NEVER SELL YOUR FIRST HOME

The 12 Questions Your Client Will Ask You About Real Estate and Real Estate Finance

(And the Answers You Need to Know)

Brendan Donelson

"Brendan's approach is spot on."
—Art Laffer

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Question 1

Can you explain Renting vs Owning – What is the benefit of owning?

Most online calculators or websites that talk about renting versus owning are always going to steer you towards owning. This has bothered me for years, so I created an Excel spreadsheet that outlines all the details of renting versus owning. I want to give people a genuinely honest answer. Shocking, right? The rent versus own analysis is actually very simple; it shows the annual household cost of renting, and compares it to potential mortgage equity payments. With renting, you multiply your rent by 12 to get your yearly cost. And you have to add in your insurance policies for your belongings. This is called a renters policy/ renters insurance. None of these items are deductible. So for example if you rent for 2500 a month, that's $30,000 a year in annual shelter cost. We use that term because everyone has a shelter cost. In this example, you might also have a $300 a year insurance policy for your belongings. **So your total shelter cost with insurance is $30,300.** You cannot claim this on your tax return as a deduction.

On the owning side the examples we always use are very simple. We use 5% down and a $500,000 home. So this would be 25,000 down (plus closing cost and prepaids and escrow, which are normally about 2% of the purchase price – so another 10,000) and a mortgage of $475,000.

The real magic happens next as we break down the entire payment. Most people, including some mortgage professionals, don't analyze this in detail.

Principal and interest on a $475k loan at 5.5% is **$2,697.**

The principal portion of this payment goes up a little each month as the loan interest portion decreases. This is called **amortization.** In the beginning of a 30 year loan, interest is higher than principal. In this example, in the first year, the principal portion of the payment is around $533 per month on average.

Real estate taxes on a $500,000 home would be around $5,000 per year or 1% of the home's value. **$416 per month.**

Home insurance would cost about $1500 per year or **$125 per month.**

Mortgage Insurance would depend on your credit score, but it is required when you put less than 20 % down. The typical factor is between .25% and .75% of your loan annually. In this example we could use .50%, which would equate to $2,375 per year, or **$197 per month.**

Here's the math.

$2,697 ($533 principal + $2164 interest)

+ $416 (real estate taxes)

+ $125 (home insurance)

+ $197 (mortgage insurance)

= $3,435 total. Or $41,220 annual shelter cost.

But this is where the math is important. The 533 you pay per month towards principal is **$6396 annualized**. Because you are paying down the principle on an asset, when we analyze this **it is not a cost, rather it is an investment.** So we subtract this from the annual shelter cost.

$41,220

– $6,396

= $34,824 net cost.

After this, the detail becomes even more important when it comes to taxation. This is complicated, so bear with me. The federal government allows you to deduct the interest that you pay, the real estate tax that you pay, and the mortgage insurance that you pay (up to income of $110,000 annually for PMI) as an itemized deduction on your federal tax return. So if you're single and this scenario above applies to you, your standard deduction would be $12,800 on your tax return if you were renting. Your annual cost was the $30,300 number, and you would not be able to deduct any of that. So if your itemized deductions (such as charitable donations and other items) did not exceed 12,800, you would file a standard deduction return.

However, in this scenario the interest and the real estate tax monthly is $2,580 or $30,960 annually. When you're filing your tax return you would use the $30,960 as an itemized deduction over and above your standard deduction. This is where a potential refund is given to you for owning a home. I am not a tax attorney or a CPA but the calculations are relatively simple. In this example, you would have nearly a $20,000 deduction over and above your standard deduction. **This is not a $20,000 refund! Repeat, this is not a $20,000 refund.** What it is is that you would be afforded the opportunity to not pay income tax on that $20,000. So in this example, if your federal tax rate was 20%, **you would avoid paying $4000** in additional taxes to the federal government.

$41,220

– $6,396

= $34,824 net cost.

– $4,000 (tax refund)

= $30,824 net net cost after filing return

So, in this example you definitely have a higher annual shelter cost owning versus renting – but when considering all variables, **the cost of owning is often more or less the same to your wallet as renting.** So the best way to explain renting versus owning is that **the additional cost associated with owning is an investment** with a benefit and a possible tax refund. Crucially, neither did we factor any increase in the home's value in this equation nor do we factor any home maintenance into this equation. That's where most calculators online prove to be scams, because they always assume massive appreciation on the home which is not something that you as an investor should gamble with. **They seek to give you the conclusion you are seeking rather than the honest answer that you need.** Renting is usually marginally cheaper in the short term, but owning is more affordable than you would think when considering all variables – especially the long term implications. And for a lot of folks, it can be cheaper to own than to rent!

Question 2

We want to save up for a down payment. Isn't 20% the best amount to put down?

When someone tells you they want to save 20% for a down payment or that they need to pay off debt before qualifying to buy a home, here is the best way to approach that.

First, it's very important to understand how much is actually required for a down payment on a home. This heavily depends on the person's situation. The most basic type of loan, a conventional loan, requires a minimum of 3% down. Conditions can allow for any amount down above that threshold, but most commonly people put 5% down, 10%, 15%, and then 20%.

