Buying a Home

Owning Versus Renting

If you are like most people starting out on your own, you will probably rent your living space. Renting is the most economical approach in the short term. You haven't had the opportunity to save enough money for purchasing a home yet. However, the money you spend on rent is not buying you anything in the long run. You are not building up any value or equity. When you are done renting, your money is gone and you have nothing to show for it.

Owning your home means that the money you pay every month is going towards something—namely, the home you are living in! If you ever have to sell your home, you should get back some of that money. In other words, a home is an investment—possibly the single largest investment you may make in your lifetime. And for the most part, your home is a safe investment because it should grow in value over time provided you take good care of it.

Housing Choices

There are many different housing options to meet the needs of a variety of people. A single family home is a stand-alone structure that is meant to house one family. The owner is responsible for maintaining the home as well as the property on which it is located.

In contrast, condominiums are built such that several units may be connected together, and usually there is a small green space for each unit. You own the interior space of your unit. Generally (but not always) condos are smaller and less expensive than single family homes, but there is a monthly fee to cover maintenance of common areas such as elevators, lobbies, or recreational facilities. As a condo owner you do not need to worry about things like mowing the grass or repairing your roof. But you may also have some restrictions that a single family homeowner would not, such as what type of pet you may have.

Another option is a duplex or a double. These look like single family homes but are really two homes connected in the middle by a common wall. Each side has a private entrance. Some people choose to buy a duplex and live in one half while renting out the other half. The money they collect in rent helps pay for the mortgage.

Main Idea

Buying a home is an important financial decision that will impact your life for many years. Set wise spending limits and choose a mortgage that meets your specific needs as a borrower. Pick a home in a good location so that your investment will grow in value and be easy to sell when the time comes.

After completing this lesson you will be able to:

- know where to find information on homes that are for sale in your area
- compare different home options including location, size, cost, and amenities
- choose a home suited to your needs and budget
- make a wise decision about the type of mortgage you can afford
- understand the different costs associated with purchasing a home
- calculate the equity you have in your home

Key Terms

- Adjustable Rate Mortgage
- Closing Costs
- Condominium
- Down Payment
- Equity
- Fixed-Rate Mortgage
- Mortgage
- Points
- PMI (Private Mortgage Insurance)
- Single Family Home

How Do I Find a Home?

There are many different ways to find the right home for you. The easiest and often the quickest way is to work with a real estate agent. This person will ask you a lot of questions about what you need and want in a home, such as what part of town you want to live in, what size home you need, and what other amenities are important to you. Your agent will compile a list of homes for you to consider, and arrange for you to see the homes at a time convenient for both you and the seller. Usually your real estate agent will handle your paperwork when you do purchase a home and will earn a commission from the seller based on the selling price of the home. In some states an attorney is required to handle the closing even when an agent is present.

Some people will list their homes “For Sale By Owner,” meaning that they will try to sell their home themselves and avoid paying commission to an agent. This can mean their price will be slightly lower. But generally you should be cautious when buying a home directly from the owner because the owner will not be qualified as a closing agent and therefore will not be as helpful to you as a buyer. In this instance you will need to hire a lawyer to assist you at closing.

You can also find many homes listed in the paper, on the Internet, or even on television. Two of many Internet sources listing homes for sale are www.Zillow.com and www.Realtor.com. The Multiple Listings Service (MLS) is a publication as well as an online tool that lists homes for sale in an area with pictures and pertinent information such as total square footage, taxes, and lot size. Often on weekends, homes for sale will have open houses and anyone can tour them without an appointment or an agent representing them.

How Much Home Can I Afford?

There are two important things to ask yourself when considering buying a home. First of all, how much money is coming in? Second, how much money do you owe? The two key factors that will help you decide how much you can afford in a home are your earnings and your debt. It seems obvious, doesn’t it? Here are a couple of simple formulas to help you set some spending limits.

As a general rule, you should not spend more than 28% of your monthly pre-tax income on housing costs. Housing costs are considered to be the sum of your principle and interest payment, real estate taxes, and insurance each month. And you should try to limit your debt to 36% of gross monthly income. Don’t forget to count loans unrelated to housing, such as school loans, car loans, or credit card debt when figuring out the total debt you owe. Remember, though, that these are guidelines to indicate the most you should spend; only you can decide how much is wise.

