# Buying a House

## *Standard 10*

*The student will explain and compare the responsibilities of renting versus buying a home.*

## Lesson Objectives

- Discuss the reasons that people buy homes.
- Explain the terms associated with a mortgage.
- Describe the different types of lenders and housing loans.
- Identify the various costs of homeownership.
- Assess the costs and benefits of owning a home.

## Personal Financial Literacy Vocabulary

Closing costs: Costs paid when buying a house or real estate.

Down payment: The part of the purchase price paid in cash up front, reducing the amount of the loan or mortgage.

Earnest money: A deposit on a real estate purchase.

Equity: The current market value of a house (what it is worth if sold) and the amount owed on it.

Escrow:  A special bank account where funds are held temporarily until dispersed for a specific purpose.

Mortgage:  A loan to finance the purchase of real estate, usually with specified payment periods and interest rates.  A fixed rate mortgages/loan has the same interest rate for the duration of the loan while an adjustable rate mortgage/loan has a variable interest rate for the duration of the loan.

## Introduction

***Hank wants to buy a house because he is tired of renting.  He has some idea about what he wants, and he has been driving around several neighborhoods to see what is available.  He has been saving as much money as he can each month for a down payment and for closing costs.  Even though he thinks he is ready to buy, he is still a little nervous about making such a big commitment.  Some of his friends keep telling him to "got for it" while others are saying he should take his time.  Which friends are giving him the best advice?***

## Lesson

When you hear that someone is buying a house, what comes to mind?  Are you visualizing a two-story house in the suburbs with a three-car garage or a small bungalow in the city with a white fence around the yard?  Or do you think of a condo in the downtown area near all the restaurants and entertainment venues or an older house in the country with barns and horses?  Whatever comes to mind, buying home is the most expensive purchase most people will make during their lifetime.  For some, homeownership is the fulfillment of a dream, a source of pride, and a sense of independence.

The average price of a single-family home in Oklahoma is close to $200,000, compared to almost $250,000 in the United States.  Of course, local prices can vary greatly, but it is still an expensive decision to make.

Because the cost is so great, almost all homebuyers will need to secure some kind of financing to make the purchase.  Most home loans are called a mortgage, and mortgages include interest which increases the overall price of the home over the life of the loan.
Unlike other purchases, a house payment often includes a monthly payment for insurance and for property taxes.  Plus, a homeowner needs to cover the cost of landscaping, mowing, pest control, and contributions to a savings account to cover the costs of any emergency expenses such as replacing a hot water heater or washing machine.  All of these expenses should be considered when looking for a place to buy.

Choosing a home to purchase should align with your finances and your lifestyle.  The term "house" or "home" has different meanings to different people.  You may see it as a single-family residence, a mobile home, or a converted barn in the country.  Your sense of home is based on your past experiences as well as your hopes and dreams for the future.  However, the rising price of buying a home may require you to rethink some of your priorities, allowing you to make a more affordable decision.

## *Advantages and Disadvantages of Homeownership*

Most people prefer owning a home instead of renting because it provides them with greater privacy and security than living in an apartment. In addition, you are establishing a sense of permanency when making the decision to buy because it represents your desire to settle down and build a future. It also allows you to remodel or redecorate to satisfy your own tastes because it is yours—not someone else's property. So, if you want to paint your garage pink and your front porch lime green, you can do it because it is yours.

While many neighborhoods today have covenants or certain homeowner restrictions, you still have much greater freedom than renting. Before buying, you should inquire about any neighborhood restrictions and get a copy of the homeowner's association policies if there is one. That way, you will know if there are any limitations on how you use your property before deciding to live there.

One of the biggest advantages to owning a home is building equity, which means that your property is an investment that gains value over a period of time. Equity is the difference between the amount you owe on your home and the current market value, which is the amount someone is willing to pay for it. For example, if you owe $150,000 on your mortgage and someone offers to pay you $170,000, you have $20,000 in your home's equity ($170,000 - $150,000 = $20,000). While building equity is not guaranteed, most real estate purchases (including homes) tend to increase in value over time. Factors such as the location as well the maintenance and any improvements you make in the house or yard can play a big role in improving the value of your property and increasing your equity.