At the 20% down mark, people can avoid having to pay for mortgage insurance on their loan. That is the driver for most people who say they want to save for a 20% down payment. It is not necessarily a good thing to wait and save to avoid mortgage insurance, depending on how long it takes them to save the 20%. Also, a loan with 20% down versus one with 15% or 10% or 5% down has a slightly **higher** interest rate. This may seem surprising, but it is absolutely true. The reason is complex, but in layman's terms it has to do with what % of loans default at what % down. See question #5 for more details.

There are other programs that offer less down. An FHA loan requires 3.5% down. A VA loan (must have served in the military and have eligibility benefits) requires 0% down. And, depending on the bank, some offer community reinvestment loans that are considered conventional loans with 0% down. The community reinvestment loans are always income specific (you cannot make more than a certain amount annually) and sometimes area specific (in a low to moderate income area or rural property).

The next most crucial part to understand is paying off debt. Mortgage rules allow clients to have a certain amount of monthly debt that would appear on their credit report. An example would be if someone had a car that has an outstanding balance of $9,000 and had a monthly payment on that car of $400. Another example would be they have a student loan of $30,000 at a monthly payment of $300. The last example might be a credit card that they use and have not paid off in full, with a balance of $2500 with a minimum payment of $100.

This examples total:

$9,000 car **$400**
$30,000 student loan. **$300**
$2500 credit card. **$100**

$800 total debt.

So, the typical percentage of debt allowed when getting a mortgage is 45% of your gross monthly income (before taxes are taken out).

Example:

- The client makes an $84,000 salary.
- $7,000 per month gross income.
- That's $3,150 in total debt allowed including housing.

In this example, the debt of $800 per month would be subtracted from the $3,150. **Leaving a new housing payment allowance of $2,350 per month.** After this calculation is made, it would be best to determine if that housing payment meets the housing needs of the client.

This would be reverse engineered with the current market interest rate and the loan programs available.

So, following the example above, the client making $84,000 with the debt described, who is currently paying rent of $1,500 per month, says he wants to pay off his car in order to buy. He currently has $19,000 saved for his house purchase.

Paying the car would deplete the funds to $10,000. And free up the debt of $400 per month to be added to the new housing limit of $2,350. **Now $2,750.**

If we calculate on a $300,000 home with 3% down ($9,000), the monthly PITI payment would be $1,800 PI, $75 MI, $250 tax, $100 HI, $75 HOA = $2,300 total. The closing costs, prepaid and escrowed items in addition to down payment would cost $8,000. Leaving a total of $17,000 required for the deal.

So, the client paying down debt of $9,000 would actually delay their purchase for 6 to 12 months. Furthermore, if their desire to purchase a home is not to exceed a payment of $2,400, this would be their max anyway.

Every scenario can be different, but a thorough review of all the numbers is required to be sure.

Question 3

When we apply for a mortgage, what does the bank or lender look at to approve us?

The first thing looked at is your credit report, which includes what debts and monthly payments are on your credit along with payment history and other variables. This is the key to starting the process because all loan programs have credit score requirements and this shows you what you are eligible for.

The second is your income. The bank normally looks at your paystubs, your tax returns for the last two years, your W–2s, and any other item that would verify your income – including a verification of employment directly from your employer. The gross monthly income is determined by a thorough review of these items. With self–employed clients, the process is slightly lengthier, but nevertheless the gross monthly income is determined. This establishes the ranges of debt that the applicant can afford according to the guidelines. Every loan program has slightly different "Debt to Income" standards (ratios), and this is one of the most important items to confirm.

The third consideration is your assets, both available for the downpayment and closing costs (liquid funds), and your reserve assets (money left over). Those could be retirement funds, 401k funds, additional savings or stocks, or gift funds from relatives. Your asset totals are thus calculated and this helps the lender decide which program fits the best.

These three major items are the ingredients that make up a mortgage application. The rules are written in great detail regarding each of these, and the company that has been credited with being the rule makers is Fannie Mae. They are a quasi–governmental company that was established in the 1970s that regulates all conventional mortgages that were issued by banks. They collect all the data to ensure that the banks are properly lending money with rules that are designed to create a stable housing market. Freddie Mac, another quasi–governmental company, has similar rulebooks to Fannie Mae. The Federal Housing Authority (FHA) and the Veterans Administration (VA) have their set of mortgage rules as well. These are considered government loans. Whereas, the previously discussed conventional loans are not.

Most qualified mortgages require these standard items. There are, however, other mortgage loans that do not. These are considered non–QM loans. Though many banks don't offer these types.

Question 4

We don't understand our credit and credit report? What can we do to improve our scores? And why do scores matter?

First, when getting a mortgage, your credit report must be pulled by a mortgage lender or a bank. This inquiry establishes your current credit score. This is fundamental when getting pre–qualified or pre–approved for a mortgage. Receiving a consumer report with credit scores from a free online entity is not the same. Those scores do not use the required mortgage credit scoring models. They can be similar, however they are not transferable or allowed. These are often just estimates, rather than genuinely accurate numbers.

