



Educator Guide

Financial Readiness: Financial Options

Azori Sparks and Ann Vail, Ph.D.

Objectives for this Lesson:

- Define the Four “Cs” of the Loan Process
- Determine How Much You Can Afford for a House
- Calculate Front-End/Back-End Ratios
- Define Upfront Cost Associated with Buying a House

Resources for this Lesson:

- Educator Guide: *Home Buying Process: Financial Options*
- PowerPoint Presentation: *Home Buying Process: Financial Options*
- Content Guide: *Home Buying Process PDF*
- Work Sheets:
 - *Debt Repayment Work Sheet*
 - *Gross Monthly Income Work Sheet*
 - *Debt to Income Ratio Work Sheet*
 - *Front-End/ Back-End Work Sheet*

Client Packets Should Include:

- PowerPoint Presentation Handout (3 slides per page): *Home Buying Process: Financial Options*
- All Work Sheets Listed Above

Key Points**For Educator: What to Say****For Learner:**

<p>Slide #1: Home Buying Process: Financial Options</p>	<p>Introduce yourself.</p>	<p>Participant Introductions.</p>
<p>Slide #2: Objectives:</p> <ul style="list-style-type: none"> • Define the Four “Cs” of the Loan Process • Determine How Much You Can Afford for a House • Calculate Front-End/Back-End Ratios • Define the Upfront Cost Associated with Buying a House 	<p>Explain: By the end of this session, you will be able to define the Four “Cs” of the loan process, determine how much you can afford for a house, calculate your front-end and back-end ratios and define the upfront cost associated with the home buying process.</p>	
<p>Slide #3: The Four Cs of the Loan Process</p> <p>What are some of the first financial considerations you have when deciding to apply for a mortgage loan?</p> <ul style="list-style-type: none"> • Credit • Capital • Collateral • Capacity 	<p>Question: <i>What are some of the first financial considerations you have when deciding to apply for a mortgage loan?</i></p> <p>Instructor’s Note: Create a list of ideas on the board.</p> <p>Explain: The financial considerations in which both you and your lender will be interested are Four Cs of the Loan Process.</p> <p>Instructor’s Note: The bulleted “Four Cs” will come in together on the PowerPoint (upon a second mouse click) after the class discussion.</p>	<p>Discussion point: Participants will share their ideas as instructor writes them on the board.</p> <p>Ideas include:</p> <ul style="list-style-type: none"> - Determine how much you can afford to spend on a mortgage payment. - Determine who offers the best mortgage product. - Obtain your credit report and check your credit history.

Key Points**For Educator: What to Say****For Learner:****Slide #4:
Credit**

- Refers to how you have paid your bills or debts in the past.

- Free Credit Report at: www.AnnualCreditReport.com

- Be truthful about your credit history.

Explain: The first of the Four Cs is Credit.

Question: *What is credit?*

Instructor's Note: Bullets will appear upon a second mouse click.

Explain: Credit refers to how you have paid your bills or debts in the past. Your credit report is one tool lenders use to consider your willingness to repay your debts.

You should get a copy of your credit report before you approach a lender. Consumers in New Mexico are allowed one free credit report per year from each of the three major credit agencies. The agencies do not always have the same information, so it is important to check all three reports. You can get a free credit report electronically by logging onto www.AnnualCreditReport.com.

It is important when a lender asks about your past credit history to be truthful. If you have had credit problems, take advantage of the opportunity to explain your credit report history to the lender.

Some people have had bad experiences that have caused unexpected credit problems. If he/she understands your situation, your loan officer will be more willing to help you get a loan and may be able to suggest ways to improve your credit standing.

Discussion: Participants share their definitions of credit.

Key Points**For Educator: What to Say****For Learner:**

<p>Slide #5: Capital</p> <ul style="list-style-type: none">▪ Refers to the financial resources you have available in credit unions, savings and loan associations, or banks.▪ Includes:<ul style="list-style-type: none">○ Checking/Savings Accounts○ Money Market Accounts○ Certificates of Deposit	<p>Question: <i>The second of the “Four Cs” is Capital. What is capital?</i></p> <p>Instructor’s Note: Bullets will appear upon a second mouse click.</p> <p>Explain: Capital refers to the financial resources you currently have available in credit unions, savings and loan associations, or banks. This includes checking and savings accounts, money market accounts and certificates of deposit.</p>	<p>Discussion: Participants share their definitions of capital.</p>
<p>Slide #6: Collateral</p> <ul style="list-style-type: none">• Refers to an asset that guarantees the repayment of a loan.• Examples:<ul style="list-style-type: none">○ Cars○ Real Estate○ Motor home• For your home purchase, the house will be used as	<p>Question: <i>Collateral is the third “C”. What is collateral?</i></p> <p>Instructor’s Note: Bullets will appear upon a second mouse click.</p> <p>Explain: Collateral refers to an asset that guarantees the repayment of a loan. Examples include your car, real estate or motor home. When using your car or house as collateral, you agree to pay off your loan as agreed, or else surrender this asset to the lender.</p> <p>For your home purchase, the house will be used as collateral. If you fail to pay your monthly payments, you</p>	<p>Discussion: Participants share their definitions of collateral.</p>

