When buying a new home how are estimated closing costs determined? How are estimated prepaid items/reserves determined?

When obtaining financing for real estate, whether for a purchase or a refinance, estimated closing costs are determined by your lender. In fact once you've provided a loan officer with a complete loan application, they have by law, three days to get you a good faith estimate representing the loan they are proposing.

Estimated closing costs between various lenders will vary substantially which is why it is a good reason to get a couple estimates from competing lenders**.** A competent and experienced broker with a completed application is capable of completing a good faith estimate and determining closing costs. Closing costs will vary depending on the size of the loan, the third party servicers you choose to utilize (title, escrow) and your loan officer's fee for service. Be careful if your lender tells you they are not charging you anything - I don't know anyone that works for free and there are ways to mask commission earned.

There are specific costs associated with every loan. Namely title insurance, escrow or attorney fees, and underwriting fees. How these fees are represented and broken down on independent good faith estimates is where it can get confusing. Escrow fees could include: doc preparation, notary, courier fees, etc... or they may be listed in a single lump sum. This rule is true for both title and underwriting fees as well. Regardless of how the fees are represented, the final number should be overestimated, not under estimated. For this reason having a good faith come in high, or for more than you expected does not suggest you are getting taken advantage of, but rather the broker is doing their diligence to ensure you have been properly informed. These third party fees listed above, will vary between companies but are all close to one another in nature - what I have not discussed yet is the fee for service the originating agent is making for issuing the loan.

There are two ways a loan originator can be compensated: either by the lender, known as lender paid compensation; or by the borrower, known as borrower paid compensation. If you elect the lender paid model the loan originators fee for service is predetermined and cannot be negotiated between borrower and originator. If the borrower elects the borrower paid model, they originator and borrower can negotiate the fee for service, however that fee for service must be paid in full by the borrower and no credit generated from the interest rate can be used towards this expense. For this reason the only way a no cost loan can be accomplished is through the lender paid model of compensation. Regardless of what or how the loan originator is making their fee for service, they should be open and forthcoming in how much they stand to make on the transaction regardless of whether or not the law requires them to disclose it.

As for prepaid items/reserves - these include taxes, insurance, and mortgage insurance (if you have it). The number of months in reserves that is collected at closing will depend on what month it is, and where you fall in relation to the billing cycle associated with taxes, and insurance. An established impound account must have enough capital in it to pay the bills when they come due, so if a 6 month tax bill is due in two months, you will need to deposit 4 months of reserves into the account to establish it at the time of financing. This rule is true for the taxes and mortgage insurance as well. In addition borrowers should expect to pay home owners insurance and property taxes due inside of escrow if they are financing close to the end of the billing cycle. If you tax or insurance bill is due within three months expect to pay your taxes and insurance due inside of escrow when closing.