

CHAPTER 4: Purchasing a Home



Did You Know?

For many Americans, home ownership is still a part of the American dream. Some 52% of the public says it is important to own a home in order to be considered part of the middle class. But 64% of Americans say it is not affordable for young adults in their 20's and 30's today.⁴

Purchasing a home is one of the biggest investments a person will ever make. Not only is it likely to be the most expensive item that most of us will ever purchase; a home is also an important asset in determining financial health. There are many factors to consider when purchasing a home, such as down payments, interest rates, and other terms of a mortgage loan. These factors all affect the overall price you will pay for a home.

Getting a Mortgage

Whether you're talking about a \$100,000 home or one that costs millions of dollars, the simple fact is that most people do not have enough money saved to purchase a home outright. Because of this, most home buyers turn to banks, credit unions, or finance companies to get a **mortgage** to purchase their home. A mortgage is considered a long-term loan because it is paid in small amounts, typically over the course of 15 or 30 years.

- When you apply for a mortgage, potential lenders assess your creditworthiness by checking your **credit rating**. A high credit rating means that you have a history of making timely payments to people who have loaned you money in the past. The higher your credit rating, the better chance you have of being approved for a mortgage and getting a low interest rate. Consumers with lower credit ratings have been less reliable as borrowers in the past, and risk being rejected for a mortgage or getting one at a higher interest rate.
- Another key part of securing a mortgage is your **down payment**. Depending on a buyer's qualifications, most banks and finance companies require a down payment to be anywhere from 5% to 20% of the home's purchase price, or even more. In some situations, a homebuyer's

down payment may be only 3.5% of the home's purchase price, but this requires backing by the **Federal Housing Authority (FHA)**.

- Homes vary widely in price, even within the same city. Lenders will determine, based on your creditworthiness, income, monthly debt liabilities, and proposed down payment, how much money they are willing to lend you. This, combined with your down payment, will determine how much you can afford to spend on a home.
- Homeowners whose down payment is less than 20% will likely have to pay **mortgage insurance**, which protects the lender in case the homebuyer can't keep up with the payments. Homebuyers usually pay for mortgage insurance until they have 20% **equity** in the home.
- When you apply for a mortgage, you need to think about how long you want to spend repaying the loan. The longer the period of time a borrower is given to repay a loan, the smaller the monthly payment will be. However, the longer the loan, the more you will end up paying in interest. Most people choose a 15- or 30-year mortgage. The advantage of a 15-year mortgage is that borrowers can usually get a lower interest rate and build equity in the home more quickly. The advantage of a 30-year loan is that monthly payments are lower and the borrower has more money to use for day-to-day expenses and saving.
- When evaluating mortgage offers, you obviously must consider the **interest** you will be charged. **Interest rates** can vary widely from lender to lender and year to year. They are usually based on the borrower's credit rating, the length of the loan, and the down payment amount. The interest rate can make a big difference for the amount of money you pay each month and the overall cost of the mortgage, so it is important to spend time researching and getting quotes from a variety of lenders so you can choose a mortgage with the best rates for you.
- While most people prefer a **fixed interest rate** (conventional) mortgage, some opt for an **adjustable rate** mortgage (ARM). Fixed rate mortgages offer the borrower

⁴ www.bls.gov/news.release/pdf/cesmy.pdf

peace of mind, because the interest rate, and the monthly mortgage payment, will always remain the same. With an adjustable rate mortgage, the initial interest rate is usually lower than that of a conventional mortgage, but the interest rate, and the monthly payment, steadily increase over the course of the mortgage, though there is usually a **lifetime cap** to limit these increases.

- The interest on mortgage loans is typically compounded monthly. When you begin paying your mortgage, you'll make monthly payments. These payments are divided into two parts — the first part covers the interest that accrued over the month, and the remainder is applied to the loan **principal**. This is reflected in an **amortization schedule**, which outlines how each monthly payment is applied over the course of the loan.

