HUD Housing Counselors Training

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MODULE 2.1 HOUSING AFFORDABILITY/RENTING VS. BUYING

MODULE INTRODUCTION

MODULE INTRODUCTION

Housing counselors can help clients determine what type of housing is most appropriate for them, depending on their circumstances. In this module, you'll learn to calculate front-end (housing) and back-end (debt-to-income) ratios. using information about income and credit.

You'll also learn to evaluate the benefits and drawbacks of renting versus owning a home, including scope of payments, upfront costs, and tax implications.

LESSON OBJECTIVES

By the end of this module, you'll be able to:

1. Determine annual and monthly income for clients with various pay schedules and incomes and determine expenses based on documentation provided and a credit report.

2. Calculate a client's maximum housing payment, including PITIA for mortgages and rent/insurance for renting.

3. Calculate a client's back-end ratio to determine if high debt is an obstacle to meeting housing goals.

4. Apply knowledge of the Four C's of Credit (character, capacity, capital, and collateral) to client information to predict whether a client is likely to be approved for a mortgage loan or rental housing application.

5. Evaluate various housing options for a client when summarizing the costs and benefits of renting versus purchasing a home.

6. Apply knowledge regarding the funds a homeowner needs at the close of escrow for a home purchase and the funds a renter must come up with to sign a lease.

INTRODUCTION TO A HOUSING COUNSELING SESSION

Recall from Module 1 how Rebecca, an experienced housing counselor, coached her client, Stella, on financial management strategies.

In this module, we will look in on a subsequent session with Rebecca and Stella.

Before we do so, take a moment to review the notes in Stella's file from a prior session with Rebecca, as well as her Client Action Plan.

Stella

- She has two children and is divorced.

- She owns a cleaning business.

- She lives with her uncle and his family in their small apartment.

- She was denied a loan from a lender once and is now trying to improve her credit.

Client Action Plan		
File #: 000HUD123	**Counselor:** Rebecca	**Client Name:** Stella
Date: January 10, 2020	**Purpose of Visit:** Financial Counseling	
Housing Goal(s): 1. Pay off debt in six months 2. Save for a down payment to buy a house in about a year 3.		
Obstacle(s): 1. No savings 2. No money left in budget to contribute to down payment fund 3. Credit card debt		

Financial Snapshot:		Income Summary:	
Current Credit Score	---	o	Full Time Employment
Current Savings	$0	o	Part Time Employment
Gross Monthly Income (GMI)	$2,000	x	Self-Employment
Net Monthly Income	$2,000	o	Child Support
Current Monthly Expenses	$1,975	o	Spouse/Partner Employ
Monthly Debt Obligations	$358	o	Pension
Discretionary Income Left Over	$25	o	Retirement/Soc Sec
Current Mortgage/Rent	$150	o	Other
Front-end Ratio	*7.5%*		
Back-end Ratio	*25.4%*		

Housing Preferences:	*Needs*	*Wants*
Types & Features	n/a	n/a
Location	n/a	n/a

Counselors Actions/Tasks and Time Frames:
1. Follow up with Stella to review progress (by February)
2.
3.

Client Actions/Tasks and Time Frames:
1. Make budget adjustments to save $325/month, using strategies to increase income and reduce spending (beginning immediately)
2. Save tax refund toward fund for down payment (by April)
3. Pay down $300 of credit card debt (by July)
4. Save $5,000 for down payment on home (within one year)

Referrals:
1. Financial Management course—800.123.SAVE
2.
3.

Next Appointment:

Client Signature: *Stella*   **Date:** January 10, 2020

Counselor Signature: *Rebecca*   **Date:** January 10, 2020

RENTING VS. BUYING

During the first part of this session, we'll observe how Rebecca:

- Assists a client to evaluate housing options.

- Summarizes the benefits, responsibilities, and drawbacks of renting and buying.

- Outlines the upfront costs and recurring costs associated with renting and buying.

Let's enter their session.

REBECCA. I'm glad to see you again, Stella. Last time we met, we determined a few strategies for increasing your income and decreasing your expenses. Have you been able to apply those strategies?

STELLA. Well, after our last session, I started receiving child support so was able to increase my

Stella, a Client, and Rebecca, a Counselor

income without making the adjustments to increase my savings. I did, however, apply the strategies we discussed to decrease my expenses. So, I am on track with my goals for paying off my debt and saving for a down payment.

REBECCA. Great! Let's begin filling out a new Client Action Plan and record the changes in your income due to the child support. Then, we can begin to figure out if you can afford to buy a home.

REBECCA. So, there are two options that will allow you to move out of your uncle's home—renting or buying. Previously, you said you wanted to buy, but I suggest we compare both options before you make a decision.

STELLA. Well, I'd really like to buy rather than rent. I want to decorate the place how I want, and have a more permanent home for us to settle in and a more permanent school for my kids.

REBECCA. While there are many benefits to buying, there are other factors to consider. Let's take a closer look at the benefits, responsibilities, drawbacks, and costs associated with buying and renting.

STELLA. Okay.

Renting

Benefits

- Defer most repair, maintenance, and yard work responsibilities and expenses to the landlord.
- Avoid the hassle of paying bills for utilities (sometimes) and property taxes (always).
- Maintain greater flexibility to move if circumstances change (e.g., uncertainty about a neighborhood, fluctuations in income, or other reasons).

Responsibilities

- Pay rent on time.
- Comply with the rules and guidelines that govern your lease.
- Carry out reasonable care of the property such as changing light bulbs, testing fire alarms, and other tasks as outlined in the rental agreement.