Key Points**For Educator: What to Say****For Learner:**

collateral.	could lose the house.	
<p>Slide #7: Capacity</p> <ul style="list-style-type: none"> • Refers to your ability to repay the loan. • Includes: <ul style="list-style-type: none"> ○ Occupation ○ Employment History ○ Salary ○ Length of time in your present job ○ Monthly expenses ○ Current level of debt ○ Length of loan debts ○ Dependents ○ Alimony/Child support ○ Other obligations 	<p>Explain: The last “C” is capacity. Capacity refers to your ability to repay the loan.</p> <p>Your occupation, employment history, salary and length of time in your present job all are used to determine your capacity.</p> <p>Explain: <i>What might be included when determining someone’s capacity?</i></p> <p>Instructor’s Note: Bullets will appear upon a second mouse click.</p> <p>Transition Statement: You may be asking yourself, “How much can I afford to pay for a house?” Your capacity will help you determine a ballpark figure of how much you can afford.</p> <p>Knowing your capacity should give you a general idea of what a lending institution will be willing to loan you. It is important to know that just because a financial institution qualifies you for a certain amount, you do not have to accept the full loan. They may qualify you for more than you can comfortably afford to pay. Ultimately, you are responsible for deciding if you want a mortgage loan for the full amount for which you qualify.</p>	<p>Discussion: Participants share their ideas of things included in determining someone’s capacity.</p>

Key Points**For Educator: What to Say****For Learner:****Slide #8:****What Can You Afford?**

Example:

Annual Household Income =
\$30,000

Could Possibly Afford: $\$30,000 \times 2 = \$60,000$ $\$30,000 \times 2.5 = \$75,000$

Explain: Many people estimate that they can afford a house that costs up to 2 or 2 ½ times their gross household income before taxes.

Consider this example. A family's annual household income is \$30,000. This family could possibly afford a house ranging from \$60,000 - \$75,000.

Question: *Do you have any questions on calculating how much you can afford to pay for a house?*

Transition Statement: Remember that the amount you can afford for a house may be different from the loan amount for which you qualify. This household may qualify for a loan of \$85,000, but should strongly consider whether they can comfortably afford a loan of more than \$75,000.

Participant questions.

Key Points**For Educator: What to Say****For Learner:****Slide #9:****Debt-To-Income Ratio (DIR)**

DIR = A percentage used as a guide to determine how much money you can borrow.

DIR=

$$\frac{\text{Monthly Debt Payments}}{\text{Total Gross Monthly Income}}$$

Explain: The amount for which you *qualify* will be determined by your financial institution. Lenders will review your debt-to-income ratio (DIR) when considering your application for a loan. Your DIR is a percentage used as a guide to determine how much money you can borrow.

Activity: To determine your DIR, use this *Debt-To-Income Ratio* Work Sheet along with your financial information from the Money Management Section.

Activity: If you have not completed the *Debt Repayment* Work Sheet and the *Gross Monthly Income* Work Sheet (both from the Money Management Section) you will need to complete these at home to determine your DIR.

The DIR is calculated by adding all your monthly debt payments (which include credit cards, car payments, school loans, bank loans and any other monthly expense reported on your credit report, such as child support) and dividing the total by your gross monthly income (income before deductions).

Activity: *Debt-to-Income Ratio* Work Sheet.

Activity: Distribute *Debt Repayment* Work Sheet and *Gross Monthly Income* Work Sheet to participants not able to attend the Money Management sessions. Participants will have to complete these worksheets at home.

Slide #10:**Debt-To-Income Ratio (DIR)**

Example of a DIR Calculation:

Current Monthly Debt = \$200

Gross Monthly Income = \$2,500

Example: Refer to the *Debt-To-Income Ratio* Work Sheet as we discuss this example. A family has committed to \$200 of monthly payments, including credit cards, student loans and a car loan. (The current debt does not include things like the monthly phone bill or electric bill.) Their gross monthly income is \$2,500 (\$30,000 Annual Household Income). The DIR would equal \$200

Key Points**For Educator: What to Say****For Learner:****DIR = \$200/\$2,500 = 8%**

divided by \$2,500 or 8%.

