



# **Lesson 17**



Buying a Home

# Key Terms

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- ▶ Adjustable Rate Mortgage (ARM)
  - ▶ Closing Costs
  - ▶ Condominium
  - ▶ Down Payment
  - ▶ Equity
  - ▶ Fixed Rate Mortgage
  - ▶ Mortgage
  - ▶ Points
  - ▶ Private Mortgage Insurance (PMI)
  - ▶ Single Family Home
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# Owning Versus Renting

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## ▶ **Renting**

- ▶ Most economical approach in **short term**
- ▶ Gives you time to save money toward the purchase of your own place
- ▶ Paying someone else for the privilege of living in their property

## ▶ **Owning**

- ▶ Money you pay every month goes toward something you own
  - ▶ If property value goes up, you get to keep any money from the sale of the property once you pay off any loans for which the property is pledged against
    - ▶ Housing is a safe investment because it should grow in value over time provided you take good care of it.
    - ▶ Can deduct mortgage interest from your taxes.
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# Housing Choices

# Single Family Home

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- ▶ Stand-alone structure
- ▶ Intended to house one family
- ▶ Owner responsible for **maintaining** home and property on which it is located



# Duplex

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- ▶ Look like single-family home
- ▶ Actually **two homes** connected by a middle common wall
- ▶ Each has private entrance
- ▶ Each owner responsible for own side of **property**



# Townhouse

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- ▶ Dwelling that shares **one or two** walls with other residences
- ▶ Normally part of a townhouse **complex**
- ▶ Normally has a **homeowner's association** (HOA) & all residents pay HOA fee
  - ▶ Fee pays for insurance/maintenance of structures, maintenance of common areas
- ▶ Owner responsible for maintenance of interior & all functions (electric, plumbing, HVAC)



# Condominium

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- ▶ Similar to apartments
  - ▶ Several units connected together
  - ▶ Share common walls/floor divisions
- ▶ Often have **common entrances** to building for all residents
- ▶ Normally have HOA (and fee) to pay for same items as townhouse



# How Do I Find a Home?

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## ▶ Real Estate **Agent**

- ▶ Someone who specializes in buying & selling properties
  - ▶ Have access to databases of all available homes
  - ▶ Can help you find potential properties that meet your desires
  - ▶ Can help you negotiate through the buying process
  - ▶ Seller normally pays buyer's agent a commission (percentage of sale price) as fee (2 – 3% on average)
- ▶ Quickest way to find a home



## ▶ **“For Sale By Owner”** (FSBO)

- ▶ Property sold by owner who wishes to avoid paying commissions to buyer’s and seller’s agents (can be 5 – 6% of selling price)
- ▶ Seller will normally provide buyer no assistance in the purchase process
  - ▶ Buyer needs to know what he/she is doing concerning buying a home, or pay an attorney to help with the process

## ▶ **Paper/Internet/Television**

- ▶ Properties listed by agents & FSBO
- ▶ Can get details about property (size, location, pictures, etc.)
- ▶ Can find properties you want your agent to show you (or pursue as a FSBO)



# How Much Home Can I Afford?

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- ▶ Rule of Thumb: don't spend more than **28%** of your monthly pre-tax income on housing costs (mortgage, insurance, taxes, utilities, etc.)
  - ▶ Try to limit overall debt (housing, transportation, student loans, credit cards, etc.) to **36%** of your gross monthly (pre-tax) income
- ▶ Must have solid grasp of your current budget
  - ▶ Current **income**
  - ▶ Current **expenses** (not including housing expenses)



▶ **Must have good understanding of all housing costs you will incur once you purchase property**

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- ▶ Mortgage
- ▶ Property Taxes
- ▶ Property Insurance
- ▶ HOA fees (if any)
- ▶ Utilities
- ▶ Routine maintenance/repairs
- ▶ Unexpected repairs



- ▶ Use budget (including additional expenses to be incurred through home ownership) to determine what you will be **comfortable** paying in a monthly payment
  - ▶ Once you commit to owning property, will you still have enough money left over for:
    - ▶ Fixed expenses (car payments, loan payments, etc.)
    - ▶ Living expenses (groceries, fuel, etc.)
    - ▶ Entertainment expenses/spending money
    - ▶ Savings
    - ▶ Investment
  - ▶ Once you know monthly payment, how much you can afford is determined by **interest rate** on loan and term of loan
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## Example

Link to financial calculator to determine mortgage amount

# What's a Mortgage?

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- ▶ Specific term used to describe a loan to purchase **real estate** (property)
  - ▶ You make payments on the mortgage for a significantly longer time than typical loans
    - ▶ 15/30/40 years
  - ▶ If you default (or don't pay back), the lender will take your home.
  - ▶ You don't own the title to your home until you pay the mortgage in full.
- ▶ You must **qualify** for the loan
  - ▶ Based on your **credit score**/report and current income/expenses, you meet the lender's criteria for lending you money



# Mortgage Basics

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## ▶ **Principal**

- ▶ The amount you are borrowing
  - ▶ Amount of property price you are paying up front (down payment)
  - ▶ Other costs?

## ▶ **Down Payment**

- ▶ May have to pay portion of purchase price up front
  - ▶ Your “skin in the game”
  - ▶ If you have to put your own money up to buy the house, the less likely you are to default on the loan
- ▶ Some banks may start requiring minimum down payments on mortgages due to the “mortgage meltdown” that started contributed to current recession



# Banks vs. Finance Companies

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- ▶ You can get a mortgage from:
  - ▶ Banks
    - ▶ Finance directly through your bank
  - ▶ Credit Unions
    - ▶ Finance directly through the credit union
  - ▶ Finance Companies (aka Mortgage brokers)
    - ▶ These are professionals paid a fee to bring together lenders and borrowers.
    - ▶ Finance companies work with dozens (up to hundreds) of lenders as freelance agents.
      - Think of them as “scouts.”
      - Your loan may be from one of many different banks.