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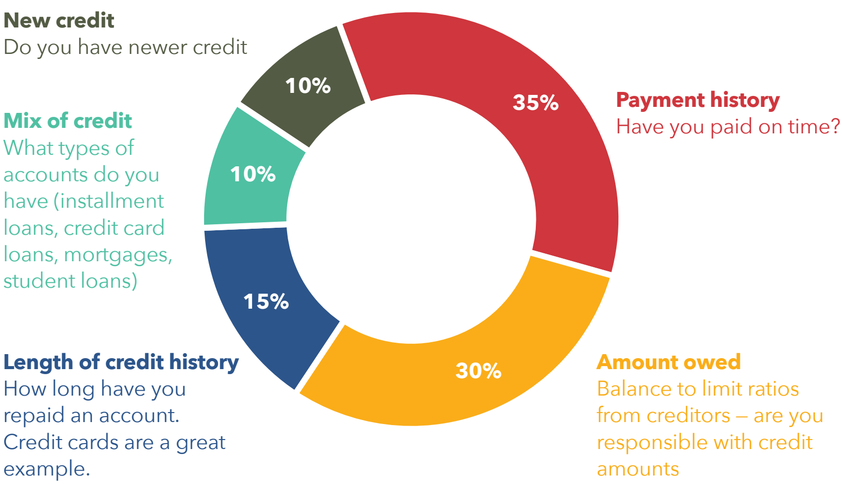
The three major repositories that hold the credit data are TransUnion, Equifax and Experian. These entities receive payment data from most banks, creditors, and other companies that provide loans to people. Information such as the initial loan start date, monthly payment amount, the total amount of the current loan, and whether the loan is paid on time is reported. Additional data is presented on credit reports, such as outstanding collection accounts, charged off accounts, or any history of bankruptcy reportings.

Once your report is pulled, each repository gives you a score based on these five factors:



Here's a quick guide to scores

780–820 A+ rating	These are the highest scores and get premium rates for mortgage products
740 - 779 A rating	These are the highest scores and get premium rates for mortgage products
700 - 739 B rating	Decent credit, premium rates not offered, certain programs are ineligible
660 - 699 C rating	Poor credit, premium rates not offered, government programs become better options
620 - 659 D/F rating	Extremely poor credit, most programs ineligible or compromised rates and terms.

In general, the best ways to improve your credit rating are as follows;

1. Make your monthly payments on time. Doing this consistently on your accounts for 6 months, one year, or two years is best.
2. Do not max out your credit card balances. The best balance to limit ratio is between 10% and 30% of the limit. Example you have a $5000 credit card limit. Charging up between $500 and $1500 is ideal. In this example, if you can pay your total amount monthly and reset back 20 balances and repeat, this is the best way to use a credit card in the scoring model.
3. Have at least two credit cards that you use. A credit card that sits with a zero balance and doesn't have any activity doesn't help your credit score.

4. Have an installment account. Maybe a car loan or some other type of loan that you pay on regularly.
5. If your credit is limited or you don't have a credit score, you must get a secured credit card that will typically require a $500 deposit. This becomes the credit limit you can borrow against. This will report to the repositories as a credit card. You can also consider adding yourself as an authorized user to a relatives credit card that is paid timely and being used properly as defined above.
6. Collections and judgements. Do not do anything with these without consulting with a mortgage lender who has the ability to run a credit simulator to see what paying them off actually does to your credit score. Paying for these items can sometimes have a negative impact on your scores. In some cases, judgements and collections are required to be paid in order to qualify. It's best to look at these as early in the process as possible.

Overall, your credit (and credit score) is the first thing that either makes the mortgage process easy, or more difficult. Obtaining your scores and information from a mortgage credit report will allow you to immediately know where you stand. Delaying this doesn't help you. And credit scores are essential to qualifying for specific loan products and receiving the best rates, and the best mortgage insurance rates.

Question 5

What is PMI, and how much do I need to put down to avoid PMI? Can a higher down payment really result in a HIGHER interest rate?

The simplest answer to this question is that 20% down helps you avoid PMI. However, there's a lot of controversy around PMI and whether it's good or bad, or if it's something you need to "avoid."

Historically, private mortgage insurance was created to help people who did not have the ability to make a large down payment to purchase a home. Up until around 1980, down payments needed for buying a home were in excess of 20%, ranging between 20 and 50% down for bank requirements. Most people didn't have that kind of money. So mortgage insurance allowed people to put less than 20% down and also protected the bank against default. The banks collected the premium monthly from the borrower, and if the borrower failed to pay, the mortgage insurance company would assist the bank in handling the foreclosure and protect the bank for up to 80% of the original value of the home. This worked for 10 to 20 years. Then banks started offering second mortgages and the stigma around "avoiding mortgage insurance" first surfaced. For a brief period of time, having a first mortgage of 80% and a second mortgage of 10% or 15% of the home's value became the normal loan to "avoid mortgage insurance."