Career Link

Most mortgage companies require a borrower to have enough homeowners' insurance coverage to pay off the mortgage's outstanding balance, which is not always enough to cover the home's value. Basic insurance pricing assumes that the home's full value is being insured. Actuaries make the adjustments necessary to price the insurance when this is not the case.

Other Costs Associated with Home Loans

When shopping for a mortgage, there are other factors to consider besides the interest rate and length of the loan. Borrowers should also pay attention to **closing costs** and **prepayment penalties**. Closing costs include a wide range of fees in addition to the cost of the home, such as fees for title searches, deed filings, property surveys, real estate agents, and lawyers. Prepayment penalties are fees charged for paying off a mortgage too quickly. Some low interest

rate mortgages have pre-payment penalties to encourage borrowers to pay interest for the full term of the loan.

When purchasing a home, a buyer may be asked to put money into **escrow**. This lets the seller know that the buyer is committed to purchasing the home. In turn, the buyer does not risk losing his or her money if the seller cannot meet the conditions necessary to sell the home (such as passing a home inspection).

As you can see, getting a mortgage can be a complicated process with many factors to consider. One way consumers are protected is through the **Truth in Lending Act**. This legislation is designed to make sure that home buyers have enough information to completely understand the interest rate and terms of the mortgage.

Refinancing and Foreclosure

As time goes by, interest rates change based on the economy and other factors. Sometimes rates enter a trend where they become lower and lower. As interest rates decrease, borrowers can try to **refinance**. Borrowers who had low credit scores when they initially purchased their home may also be able to refinance once they've improved their credit rating.

As with any loan, borrowers must shop around and add up the costs associated with refinancing. Because refinancing involves getting a new mortgage, borrowers usually pay many of the same types of closing cost fees they paid when the original mortgage was processed. For borrowers who are planning to sell their home, these fees could add up to more than the savings expected from refinancing for just a few years. Likewise, prepayment penalties might outweigh the savings expected from refinancing.

Sometimes borrowers are unable to meet their financial obligations and make their mortgage payments on time. For these **delinquent** borrowers, who are unable to fulfill the terms of their mortgage contract, lenders can either establish a **workout** or initiate a **foreclosure**. When a borrower has a property foreclosed upon, this becomes part of his or her credit report for a period of seven years and can prevent the borrower from obtaining loans in the future.



Activity 1

SET A HOME-BUYING BUDGET

The first step in shopping for a home is to determine how much you can afford to spend. Look at the families profiled in the chart below and determine the price each can pay for a home using the calculator at www.trulia.com/house-affordability-calculator. Use your city or a city of your choice to answer the calculator's zip code question. After you fill in the chart, answer the questions to learn more about each of the factors that contribute to a home-buying budget.

FAMILY	ANNUAL INCOME	DOWN PAYMENT	MONTHLY DEBT	CREDIT SCORE	HOME PRICE
A	\$100,000	\$50,000	\$1,500	725	\$
B	\$100,000	\$50,000	\$500	725	\$
C	\$100,000	\$50,000	\$1,500	675	\$
D	\$80,000	\$50,000	\$500	725	\$
E	\$80,000	\$30,000	\$500	725	\$
F	\$80,000	\$30,000	\$1,500	675	\$

1. Families A, B, and C all have the same annual income, but their monthly debt and credit scores vary. Where did you see the biggest difference in the home price they can afford — between A and B, A and C, or B and C? What factor seems most responsible for this difference?

2. Families B and D have different incomes, but the same monthly debt and credit score. How does their income difference affect the home price each can afford?

3. Compare the home prices for families A and D. What does the difference suggest about the relative importance of income and debt for determining a home-buying budget?

4. Families D and E are identical except for having different down payments. How important is down payment as a factor in determining how much one can afford to pay for a home?

5. Families D and F have the same income, but their down payment, monthly debt, and credit scores are very different. How do these three factors seem to affect how much they can afford to pay for a home?