## ▶ Points

▶ Percentage of overall loan you pay in advance of receiving the loan

▶ Each “point” you pay will be 1% of loan

### ▶ Discount point

▶ Lenders normally offer you better interest rate if you pay points in advance

□ Relatively small amount up front may save you a lot over the life of the loan due to lower monthly payments

### ▶ Origination point

▶ Lender may charge a point as a fee to cover the various processing expenses associated with funding the loan

▶ May have to pay as a closing cost



## ▶ Private Mortgage Insurance (PMI)

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- ▶ Protects lender in case you stop paying mortgage
  - ▶ Lender can still foreclose on you, kick you out of property, and take possession of property
- ▶ Required if borrowing more than specified percentage of property value (usually 80% but depends)
- ▶ Will add to monthly cost of mortgage



## ▶ Closing Costs

▶ Costs you are responsible to pay when taking ownership of property

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▶ **Closing** – legal process of transferring ownership of property (and committing to mortgage)

▶ Possible closing costs

- ▶ Obtaining credit report
- ▶ Title search on home
- ▶ Home warranty (if wanted)
- ▶ Inspection fees
- ▶ Appraisal fee
- ▶ Loan origination fee
- ▶ Points
- ▶ PMI
- ▶ Other



## ▶ Property Insurance

- ▶ ~~Not actual part of mortgage itself (not part of loan)~~
- ▶ Lender may require you to include insurance payment on property with your monthly payment (escrow)
  - ▶ You find insurance company to insure your property
  - ▶ Insurance company sets premium and writes policy
  - ▶ You include monthly premium with your monthly mortgage payment
  - ▶ Your lender makes the premium payments to the insurance company



## ▶ Property taxes

- ▶ Most lenders want to collect what you will be required to pay your locality in property taxes
- ▶ Lender determines how much property tax will be owed based on current tax assessment (by locality) on your property and the current property tax rate
- ▶ Lender then determines how much you must pay each month (on top of your mortgage and, if required, insurance) so they will have enough to pay your property tax bill when it is due

*Property taxes and insurance collected by lender and saved until payment to locality/insurance company when it is due are called **impounds***



# Different Types of Mortgages

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## ▶ **Fixed Rate Mortgage**

- ▶ Interest rate stays the **same** for the life of the loan
- ▶ Monthly payment (principal & interest only) will not change
  - ▶ If taxes and/or insurance go up (if lender collects impounds), your payment may go up, but not due to changes in the mortgage
- ▶ Monthly payment is lower on longer-term mortgage than shorter-term mortgage
  - ▶ Overall amount of interest paid will be higher

## **Example**



## ▶ Adjustable Rate Mortgage (ARM)

### ▶ Interest rate is ***variable***

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- ▶ Can change during life of loan
  - ▶ If interest rate goes up, your monthly payment goes up
  - ▶ If interest rate goes down, your monthly payment goes down
  - ▶ Interest rate is tied to some major interest rate
    - ▶ Prime Interest Rate
    - ▶ Rate on US Treasury Bills
    - ▶ Other
    - ▶ Your rate is that rate + some specified percentage
      - Ex: Prime + 3%
  - ▶ Interest rate will normally start out fixed for some specified time, then adjust
  - ▶ Interest rate may start out fairly low (less than on fixed rate)
  - ▶ Risk is when rate adjusts and you can no longer afford your payment because it went up too much
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## ▶ Balloon Mortgage

- ▶ Mortgage starts out at fixed rate for specified period of time
- ▶ At end of specified period, **entire balance** (“balloon”) is due
- ▶ Will need to refinance new amount or get a new mortgage when this happens
- ▶ Good for someone who
  1. Doesn't plan to stay in the house longer than when the “balloon pops”
  2. Is in a market where property values are increasing, and will make enough on the sale of the house to pay off the existing mortgage



# What Mortgage Best Suits Your Needs?

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## ▶ Ask yourself:

- ▶ How long do I plan to live in this house?
- ▶ Would I rather pay a slightly higher monthly payment and know it will not increase in the future?
- ▶ Is it likely that interest rates will come down in the future and my payment could be lowered?
- ▶ Am I willing to refinance in a few years?



# Location, Location, Location

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- ▶ Location is **very** important
  - ▶ At some point, you will probably want to sell
- ▶ Want to be in a location where
  - ▶ The likelihood of you selling will be good
  - ▶ The likelihood of the **property value** going up is good



## ▶ Factors to consider

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- ▶ Overall safety of neighborhood
- ▶ Good police & fire protection
- ▶ Good schools
- ▶ Convenience to shopping
- ▶ Location relative to recreation (library, park, etc.)
- ▶ Is it near train tracks/freeway/other noisy locations (can be a negative to some)



# How Much of My Home Do I Really Own?

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- ▶ Called **equity**
- ▶ How it's determined:

$\text{equity} = \text{fair market value} - \text{outstanding loan balance}$



# Example 1

Current fair market value of home	<b>\$189,000</b>
<i>minus</i>	
Outstanding loan balance	<b>\$141,000</b>
Equity	<b>\$48,000</b>



## Example 2

Current fair market value of home	<b>\$225,000</b>
<i>minus</i>	
Outstanding loan balance	<b>\$305,000</b>
Equity	<b>-\$80,000</b>

