Work Smart: Helping Buyers Through Tough Terrain

In the new financing landscape, buyers need more support from you. Get a crash course in financing to learn how you can ensure buyers can come up with the money to buy the home they've chosen.

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As credit standards tighten and financial markets struggle to find the bottom, home buyers' ability to get an affordable mortgage has never been a more critical component in the real estate transaction.

The easy mortgage money is long gone. Today, most lenders require at least 10 percent to 15 percent down for conventional loans, along with a good credit record and proof of the buyer's income before making a loan. The challenge is especially great for first-time buyers who don't have the equity cushion of long-time owners.

Many sales associates rely heavily on mortgage specialists to handle financing from start to finish, but David Fialk, CRB®, CRS®, broker-owner of Choice Realty Co. in Iselin, N.J., advocates that you do more—for both the buyers' benefit and your own. "I go through a half-hour review session with all the buyers I meet for the first time," he explains.

After a preliminary information exchange, Fialk gets frank with the buyers. "Depending upon their price range and down payment, I calculate their monthly mortgage payment based on the average interest rate in our area and ask if they're comfortable with that big a payment each month," he says. "Then I ask their income to make sure it warrants a payment like the one we've just discussed. I also make sure they contact a mortgage rep so that I get a preapproval letter in hand."

Let's face it, unless your buyer clients can get financing, you waste your time and theirs in helping them find the perfect home. As a listing salesperson, you lose valuable selling time on the market while a buyer negotiates with a lender, only to have the loan fall through.

What should you do to ensure that buyers can come up with the money to buy the home they've chosen? We're here to help with a crash course in financing. We've also provided some mortgage calculation pointers to assist you in helping the borrower understand the costs of mortgages and homeownership.

4 Steps to Smooth Financing

Step 1: Know the (Credit) Score

While a frank discussion like the one Fialk describes is essential in selecting a price range for homes to show, it's a lot harder these days to estimate how large a mortgage loan buyers will be able to secure. For decades, real estate salespeople have relied on a few handy rules—like pegging home price to three times a buyer's annual income—to determine an appropriate price range.

Another rule used to be 28/36—your mortgage payment could be up to 28 percent of your gross monthly income, and your total debt couldn't be more than 36 percent of your gross monthly income.

Unfortunately, "it isn't quite as black and white as it used to be," says Mark Steele, president of Howard Hanna Mortgage Services in Pittsburgh. "One big factor that's changed mortgage lending is the widespread use of automated underwriting software, which is required for lenders to be able to sell loans on the secondary mortgage market. This software takes certain things into account, like credit scores, that weren't considered before."

"Everything now is more credit score–driven," agrees Ron McGuire, president of Tucker Mortgage LLC in Indianapolis. Credit scores, sometimes called FICO scores after Fair Isaac Corp., which developed the most widely use scoring system, rate buyers' creditworthiness.

Another system called VantageScore was launched in 2006 by the three major credit rating agencies. How high a credit score is will directly affect how much someone will be able to borrow and at what interest rate.

Factors that can bring down buyers' credit score include using most of their available credit by maxing out their credit cards and applying for credit at many places within a short time period. And though it might sound counterintuitive, having few lines of credit with low use also can have a negative effect on credit scores because such behavior leaves lenders with little information from which to judge the buyers' ability to repay debt.

FICO scores range from 300 to 850. VantageScore ranges from 501 to 990. "Any [FICO score] above 720 is considered good," says McGuire. "Once you get below there, you have a price adjustment like a higher interest rate or points."

"Roughly 50 percent of consumers have a FICO score of 700 or above," says Brad Blackwell, executive vice president and national retail sales manager for Wells Fargo Home Mortgage in San Francisco. "Any number of factors determine a credit score, the biggest being the amount of credit you've used and your record of paying that credit back on time."

If buyers' credit scores are low, offer tips for raising them. "The best way for buyers to improve their credit score is to pay their bills on time, even if they can afford only the minimum payment," says Blackwell. "If they can afford more, they should pay down their debt, which will improve their score."

Another common problem: "People don't think they need to pay back their student loans," says Steele. "If you don't pay back your student loans, you can't get a mortgage loan. It's that simple."