Owning a home also has some tax benefits because the interest on your loan is tax deductible on your federal income tax and on most state income taxes. The property tax you pay is also deductible on your personal income tax. While being able to deduct your interest and property taxes helps offset the cost of homeownership, it is not the best reason to buy a home.

Like any other choice you make, buying a house has its disadvantages. First of all, owning a home is a substantial financial commitment. It requires a down payment on your mortgage, and oftentimes you pay additional fees such as points and title insurance. Points are a one-time fee you pay the bank or mortgage company when you borrow money, and title insurance is a charge to inspect the history of the property to ensure the seller can legally sell it to you. In addition, you cannot pack up and move as easily because it is your property, and you are responsible to make payments and maintain it until it is sold to a new owner.

As an owner, your living expenses tend to be higher when owning a home than when renting. Because you are responsible for paying all costs for utilities, repairs, water, landscaping, painting, and so on, homeownership requires a commitment of time, energy, and money. Also, there is a potential risk that your property will decline in value, meaning you could lose some of the money you invested.

Basically, what was an advantage to apartment living is a disadvantage to owning a home and vice versa. That is the reason it is important to consider your personal finances, preferences, and lifestyle before deciding where to live. Your situation will be different from your friends and other family members, and that situation will change throughout various stages of your life.

## *Financing a House*

Determining how much house you can afford is the first step to buying a home. Even though you can use a formula to determine how much you afford, it does not mean you have to spend that much on your housing. Formulas are only guides to help set a maximum recommended amount. Most people are inclined to overbuy — spending more than they can on a house — then facing higher than anticipated utility bills, property taxes, insurance premiums, etc.

Following are several terms and processes related to securing a mortgage to help purchase a home or other real estate properties.

**Preapproval.** Most potential homebuyers will start the buying process by getting preapproved for a mortgage. This process requires you to complete an application with a bank or mortgage company to determine the maximum amount you are eligible to borrow. Going through the preapproval process means a lender has taken all of the steps necessary to evaluate your creditworthiness to buy a home.

In the preapproval process, lenders attempt to determine how much you can afford to pay monthly for your total housing costs, including the house payment (both the principle and interest), taxes, and insurance. Some lenders use a housing expense ratio, which says you can afford to pay up to a certain percent of your monthly gross income in house payments while others use a debt ratio formula which says your house payment should not be more than a certain percent of your overall debt. The percentage used in both of these formulas may vary from lender to lender, but most tend to run about 30 percent for the house payments to gross income and about 40 percent for your overall debt ratio. Remember, they will approve you for the maximum amount, but you can spend less to ensure you have sufficient funds for all other planned and unplanned expenses.

REMINDER

*Almost all homebuyers will need to secure financing to purchase a home. Determine how much house you can afford is the first step to buying a home.*

Being preapproved for a loan is different from prequalifying. Prequalifying simply gives you a rough estimate about the amount you might qualify to receive. If possible, it is better to be preapproved than prequalified before you start looing for a place to buy.

## Closing Costs

Closing costs are the expenses you need to pay when getting a housing loan. In most cases, you will need to make a down payment on a house somewhere between 3 percent and 20 percent of the purchase price. You also will need to pay about another 5% on other closing costs. These costs include title insurance, attorney’s fees, property survey fees, recording fees, lender’s origination fees, appraisals, credit reports, termite/mold inspections, escrow payments, and the home inspection report.

Down payments are required to protect the lender in case you default (or fail to pay) your loan. If you cannot pay the full 20% down, you will be required to purchase private mortgage insurance called PMI. The PMI basically helps guarantee your down payment to the lender. Another option is taking out two loans: one for the mortgage and one for the down payment. This option generally results in higher interest rates and higher monthly payments. Also, some lenders may refuse to accept this option because it tends to be higher risk than paying for PMI.

Escrow payments are payments made to a special account held by the lender to pay for your property taxes, homeowner's insurance, and other fees that are paid as part of your monthly loan payment. Sometimes called a reserve account, an escrow account may or may not be required for a loan, depending on your lender.