Drawbacks

- Cannot build equity.
- Have limited control over decorating and major changes to home systems.
- Forfeit the opportunity for tax benefits, such as deductions for mortgage interest, mortgage insurance premiums, loan discount points and/or origination fees, and state or local property taxes, among other potential benefits.

Upfront Costs

You may incur the following expenses upon signing a lease to rent:

- Application fee
- Security deposit—returned to the tenant at the end of the rental period if all of the rental requirements are met
- First and last month's rent
- Pet deposit for pet owners

Recurring Costs

As a tenant, you may incur most, if not all, of the following recurring expenses:

- Rental payment
- **Renters insurance**
- Monthly cable and utilities fees

Buying

Benefits

- Obtain greater control over decisions related to living environment.
- Settle into a community and school system.
- Avoid home inspections by landlords or other authorities.
- Modify home to suit personal preferences.
- Qualify for tax benefits, such as deductions for mortgage interest, mortgage insurance premiums, loan **discount points** and/or origination fees, and state or local property taxes, among other potential benefits.
- Build **equity** by making monthly payments.

Responsibilities

- Make monthly mortgage payments to avoid the risk of **default** and **foreclosure**.
- Uphold standards and rules set forth by communities or homeowner associations.
- Carry out and/or fund home repair projects, maintenance tasks, and yard work.

Renters Insurance

An insurance policy that provides coverage for damages, within a rental property, to renters' belongings and liability. Additionally, it can offer protection to renters for losses resulting from liability claims from accidents occurring on the property that are not caused by property structural problems.

Discount Points

A type of pre-paid interest normally paid at closing and generally calculated to be equivalent to 1% of the total loan amount. The borrower pays them to reduce the interest rate on a loan. You can purchase a lender-determined number of discount points to give you a lower rate and lower monthly mortgage payment.

Equity

Value of ownership interest in property. Determined by the difference between the fair market value of a property and the remaining mortgage balance owed.

Foreclosure

A legal process in which mortgaged property is sold to pay the loan of a defaulting borrower. Foreclosure laws are based on the statutes of each state.

Default

The inability to make timely payments or fulfill legal obligations of loan terms. Mortgage loans are typically considered in default when a payment has not been made after 60 to 90 days.

Drawbacks

- Bear the risk of property value degradation due to market crashes and other causes.
- Limit flexibility of relocation, as selling a home is more complicated than terminating a lease.
- Accept the liability of accidents on your property.

Upfront Costs

You may incur the following expenses during the purchase process or at the close of **escrow**:

- **Down payment**
- **Closing costs**
- Lender fees
- Discount points
- Title insurance
- Home inspection fees
- Escrow deposit
- Property taxes (for multiple months)
- Private mortgage insurance (for multiple months)
- Attorney's fees
- Costs associated with transporting and placing a new manufactured home or relocating an existing one

There are many factors to consider when calculating closing costs. While some costs are based on the purchase price (e.g., title insurance, realty transfer tax), others are based on the loan amount (e.g., loan origination fees, prepaid interest). Generally, closing costs average between 3 to 4% of the home purchase price but are based on a variety of factors and may be higher or lower. For example, a $200,000 home would typically have closing costs ranging from $6,000 to $8,000.

Escrow

Funds to be used for specific purposes by parties carrying out a mutual transaction, deposited with a third party. Commonly used by lenders to allocate funds for a homeowner's property taxes, insurance premiums, or other fees when they become due.

Down Payment

A cash payment that homebuyers are typically required to pay when closing on a home loan, which represents a percentage of the total price of the home.

Closing Costs

Fees for final property transfer that are not included in the price of the property. Typical closing costs can include loan origination fees, discount points, appraisal fee, survey, title insurance, legal fees, real estate professional fees, prepayment of taxes and insurance, etc. While closing costs often range from 3 to 4% of the purchase price of the home, they can be lower or higher, depending on geographic region or loan type.

Recurring Costs

As a homeowner, you may incur most, if not all, of the following recurring expenses:

- Mortgage payment
- Maintenance tasks
- Home repairs
- Home system replacements
- Property taxes
- **Homeowners insurance**
- Monthly cable and utilities fees

> **Homeowners Insurance**
>
> An insurance policy that can provide coverage for damages to a dwelling and contents that belong to the homeowner. Additionally, it can offer protection to homeowners against losses resulting from liability claims from accidents occurring on the property. Homeowners insurance is mandatory for most homeowners with mortgages to obtain.

KNOWLEDGE CHECK 1

Based on the simple information you are given about each of Rebecca's clients, determine which housing option appears best for them. In the space before each line, write "A" for renting and "B" for buying.

____ 1. Bob is averse to financial risks.

____ 2. Jan has saved a significant amount of money in order to comfortably pay a down payment and closing costs.

____ 3. Jenny really enjoys interior design and would like to make her home exactly how she wants it.

____ 4. Rachel takes great satisfaction in doing her own home repairs.

____ 5. Jimmy has a nine-month contract with his current job.

____ 6. Eva has heard that the neighborhood where she is looking at houses does not have the best schools, but she wants to give it a try.

____ 7. Ben is meticulous in his taxes and strives to get any tax deduction possible.

KNOWLEDGE CHECK 2

If Rebecca's client, Ben, obtains a mortgage for a home that costs $90,000, which is the most likely amount that he will pay for closing costs?

A. $1,000
B. $3,500
C. $7,000
D. $10,000

KNOWLEDGE CHECK 3

Review each statement to determine if it is true or false based on what you know about the upfront costs of renting and buying. For those that are true, place a "T" before the statement. For those that are false, place an "F" before the statement.