The federal government passed a law that made mortgage insurance tax deductible around 1999, so if you made $110,000 annually or less, you could deduct mortgage insurance on your tax return. This law is still in effect. The biggest difference with mortgage insurance in the modern era is that the premiums for mortgage insurance are now heavily weighted on the client's middle credit score. The higher the score, the lower the mortgage insurance premium. And more importantly, a purchase loan with mortgage insurance at 85%, 90%, and 95% has cheaper base interest rates than a loan at 80% without mortgage insurance. Because most loan defaults happen within the first year of someone owning the home, Fannie Mae created better pricing on loans with mortgage insurance. So your clients with high credit scores can most likely borrow money with mortgage insurance and receive better terms, **and the mortgage insurance will go away when their home equity reaches 20% of the original purchase price.**

Example:

$400,000 purchase price with 10% down.
10% is $40,000.

Base interest rate is .125% better than loan with 20% down.

Original loan amount $360,000. Typical premium on this would be .15% annually or $540 dollar ($45 per month included with mortgage payment). This premium would drop after 6 1/2 years on a regular payment schedule. $3450 in total premium paid in order to keep $40,000 in pocket.

Now, factor in the .125% savings in rate. That's $25 per month for 6 1/2 years. That's $1,850 dollars.

So, net total cost of $1600 to keep $40,000 invested somewhere else for 6.5 years.

Question 6

How do underwriters look at my income if Self employed? How does claiming less affect my ability to borrow more?

The easiest way to answer this question is to give you a thorough understanding of who actually calculates your income. These people determine the level of income that goes into your file which affects how much you can borrow based on the debt to income calculations.

The underwriter with most mortgage companies is just like a judge in a courtroom. They know the rules, and they are presented with a case (your loan application) by a loan officer/mortgage originator (the lawyer, if you will.) The loan officer has a processor and (usually) an assistant. Those three people are the ones who should know the rules on determining how to calculate your income. Their collective knowledge, competency, and understanding of the rules are essential for accuracy. The rules are printed very clearly in guideline books by the entity that writes the rules for all the banks and mortgage companies. This entity is known as Fannie Mae. Fannie Mae has a very specific rulebook on determining income for every scenario possible. The rulebook for self–employed borrowers is at least 50 pages thick, outlining every nuance and detail with regards to people and how they earn their income and how they file tax returns and all of the variables.

The best way to determine your monthly income in the eyes of a mortgage lender is to submit the last two full years of tax returns and a current year–to–date profit and loss.

The lender can meticulously go through the return and use the self–employed calculation worksheet that Fannie Mae provides all lenders. Think of this like a hard math equation where if you make one wrong calculation, you get the whole answer wrong. In a perfect world, this calculation is completed by the loan officer, their team, and their processor. So three sets of eyes have looked at it prior to an underwriter reviewing it.

Once this number is determined, most self–employed people wonder why it's less than they "actually make."

This is one of the hardest questions to answer. But here's the facts.

The standard mortgage qualification system can only use the federal income tax returns as a basis to calculate taxable income. When self–employed people approach their accountants, typically the accountant includes many items in the deductions from income to help lower the taxes paid. Therefore, the more the expenses that are "written off", the lower the tax bill. This becomes the double–edged sword. Less taxes equals less income reported.

So, how do you avoid this problem of having lower taxable income but still want to be able to qualify for a mortgage? The answer is simple. You must plan. Sitting down with a competent mortgage advisor and reviewing the returns in detail, establishing a plan for the next 12–24 months, possibly amending old returns (and paying more in income tax) could help. There's no set answer, but reviewing the details is the best place to start.

Question 7

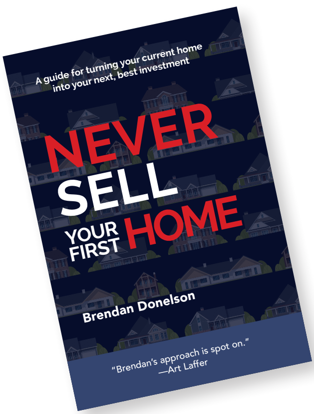
What are the Best Routes to Invest in Real Estate?

When you don't own a property yet, the easiest way to buy a home as a first time home buyer is with a low down payment mortgage loan. The government loan options are with an FHA loan. This loan requires 3.5% down payment and will have a maximum loan amount of around $500,000, depending upon the area/city. The next option is a conventional loan with 5% down (There are options for 3% down conventional loans, but they are more expensive).

Your down payment becomes your "investment," and then as you are making payments on your mortgage and paying principal each month you reduce your mortgage balance. So, the investment in real estate becomes the following three items. Your down payment, your monthly principal reduction, and your property appreciation (this is a moving number depending upon your market).

Outside of owning your principal residence or owner–occupied home, the next easiest way to get into real estate investing is to purchase an investment property. These require 20% to 30% down payments, which clearly is more than purchasing a primary owner–occupied home. After investment properties, the next easiest route is to purchase a second home, typically at least 100 miles away from your primary residence.

Lastly, if you own your current home, one of the easiest transitions into owning more real estate is to keep that home and turn it into your first rental property and move into your next home as your primary.



Brendan Donelson recently wrote, "Never Sell Your First Home," which is an authoritative take on how to turn your current residence into an investment empire. Ask him about it! (615) 207–8254

Question 8

What are the different types of investment properties I should look for?

