. That's something that's not talked about a lot. Most people are so focused on the down payment, they're not also thinking, "I also need to have a little bit of reserves."

Additional monies that's needed in general, you need an additional 5% to cover closing costs. Now closing costs, that is quite the laundry list. At the end of your mortgage process. You're all going to be sitting around at the attorneys table or the settlement agent's table, and they're going to produce a settlement statement. And this is going to basically outline all the monies required to be able to buy this property. It's the purchase price, minus the loan amount, and then everything else on top of that. Well, what is everything else? Well, starting with the bank, that's going to be your appraisal costs, inspection costs, if you need an inspection, we'll talk about that later. Credit reporting costs, flood search costs, origination fees. It's usually like 1% typically. Then they have some application fees, underwriting fees. When it comes to the attorney fees. There's doc prep fees, you have your recording fee, and you have your lien search fee. You also have a thing called title insurance that you have to pay for. All these things add up and you can't avoid them. And not many loan programs are available out there that will cover some of these fees. That typically has to be an out of pocket cost. Now you can get seller assist, you know if you can you and your realtor can work out a program where you know, maybe you get 3% seller assist. That 3% can be applied towards these costs. But you can't bank on getting seller assist all the time. That is up to the seller of the home to decide if they want to do that or not. And typically, if you're going to ask for that, then expect them to increase their sale price to offset what they're having to give up. But in general, you need monies for down payment, you need monies for closing, and you need monies in reserve for the approval process.

Andrew 15:31

Absolutely. I mean, having just bought a house a year ago, March 2020, myself, I tell you that it's good to have a lot of cash on hand, and things keep popping up, that you might've not thought about. But I also have a little anecdotal story about seller concessions.

William Post 15:49

Okay.

Andrew 15:50

When I bought my house, the sellers had actually bought the home from an estate, lived there for a year and turned around, put the house back on the market. And that can be good as a flipping style and if any of the audience wants to go back and listen to a previous podcast with Alex, we actually do talk about flipping houses and real estate.

But in my instance, the sellers didn't put a whole lot of effort or money into updating really anything. And really, were just hoping that having a year of appreciation on the market was going to satisfy it. And they bet wrong, and it actually sat on the market for nine additional months before I even saw it.

And so when it came time to negotiate for the price, I was able, and by me, I mean, my real estate agent really helped me. We were able to ask for seller concessions to kind of sweeten the deal, since we knew they were not in an advantageous position. So it can actually go where, depending how badly someone wants to move something, you can also sweeten it.

William Post 16:54

Absolutely. Yep. Absolutely. To mention, the other costs are, you know, typically you need 12 months' worth of homeowners insurance.

Andrew 17:00

Yes. And the one year homeowners insurance, I think is a good thing that a lot of people pay a lot of bills monthly. And a whole year's premium is a little different. It can actually switch after that first year, but that first year, they need that be ready to pay that amount.

William Post 17:16

While they do and in many cases, you also have to have an initial escrow account. If your loan requires escrow, which is basically a glorified savings account associated with the mortgage for the purposes of taxes and insurance and sometimes PMI is included in there. It's basically any payments that are aside that are not principal and interest. In order to have that account funded properly so when the real estate bills come out, say in a few months, you have to have adequate cash there in order to cover those bills.

So additional escrow deposit may be required. I also forgot to mention real estate taxes. The real estate taxes get prorated, so the seller of the home have already paid their real estate taxes up to the date of the closing. But those taxes cover the remaining months of the year, they're going to get a credit back for those taxes and you as the new homeowner will need to pay for them. Sometimes that's incorporated with the escrow, sometimes it shows up as a separate line on the settlement statement. So in addition to all those things, I've already mentioned, the homeowners the initial escrow deposit, but also the tax there. So you can see quickly how the down payment monies may not be enough. If seller assist isn't an option there, always have cash available.

Andrew 18:40

Great!

Moving along collateral.

William Post 18:44

Collateral. So with the mortgage, this one's pretty obvious, right? This is the home itself. And you're going to sign that sales agreement and that starts the clock on this whole entire process. Within that process, an appraisal will be ordered. And most of us are familiar with how appraisals work. They are going to generate a report that shows comparable that have sold in the local market during a narrow window of time to make sure that the price in which the seller is asking for the home is reasonable.

The bank doesn't want to lend if they can't verify the value in some form or another. There's a chance there that the appraisal value could differ from the sales price. The appraisal value could be higher than the sales price and that's the case job well done buyer. But there are times when the appraisal value comes in at less than the sale price. At that point, you have to work with your realtor to renegotiate the terms. If the owner of the home isn't willing to come down. Then you either have to come up with more money or continue shopping.

