Buying A Home

For the vast majority of American homeowners, their home is their most important financial asset. Many homeowners say their home accounts for all or most of their personal financial worth while others say it represents about half of their worth.

Regardless of their size and location, homes are expensive: they are probably the most expensive items that most of us will ever purchase. 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.

Part of purchasing a home involves saving up enough money to make a down payment. Most banks and finance companies require buyers to make a down payment; depending on a buyer's qualifications, this down payment may be anywhere from 5% to 20% or more.

Independent Practice

A family decides 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 on the house. In order to buy the home, the bank must agree to give the family a loan for $125,000.

Using the information above, calculate the following:

If the family puts $25,000 down on the house, what percentage of the purchase price of the home does this amount represent?

Do you think it is a good idea for the family to put more than 5% down for the house? Why or why not?

Shopping For A Home Loan

As with any other loan, the bank is going to charge interest on the loan. Since borrowers pay interest on the loan each month, part of the borrower's mortgage payment will be interest paid to the bank, and the remainder of the payment will be applied to the loan principal. Interest rates can vary widely from lender to lender. They are typically 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 on the amount of money paid each month and the overall cost of the home, so it is important to take the time to research various lenders and get interest rate quotes from them to secure the best loan with the most ideal terms.

While most people prefer to have a fixed interest rate, or conventional mortgage, people will sometimes opt for variable interest rate mortgages. Fixed rate loans offer the borrower peace of mind, because the loan's rate and the monthly payment amount will always remain the same. With a variable rate mortgage, the initial rate is usually lower than that of a conventional loan; the disadvantage is that borrowers don't know whether their monthly payments will increase or by how much they will increase, though they have some protection based on the loan's lifetime cap.

When considering a mortgage loan, borrowers must think about how long they 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 the borrower will end up paying in interest. Most people choose a 15- or 30-year home loan. The advantage of a 15-year loan is that borrowers can usually get a lower interest rate and will build equity in the home more quickly. The advantage of a 30-year loan is that payments are lower and the borrower will have more money to use for day-to-day expenses and saving.

When borrowers apply for a home loan, part of the loan review process involves a credit check so that the lender can assess the borrower's creditworthiness. One of the tools used to assess creditworthiness is called a 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 rating, the better chance you have of getting a loan and having a low interest rate. Consumers with lower ratings have been less reliable as borrowers in the past, and risk being rejected for the loan or getting the loan at a higher rate of interest

Independent Practice

Use an online loan calculator to create an amortization schedule for a mortgage.
(try http://www.bankrate.com/calculators/mortgages/amortization-calculator.aspx
or Google "online mortgage calculator amortization schedule")

Calculate the loan costs using the following loan information:

the home costs $150,000

the borrowers can put a $25,000 down payment on the home resulting in a loan for $125,000

the interest rate is 8.00%

the sample spreadsheet at the bottom of this page illustrates just the first four months of the loan

(Assume that the borrower is making monthly payments on a 30-year fixed-rate loan.)

Month	Loan Interest Rate	Loan Payment	Principal	Interest	Principal + Interest	Calendar Year Interest	Loan Balance
1	8.00%	$917.20	$83.87	$833.33	$917.20	$833.33	$124,916.13
2	8.00%	$917.20	$84.43	$832.77	$917.20	$1,666.11	$124,831.70
3	8.00%	$917.20	$84.99	$832.21	$917.20	$2,498.32	$124,746.70
4	8.00%	$917.20	$85.56	$831.64	$917.20	$3,329.96	$124,661.14

Answer the following questions based on the loan data:

What happens to the interest payment and loan repayment amounts over the course of the loan?

What is the total cost of the home by the time the entire loan has been repaid? Don't forget to include the initial $25,000 down payment in the cost.

What do you think would happen to the cost of the house if you applied $100 extra to the loan repayment (principal) column each month? Explain why.

Assume you have a variable interest rate that began at 4% and rises a 1⁄4% a year for the first 10 years of the loan and then declines 1⁄4% every two years for the remaining life of the loan. What is the total cost of the loan repayment over the course of the loan now?

If you had the choice, would you select a fixed or variable rate of interest? Why?