There are many types of investment property. **Here are the 7 most common I see.**

TYPE 1

People buy their first home and outgrow it, but they end up keeping it and moving into their next home. This first property already had a mortgage on it and they possibly used a home equity line to purchase their next home. Or they used cash that they had saved up through the years. Their first rental property turns out to be easier because they had lived in the property for a specific period of time (1–10 years typically) and know the function of the home (roof, HVAc, electrical, plumbing) and the neighborhood.

TYPE 2

This could be a single–family home, a townhome, or a condominium that someone purchases outside of owning their current home. Typically this requires a down payment of 20 to 30% of the purchase price and then advertising for a renter. Property management and ongoing maintenance are things to understand and look out for. This is a very basic type of investment and typically yields a solid return **over a longer period of time.** The biggest factor in the return is the appreciation of the value of the property, then the reduction of principal on the mortgage due to collected rent from tenants. If the rent is more than the total mortgage this would be considered **cash flow,** which eventually could be additional income.

TYPE 3

The third type of property is very similar to the second where it is a single–family home, a townhome, or a condominium. But the type of rent on this property would be using short–term rental income instead of long–term. This requires a short term rental permit, and is typically advertised on Airbnb, VRBO, or other similar websites. There is much more owner involvement with this type of rental – where your renters are typically staying for 2 to 4 nights, paying you a nightly fee.

This involves having a cleaning service to clean the rental after the people leave. This can be more profitable than a long–term rental, however it does require more maintenance and more work. Additionally, more upfront cost is required due to furnishing an entire home. If you choose to have a short term rental, you are getting into the **hospitality/ rental business.**

TYPE 4

A multi–family home. These can be duplexes, triplexes, or quad plexes, etc. 2 to 4 unit properties can be financed with a regular mortgage, or even a government mortgage. These homes have more required maintenance, but diversify your risk as you have more tenants under one roof. **The long–term benefits of multi–family properties are usually higher cash flow, however, multi–family properties don't typically appreciate in value as fast as single–family properties do.**

TYPE 5

Fixer–upper/rehabs – these homes can be ones that are purchased in very poor condition, using your own funds or a loan from a bank to rehab the property. These can be sold and turned for a profit, which then would be a taxable event. Or they could be retained and turned into a rental. Typically, when people purchase fixer–upper's, their intent is to make money in that calendar year. Most people don't classify these as true investment properties because you are not planning to hold the property. Rather, this would just be classified as an investment in the short–term to enable a faster rate of return on your money. With fixer–upper's, there can be lots of decisions and unknowns. The rate of return on a fixer–upper completely depends on your experience, the property, and the crew you hire to do the renovation. **TV shows have made this work seem easy. Almost to the point of being glorified! It's hardly that.** Inexperience can cost you a lot if mistakes are made.

TYPE 6

Second homes at the beach or in the mountains....and tiny homes. These homes can be parlayed into rental properties with the new rules surrounding second home financing. You can occupy these properties yearly for as few as 15 days to classify as second home usage. Then, the remainder of the time is rented out. Obviously, these wouldn't be close to where you currently live and distance can create problems with management and maintenance. However, there are lots of interesting new opportunities with properties like these. Ask Brendan about Tiny homes if you are curious! (615) 207–8254

TYPE 7

Commercial or mixed use properties – many people might want to buy a commercial property for their business or a place where they could start a second business. This would include retail space, warehouses, office buildings, office condos, or commercial farms. The financing is based on the business or businesses that will make and is very different from residential mortgage financing. Down payments are typically much larger.

Question 9

I want to keep my current home and turn it into a rental and buy a new one. Is that possible?

Keeping your first home and turning it into a rental could be one of the most profitable decisions you could ever make. Most people have these questions;

"How do I get the equity out of my house to make this happen?"

"How do I find a renter and how much do I rent it for "

"Should I become the landlord or should I hire a property management company?

"How do I know how much I qualify for with my next home and exactly how much money will I need?"

There are many steps, and they can be taken in different order depending on the situation. Nonetheless, here's the list:

1. Determine the next home you want to buy for yourself...where is this property located? Get all the details on paper. Establish a range of prices (ex. Your current home you purchased for 300,000 three years ago and you owe 260,000 on the home. It's worth about $400,000 and you could rent it for $750 more per month than your mortgage payment. You're thinking your new home is in a different area around town and the new home range is between 575,000 and 750,000). These are all hypothetical.

2. Do a thorough assessment with a mortgage consultant. Have your credit report pulled to review your current mortgage payment and any other monthly debts. Have them review your income. This would be a thorough income review of your tax returns, pay stubs , and potential future rent received on your property. This might be needed in order to qualify.

3. Run the math to show what you can qualify for. Each potential future home could have different taxes, homeowners insurance, or HOA monthly costs. Because there are a lot of moving numbers, it would be wise to review multiple scenarios beside each other. Any slight miscalculation or change can cause issues with qualifying. Get very specific on the total amount of money

needed for down payment, closing costs and moving costs. From here, get officially pre–approved with that lender.