It is a wise idea to know how much house you can afford before you begin searching. Choosing a home can be an emotional decision, and if you do not have a good idea of what your limits are initially, you might be tempted to take on too much debt. Do not be trapped by a well-meaning friend or an enthusiastic real estate agent telling you "it won't hurt to look" at a home that is wonderful but out of your price range.

What's a Mortgage?

Buying a home is a huge financial commitment. Few people have the cash to purchase a home outright. A mortgage is a way of borrowing money to buy a home and paying it back over a long period of time. A mortgage is a legal agreement between you, the borrower, and a lender, usually a bank. You agree to repay the amount of the loan, with interest, by making monthly payments over a period of time. You must provide the lender with information about your personal finances, income and savings when you apply for a mortgage. If you default on the loan, which means you stop making payments, the lender will take possession of the home from you.

Once your mortgage application is approved, the lender will provide you with a payment booklet full of coupons. Each month, when you write your check, you will send a coupon along with it. You can choose to pay additional money if you like—this enables you to pay off the loan more quickly. Note also that there is a penalty if your payment is late.

You will want to shop around for the best interest rates before you choose a mortgage. Mortgage companies and banks are competing for your business and will not all offer the same deals. Check with several different lenders before making a selection. Be sure to consider all the different factors—the interest rate, the length of the loan, the points owed at closing, etc. When you apply for a mortgage you must provide the lender your personal financial information in order to be approved for the loan.

Mortgage Basics

As you begin to think about buying a home you will need to learn many new concepts. One of the first things you need to decide is how much money you have available for your down payment. The down payment is the initial sum of money that you pay toward your house. The amount you will need to borrow is equal to the selling price minus the down payment. The larger the down payment, the smaller the loan will be. Sometimes there is a minimum amount you must have for a down payment, such as 5% of the cost of the home.

When you take out a loan, whether for a home, a car, or for college, you always need to pay back the amount of the loan plus interest. Interest is what it costs you to be able to use someone else's money. So each month when you make your mortgage payment, part of the payment will go toward paying back the principle, or amount of the loan, and the rest of the payment will be interest. Interest is always calculated as a percentage of the outstanding loan amount.

At closing, when you complete the paperwork to buy your home and sign that first check, there will be other costs besides the down payment. These added fees, paid by the borrower, are called closing costs. The cost of obtaining a credit report, the cost of doing a title search on your home, the appraisal fee, and the purchase of title insurance are all examples of closing costs. Points are also examples of closing costs. Origination points are added fees to cover various processing expenses for the loan. Discount points are like interest paid up front to reduce the amount of the monthly mortgage payments. A point is calculated as 1% of the loan amount.

Another cost you may incur as a borrower is called Private Mortgage Insurance, or PMI. Private mortgage insurance protects the lender in case you, the borrower, cannot make your loan payments. Typically the borrower must purchase PMI if the amount of the loan is very close to the value of the home. In the computer exercise you will see how increasing your down payment lowers the cost of PMI because you are borrowing less money and there is less risk for the lender.

Different Types of Mortgages

There are a few basic types of mortgages, and several variations of these. First is the fixed rate mortgage. Although the length of the loan can vary, the interest rate will not change for the life of the loan. In other words, your payment will be exactly the same each month. Most fixed rate mortgages will be for either 15 or 30 years. A 15-year mortgage will have a higher payment than a 30-year mortgage for the same amount, because you will be paying off the loan in less time. But, as you will see in the computer exercise, you will pay much less in interest over the life of a 15-year loan.

The second type of mortgage is called an adjustable rate mortgage, or ARM. There are many different types of ARMs. Generally, though, the interest rate is fixed for an initial period of time, say 5, 7, or 10 years; then it can fluctuate up or down based on a national index such as the U.S. Treasury bill rate. With an ARM you can often start out with a fairly low interest rate, but the risk is that when it becomes eligible for adjustment, the interest rate may increase significantly.

A balloon mortgage starts out like a fixed rate mortgage but the balance of the loan, or balloon, is due in one large payment after a short period of time, say 5 or 7 years. Usually someone who chooses this type of mortgage doesn't plan to be in their home for very long. Otherwise, most people need to refinance or get a new mortgage when the balloon payment is due. Refinancing simply means replacing your existing loan with a new loan, often to take advantage of lower interest rates.