Slide #11:**Debt-To-Income Ratio (DIR)**

- Financial institutions have different guidelines for DIR.
- If your DIR is high:
 - may not qualify you until you lower your debts
 - may qualify you, but give you a loan option that could be risky. Taking the loan may not be the best option.

Explain: Financial institutions have different guidelines for DIR. If your DIR is high, you may be seen as too much of a risk. In this case, you will have to pay down your debts before you qualify for a loan.

Other financial institutions may qualify you for a loan even if you have a high DIR. There is no set percentage that is considered a high DIR. If your monthly debt is \$1,225 and you earn \$3,500 a month (DIR =34%), your DIR may not be considered high. On the other hand, if your DIR is 35%, with your monthly debt being \$630 and your monthly income only \$1,800, the lender may see you as a high risk. Usually, the more income you make, the higher a DIR you can have without being considered a high risk.

Keep in mind that just because you qualify for a loan does not mean you can comfortably afford the monthly payments. Taking the loan may not be the best option.

Transition Statement: You need to determine if you can comfortably afford the monthly loan payments of your mortgage. Let's discuss some factors to consider when deciding on a loan.

Key Points**For Educator: What to Say****For Learner:****Slide #12:
Questions to Consider****Ask yourself:**

With this mortgage payment will I:

- Have enough money at the end of the month to save for unexpected expenses?
- Have enough to maintain my current lifestyle?
- Have enough income to make the mortgage payment if my partner loses his/her income?

Explain: Before you take out a mortgage loan, ask yourself these questions.

Instructor's Note: Refer to the three questions on Slide #11.

Explain: If you hesitated to answer “yes” to these questions, you might consider a different mortgage option with lower mortgage payments, or consider waiting to purchase a house.

Transition Statement: Also, make sure you understand the full picture before you accept a loan product. You need to ask if the mortgage payment includes all monthly costs, including interest, insurance and taxes. If you are only considering the principal payment of your loan, you can expect your monthly payment to be substantially higher. Consider the entire monthly mortgage payment, which will include four things, known as PITI. Let's define PITI.

Key Points

For Educator: What to Say

For Learner:

Slide #13:

PITI

Principal – Amount applied to the loan to lower the outstanding balance.

Interest – Cost of borrowing money.

Taxes – $1/12^{\text{th}}$ of the estimated annual property tax.

Insurance – $1/12^{\text{th}}$ of the annual homeowner’s premium.

Explain: PITI is the acronym for Principal, Interest, Taxes and Insurance. These four costs are included in your monthly mortgage payment. We will discuss your monthly mortgage payment in much more detail in Lesson 5, but, briefly, let’s discuss these four areas.

Question: *Can anyone explain what the principal of your loan is?*

Instructor’s Note: Definitions will appear upon a second mouse click.

Explain: Principal refers to the amount you pay each month that is applied to the loan to lower the outstanding balance.

The interest is the cost of borrowing money. Your mortgage also will include $1/12^{\text{th}}$ of the estimated annual property tax each month and $1/12^{\text{th}}$ of the annual homeowner’s premium insurance policy.

Discussion: Participants share their definitions of principal.

Key Points**For Educator: What to Say****For Learner:****Slide #14:****PITI – Front-End Ratio**

Equal to or less than:

25% - 28% Monthly Income

Example:

Monthly Gross Income = \$2,500

$\$2,500 \times 25\% = \625

$\$2,500 \times 28\% = \700

\$700 = Maximum monthly mortgage payment to which a family with \$2,500 monthly income should commit.

Explain: Lenders usually require the PITI (or monthly mortgage payment) to be less than or equal to 25% - 28% of your monthly gross income.

Example:

Consider a family whose monthly gross income is \$2,500 (\$30,000 Annual Household Income). 25% of their income would equal \$625. 28% of their income would equal \$700. This family should not commit to more than \$700 per month for a house payment.

Explain: This is considered the front-end ratio (monthly mortgage payment less than or equal to 25% - 28% of your monthly gross income).

Activity: To determine your front-end ratio, you can use this work sheet.

Question: *Do you have any questions about the Front-End Ratio?*

Transition Statement: You also may notice that this work sheet includes a formula for a back-end ration. Let's discuss this calculation.

Activity: Distribute the *Front-End / Back-End Ratio* Work Sheet.

Participant questions.

Key Points**For Educator: What to Say****For Learner:****Slide #15:
PITI – Back-End Ratio**

Equal to or less than:
33% - 36% Monthly Income

Example:

Monthly Gross Income = \$2,500

$\$2,500 \times 33\% = \825

$\$2,500 \times 36\% = \900

\$900 = Your mortgage (\$700) and all other long-term debt should not exceed this amount.