4. Figure out where the money for the deal is coming from. Most of the time, the easiest solution is to obtain a home equity line of credit on your current home while you are still living in the property. Home equity lines of credit (HELOC) are allowed up to 90% of your current home's value. The 90% would include your current mortgage. Example. $260,000 current mortgage. House worth $400,000. 90% is $360,000 total loans. Subtract $260,000 current mortgage leaving $100,000 HELOC. HELOC's are tied to the prime rate plus a margin. Currently the locks are ranging around 5%. He locks offer interest only payments. So if you were to write a check for $100,000 for your next house as the down payment on your home equity line of credit, that monthly payment would be about $450. Your lender will add this to the detailed calculations for loan approval.

5. Begin advertising your property for rent. You can do this in local publications, or on mini property websites. You can get a feel for what the market will pay you. Remember you can advertise something and say that it would be available soon to see what type of calls you would receive. This will give you a gauge on how marketable your property is to rent.

6. Assess your timeline. When do you want to pull the trigger?

Now that you have the major six bullet points, there will be dozens of other questions that you'll be asking yourself. Should I be my own landlord? Do I want to be? What does a property manager cost? There are a lot of variables when it comes to property management. Here is something I tell people all the time. Remember you've lived in this home for three years. You have your own set of repair people that have helped you with the property. This will make it easy when you leave the property… because you can use the same people to call on to do any repairs that your tenant may need. This is one of the reasons why vacating your current home and turning it into a rental is so smart. You know how the house lives. You know the neighborhood. You know the neighbors. This will give you a lot of security in knowing that you have taken care of it and… your next tenant might take better care of it.

Property management generally costs 10%~15% of your rent. Property managers can also place tenants for your property; they typically charge an additional fee for this as a one time placement fee. Property managers can prepare a current lease and get signatures. They handle maintenance issues and calls. They do not pay for the maintenance on your home or any repairs. You do. They can handle tenant disputes and basic communication from your tenant.

Question 10

If I own my home, when should I refinance or look at refinancing?

Refinancing your current mortgage requires reviewing your current income, current credit, the current value of the home, and the purpose of the refinance.

The **three** main reasons people refinance are as follows.

Reason 1

Their current mortgage rate is higher than the current market available rates. By refinancing with a lower rate, the savings monthly would benefit them. This is known as a rate and term refinance. Example– someone has a $350,000 mortgage. The interest rate is at 6.75%. Their monthly payment is $2350. The current market rate is 5.25%. If they refinanced the $350,000 balance, plus closing cost of $5000, for a new loan of $355,000, their new payment would become $2000 a month.

In this example, the new mortgage would save them $4000 a year and increase their cash flow allowing them to either pay off other debt, use the money towards something else in their budget, or two make extra payments on the loan to decrease the term of the loan.

Reason 2

Along with their mortgage, they have other debt at higher interest rates that needs to be consolidated. This is a debt consolidation refinance, also coined a cash out refinance because you are using the equity in your home to pay off other debt. Example– someone has a $300,000 loan at 5.75%. The payment is $2,000 per month. They have 4 credit cards totaling $50,000. The minimum payment is $750 per month total. The average rate on the credit cards is 14%. They decide to consolidate with a $350,000 mortgage, with $5000 in closing cost. The new rate on the mortgage would be 5.5%. Their new payment is $2,250. This would save them $500 a month cash flow, allowing them to either pre–pay the mortgage to reduce the term or to free up the money for other areas of their budget.

Reason 3

A cash out refinance to use the money for other purposes. This would be where there's equity in the home and by doing a cash out refinance and receiving funds at closing, these funds could be used elsewhere. Example– you currently have a mortgage of $200,000 and you wanted to take $100,000 equity out of your home and purchase a boat, car, piece of real estate, make an investment in the stock market, this is possible. The new loan of 300,000+ $5000 in closing costs would have a higher payment than your previous mortgage of 200,000. However you would have $100,000 at closing to then be able to write a check for whatever investment you plan on making.

Refinancing mortgages and rearranging terms can be beneficial, but should be utilized with caution. Sometimes the cost of refinancing outweighs the benefit. In certain instances where this is the case, a Home Equity Line of Credit (HELOC) is a better option for either debt consolidation or cash out scenarios.

Question 11

What are the most efficient ways to consolidate debt? Should I do that with a HELOC or by refinancing my mortgage?

Consolidating debt and improving cash flow is something everyone could benefit from. When someone owns a home and has a current mortgage on that property, there are times that refinancing could benefit them financially. There are also many times where the equity in their home could be used to reposition other debt.

Here are the **three** most simple ways that refinancing could benefit people.

First Way

When someone has a higher interest rate on their current mortgage. Example– their current rate on a 30 year loan is 6% fixed. The market improved and rates dropped to 4%. A "rate/term"refinance would lower their rate and recast their mortgage out for whatever term is offered. This calculation doesn't take very long to determine the closing costs on the refinance mortgage divided by the savings of the lower interest rate. The number of months to break even is the focal point. **Typically, if you can break even in 12 months or less, a rate/term refinance is encouraged.**

Second Way

Would be a debt consolidation refinance. This is known as a "cash out" refinance. Technically when you were consolidating debt, you were not walking away with cash. However you are combining your current mortgage, other credit card debt, or installment loans with high interest rates, or student loan debt, or anything that the term or the payment would benefit by consolidating it into a 30 year mortgage.