In order to choose the mortgage that best suits your needs, ask yourself these questions:

- 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?

The answers will tell you whether a fixed rate or adjustable rate mortgage is right for you, and whether a longer or shorter term mortgage will work the best.

Location, Location, Location

Choosing a home in a good location is very important, mainly because at some point in the future you will probably want or need to sell it. Some important considerations are safety and civic issues. Does the neighborhood have good police and fire protection? What school district do the residents belong to? Is the home conveniently located near shopping? A library? A park? Are there sidewalks? Well-lit streets? Having some of these amenities adds value to any neighborhood.

Certain qualities that might make a home look like a bargain when you are buying may also make it more challenging to sell at a later date. For instance, suppose there are railroad tracks running somewhere close to a property. The presence of these tracks could mean a slightly lower price for you as a buyer. And perhaps you find the sound of a train at night rather quaint. But another person might strongly object to hearing the train at all, and would not consider this a desirable home.

The value of a home is also influenced by its surroundings. You do not want to own the biggest or fanciest home on the street. Why? Because its value will be limited by the value of the smaller, simpler homes surrounding it. Most people would rather buy a fancy home if it is surrounded by other fancy homes.

How Much of My Home Do I Really Own?

Suppose you want to know how much real ownership you have in your home. As long as you are making mortgage payments, part of your home still belongs to the bank. Here's a formula to calculate the ownership, or equity you have in your home:

Equity = fair market value – outstanding loan balance

First, you need to determine the fair market value of your home. That is, what could you realistically sell your home for today? If you have made a wise investment, your home will have appreciated and the market value will be more than what you paid for it originally. You might look at other comparable homes nearby that have sold recently to see what price they sold for, or get your home appraised to determine its fair market value.

Second, you need to calculate the amount of principle still owed on your loan. This amount should be stated on each payment coupon that you send in with your check. If you subtract the amount still owed on your loan from the fair market value, that will be the amount of equity you have in your home. The longer you live in your home, generally the more equity you build up because you have paid off more of your loan.

Here is an example. When Stuart purchased his home five years ago he took out a loan for $130,000. Stuart thinks he could sell his home today for $152,000. He has paid off $5,000 of the loan, so the outstanding loan balance is $125,000. His equity in the home is $152,000 – 125,000 = $27,000.

Summary

There are many resources available to help you find a home. Before you begin your search, have a clear idea of what you can afford to spend, both for the down payment and on a monthly basis. Choose a home in a location that will appreciate in value and be easy to sell when the time comes. Examine the different mortgage options to get the best interest rate and a payment that fits your budget. Build up equity in your home by working to pay off your loan.

Key Terms

Adjustable Rate Mortgage
In this type of mortgage the interest rate can vary at certain points in the life of the mortgage. Usually the interest rate is tied to an index such as the U.S. Treasury bill rate. An adjustable rate mortgage is sometimes called a variable rate mortgage.

Closing Costs
These are additional costs paid by the borrower when buying or refinancing a home. For example, fees paid for a title search, an appraisal, a loan origination fee, title insurance, taxes, or the cost of a credit report.

Condominium
A dwelling in which you own your individual unit, and a group or association owns the common areas such as green space, recreation facilities, etc.

Down Payment
A sum of money that you pay at closing. The selling price of the home less the amount of your down payment is the amount you will need to finance, or borrow.

Equity
The monetary value of your ownership. To determine your equity in your home, subtract the amount you still owe on the home from its fair market value, or the price it would sell for.

Fixed Rate Mortgage
In this type of mortgage the interest rate remains the same throughout the life of the mortgage; it will not increase or decrease. Your payment due will be the same each month.

Mortgage
A legal document that uses property to secure a loan. Often the loan itself is referred to as a mortgage.

Points
A point is equal to 1% of the amount of the loan. Sometimes by paying more points at closing you can reduce the interest rate on your loan.

PMI (Private Mortgage Insurance)
Insurance that protects the lender in case the borrower defaults and is unable to repay the loan. Generally a borrower must pay PMI if their equity is less than 20% of the home's value.

Single Family Home
A free-standing residential building meant for one family to occupy, usually found outside of cities and in neighborhoods with other single family homes. Most single family homes have a yard as well.