**Housing Expense Ratio**

Suppose your gross monthly income is \$2,000. Your house payment — including taxes, insurance, and interest — should not exceed \$560 a month.

(\$2,000 x .30 = \$600)

**Debt Ratio Formula**

Suppose you pay \$500 a month in bill payments (car, credit cards, etc.) and your gross monthly income is \$2,000. Your house payment — including taxes, insurance, and interest — should not exceed \$300 a month.

(\$2,000 x .40 = \$800

&

\$800 - \$500 = \$300)

### *Fixed Versus Adjustable Rates*

When qualifying for a mortgage, you may have the option of choosing two different types of loans: a fixed rate loan or an adjustable rate loan. A fixed rate loan has the same interest and the same monthly payment as long as you have the loan. Adjustable rate mortgages (called ARMs) start with lower than average interest rates that increase at specific points in time. While it sounds great to have a lower than average interest rate, the payments will increase as the interest rates increase. If the interest rate takes a big hike, your payment will also take a big hike — making it more difficult to meet your monthly financial obligations and putting you at risk to keep your home.

It is generally recommended that you get a fixed rate loan to better manage your monthly expenses. However, if you plan to live in the house for only a few years, an ARM might be an option to consider. Be sure that you totally understand everything in your loan contract because some ARMs have "temporary" or "teaser" rates used an incentive for you to borrow from their company. These temporary or teaser rates can jump significantly within a few months, leaving you with much higher payments that put a strain on your monthly budget. As a general rule, you are overspending on your housing expenses if you need an ARM to qualify for a house or to set the payments at an amount you can afford. It is always better to buy less than more to avoid putting our financial future at risk.

**THREE WAYS TO REDUCE YOUR MORTGAGE COSTS**

1. Make a larger down payment. It lowers the amount of money you borrow. If you borrow less, you will pay less interest which reduces the overall cost of your loan.
2. Shop around for interest rates. The lower the annual interest rate, the less interest you will pay.
3. Make extra payments on your loan. The faster you pay off the loan, the less interest you will pay. When making an extra payment, be sure to put a note on your check requesting the payment go toward the principal.

## *Congratulations! You're Approved!*

Finding the right house can be as challenging as finding the right lender and the right loan. Because you are investing a high percentage of your income in your purchase, you probably want to look around and get plenty of advice on neighborhoods before making an offer on a house. Many people prefer to work with a real estate agent or Realtor®, a licensed professional who specializes in selling real estate. Real estate agents often concentrate on different neighborhoods or different price homes. You might want to talk with friends or family members who have used an agent to get their recommendation. You can also call several real estate offices and visit with one of their agents before making a decision. Be careful about using an agent who continually recommends homes or neighborhoods above your price range.

Real estate agents are trained in helping you make good choices about your purchase. A good agent will show you homes that are for sale in your price range, help negotiate the terms and sales price when making an offer, and assist in finding the right people to do home inspections or minor repairs. While real estate agents may work with both buyers and sellers, they have an obligation to fairly represent both parties in a transaction. Typically, the seller of the house—not the buyer—is responsible for paying the agent's fees. Even if you find a house "for sale by owner", it may be helpful to use a real estate agent or an attorney to help process the paperwork and protect your rights in the transaction.

When buying a house, you have the option of offering less than the listed price. The deal is not completed until both the buyer and the seller accept the terms and price offered. You may also choose to include several contingencies in your initial offer. A contingency is a condition that must be met or the deal is cancelled. Some examples of contingencies include the house passing a home inspection by a professional inspector; the house appraising for an amount similar to the sales price; your ability to secure satisfactory financing for the house, and your ability to sell your house.

The process of buying a home will often require you to negotiate on the price or the contingencies.

However, you do not have to compromise or give in on anything that makes you uncomfortable. It is always important that you do what is best for you. Even though it seems like the “perfect” house, the terms of the contract are more important. Knowing your limits and sticking with them will help ensure you are making the best choice.