Example:

Your current mortgage is at 4%. You have credit card debt of $20,000 at 11% you have an installment loan at 8% on a car. You combine all three of these loans into your mortgage, and your cash flow improves monthly. Because the mortgage is amortized over 30 years, you are not necessarily benefiting financially by consolidating the debt, you are creating cash flow monthly and using some of the equity in your home to do so. This move can be very beneficial when you want to use your monthly income for other things such as investments, school tuitions, or other things you deem essential that would benefit you. The old saying that "your home equity has no rate of return" comes to mind when describing a cash out refinance. Your equity in your home can be put to use in this example.

Third Way

When your mortgage is currently better than the market rates being offered, a home equity line of credit might be the best solution. This would trump a cash out refinance because home equity lines are cheaper than obtaining a mortgage, a little bit easier at times, and if you have enough home equity become the perfect solution for cash flow problems. They are also a great solution for money needed for home projects, using a down payment on another home, or possibly investing elsewhere. Home equity lines are available in the following scenarios;

You cannot typically exceed 90% of your home's value.

Simple example:

Current home value $500,000.

Current mortgage $350,000 (at 3.5%).

This mortgage represents 70% of the value of the home. The Home Equity line would be possible up to $100,000 (20% of your homes value).

$350,000 mortgage (70%)

$100,000 HELOC (20%)

$450,000 Total loans on home (90%)

Home equity lines of credit offer interest only terms typically for 5 to 10 years. This helps with cash flow significantly. You can always add additional payments to your home equity line to pay down the principal balance.

Question 12

We want to buy a lot and build our dream home. What do we need to think about?

When thinking about wanting to build a custom home, there are many rules you need to understand. This type of loan is considered to be one of the riskiest a bank can issue because of the number of variables that can go wrong.

Typically, someone who wants to build a custom home falls into one of **three categories:**

Category 1

You have a piece of land that you might want to purchase and hold for a little while figuring out your plan.

Category 2

You already purchased the land that you want to build on in the future in cash or with a lot loan.

Category 3

You live in your current home but want to build your next house custom. You have possibly met a builder or architect or both. There's a subdivision somewhere with a lot you like. The developer/builder will sell you the lot and wants to control the process of design along with making sure your builder is approved to build in their subdivision.

These are general descriptions but typically cover most scenarios. However, every scenario we've financed in the past 25 years is always a little different with something unique.

Here are the 10 concepts you need to know and understand:

1. The initial land or lot acquisition only – this can be done with a land loan. This type of loan typically requires 25% or more down. These loans typically have shorter terms. Meaning 1–5 year call. Banks don't typically lend on land long term because there's no cash flow opportunities. Banks usually want their money back sooner. You'll do this type of loan when you are only prepared to buy the land, and don't have an architect, builder or plans

specifically set. Smaller community banks and credit unions are better sources that offer land loans. Some larger banks do as well, but typically with more strings attached.

2. The architect and design part. Everyone who has ever wanted to build their dream home starts with looking at designs, pictures, and websites online. For the most part, everyone has their style of floor plan aesthetics and materials that they want in their dream home. This is what architects synthesize. They take the collective sum of your dream and vision and then put it on paper. You can hire an architect to design a completely custom look and feel or you can purchase previously designed plans by an architect and use those. Or you can do a combination of both. In the end, the architect becomes an essential part of the process because they are laying out the blueprints for how the home is to be built. Typically the architect and the builder have a working relationship so that when questions arise during the process, and the plans don't exactly detail certain items, the two can communicate to effectively manage decisions while the home is being built. Architect fees can range from \$8,000–\$25,000, depending upon the size and scope of the home. This cost can sometimes be absorbed in the loan, but it is never fronted. This cost is something that initially comes out of pocket for most clients when they are in the initial stages of deciding what they want.

3. The Construction to Permanent mortgage is a one–time closing loan where the construction loan is established to build the home, and then a permanent mortgage replaces the construction loan at the end of the construction term. A typical construction loan lasts for 12 months. The loan is set up from the beginning to fund the construction in incremental "draws". These draws are established during the loan approval by a sample draw schedule that your builder provides to the bank. Experienced builders typically have a proven formula that they use to build a home from the ground up.

4. The builder needs to be approved by the bank. This process is not painstaking, rather just detailed so that you are protected. The bank wants to know that the builder has a current contractor's license, proper insurance, trustworthy subcontractors (they are asked to provide a list of subcontractor references), and their financials. Remember that your builder is requesting large sums of money during the construction of the home and then trusted to pay the subcontractors in a timely manner. This is where everyone assumes that every builder has their back office together and wouldn't make mistakes. We've found this to be a very revealing part of the process when a builder isn't organized enough to go through the bank approval process efficiently. Take notes, people.

5. Doing the math—discovering how much loan you will receive is very much a process when doing a construction to permanent mortgage. The rules are very simple. The loan is based on the total construction costs (including builder fees) plus the lot value or the appraised value… whichever is less. Here's an example. The construction costs (builder contract) on a home are 750,000. The lot value is 250,000. This totals $1,000,000. The initial appraisal comes back at $1,100,000. Most banks have standard Loan–to–Value guidelines that they can send you so that you can reasonably predict how much you can borrow. Here's a good rule of thumb; 90% Loan up to $1 million with PMI, 80% Loan up to $2 million. Most Banks will offer 30 & 15 year fixed terms, and possibly Adjustable Rate terms with a 5 Year arm or 7 year Arm.