Another thing to consider is whether or not the home itself is going to conform. A lot of us love watching HGTV and watching these flip homes, right? These houses that are in disarray and you go in there and you have vision of what it could be. And that is all fine and dandy, but understand that, there are certain rules that a house has to fall within in order to conform. You want conforming mortgage rates, because they're the favorable ones. Anything outside of that, you're going to be paying a lot more in interest. When you're looking at a house, and it is unfinished, or it's in disarray. Regardless of its potential, most of those items are going to push it outside of the conforming market. Which means you're going to have to pay out of pocket for or you have to be willing to get a different loan for. So if you're looking for a construction loan, as a remodel, or you know the house and got great property, but it really needs got it, or maybe only maybe somebody bought the house took on more than they can chew finished half of it and the other half isn't finished. The potential is there and it might be a great value buy, but it may fall outside of the rules of the conforming mortgage market. So as first time homebuyers it's typical because our budgets aren't as open as they are for somebody who's purchased and sold homes in the past are further along in their career. So we tend to look at middle of the market homes or even homes that are in places of potential, we'll put them that way. Just because the opportunity is there doesn't mean that the loan is going to fit the opportunity. And not all houses qualify within these products. And some people get appraisals and inspections mixed up. If anything comes up on the appraisal, let's say there's a crack in the foundation, or there's you know, chipping paint on the outside or they come back and say roof looks like it has less than five years' worth of life in it. Or you know, there's an observation that it's knob and tube wiring. If it's older home from how the less than 100 amp electrical service or a shared septic tank. There's things that are clearly in disrepair. This may require an inspection. Depending on the appraisers, findings it may disqualify the borrower from certain loan programs, and the banker may require you to address these things. The banker if it seems vague, they're not sure then they may require an inspection, to have somebody come out and actually certify if this home is safe or these things are in working function. Typically inspections are optional. They are not required. So know that if you are somebody that wants an inspection done, but the bank does not require it, that is an additional out of pocket cost. That won't show on the settlement statement and only show up on the on the closing statement at the end, if it is required. Now, I would always ask my borrowers this, "How handy are you? How familiar are you with maintaining a home? Do you have friends that are contractors or friends and family that are savvy with what to look for?"

If your answer is no, then I would strongly suggest an inspection. Because something's always going to go wrong with the house. And you don't want surprises especially if you're not familiar with the requirements of maintaining a home. This is where you may want just the peace of mind of knowing that when I sign that dotted line at the end of the day, and I get the keys to my new house that I have a clear conscious or I have an awareness of what I may need to fix over the next 10 years.

Andrew 23:24

That's actually interesting. I hadn't heard too much about bank ordered inspections. Typically I think of it as the appraisal is kind of for the bank and the inspection is kind of for you.

William Post 23:36

Yes, it's good that it doesn't happen often because that means the home's not in disrepair.

Andrew 23:41

Especially for older homes, things that are you know, 100 years old or older where they've had multiple-multiple owners. I think its good idea in the current owner may not really know what is going on. It's good idea to get a professional opinion.

William Post 23:55

Yep, absolutely.

Andrew 23:56

And that's of course, like you said, if you if you are yourself, especially handy, I guess you can forego it. But the close the five C's is miscellaneous costs, and I think this actually might be our biggest section because as I am learning, it's almost never ending list.

William Post 24:11

Yeah, absolutely. There are so many additional costs that we don't think about after the initial purchase. We are very unequipped typically when we come into our first home maybe we've never had to take care of a lawn before. Well do you have shovels? Do you have a lawnmower? Do you have rakes? That's just the lawn we haven't gone inside the house yet. A lot of folks you know, they can't take on a full remodel to make it their own and something they really want to do is just paint the rooms their own color. Well how much does paint? Paints anywhere from $30 to $80 a gallon depending on what you want to get. And you've got to buy the rollers and the plastic and the tape and all that jazz. Then times the number of colors times the number of rooms you can see how you can drop $1,000 in just painting your house. And then never mind when something goes wrong. Because something will go wrong. Maybe a line in your dishwasher breaks, the seal gets dried out, any of your appliances could go. You know, there's always something that's going to go awry with homeownership. It’s just like owning a car. Even if you take care of it perfectly, you still got to buy new tires every couple of years, right? Your family expands, you know, or you get married, you buy a dog. All these are additional costs that you didn't have the opportunity prior to owning a home. It opens up just a whole new world but the world's expensive.

Andrew 25:34

I guess the only other thing I'd really like to add would be, something is going to break just because everything in this world is finite, and has a useful lifetime and things go. Or unfortunately, you can buy a lemon brand new things can break, too. So…

William Post 25:50

Absolutely.

Andrew 25:51

Just generally, there's a lot of pressure to become a homeowner. I think it's a big point of pride. It's been part of the American dream since forever. And you know, that white picket fence kind of thing. A house is a really big commitment, and the average American doesn't live in their house for 30 years. But if you really are planning or let's say you're even unsure about where you're going to be, in five years, buying a home, just because you feel like you should isn't the even, I would say it's not a good idea.