____ A. Renters generally pay a security deposit upon signing a lease.
____ B. The average cost due upon signing a lease for a rental is typically 20% of the monthly rent.
____ C. Closing costs are typically comprised of lender fees, discount points, title insurance, home inspection fees, escrow deposit, property taxes, private mortgage insurance, and attorney's fees.
____ D. A client who desires to purchase a home that costs $150,000 could be required to pay $7,000 in standard closing costs.

CALCULATING FRONT-END RATIOS

CALCULATING FRONT-END RATIOS

Let's return to the counseling session with Stella to see how Rebecca:

- Determines if a property is affordable for a client to purchase.

- Figures out a client's monthly income.

- Estimates a client's potential monthly housing expenses.

- Calculates a client's housing affordability using front-end ratios.

STELLA. I don't have any home repair skills or enough savings for a down payment and closing costs. I also have been considering moving closer to my sister in Florida. So, I can see how renting could be a better fit for me now. However, I already have my heart set on buying a unit in the new townhome complex being built down the street from me.

REBECCA. I suggest we first determine if the townhome complex is affordable for you. Do you know what the average price of a unit will be?

STELLA. I think it was somewhere around $95,000.

Rebecca then helps Stella calculate what her front-end ratio would be if she bought a townhome in the new community. The front-end ratio represents the percentage of gross monthly income a client spends or plans to spend on monthly rent or mortgage payments. It is also known as the housing ratio. You calculate a front-end ratio using the following formula:

$$\text{Front-end ratio} \quad = \quad \frac{\text{Monthly housing expenses}}{\text{Gross monthly income}}$$

Let's learn about each component of the formula; then, we'll see the calculations for Stella's front-end ratio.

Front-End Ratio

Homeowners

Typically, a front-end ratio of 28% is considered affordable for homeowners obtaining a **conventional loan**. A front-end ratio guideline for homeowners obtaining an FHA loan is 31%, though exceptions are possible if clients meet certain criteria. Thus, clients who are considering buying can focus their home search on properties that allow them to maintain a front-end ratio equal or less than 28%, or 31%, depending on their loan type.

Renters

Typically, a front-end ratio of 30% is considered affordable for renters. Thus, clients who currently rent and have a ratio greater than 30% could benefit from relocating to a more affordable rental property.

Monthly Housing Expenses

Homeowners

Monthly housing expenses for homeowners, commonly referred to collectively as PITIA, include:

- **Principal**
- **Interest**

Front-End Ratio

A rate that calculates a borrower's housing expenses as a percentage of gross monthly income. Used by counselors to measure client housing affordability. Frequently used by lenders to qualify borrowers for a mortgage. Also called a housing ratio.

Conventional Mortgage Loan

A mortgage loan backed by private lenders. Conforming conventional loans follow lending rules set by the Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac). Non-conforming conventional loans fall outside the guidelines, so they cannot be sold to Fannie Mae or Freddie Mac. Though not insured by any government program, loans with a down payment less than 20% of the purchase price may require private mortgage insurance.

Principal

The amount of money borrowed to buy a house or the amount of the loan that has not been paid back to the lender. This does not include the interest paid to borrow that money. The principal balance is the amount owed on a loan at any given time. It is the original loan amount minus the total repayments of principal made.

Interest

Part of a mortgage payment. Interest is the interest rate the bank charges you for borrowing their money.

- **Taxes**

- Insurance (homeowners insurance and **mortgage insurance premiums** or **private mortgage insurance**, as applicable)

- **Association dues** and special assessments

Monthly housing expenses may also include:

- **Ground rent**

- Payments for any acceptable secondary financing

Renters

Monthly housing expenses for renters include:

- Monthly rent

- Renters insurance

Gross Monthly Income

Gross income refers to money earned before taxes and other deductions. Clients may have a variety of pay schedules and sources of income. To determine a client's gross monthly income:

1. Identify the client's pay schedule for each source of income. Sources may include employment, Supplemental Security Income (SSI) and/or Social Security Disability Insurance (SSDI), pension or other retirement benefits, family support, including child support and alimony, public assistance, or income from a second job.

2. Select the appropriate calculation for gross monthly income for each source of income based on its pay schedule.

3. Perform the calculation for gross monthly income for each source of income.

4. Add all products together to determine a client's gross monthly income.

Taxes

Property taxes charged by the municipality in which your home is located. Proceeds pay for education, law enforcement, and other services. These are mandatory and typically cost 1% of the value annually, though the tax rate can vary depending on geographic region.

Mortgage Insurance Premium

A monthly payment, usually part of the mortgage payment for FHA loans, paid by a borrower for mortgage insurance.

Private Mortgage Insurance

Insurance policy that protects a lender from potential risks when a homebuyer pays less than 20% for a down payment. Although the policy protects the lender and is typically selected by the lender, the homebuyer is responsible for the monthly payment.

Ground Rent

Money paid by a tenant to a landlord when the tenant owns the dwelling or structure but does not own the land on which the dwelling is situated. In such cases, the tenant may take out a loan to purchase the dwelling, but must also pay rent for the land. Also called lot rent.

Association Dues

Charged by community or Homeowners Association to pay for repairs, upkeep, landscaping, improvements, and property management.

