Down-payment Strategies: Financing vs. Cash

By: David Hertlein, Private Banking Relationship Manager

Like many types of financial strategies, there is no "one size fits all" approach when considering down payment options for real estate. Strategies can vary all across the board for individuals as they develop a plan that works for their personal goals and financial circumstances.

Individuals and families must look at their overall balance sheet to determine what strategies are the most advantageous to their long-term wealth plan and affordability. In this article, we discuss what one *can* do, but not necessarily *should* do — it's important to consult with a trusted banker and your financial advisor to help develop a plan that is suited to your individual financial circumstances.

Options for Financing a Down Payment

Lenders allow individuals to use borrowed funds secured by an asset to supplement a primary home mortgage loan. You may also use a nontraditional loan for the full purchase price of the home. In this article, we will explore the scenario where these options are used in conjunction with a long-term mortgage loan. These options offer creativity — as well as leverage — for those looking to keep money in the markets or other performing investments.

Once the lender determines how the type of borrowed funds may impact your qualifying and overall financial profile, the loan can be secured by items such as:

- Stocks, bonds, or other marketable securities
- 401(k) accounts
- Real estate (a home equity line of credit [HELOC] on another piece of real estate)
- Non-traditional assets

Each of the above may have additional restrictions, based on the type of funds being used. It's important to discuss this with your banker to ensure your total loan to value, credit rating, and debt service coverage meet the loan policy.

Good to Know ...

"Residential real estate is classified in three major categories: primary residence, second home, and investment property. The classification impacts those terms at which the bank can offer a loan, the minimum amount required for a down payment, and the interest rates a lender will offer you on those loans.

Assuming credit profiles for the borrower are the same, the investment property and second home will have higher risk-based pricing adjustments and re-quire larger down payments, which are set by the lender, or bank offering the loan, or one of the secondary market guidelines issued by the GSEs, Fannie Mae and Freddie Mac. They have determined a borrower is less likely to de-fault on their primary residence than their investments or second homes, therefore making it a less risky investment to the lender.

Non-conforming loans, or "jumbo" loans, also have these risk-based adjustments, and may vary greatly by the bank offering the loan product."

– David Hertlein, Private Banking Relationship Manager

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The advantages of financing a down payment:

- May prevent you from having to liquidate funds from certain investments, which may have an unrealized gain, or not be advantageous due to market performance (such as what we are experiencing currently)
- Allows you to earn the spread between the costs of the short-term loan and the returns on your financial investments
- Allows you to maintain liquidity for higher-cost debt or cash needs for other purposes

The disadvantages of financing a down payment:

- Typically, the loan is on a short term with a variable-base rate, which exposes you to risk should markets and rates change
- May possibly cause you to be over-leveraged in specific debt
- Ties up equity in the real estate, preventing future borrowing and reducing the amount of money you would be returned upon the sale of the asset
- Costs interest to borrow

Using Cash Reserves for a Down Payment

Cash reserves held by the borrower can always be used for a source of funds for the down payment, or equity portion, in conjunction with a primary lien mortgage. The lender verifies the assets in the borrower's accounts to ensure they are not borrowed from another individual or are part of an unsecured loan.

The advantages of making a larger cash down payment:

- Lower initial balance on the loan, typically lower monthly payments on the debt
- Reduces or eliminates private mortgage insurance (80% or less loan to value)
- Typically results in lower interest rates, as more equity is seen as lower risk, and less risk-based rate pricing adjustments
- Immediate equity in the home that can be used for future borrowing needs or as a gain upon the sale of the real estate

The disadvantages of making a large cash down payment:

- Less liquidity to use cash for other expenses, or for additional investments
- Less liquidity to pay off any higher interest-bearing debt (e.g., other loans, such as student loans, practice loans, car loans, etc.)
- Ties up the cash in real estate; can be costly or restricted when trying to obtain funds back via a HELOC or cash-out refinance

Additional Considerations to Keep in Mind

- Secured borrowed funds in the form of a mortgage, HELOC, and a securities-backed line of credit are measurable and typically on standard repayment terms predetermined by the notes that accompany those loans. This is what gives a bank security that those debts will be paid.

- If you are borrowing above 80% of the home's value, you should consider the cost of the additional debt from an interest perspective. You would not want to borrow more for a down payment if the terms caused the blended interest rates to be higher than other liabilities.
- Look at all your debts and identify what's costing you the most, based on APR (annualized percentage rate). It's wise to pay off those higher interest debts before adding more cash to a home purchase. If the interest rate on the mortgage is lower than the interest you pay on other debts, then paying off the higher interest debt first will free up more of your monthly income to go toward the lower-interest mortgage loan.
- Typically, loans with a loan-to-value higher than 80% require lenders engage a private mortgage insurance (PMI) provider to secure a risk-based policy on that loan.
- PMI is a credit and loan-to-value-based premium based on an annual percentage of the loan amount (for example, an estimated .30 basis points up to 1.50%) that can add to your overall cost of credit. It's important to factor that figure into your interest rate and your overall cost of financing.
- If you're a borrower who doesn't have as much saved but has a higher annual income or receives a larger bonus throughout the year, you could consider a higher loan-to-value and a higher payment. You can then apply principal payments throughout the year — monthly, semiannually, or annually, to offset the initial higher loan-to-value. This strategy is often used for a borrower with variable income. That said, it's imperative you have a good understanding of the likelihood your bonus and commission will continue.
- Borrowers on a fixed income or salary may want to make a larger down payment to keep the monthly loan payments lower and avoid PMI.
- When possible, make the largest minimum down payment to ensure that you can secure the lowest rate and fees for the mortgage. This results in a lower APR, based on your credit profile and loan terms.

Next steps

When trying to decide the best down payment strategy for your financial situation, you can encounter many uncertainties associated with the decision-making process. Commerce Financial Advisors are here to help. Call us today.

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David is a private banking relationship manager for Commerce Trust Company. As a member of the private client team and an experienced, tenured private banker, he and his dedicated client support staff are responsible for ensuring each client's experience with Commerce Trust exceeds expectations. David's specific responsibilities include management of our clients' day-to-day banking, cash management, and credit needs, while also helping them navigate the wide array of our financial services to find the solutions that best fit their needs. He joined Commerce in 2022. David earned his Bachelor of Science in Business Administration in finance and economics from Christian Brothers University in Memphis, Tennessee. David serves as Athletics Association Treasurer and Soccer Coach for Our Lady of Lourdes Parish and School and volunteers at St. Louis Area Foodbank/Feeding America.