William Post 26:21

Yeah. When you're going through this process, something I would always encourage my customers with is to keep perspective and be patient. The perspective piece of exactly what you're talking about.

There's very few things that we have to make a decision on in life that last a lifetime. I would dare say that expanding your family and buying a home are the two single most important things that are going to happen in the early part of your life. They are the toughest decisions, because that's a lifetime commitment. This is a 30 year marriage that you're getting into with a mortgage. And this is going to typically overlap your career changes. The likelihood that you're going to be at a career for 30 years versus have a 30 year mortgage, pretty low. But that mortgage is going to be there. And this is a 30 year decision. It is a very weighty decision. There's nothing wrong with not being a homeowner and taking your time into that decision. The mobility is really important and in fact, there are lots of studies out there that show that there are fewer and fewer people that have that urge to own a house. They like the flexibility.

Once you own a home, you're grounded in a way you've never been grounded before. Once your family starts growing within the home, the ease to just get up and move becomes so much harder. But it's on you to assume the responsibility factor what you're comfortable with. Paint your lane and stay in your lane. And if you're not sure what that lane looks like, this is why you want to talk to an advisor. To be able to really just outline all of your options and have a real conversation. I'd like to hear some of your thoughts on this, Andrew.

The other item I always want to encourage is be patient. Think about everything that's involved with this mortgage process. You're working with a realtor, you're working with the lender, you’re working with underwriters, and you’re working with an attorney, you’re working with an appraiser, an inspector. There are a lot of professionals involved with making this mortgage happen. And all those other professionals are working with 30 other folks just like you. While you are waiting for the next process to happen, sometimes you can go crazy, because it's on the forefront of your mind all the time. And you can get antsy. But keep perspective that there are a lot of professionals with a lot of responsibilities that are involved with making this happen.

It is typical for a mortgage from the point, you sign the sales agreement to the settlement date, to go six plus weeks. That's a long time. Even if you do everything perfectly, you're going to have more downtime than uptime when it comes to this process. You do your part, you be prudent. And know that the anxiety and the excitement are very normal, but just make sure that they're not misplaced with the process.

Andrew 29:07

Hmm, I really like how you said everything. As a consumer I get that you want everything right now. The people I work with actually did a pretty good job of setting expectations. That does lead me into the horror I had trying to buy my house that kind of just goes to show you that it helps to have a plan. It helps to have thought out every single step but sometimes things can just pop up anyway.

When I was going through mine, in New York at least, attorneys often help with this process. And there's often a clause in the contract that the attorney will review. Either party can reject the contract outright for any reason, without any kind of cause but there's usually a time stamp on it. For me after this had passed, and it was actually approaching the time for closing, another seller appeared out of nowhere, and the buyer wanted to back out.

And it actually created a little legal skirmish that I wasn't anticipating. And my real estate attorney that I was using wasn't a litigator. So I had to hire an outside second attorney, to assist us in the process. It ended up working out. But that was a tense experience. I wasn't anticipating at all, as a financial planner, you think I would have thought through everything, but the best laid plans can have things just thrown in your way, anyway.

William Post 30:36

I've had situations where we were at the closing table, and maybe something wasn't quite to expectation. Around here we have a lot of gas lease activity, where I live. And there was a period of time that when real estate was sold, you'd sell the property, the house itself has one asset, and then the royalties is as a separate asset, if you wanted to purchase them. Well, there are some assumptions there. You know, if it's not already producing income, and the homework hasn't been done, you know, there was cases where we get to the closing table, and maybe we find out that the seller actually never owned the rights to begin with.

Andrew 31:11

I've heard of sellers selling houses where they didn't have the right to sell it. That happens in a title search.

William Post 31:16

Yeah, depending on you know, if you live in rural parts of America, where deeds haven't been updated for a long period of time, the attorney does their title search, their deed search, I think in New York, it's called an abstract. They may uncover that, look, there's more owners to this home than what you guys realize. And we have to get their permission to sell. Or maybe they don't own it like they thought they did. They don't have the rights to sell it. There's so many things that could go wrong in this process, and we have to be flexible.

In all of these circumstances, it's rare that something happens, that's actually to your benefit. It's usually at a cost, right? That's that miscellaneous cost category. We just always have to be conservative with what we have to put on the table because it may or may not be enough at the end of the day.

Andrew 32:06

Will, I really appreciate you being part of the podcast.

William Post 32:09

Thanks for having me. It was fun.

Andrew 32:11

I know we went through a lot of information and some of it was pretty technical. So if anyone in our audience has any questions, please send them to info@jgua.com and also find us on social media and our website for additional content. Until next time, stay smart.