Gross Monthly Income		
Pay Schedule	**Calculation for Gross Monthly Income**	**Example (rounded to the dollar)**
Hourly	Total hourly pay before deductions × hours per week × 52 weeks per year ÷ 12 months	$10/hr x 35 hrs × 52 weeks ÷ 12 months = $1,517
Weekly	Total weekly pay before deductions × 52 ÷ 12	$750 × 52 weeks × 12 months = $3,250 monthly
Bi-weekly	Total bi-weekly pay before deductions × 26 ÷ 12	$1,000 x 26 ÷ 12 = $2,167 monthly
Semi-monthly	Total semi-monthly pay before deductions × 2	$1,200 × 2 = $2,400 monthly
Monthly	Total monthly pay before deductions	No calculation needed
Self-employed	Average **adjusted gross income**, or AGI, from tax returns and/or Profit and Loss Statement, or P&L, as applicable ÷ the number of months of income counted (See below for further information on determining income for self-employed clients.)	$70,587 ÷ 24 = $2,941 monthly

Note: Some clients receive irregular income, from a seasonal or part-time job. For these clients, you can calculate the average monthly income or utilize the appropriate pay schedule based on receipt of income. For example, if a client is paid every week but the number of hours worked per week varies, it is helpful to calculate gross income based on the hourly rate instead of the weekly rate. To do this, determine the average number of hours worked each week and then use the hourly pay schedule calculation to determine the gross monthly income.

CALCULATING INCOME FOR SELF-EMPLOYED CLIENTS

Let's take a closer look at determining gross monthly income for borrowers who are self-employed. Lenders determine income for self-employed borrowers based on income history. In these cases, income is calculated using average **adjusted gross income**, or AGI, from the previous two years of tax returns. In certain circumstances, calculations also include income from **profit and loss statements**, or P&L statements.

For FHA loan underwriting purposes, a borrower with a 25% or greater ownership interest in a business is considered self-employed. Basic types of business structures include sole proprietorships, corporations, limited liability or "S" corporations, and partnerships. The following criteria apply for self-employed borrowers.

> **Adjusted Gross Income**
>
> Gross income minus adjustments, or reductions, that one is eligible for, such as deductions for unreimbursed business expenses, tuition and fees, and contributions to certain retirement accounts.

> **Profit and Loss Statements**
>
> A summary of revenue, costs, and expenses incurred during a defined period, such as a fiscal year.

Period of Self-Employment

- If two years or more, then income is considered stable and effective.

- If between one and two years, then the borrower must have at least two years of documented previous employment in an equal or similar line of work.

- If less than one year, then income may not be considered.

Documentation Required

- Most recent two years of individual tax returns, with all applicable tax schedules.

- Year-to-date P&L statement and balance sheet.

- Self-employment borrowers may also need to submit business income tax returns, as applicable. Corporations and "S" corporations may need to submit a business credit report.

P&L Statement Details

- If a borrower files quarterly tax returns, then the income analysis may include income through the period covered by the tax filings. If not, then the income shown on the P&L statement may be included in the analysis, provided the income stream based on the P&L is consistent with previous earnings.

- If the current P&L statements show income considerably greater than what is supported by the previous year's tax returns, the lender must base the income analysis solely on the income verified through the tax returns.

- If the borrower's earnings trend for the previous two years is downward and the most recent tax return of P&L is less than the prior year's tax return, the borrower's most recent year's tax return or P&L must be used to calculate his/her income.

EXAMPLE FRONT-END RATIO CALCULATION

During their first meeting, Rebecca calculated Stella's front-end ratio based on the rent she pays to her uncle and documented it in the Client Action Plan on page 5, using the formula below:

To determine what Stella's front-end ratio would be if she purchased the $95,000 townhome, Rebecca uses Stella's updated financial information and makes a few assumptions about the loan Stella might obtain.

In Rebecca's example, Stella will try to qualify for a 30-year fixed rate FHA loan with a 4.2% interest rate. She will make a down payment of 3.5%, leaving a loan amount of nearly $92,000. Stella and Rebecca take the following steps to calculate Stella's front-end ratio.

Front-end ratio = $150 (Monthly housing expense) / $2,000 (Gross monthly income)

Front-end ratio = .075

Front-end ratio = .075 x 100

Front-end ratio = 7.5%

Calculating Stella's Front-End Ratio

Step 1—Calculate Stella's Monthly Housing Expenses

Add all monthly expenses for townhome

$450	princial and interest (calculated using an online mortgage loan calculator)
$110	property taxes
$65	MIP (factored from 0.85 rate)
$25	homeowners insurance
+ $60	homeowners association dues
= $710	monthly housing expense

Note: Mortgage insurance premium, or MIP, rates may change. Visit the FHA Resource Center at HUD.gov to find current rates. See Module 2.2 for more in-depth information about MIP.

Step 2—Calculate Stella's Gross Monthly Income

Documentation needed:

- Stella's individual tax returns for the previous two years. (As the owner of a sole proprietorship, Stella does not file business returns.)

- Stella's year-to-date P&L statement for the current year. (She has not yet needed to file quarterly income taxes.)

- Child support deposit slips and court order outlining that child support will be required for no less than five years.

Note: After securing child support, Stella stopped pursuing efforts to make and sell jewelry for extra income. She does earn more after increasing her rates at her cleaning business, but she does not yet have the income history to support the higher earnings amount.)

Step A

Calculate Stella's average gross monthly income from her self-employment earnings.

Formula: Average gross monthly income = Adjusted gross income ÷ number of months of income counted

Average gross monthly income = (AGI 2019 + AGI 2020) ÷ 24

Average gross monthly income = ($25,050 + $22,950) ÷ 24

Average gross monthly income = $2,000

Step B

Calculate Stella's average monthly income from her child support.

Formula: Average gross monthly income = Monthly amount

Average gross monthly income = $350

Step C

Calculate Stella's total gross monthly income by adding the totals of both income sources together.

Formula: Total gross monthly income = Self-employment + Child support

Total gross monthly income = $2,000 + $350

Total gross monthly income = $2,350

Step 3—Calculate Stella's Front-End Ratio

Step A

Calculate Stella's front-end ratio.