Other Costs Associated with Home Loans

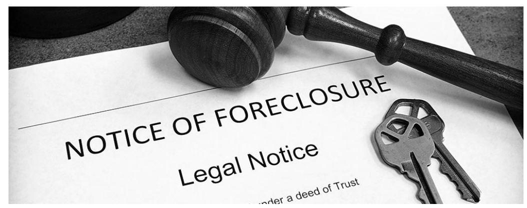
When shopping for a home loan, there are other factors to consider besides interest rate and the term of the loan. Borrowers should also pay attention to closing costs and pre-payment penalties. Closing costs include a wide range of fees in addition to the cost of the home, such as title searches, deed filings, property surveys, and lawyer's fees. Some loans with low interest rates have pre-payment penalties which require the borrower to keep the loan and pay interest on it for a set number of years.

When purchasing a home, you may be asked to put money into escrow. This lets the seller know that the buyer is committed to purchasing the house. In turn, the buyer does not risk losing his or her money if the seller cannot meet the conditions necessary to sell the house (such as passing a house inspection). As you can see, getting a loan 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 the consumer has enough information to completely understand the interest rate and terms of the loan.

Refinancing and Foreclosure

In our previous example, the fixed interest rate on the home loan was 8%, which is locked in for the life of the loan. As time goes by, interest rates change. Sometimes rates enter a trend where they become lower and lower. As interest rates decrease, the number of people interested in refinancing tends to increase since a new loan will ultimately be less costly to the borrower. Just like with the initial loan, borrowers must shop around and pay attention to the costs associated with refinancing. Since the borrower is still seeking a loan, the borrower will again pay many of the same types of fees paid when the original loan was processed. If a borrower is planning to sell the property in the next few years, then refinancing may not be a wise decision because of the costs of securing a new loan; additionally, there may be prepayment penalties in e ect which would increase the cost of getting a new loan.

Sometimes borrowers are unable to meet their financial obligations and pay their loans on time. When a borrower is delinquent and unable to fulfill the loan contract as negotiated, lenders have two choices: they 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.



Independent Practice

Using an online loan calculator, experiment with the loan by inputting the following data and analyzing the results shown in the loan amortization schedule:

The initial fixed interest rate on the loan was 8%. Let's say the borrower decides to refinance after 5 years to a 6.5% fixed rate loan for the remainder of the loan. *HINT: Remember to include the $2,500 of closing costs incurred when the home was refinanced.*

How will this affect the borrower's annual payment?

The overall price paid for the home?

The initial fixed interest rate on the loan was 8%. After paying this rate for 8 years, the borrower decided to refinance at a rate of 5%. After paying $2,000 in closing costs and making the new loan payment for 2 years, the borrower sells the house.

What happened to the borrower's annual payment after the home was refinanced?

In the end, how much money did the borrower end up saving/losing as a result of this decision?

Terms and Definitions

mortgage
a loan used to purchase a home

down payment
the amount of money a buyer pays in cash for the purchase of a house

interest
money that is paid to the lender by the borrower for the use of the lender's money

principal
the original borrowed amount

interest rate
percentage paid to the lender for the privilege of borrowing the money

credit rating
a ranking, typically expressed as a number or letter, based on one's credit history and used by financial institutions for loan and credit approval

fixed interest rate
interest rate that stays the same over the course of the loan

variable interest rate
interest rate that can change over the course of a loan

lifetime cap
a limit on how much the interest rate of a variable-rate loan can increase

equity
a home's market value less the outstanding mortgage balance

amortization schedule
a schedule for repaying the loan

closing costs
fees paid in addition to the cost of the home

Terms and Definitions

pre-payment penalties
fees designed to keep the borrower from paying the loan off early

escrow
property or money held by a third party until the terms of a contract are met

Truth in Lending Act
requires lenders to explain how they compute loan charges and list the annual percentage rate; also gives the borrower three business days to opt out of the loan

refinancing
paying o the original loan by taking out a new, typically more favorable loan

delinquent
past due on a scheduled loan payment

workout
formal repayment or loan forgiveness arrangement between a borrower and lender

foreclosure
legal process that allows a lender to seize property if the mortgage loan is not paid; typically, the lender sells the property and applies the proceeds to the outstanding debt