6. Getting your loan approval is very similar to getting a regular mortgage. Your credit report is obtained, your income documents are reviewed, and most importantly your down payment and reserve cash is painstakingly reviewed. Most credit score requirements for construction loans are to have a 700 or higher middle credit score. Most income documents are as follows; two years of tax returns, current pay stubs or year to date profit and loss statements if you are self–employed,

bank statements for two recent months (including assets statements and retirement statements.) And of course, one of the most important final documents is the signed builder contract including all plans, specifications of the materials in the home (called "specs") and the builders proposed draw schedule. The underwriting process typically takes about one week. All banks will read the contract you sign with your builder. In the contract there will be areas where the builder outlines potential cost changes and variables with pricing. WITHOUT EXCEPTION, every initial contract signed with a specific price outlined changes in the end 12 months later. This is the reason the bank has a cash reserve requirement. Reserve requirements are typically 3–12 months of "end mortgage" payments. Example, on your $800,000, the final Principal, Interest, Real Estate Tax, and Homeowner's Insurance monthly payment is $5,500. The reserves required for this loan could range from $16,500 to $66,000 post closing. These funds can be calculated from cash sitting in checking or savings accounts. Or from a portion of your retirement or 401k accounts.

7. Understanding what happens at "closing." Once your loan is cleared to close from underwriting and the final numbers are verified, the closing date is established. If you already own the lot, this loan is treated as a refinance transaction (which doesn't change the terms or much of anything listed here) And if you're acquiring the land through this transaction, it is treated as a purchase transaction. Many times when people already own the lot, closing day essentially establishes the construction loan being attached to the property. In these examples, these people do not bring money to closing because they have equity in the deal in their lot. If clients don't have the equity in their lot or are acquiring the lot through this purchase transaction, the closing day is where they bring their money into the deal. As outlined above, this number is established during underwriting and when the appraisal is received. This number is not established right before closing, ideally. However, because there are so many moving parts to a construction to permanent loan, be very

careful to not underestimate how much money you will need in the transaction.

8. The payments and loan distributions during the construction period – when you close on your loan you may have an initial loan balance because you paid off a previous lot loan. You might also have zero loan balance if you acquired the lot and brought your down payment and closing costs to the table when you closed. Regardless, when the builder begins construction after your closing, they begin requesting money either in advance for materials based on their draw schedule or whatever was agreed to in the contract. So in the example listed above, if you were approved for an $800,000 construction to perm loan, and you brought $200,000 to closing (plus closing costs), then your construction line of credit of $800,000 would begin at $0. If your transaction was treated as a refinance, and let's say you had a $200,000 lot loan already, you would bring $200,000 to closing (plus closing costs). The closing attorney would take the $200,000 from you to pay off the Lot loan in order to clear the property of any liens. Then the $800,000 Construction to Perm loan would be attached to your property beginning with a $0 balance construction line. The builder will begin requesting draws and the interest will begin accruing on your loan on a daily basis. This interest is based on the amount that you have funded. The interest amount obviously grows as the loan goes from month to month. Example– the first month you might have a $100,000 amount drawn in this simple example if the interest rate were 5%, the monthly payment would be around $400. In the second month if your balance was $200,000, your simple interest payment would be $800. And this proceeds until the 12 month when your construction loan is fully funded at $800,000 with an interest only payment of $3,600. You are required to make the monthly payments during the construction. The option of "rolling in" these payments during the construction because you are living somewhere else (and have a monthly payment there) is typically not allowed. There might be some

specialty rehabilitation loans out there that allow this, but this is not common with One Time Construction to Permanent loans.

9. Any cost variables that happen during construction – this is unfortunately a very touchy subject when it comes to current construction to permanent loans. Because all the numbers are established upfront with the appraisal and with the builder contract and the valuation of the future home that is getting ready to be built, the passage of time and variables creates a hardship. Especially when it comes to material costs changing and or clients wanting to change key things in the home during the process. This is a problem when the client does not have the money and still wants to make changes to the specifications of the home and or the builder has underestimated some of the cost. This is in the reserves that were calculated to become essential in helping the client over the finish line. In many instances, the client pays for changes out of their own pocket because the construction loan was set to fund what was described upfront. There are exceptions in extreme cases where the construction line can be manipulated or increased but this requires going back into underwriting and a new appraisal on the home. This can change your loan terms, require additional closing costs, and paperwork, and can be cumbersome. This is done in extreme cases, so hopefully you don't experience this if you go through the process.

10. The Finish line –after 12 months of being under construction and watching the property take shape, the eventual construction line is converted into a permanent mortgage. Your payment estimates that were given to you during the loan closing then become real. Because your property never had a tax assessment and your homeowners insurance premiums might change, your final mortgage payment is based on the $800,000 loan at the terms that were locked up front, but your monthly escrow for taxes and insurance are typically calculated at the end.

"Brendan's approach is spot on. If most Americans could figure out a way to keep more real estate, they'd be wealthier. This book is a great read from an author who knows what he's writing about!"

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