6. Based on your analysis of these examples, what advice would you give someone who is planning to shop for a home?

Activity 2

UNDERSTANDING AMORTIZATION

The Chen family has decided to purchase a home for \$150,000. They currently have \$30,000 in savings, but they are only willing to make a down payment of \$25,000. In order for them to buy the home, a bank must agree to give the Chens a loan for \$125,000. Use this information to calculate the following:

1. What percentage of the home's purchase price does their down payment represent? _____%
2. Do you think it is a good idea for the Chens to make this size down payment? Why or why not?

To better understand how mortgages work, create an amortization schedule using the online calculator at mortgagecalculator.org. First, click the "Show Amortization Tables" link at the bottom of the calculator and check only the box for "Show monthly amortization table." Then input the Chens' home cost and down payment. Assume they will have a 30-year fixed-rate mortgage with an 8% interest rate. Input zeros for the remaining items in the calculator, then click the "Calculate" button. Scroll down the webpage to see the monthly amortization schedule, which will start off like the one shown here.

MONTH	MONTHLY PAYMENT	INTEREST	PRINCIPAL	BALANCE
1	\$917.20	\$833.33	\$83.87	\$124,916.13
2	\$917.20	\$832.77	\$84.43	\$124,831.70
3	\$917.20	\$832.21	\$84.99	\$124,746.70
4	\$917.20	\$831.64	\$85.56	\$124,661.14

Use the amortization schedule and the mortgage summary information to answer the following questions.

3. What happens to the interest and principal amounts over the course of the mortgage?

4. What is the total cost of the home after the mortgage has been paid off? Don't forget to include the \$25,000 down payment in the total cost. \$ _____
5. What do you think would happen to this total cost if the Chens paid an extra \$100 each month to reduce the principal? Why?

6. What would happen if the Chens took a 30-year adjustable rate mortgage with a 4% interest rate that increases by .25% after the first year, with expected subsequent increases of .25% per year up to a maximum interest rate of 8%. Use the calculator at www.mortgagecalculator.org/calcs/fixed-vs-arm.php to compare this adjustable rate mortgage with the fixed rate mortgage described above. (Input zeros for the remaining items in the calculator.)
 - a. What happens to the monthly payments over the course of the adjustable rate mortgage?

 - b. What is the total cost of the home after the adjustable rate mortgage has been paid? \$ _____
7. If you had the choice, would you select a fixed rate or adjustable rate mortgage? Why?

8. Now suppose that the Chens decide to refinance their fixed rate mortgage after 5 years. Their new 30-year mortgage has a 6.5% fixed interest rate, with closing costs of \$2,000. Use the calculator at www.mortgagecalculator.org/calculators/should-i-refinance.php to find out how refinancing will change their mortgage costs. (Input zeros for any information not provided above.)
 - a. What is the Chens' monthly mortgage payment after refinancing? \$ _____
 - b. What will be their total savings after their new mortgage has been paid off? \$ _____

Activity 3

A HOME OF YOUR OWN

You are buying your first home and want to select the best possible mortgage. Use the calculator at mortgagecalculator.org/calcs/fixed-vs-arm.php to compare a 30-year fixed rate mortgage with a 5.5% interest rate, and a 30-year adjustable rate mortgage with a 3.25% interest rate that increases by .25% each year after the first year, up to a maximum interest rate of 9.25%. (Input zeros for the remaining items in the calculator.)

Assume that you are purchasing a \$200,000 home with a 20% down payment. Use the information provided by the calculator to answer these questions.

1. What is your monthly payment with each mortgage?

Fixed rate mortgage payment: \$_____ per month

Adjustable rate mortgage payment: \$_____ per month

2. What is the total cost of your home after you have paid off each

mortgage? Total home cost with fixed rate mortgage: \$_____

Total home cost with adjustable rate mortgage: \$_____

3. Which mortgage seems the better choice for you? Why?

4. What financial risks do you face by selecting this mortgage?

5. What are the financial benefits of your choice?