When making an offer on a home, you will probably be required to put down a deposit called earnest money. Earnest money shows that you are making an offer in good faith and are serious about buying the property. Your deposit is held by a third party, such as a real estate agent or a title company, until the closing where it is applied toward the down payment or closing costs. You will probably forfeit your earnest money if you change your mind about buying the house after the contract has been signed by both parties unless you have spelled out the reason in the contingencies

**QUICK HOUSE BUYING TIPS**

- Know how much you can afford.
- Be preapproved before starting your housing search.
- Spend less than the lender will give you.
- Avoid buying the most expensive house on the block.
- Use a professional to help guide you through the process.

While your hard work and effort to find a house and get a mortgage is an accomplishment, it is just the beginning of being a homeowner. Taking the time to maintain your house and upgrade it as necessary will help protect your investment.

## Conclusion

There is an old saying that says three things give property value: location, location, location! When buying a house, the location is certainly an important factor to consider. Buying a house is similar to making any other investment. You want to buy smart. That includes finding the right house in the right location, then continuing to maintain it as long as you own it. Knowing what you want and what you can afford will help you make a good choice when buying a home. While others may encourage you to spend more or buy what they like, the ultimate decision is yours. Comparison shopping for a mortgage is as important as shopping around for the right house. The rate of interest and the mortgage terms will have a big impact on the total amount. you pay for your purchase.

FINAL NOTE: Obviously, Hank has been thinking about buying a house for several months and has even taking some initial steps to make it happen. However, he still seems to be in the “looking” stage. You probably want to advise him to go see a lender to get preapproved for a loan and then contact a real estate agent to help him find the right house. While some of his friends make it sound like it is easy to just go buy a place, there is much more involved in making a good decision about buying a house.

This lesson was written and created by Oklahoma educators in partnership with
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Name: ______________________________ Class Period: _____________________________

# Buying a House Review 10.3

Answer the following questions and give the completed lesson to your teacher to review.

1. Which of the following is an advantage to buying a house?
   a. You can expect to have limited expenses for maintenance.
   b. You have little or no ability to make decorating changes.
   c. You have many options for neighborhoods, price, size, and locations.
   d. You may have to qualify for a loan.

2. Which of the following is a disadvantage to buying a house?
   a. You need a down payment and earnest money.
   b. You probably cannot find a place that meets your needs.
   c. You can use a real estate agent to help you locate a house.
   d. You can negotiate the price with the seller.

3. When looking for a house, you should consider all of the following <u>EXCEPT</u> the
   a. price of the house.
   b. color of the walls in the dining room.
   c. neighborhood where the house is located.
   d. payments you make on other debt you owe.

4. When applying for a mortgage,
   a. the monthly payment is all that matters.
   b. the interest rate is all that matters.
   c. shop around until you find the best terms, including interest rate and monthly payment.
   d. borrow money from the same place as your friends; if it is good enough for them, it should be good enough for you.

5. When negotiating an offer on a house, your top priority is
   a. making an offer that is best for you.
   b. making an offer that is best for the seller.
   c. buying the house, regardless of what it costs.
   d. guessing what the seller will accept.

Name: ______________________________ Class Period: ____________________________

# Mortgage Calculations Activity 10.3

Use the information in your lesson to answer the questions in Part A and make the required calculations in Part B. Be sure to show your work in Part B.

Part A

1. Identify three advantages of owning a home.

    1.

    2.

    3.

2. Identify three disadvantages of owning a home.

    1.

    2.

    3.

Part B

1. Dane and Amber plan to buy a house for $130,000. They want to make a down payment of 20% to avoid PMI charges. How much money will they need for a down payment?

2. Benny and Sylvia have a combined gross income of $3,500 a month. They want to buy a house instead of continuing to rent. Using the Housing Expense Ratio, how much house payment can they afford?

3. Marcy has just gotten a promotion at work and she wants to buy a house. She currently pays $350 a month for a car payment and $200 a month on her credit cards. She has a gross monthly income of $4,000. Using the Debt Ratio Formula, calculate her potential maximum monthly house payment.