Formula: Front-end ratio = Monthly housing expenses ÷ Gross monthly income

Front-end ratio = $710 ÷ $2350

Front-end ratio = 0.302

Step B

Convert the integer into a percentage.

Formula: Front-end ratio percentage = Integer x 100

Front-end ratio percentage = 0.302 x 100

Front-end ratio percentage = 30.2%

Result

If Stella were to purchase the townhome, her front-end ratio would be 30.2%, which qualifies under the FHA maximum guideline of 31%. A conventional loan may not be an option for her, as conventional loans often have a 28% maximum front-end ratio.

KNOWLEDGE CHECK 4

A couple, the Smiths, recently scheduled a meeting with Rebecca. They have owned their home for seven years and have accumulated some equity in the home. However, they are now struggling to pay their mortgage, because the wife left her full-time job when she had a baby. Her husband's salary is paid in installments of $900 a week, which are subject to deductions and other withholdings. Each month, they pay $1,000 in principal and interest, $110 for taxes, $130 for insurance, and $20 in homeowners assessments.

What is their current front-end ratio (as a whole number with no decimal point)?

A. 32%
B. 30%
C. 28%
D. 26%

MAXIMUM MONTHLY HOUSING PAYMENT

REBECCA. Looking at your numbers, your estimated front-end ratio would be 30.2%. So, the townhome should be affordable with an FHA loan. However, since you are not certain that you want to accept the responsibilities of homeownership, let's determine what you can afford to pay for a rental.

STELLA. That's a good idea. I could search online to see if there are any rentals in my price range that I like as much as the townhome.

To determine how much monthly rent Stella can afford to pay, Rebecca uses the following formula:

$$\text{Maximum monthly housing expense} = \frac{\text{Total monthly debt expenses}}{\text{Gross monthly income}}$$

Calculating Stella's Maximum Affordable Monthly Housing Expense

Step 1—Calculate Stella's Gross Monthly Income

Recall earlier steps taken to calculate Stella's gross monthly income. Rebecca adds Stella's self-employment earnings and her monthly child support for a total gross monthly income of $2,350.

Step 2—Calculate Stella's Maximum Affordable Monthly Housing Expense

Step A

Convert the front-end ratio for renters from a percentage to an integer. Recall that the maximum front-end ratio for renters is 30%.

Formula: Front-end ratio (rental) = % ÷ 100

Front-end ratio (rental) = 30% ÷ $100

Front-end ratio (rental) = 0.30

Step B

Calculate the maximum affordable monthly housing amount using the maximum front-end ratio and Stella's gross monthly income.

Formula: Maximum affordable monthly housing expense= Front-end ratio (rental) x Gross monthly income

Maximum affordable monthly housing expense = 0.30 x $2350

Maximum affordable monthly housing expense = $705

Result

Rebecca determines that Stella's maximum affordable monthly housing expense is $705 a month.

KNOWLEDGE CHECK 5

One option that Rebecca suggests to the Smiths is to sell their home and rent a home that is smaller and more affordable. If the Smiths decide to do this, they will no longer have a mortgage, so what is the maximum amount that they can afford to pay in rent and renters insurance each month?

Tip: Recall that the husband's salary is paid in installments of $900 a week, which are subject to deductions and other withholdings.

A. $870
B. $1,092
C. $1,152
D. $1,170

KNOWLEDGE CHECK 6

If the Smiths sell their home and purchase a more affordable property, what is the maximum amount that is affordable for the Smiths to pay in PITIA each month if they obtained a conventional loan?

Tip: Recall that the husband's salary is paid in installments of $900 a week, which are subject to deductions and other withholdings.

A. $870
B. $1,092
C. $1,152
D. $1,170

CALCULATING BACK-END RATIOS

CALCULATING BACK-END RATIOS

Now, we will return to the session with Stella where Rebecca:

- Calculates a client's back-end ratio.

- Introduces factors used to determine who will be approved for a mortgage loan or rental housing application.

REBECCA. Based on our calculations, you can afford to spend up to $705 a month on a rental property or up to $728.50 monthly on an FHA mortgage if you choose to buy. If you are interested in qualifying for a conventional mortgage, you might consider a home with a lower purchase price, review opportunities to increase your income, or save for a larger down payment.

STELLA. I'm glad I had your help calculating my front-end ratios. That was very informative.

REBECCA. This may not be the last time you hear about front-end ratios. If you decide to buy a home and begin to shop around for a loan, lenders will also calculate your front-end ratio to make sure you can afford the loan.

STELLA. During our last session we talked about credit and the importance of improving my credit to get approved for a loan. So, lenders look at both my credit score and the front-end ratio? Is there anything else they look at?

REBECCA. Yes. Lenders will also calculate what is called a **back-end ratio**, or **debt-to-income ratio**, and will assess additional details of your credit history—specifically the Four C's of Credit.

STELLA. First, can you explain what a back-end ratio is?

REBECCA. Sure. It is a ratio that compares the total of all pertinent monthly debt payments (e.g., mortgage, real estate taxes and insurance, car loans, and other consumer loans) to gross monthly income. Let's see what yours would be if you bought the townhouse.

> **Back-End Ratio**
>
> A rate that calculates a borrower's total monthly debt, including housing and other debt obligations, as a percentage of gross monthly income. Frequently used by lenders to qualify borrowers for a mortgage. Also called a debt-to-income ratio.

Rebecca helps Stella calculate her back-end ratio, a calculation lenders will do if she applies for a loan using the following formula:

$$\text{Back-end ratio} = \frac{\text{Total monthly debt expenses}}{\text{Gross monthly income}}$$

Let's learn about each component of the formula and then determine Stella's back-end ratio.