Step 2: Get Out in Front of Underwriting

Now that the entire mortgage landscape has changed, the most foolproof way to ensure buyers can borrow the money for the home they want is to encourage them to get prequalified before they start looking. Or is it preapproved? If you're not sure of the difference, you're not alone.

"Typically when lenders prequalify, they ask buyers their income, how good their credit is, and, based on the information they verbally receive, they calculate how much of a loan the buyers qualify for," explains Blackwell. "The loan officer will write a letter to the buyers saying, 'By my estimation, this is how much you qualify for.'"

Unfortunately, that estimate is only as good as the information the lender's been told. Even if buyers are above board, they may not be aware of a problem in their credit report that prevents them from getting the loan amount or interest rate necessary to purchase the home you've helped them find.

"A preapproval is a more powerful tool for understanding how much buyers can qualify for and for showing to prospective sellers so that they know they have qualified buyers," adds Blackwell. "With a preapproval, lenders will pull a credit report, at times verify income, and based on the information, essentially preunderwrite the loan to determine the buyers' qualifications. They won't give a final approval, but a preapproval is much stronger than a prequalification."

During the actual loan underwriting process, lenders comb through buyers' finances to evaluate the risk of making the loan. In addition to the credit score and debt repayment, lenders also look at income and other assets.

"Lenders like to see two years of employment history," explains McGuire. But that doesn't necessarily mean at the same job. "We look more at the buyers' time in the line of work to be comfortable they'll be able to earn that income in the future," says Blackwell. "If they've been in a job only one year but show a track record of being in that line of work, generally we'll be comfortable with that."

The days of stated income loans—for which buyers simply told lenders their income without lenders' verifying the amount—are over. "If buyers are self-employed, we'll review at least two years of their tax returns, which we'll average to get an income figure. Buyers can also use other income sources to qualify for a loan as long as it's substantiated for two years," says Blackwell.

Liquid assets such as savings accounts and stocks also factor into loan underwriting. "Underwriters like reserves, usually of two to three payments of principal, interest, taxes, and insurance," says McGuire. "If it's a borderline file and the buyers have reserves, the loan will get approved. If they don't, more than likely they'll be rejected." Negotiating with sellers to have them pay buyers' closing costs is one way for buyers to have reserves, he suggests.

Step 3: Understand the Lingo

Although many sales associates rely on lenders to guide buyers through their loan options, understanding the nuts and bolts of today's new lending world helps you help buyers.

Factors that could influence the buyers' loan terms are the loan amount itself, the length of the loan, and the loan-to-value ratio (how much of the total value of the home is being financed). Lenders typically price loans based on risk, explains Blackwell.

For example, large loans might have higher interest rates both because more money is at risk and because of liquidity issues in the marketplace. Also, making a 5 percent down payment might mean a higher interest rate than putting 20 percent down, again because more money is at stake relative to the value of the home.

"If buyers are considering an adjustable rate mortgage, be certain they understand what their monthly payment may look like at the first adjustment period," says Bob Dorsa, president of the American Credit Union Mortgage Association in Las Vegas.

Although many people are shying away from ARMs today, equating them with subprime problems, that may be too conservative a position. "Look at buyers' situation any time you're talking about an adjustable rate," says Steele. "There are safe adjustable rates that don't adjust every month. Most 5/1 ARMs offer a fixed rate for five years and then adjust every year. That may be good if this is the buyers' first house and they plan to stay for less than five years and don't base their decision solely on their ability to sell them. That can save them a quarter, a half, or three quarters of a point on their interest rate."

Buyers also need to understand how a 30-year or a 15-year fixed rate loan term affects payment amounts and total loan interest costs. Today, the interest rate difference between the two has shrunk because there isn't as much demand for a 15-year mortgage as in the past. But buyers will still build equity faster with a 15-year mortgage and pay a lower interest rate than with a 30-year loan.

Also, advise buyers to ask about points, which are upfront fees based on a percentage of the loan amount. A lender charges points to originate the loan and as an offset for lower interest rates. One point equals one percent of the loan amount.

"Buyers can pay points if they want a lower interest rate," says Blackwell. "They should calculate how long they'll be in the house and determine whether it's worth it to pay points to get a lower interest rate."

Step 4: Know Where the Reliable Money Is

If you've recently had transactions fall through because lenders quietly faded away without notice or wouldn't make a commitment weeks after the loan application was filed, you know how important having a list of reliable lenders can be.