Explain: Lenders will usually require your PITI *plus long-term debt* (the debts discussed earlier: credit cards, school loans, child support, bank loans) to be less than or equal to 33% -36% of your monthly gross income. This is considered the back-end ratio.

Example:

Consider the same family whose monthly gross income is \$2,500 (\$30,000 Annual Household Income). 33% of their income would equal \$825. 36% of their income would equal \$900. This family should not commit to more than \$900 per month for a house payment and all other long-term debts.

Activity: To determine your back-end ratio, you can use this same worksheet.

Question: *Do you have any questions about the Back-End Ratio?*

Transition Statement: Using these calculations, you should be able to determine an estimate of how much you can afford for a house. Two other important considerations are your down payment and closing costs. These are upfront costs not included in your mortgage payment. Let's discuss each of these in more detail.

Participant questions.

Key Points**For Educator: What to Say****For Learner:****Slide #16:
Upfront Cost****Down Payment**

The difference between the cost of the house and the amount financed.

Closing Costs

Fees associated with purchasing a house and applying for a mortgage loan.

Explain: The down payment is the difference between the cost of the house and the amount financed. The amount depends on the type of finance programs available (which we will talk more about in the following lesson, *Shopping For a Mortgage*).

Different people look for different down payment options. Some make a higher down payment to keep their mortgage payment lower while others may not have the money available for larger down payments.

The closing costs are fees associated with purchasing a house and applying for a mortgage loan. Closing costs vary depending on the type of loan and services provided. We will be covering closing costs in more detail in *The Mortgage Process Lesson*.

**Slide #17:
Upfront Cost
Example #1**

House = \$100,000

Financing 98% = \$98,000

Down Payment = \$2,000

Estimated Closing Cost: \$2,400

Upfront Cost = \$4,400

Explain: To give you an idea of how much money you will need up front when purchasing a house, let's consider these three examples.

Example #1:

If you purchase a \$100,000 house and decide to finance 98% of the house (\$98,000), you would need a down payment of \$2,000. Your closing costs would consist of the fees associated with processing your loan. In this scenario, using the information provided, we could estimate that the loan closing costs to be about \$2,400.

Key Points

For Educator: What to Say

For Learner:

<p>Slide #18: Upfront Cost Example #2</p> <p>House = \$100,000 Financing 80% = \$80,000 Down Payment = \$20,000 Estimated Closing Cost: \$2,400</p> <p>Upfront Cost = \$22,400</p>	<p>Explain: You may want to have a larger down payment for your house purchase in order to keep your mortgage payment lower, lower your interest rate or decrease your fees.</p> <p>Example #2: If you purchase a \$100,000 house and decide to finance 80% of the house (\$80,000), you would need a down payment of \$20,000. Your closing costs would again consist of the fees associated with processing your loan and could reasonably be estimated at \$2,400.</p>	<p>Participant questions.</p>
<p>Slide #19: Upfront Cost Example #3</p> <p>First Time Homebuyer Programs</p> <p>House = \$100,000 Financing 100% = \$100,000 Down Payment = \$0 Estimated Closing Cost: \$2,400</p> <p>Upfront Cost = \$2,400</p>	<p>Explain: Finally, there are special First Time Home Buyer Programs that allow you to finance 100% of your house and require no down payment. With this loan option, you are required to pay only the closing costs up front.</p> <p>Example #3: Your closing costs would again consist of the fees associated with processing your loan, estimated at \$2,400.</p> <p>Question: <i>Do you have any questions about down payments or estimated closing costs?</i></p> <p>Transition Statement: In the next lesson, we will cover different financial institutions and loan options available, which will allow you to take the next step in the <i>Home</i></p>	<p>Participant questions.</p>

Key Points**For Educator: What to Say****For Learner:**

<p>Slide #20: Summary</p> <ul style="list-style-type: none">• Defined the Four “Cs” of the Loan Process• Determined How Much You Can Afford for a House• Calculated Front-End/Back-End Ratios• Defined Upfront Cost Associated with Buying a House	<p><i>Buying Process: Shopping for a Mortgage.</i></p> <p>Lesson Summary: Congratulations! You have completed <i>Financial Options</i> in this Home Buying Process series of classes.</p> <p>Today we have defined the Four “Cs” of the loan process, determined how much you can afford for a house and calculated your front-end and back-end ratios. We have also defined upfront cost associated with the home buying process.</p> <p>Question: <i>Are there any questions?</i></p>	<p>Participant questions.</p>
--	---	-------------------------------