Back-End Ratio

Homeowners

Though the maximum back-end ratio for conventional loans was traditionally 36%, limits can increase to 45% depending on the loan product. Eligible clients who meet specific criteria may even qualify for certain mortgage products with back-end ratios as high as 50%.

Back-end ratio guidelines for clients with an FHA loan or Energy Efficiency Mortgage loan can stretch to 43% and 45%, respectively. However, lenders can make exceptions provided that clients meet certain criteria and demonstrate ability to repay the loan.

Renters

Rental agencies or landlords may deny potential renters if the monthly rent creates a back-end ratio greater than 36%, though it is very common to allow a higher ratio.

Total Monthly Debt Expense

Typically, the expenses included in the back-end ratio calculation are loan payments, recurring debt payments, and housing expenses.

Examine a client's credit report to identify critical information, such as debt obligations or other debt expenses, including:

- Monthly car loan obligations
- Monthly student loan payments
- Minimum credit card payments
- Monthly alimony obligations (outgoing)
- Monthly child support payments (outgoing)
- Estimated monthly housing expenses (PITIA) or rent and renter's insurance

And add all debt obligations and housing expenses together.

Note: The regulations defining the type of loan product that a client obtains will determine which of the loan obligations an underwriter will consider when calculating monthly debt expenses. For example, when reviewing applications for FHA loans, underwriters will only consider:

- *Estimated monthly housing expenses (PITIA)*
- *All debt payments that are on revolving or open-ended accounts*
- *All closed-ended debts with recurring payments that extend ten months or more*
- *All debt payments that will affect the borrower's ability to pay the mortgage during the months immediately after loan closing*

Gross Monthly Income

Recall the earlier steps taken to calculate gross monthly income. Also, refer to the Gross Monthly Income Formulas chart found in the Resources section. Remember to identify all sources of income.

Now, using the back-end ratio formula, let's calculate Stella's back-end ratio.

CALCULATING STELLA'S BACK-END RATIO

Step 1—Calculate Stella's Monthly Debt and Housing Expenses

Identify the following debt expenses on Stella's credit report and estimated housing expenses and add them together.

$308 monthly car loan obligation
$27 minimum credit card payment for card #1
$23 minimum credit card payment for card #2
+ $710 monthly PITIA
_____

= $1,068 monthly debt and housing expenses

Step 2—Calculate Stella's Gross Monthly Income Calculation

Recall the earlier steps taken to calculate Stella's gross monthly income. Rebecca adds Stella's self-employment earnings and her monthly child support for a total gross monthly income of $2,350.

Step 3—Calculate Stella's Back-End Ratio

Step A

Plug Stella's figures into the back-end ratio formula.

Formula: Back-end ratio = Total monthly debt and housing expenses ÷ Gross monthly income

Back-end-ratio = $1,068 ÷ $2,350

Back-end-ratio = 0.454

Step B

Convert the integer into a percentage.

Formula: Back-end ratio percentage = Integer x 100

Back-end-ratio percentage = 0.454 x 100

Back-end-ratio percentage = 45.4%

Result

If Stella were to purchase the townhome, her back-end ratio would be 45.4%, which exceeds the qualifying FHA limit of 43%. Given Stella's limited funds for a down payment, she would not likely qualify for a conventional loan with her back-end ratio exceeding 45%.

KNOWLEDGE CHECK 7

The Smiths explain to Rebecca that they've already found a smaller, more affordable home they've considered buying. It would cost them $990 each month in PITIA. Considering they pay $210 in car loan obligations, $50 in student loan payments, and a minimum of $80 total in credit card payments each month, and assuming all of these loan payments will be recurring for more than ten months, what would their back-end ratio be if they purchased the home?

Tip: Recall that the husband 's salary is paid in installments of $900 a week, which are subject to deductions and other withholdings.

A. 40%
B. 38%
C. 36%
D. 34%

KNOWLEDGE CHECK 8

Under special circumstances, what is the highest possible maximum back-end ratio that could qualify for a conventional mortgage?

A. 50%
B. 45%
C. 43%
D. 36%

FOUR C'S OF CREDIT

Now let's return to the session to observe how Rebecca addresses the Four C's of Credit.

REBECCA. Unfortunately, Stella, your back-end ratio is high for both conventional and FHA loans.

STELLA. Oh, no! So even if I decided I wanted to buy the townhome, I can't qualify? I thought I saw something earlier about debt payments. It said that FHA does not consider the recurring payments for closed-ended loans if there are less than ten months of payments remaining. I will pay off my car in only nine months.

REBECCA. I didn't realize it was almost paid off. In that case, if you were to apply for an FHA loan now, a lender would not have to consider your car payment, and your back-end ratio would fall to 32.3%.

However, if you wait to buy a home until after the car is paid off, you will have an extra $308 each month to handle unexpected expenses.

STELLA. Well, that's much better news. I know I need to save more money for a down payment and other costs anyway, so I definitely want to wait until the car loan is completely paid off. What will determine if my credit history is favorable?

REBECCA. The Four C's of Credit are the factors lenders and landlords use to judge whether you are likely to pay your mortgage and eligible for loan approval. Let's take a look at each of these factors.

Character

Lenders will review a borrower's credit history, employment history, and housing stability to determine the likeliness the borrower will repay their debts.

Capacity

Lenders may consider the following indicators to determine a borrower's capacity to repay outstanding debt:

- Consistency of employment and income

- Adequacy of income to repay debt

- Recurring debts

- Frequency and type of wages

Capital

Lenders will inquire about how much money a borrower has saved to pay a deposit or down payment for the home s/he intends to purchase.