Make sure buyers know how to pick a lender who'll be at the closing table as planned. "Even if buyers tell me they're already working with a lender, I provide them with a printed list of four lenders we know from previous transactions whose support staff is just as good as the mortgage representative and whose products are competitive," says Fialk.

Tighter loan availability may also present opportunities for brokerages that operate their own mortgage operations. Just don't forget to disclose any relationship you have right up front.

"Buyers should ask to see a lender's financial statement," advises Dorsa. "If there's any hesitation in providing the information, it might be a red flag." McGuire also suggests checking with state attorneys general and the Better Business Bureau to see if any complaints have been filed against a lender.

Experts say the best sources of financing today are through established financial institutions, like banks and credit unions, which offer both conventional and government-insured loans such as Federal Housing Administration loans and Veterans Administration loans. "No down payment loans are pretty much gone, but there are loans you get with 3 percent down, most notably FHA loans," says Blackwell.

"In our market, the FHA hadn't been invoked in years," says Steele, "and it now represents 40 percent of what we're doing." That increase can likely be credited to the program's higher loan limits, for which NAR lobbied extensively.

In most counties, the FHA is only permitted to insure loans that don't exceed 125 percent of the median home price. In designated high-cost areas, the loans can go up as high as $729,750 which is 175 percent of the $417,000 permanent conforming loan limit for Fannie Mae and Freddie Mac. This high cost limit is in effect only for 2008, but NAR is working to make it permanent.

When the Department of Housing and Urban Development released its latest median home prices in March, the number of homes that could qualify for FHA loans grew. Keeping up-to-date on FHA changes and other mortage developments is critical to building trust with clients. That trust and openness about buyers' financial picture, Fialk says, will enable you to close transactions in today's tight financing market.

Low-Cost Financing Sources That Can Rescue A Deal

You're working with wonderful buyers, but they're just shy of meeting all the financial requirements to purchase a home. Here are sources and strategies that may help.

Consider seller financing. The use of seller financing—in which the seller agrees to take a promissory note from the buyers for the purchase of the sellers' home—has dropped because fewer sellers can finance the sale of their current home and buy another, says Mark Steele, president of Howard Hanna Mortgage Services in Pittsburgh. However, if buyers are creditworthy, it doesn't hurt to ask whether sellers have the means to swing a seller-financed transaction.

Suggest leasing with an option to buy. A lease-option agreement allows buyers to rent a home with the promise of a sale at a certain price while they gather a down payment. Often the sellers agree to apply a portion of the monthly rent toward the down payment. If a seller's home is languishing on the market, this might be a good way to secure an eventual sale and help a buyer.

Keep an eye on credit unions. Credit unions are often a well-kept secret, but they can be an economical source of financing. "Credit unions can afford to make loans at below-market rates because they get a better yielding investment than they can get from U.S. Treasury bonds," says Bob Dorsa, president of the American Credit Union Mortgage Association in Las Vegas. Most credit unions service their own loans and occasionally even run "specials" on loans, says Dorsa. For a free, eight-minute DVD explaining why Realtors® should be confident referring buyers to credit unions, go to the association's Web site at www.acuma.org.

Turn to IRAs. Remind buyers to investigate whether borrowing from their Individual Retirement Accounts can help generate cash for a down payment. "Borrowing isn't a bad way to come up with a down payment if the retirement plan permits buyers to do that and they can repay the loan," says Steele. IRS rules also permit you to withdraw up to $10,000 penalty free once in a lifetime to purchase a home. However, you must be either a first-time buyer or someone who has not purchased a home in at least two years. Otherwise IRA withdrawals for home purchases are subject to a 10 percent penalty. And while buyers won't pay a penalty if they meet the withdrawal requirements, the amount withdrawn or borrowed will be taxed as income.

Tap family members. Many loan programs allow buyers to use gifts from family members for a down payment or closing costs. "It's an excellent way to get a down payment," says Steele, who notes that some programs such as the FHA place restrictions on how much can be given and how the funds can be transferred.

Know all the programs available. In addition to FHA financing, HUD offers the Homeownership Voucher Program, which helps first-time buyers with mortgage and other homeownership expenses. Many states have local housing authorities that help buyers purchase with low down payments.