Collateral

Lenders will often request a borrower to pledge specific property or assets as collateral to a lender to secure repayment of a loan. For a homebuyer, the collateral is the home s/he is purchasing.

Rebecca explains to Stella that if she decides to obtain an FHA loan, references to the Four C's factors will differ slightly, as follows:

- Credit history

- Capacity to repay

- Cash assets available to close the mortgage

- Collateral

After discussing the Four C's, Stella and Rebecca create a new Client Action Plan, which contains previous information, and includes relevant updates. For example, Stella added the goal: "Decide whether to rent or buy." A client action/task was also added, which will help Stella decide whether to rent or buy: "Attend a First-time Homebuyers Education Course (in April)." By attending this course, Stella will have the opportunity to reflect further on the responsibilities of homeownership and determine if it is the right choice for her.

Client Action Plan		
File #: 000HUD123	**Counselor:** Rebecca	**Client Name:** Stella
Date: March 10, 2020	**Purpose of Visit:** Renting vs. Buying	
Housing Goal(s): 1. Pay off debt in six months (carried over from meeting in January) 2. Save for a down payment to buy a house in about a year (carried over from meeting in January) 3. Decide whether to rent or buy		
Obstacle(s): 1. Limited savings 2. Limited money left in budget to contribute to down payment fund 3. Credit card debt		

Financial Snapshot:		Income Summary:	
Current Credit Score	---	o	Full Time Employment
Current Savings	$600	o	Part Time Employment
Gross Monthly Income (GMI)	$2,350	x	Self-Employment
Net Monthly Income	$2,350	x	Child Support
Current Monthly Expenses	$1,850	o	Spouse/Partner Employ
Monthly Debt Obligations	$358	o	Pension
Discretionary Income Left Over	$500	o	Retirement/Soc Sec
Current Mortgage/Rent	$150	o	Other
Front-end Ratio	*6.4%*		
Back-end Ratio	*21.6%*		

Housing Preferences:	*Needs*	*Wants*
Types & Features	n/a	n/a
Location	n/a	n/a

Counselors Actions/Tasks and Time Frames:
1. Follow up with Stella to review progress (by May)
2.
3.

Client Actions/Tasks and Time Frames:
1. Save tax refund (anticipated to be $1,200) toward fund for down payment (by April–carried over from meeting in January)
2. Pay $50 monthly toward a $300 credit card debt (by July–carried over from meeting in January)
3. Save $5,000 for 5% down payment on home (within one year–carried over from meeting in January)
4. Attend a First-time Homebuyers Education Course (in April)

Referrals:
1. First-time Homebuyers Education Course–800.222.3444
2.
3.

Next Appointment: May 10, 2020

Client Signature: *Stella*   **Date:** March 10, 2020

Counselor Signature: *Rebecca*   **Date:** March 10, 2020

KNOWLEDGE CHECK 9

If the Smiths decide to apply for a new loan to buy the more affordable home, which would support the approval of their application?

A. Insufficient capital to cover the down payment
B. Poor credit history
C. Inconsistent employment
D. High gross annual income

SUMMARY

In this module, you learned to:

1. Determine annual and monthly income for clients with various pay schedules and incomes and determine expenses based on documentation provided and a credit report.

2. Calculate a client's maximum housing payment, including PITIA for mortgages and rent/insurance for renting.

3. Calculate a client's back-end ratio to determine if high debt is an obstacle to meeting housing goals.

4. Apply knowledge of the Four C's of Credit (character, capacity, capital and collateral) to client information to predict whether a client is likely to be approved for a mortgage loan or rental housing application.

5. Evaluate various housing options for a client when summarizing the costs and benefits of renting versus purchasing a home.

6. Apply knowledge regarding the funds a homeowner needs at the close of escrow for a home purchase and the funds a renter must come up with to sign a lease.

KNOWLEDGE CHECK ANSWER KEY

1. **Correct matched items:**

(A) Renting	(B) Buying
1. Bob is adverse to financial risks.	2. Jan has saved a significant amount of money in order to comfortably pay a down payment and closing costs.
5. Jimmy only has a nine-month contract with his current job.	3. Jenny really enjoys interior design and would like to make her home exactly how she wants it.
6. Eva has heard that the neighborhood where she is looking at houses does not have the best schools, but she wants to give it a try.	4. Rachel takes great satisfaction in doing her own home repairs.
	7. Ben is meticulous in his taxes and strives to get any tax deduction possible.

2. **(B) $3,500**

   Closing costs average between 3 to 4% of the home purchase price.

   Incorrect answers: (A) $1,000 (C) $7,000 (D) $10,000

3. **Correct true or false items:**

True	(False)
A. Renters generally pay a security deposit upon signing a lease.	B. The average cost due upon signing a lease for a rental is typically 20% of the monthly rent.
C. Closing costs are typically comprised of lender fees, discount points, title insurance, home inspection fees, escrow deposit, property taxes, private mortgage insurance, and attorney's fees.	

True	(False)
D. A client who desires to purchase a home that costs $150,000 could be required to pay $7,000 in standard closing costs.	

4. **(A) 32%**

   Incorrect answers: (B) 30% (C) 28% (D) 26%—Use the following formulas to arrive at the correct answer:

   Gross monthly income = Total weekly pay before deductions x 52 ÷ 12

   $$Front\text{-}end\ ratio = \frac{Monthly\ housing\ expenses}{Gross\ monthly\ income}$$

   GMI

   = 900 x 52 ÷ 12

   = 3,900

   Monthly housing expenses

   = 1,000 + 110 + 130 + 20

   = 1,260

   Front-end ratio

   = 1,260 ÷ 3,900

   = 0.323 x 100

   = 32%

5. **(D)** $1,170

   Incorrect answers: (A) $870 (B) $1,092 (C) $1,152—An affordable front-end ratio for renters is 30%. Use the following formulas to arrive at the correct answer:

   Gross monthly income = Total weekly pay before deductions x 52 ÷ 12

   Maximum monthly housing expense = Front-end ratio x Gross monthly income

GMI

= 900 x 52 ÷ 12

= 3,900

Maximum monthly housing expense

= 0.3 x 3,900

= 1,170

6. **(B)** $1,092

Incorrect answers: (A) $870 (C) $1,152 (D) $1,170—The standard affordable front-end ratio is 28% for homebuyers with a conventional loan. Use the following formulas to arrive at the correct answer:

Gross monthly income = Total weekly pay before deductions x 52 ÷ 12

Maximum monthly housing expense = Front-end ratio x Gross monthly income

GMI

= 900 x 52 ÷ 12

= 3,900

Maximum monthly housing expense

= 0.28 x 3,900

$$Back\text{-}end\ ratio = \frac{Total\ monthly\ debt\ and\ housing\ expenses}{Gross\ monthly\ income}$$

= 1,092

7. **(D)** 34%

Incorrect answers: (A) 40% (B) 38% (C) 36%—Use the following formulas to arrive at the correct answer:

GMI

Gross monthly income = Total weekly pay before deductions x 52 ÷ 12

= 900 x 52 ÷ 12

= 3,900

Total monthly debt and housing expenses

= 990 + 210 + 50 + 80

= 1,330

Back-end ratio

= 1,330 ÷ 3,900

= 0.341 x 100

= 34%

8. **(A)** 50%

Incorrect answers: (B) 45% (C) 43% (D) 36%—Though the maximum back-end ratio for conventional loans was traditionally 36%, limits can increase to 45% depending on the loan product. Eligible clients who meet specific criteria may even qualify for certain mortgage products with back-end ratios as high as 50%.

9. **(D) High gross annual income**

Incorrect answers: (A) Insufficient capital to cover the down payment—Lenders may request to know how much money a client has saved to pay a deposit or down payment for the home they intend to purchase; (B) Poor credit history—Lenders will review a borrower's credit history, employment history, and housing stability to determine the borrower's financial steadiness; and (C) Inconsistent employment—Lenders may consider the following indicators to determine a client's capacity to repay outstanding debt: consistency of employment and income; adequacy of income to repay debt; recurring debts; as well as frequency and type of wages.

HUD Website

www.hud.gov

Gross Monthly Income Formulas

Pay Schedule	Calculation for Gross Monthly Income	Example (rounded to the dollar)
Hourly	Total hourly pay before deductions × hours per week × 52 weeks per year ÷ 12 months	$10/hr × 35 hrs × 52 wks ÷ 12 months = $1,517 monthly
Weekly	Total weekly pay before deductions × 52 ÷ 12	$750 x 52 wks ÷ 12 months = $3,250 monthly
Bi-weekly	Total bi-weekly pay before deductions × 26 ÷ 12	$1,000 x 26 ÷ 12 = $2,167 monthly
Semi-monthly	Total semi-monthly pay before deductions × 2	$1,200 × 2 = $2,400 monthly
Monthly	Total monthly pay before deductions	No calculation needed
Self employed	Average adjusted gross income, or AGI, from tax returns and/or Profit and Loss Statement, or P&L, as applicable ÷ the number of months of income counted	$70,587 ÷ 24 = $2,941 monthly

HOUSING AFFORDABILITY FORMULAS

Result	Formula	Examples from Stella's Counseling Session	Notes
Front-end Ratio Use when the monthly housing expense and GMI are known to find the client's front-end ratio	Monthly housing expenses ÷ GMI	$710 ÷ $2,350 = .302 Convert to percentage: .302 x 100 = 30.2%	**Stella's Information** Gross Monthly Income (GMI): $2,350 Estimated monthly PITIA: $710 Total monthly debt: $358
Back-end Ratio Use when the total monthly housing, debt expenses and GMI are known to find the client's back-end ratio	(Total monthly housing + debts) ÷ GMI	$710 + $358 debt obligations = $1,068 $1,068 ÷ $2,350 = .454 Convert to percentage: .454 x 100 = 45.4%	
Maximum Monthly Housing Payment Use when the front-end ratio and GMI are known to find the Maximum Monthly Housing Payment a client can afford	Front-end ratio x GMI	**Rental Example** Convert from percentage: 30% ÷ 100 = .30 .30 x $2,350 = $705 **FHA Mortgage Example** Convert from percentage: 31% ÷ 100 = .31 .31 x $2,350 = $710	**Typical Front-end Ratio Maximums** Rent: 30% Conventional mortgage: 28% FHA mortgage: 31%
Maximum Monthly Housing Payment After Debt Use when the back-end ratio, debt payments, and GMI are known to find the Maximum Monthly Housing Payment a client can afford with their debt factored in	(Back-end ratio x GMI) - total monthly debt	**FHA Mortgage Example** Convert from percentage: 43% ÷ 100 = .43 .43 X $2,350 = $1,010.50 $1,010.50 - $358 = $652.50	**Typical Back-end Ratio Maximums** Rent: 36% Conventional mortgage: 36% FHA mortgage: 43% EEM: 45% **NOTE:** Lenders will qualify borrowers using the **LESSER** of the maximum monthly housing payment and the maximum monthly housing payment after debt