Quick Tips Your Clients Will Appreciate

1. **Score a free report.** By law, every individual is entitled to one free credit report a year. If you don't feel comfortable asking buyers their credit score or if they decline to share it with you, at least suggest they check their own score at one of the three major credit rating agencies—Experian, Equifax, or TransUnion. Even if their score looks good, suggest buyers check for errors that might affect the rating.
2. **Consider lock-in benefits.** Most lenders will allow buyers to lock in their interest rate once they're approved for a loan. That's usually a wise move. "The only times buyers may not want to lock in their rate is if they aren't going to close for several months or they think interest rates will go down," says mortgage executive Ron McGuire of Indianapolis.

3. **Factor in the premium.** “If borrowers have less than a 20 percent down payment, remind them to factor in private mortgage insurance, which might add up to another half-point to their interest rate,” says Dorsa. “Some lenders will increase the rate by one-half of a percentage point to pay the premium, while others will pass the premium on to the borrower with the hope that at some point, through appreciation, the loan-to-value ratio will drop below 80 percent and the PMI will be removed.”
4. **Look for backups, guarantees.** Suggest that buyers investigate backup financing sources, and ask whether lenders will guarantee funding. Wells Fargo, for one, offers a guarantee that it will close by the date specified in the contract or pay the buyers’ first month’s mortgage. At Howard Hanna Real Estate in Pittsburgh, “if a sales associate gets in a problem with another lender, we’ll step in and close a deal in one day where that’s required,” says Mark Steele, who heads the company’s mortgage services division.

Mortgage Math Made Easy

The Internet is full of mortgage calculators, making it easy for buyers to determine how large a mortgage they can afford and what their monthly payments at different loan amount will be. (Sites with good mortgage calculators include Bank of America, Homefair, and Wachovia. Be sure that the payment amounts include taxes and insurance as well as loan principal and interest.)

If buyers haven’t done these estimates online, you can also suggest using some standard rules of thumb to estimate how much of a home they can afford.

- Monthly mortgage payments (including property taxes and insurance) should not exceed one-third of monthly gross income. The ideal range is between 28 percent and 33 percent of gross month income
- Total monthly debt payments (including your mortgage payment) should not exceed 36 percent of total gross monthly income.
- The price of a home should not exceed 2.5 times total gross income.

But before buyers can start plugging in numbers to a calculator, they need a clear picture of their current financial picture. Use these lists as a guide to help them get a better grasp on their finances:

Monthly Income

Take-home pay/all family members (including regular overtime and bonuses):

Child support/alimony:

Pension/Social Security:

Disability/other insurance:

Interest/dividends:

Other:

Total Monthly Income=

Monthly Debt

Potential mortgage payment:

Auto loans:

Credit card minimum payments:

Child support/alimony:

Student loans:

Other loans:

Total Monthly Debt=

Comparing Fixed Rates and Adjustable Rates

When your customers are at the point of researching potential loans, one common comparison is between a fixed-rate and an adjustable-rate mortgage. Here's a sample comparison.

FIXED RATE

Potential purchase price of home: $400,000

Potential down payment: $50,000

Total loan amount: $350,000

Interest rate: 5.75% for 30 years

Monthly Payment: $2,042.00

ADJUSTABLE RATE

Potential purchase price of home: $400,000

Potential down payment: 50,000

Total loan amount: $350,000

Interest rate: 5.25% for 5 years/adjusting annually after

Monthly Payment for first five years: $1,932.71

Short-term savings with an ARM: $109.29 monthly; $1,311.48 annually; $6,557.40 over the five-year ARM term.

Should You Pay Points?

Points are fees calculated on the loan amount and paid to the lender at the closing. One point is equal to 1 percentage point of the loan. In many cases, lenders charge upfront points in return for a lower interest rate. But is it worth it? Assume you can reduce the interest rate on your loan from 5.75 % to 5.25 % by paying one point. Here's a quick calculation your buyers can use.

Potential purchase price of home: $400,000

Potential down payment: $50,000

Total loan amount: $350,000

Cost of one point to buy down the loan: $3,500

Monthly payment with no points at 5.75 % interest: $2,042.00

Monthly payment with one point at 5.25 % interest: $1,932.71

Savings by paying one point up front: $109.29 monthly; $1,311.48 annually; $39,344.40 over a 30-year loan term