Buying a Home
"An Investment to Live In"

Life Smarts:

1. Determine costs of owning a home.
2. Understand amortization and methods for paying off a home loan early.

One of the most important money decisions you'll make relates to the choice to own a home. Home ownership has several important advantages for the smart money investor. In this module, you will learn the process of purchasing and selling a home, or "real property." Each important step in this process will be discussed in detail so that you'll be confident when making this vital money management decision.

Key terms

Agent — a **real estate agent** is a person who acts as an intermediary (middleman) between sellers and buyers of real estate (homes or commercial buildings) or real property (land). The agent attempts to find people who wish to sell and buy.

HOA — a Homeowners' Association (HOA) provides people with shared values an opportunity to enforce regulations within their neighborhood. An HOA's rules may surpass city codes (rules). For example, the Homeowners Association's regulations could include conformity in the exterior appearance of homes within the neighborhood; landscape requirements; or time limits on activities generating noise. HOAs typically require monthly fees by the members of the association to maintain shared structures and areas.

Appraisal — the practice of determining the value of real property

Comps or Comparables — refers to properties with similar characteristics; for example, homes approximately the same size and price as a potential seller's home. This can be accomplished either by a real estate agent or a certified appraiser or surveyor, who will establish the value of a potential client's home or property (through a **market analysis**).

Legal Title — this is the actual ownership of the property. When a contract for the sale of land is executed, "equitable" title passes to the buyer (prior to closing). When the conditions of the sales contract are met, "legal" title passes to the buyer, in what is known as the **closing**.

Real estate escrow — refers to money held by a third party on behalf of the transacting parties (the buyers and sellers).

Appreciating Asset — real property or other possessions you own that grow in value over time.

Amortization — refers to the process of paying off a debt (often a loan or mortgage) over time through regular payments. A portion of each payment is for interest, while the remaining amount is applied toward the **principal** balance. Most home loans come with a **fixed interest rate**, meaning it never changes. An alternative to a fixed rate is an **Adjustable Rate Mortgage** or **ARM**. It is also known as a **Variable Rate Mortgage** because the interest rate changes throughout the life of the loan based on market conditions. The percentage of interest vs. principal in each payment is determined in an **amortization schedule**.

Important things to consider

When making a choice about owning a home, it is important to consider where the home is located. There are different reasons for choosing one house over another. Establishing a list of your daily activities can help in the decision of where to live. How close your home is to work, school, recreation, shopping, other family members, etc., can make living in the home more rewarding.

1. List three things you would consider important when deciding where you would like to live.

Answers will vary.

Once you have determined where you would like to live, other factors about the home come into play. The overall size of the home, details on the bedrooms, bathrooms, living room, offices, kitchen specifics, garage, and back yard all contribute to the final decision about purchasing a particular home.

2. In which part of your home do you spend the most time?

Answers will vary.

After you have determined your housing requirements, make a realistic evaluation of your current expenses and annual income to decide if you can afford everything you are looking for in a house. Having a good relationship with your credit union or bank is a vital component to the home ownership process. Most people do not have the cash on hand to pay for a home outright. Because of this, borrowing money from a lender has become the most common method for purchasing a home today. Lenders require a buyer to provide evidence of the ability to repay a loan. Examples include copies of paychecks from a steady job and proof of income from investments. Working with your own credit union or bank may be a convenient place to obtain a loan; however, there are many options available, so it is wise to shop around.

Compare the mortgage lending rates offered by three local banks in your area. Find the rates for a:

30-year fixed loan:

Lender 1 -

Lender 2 -

Lender 3 -

15-year fixed loan:

Lender 1 -

Lender 2 -

Lender 3 -

In addition to shopping for a loan, it is crucial to select the right person as your real estate agent. This person must understand your wants and needs and be willing to represent your interests during this process. There are times when the agent will represent you when you are not present. It is important to have a good line of communication between the two of you and a relationship based on trust. A lack of communication or untimely information can make the difference between getting the home you want and possibly losing out to another buyer. Once again, shop around, and select someone you believe you can work with who will help you get the best deal for the home you want.

Once you have secured an agent to assist you in purchasing a home, begin the task of finding a home to buy. This is where the agent now earns his/her pay. Many agents work with a network of other agents, locally and nationally, to generate a database of available homes to buy and sell. They can easily access this list and narrow the different choices based on location, size, price, amenities, or other criteria to provide a place to begin your home search.

After you have narrowed your home choices and have decided on one, the next step is to negotiate a price. There are several components that go into this negotiation. First, the seller will establish a price for the home. An **appraisal** of the home’s value will be determined according to the home’s age, size, location, condition, and most importantly, the value of other similar homes recently sold in the area. If the appraisal is close to the asking price of the seller, the buyer can make an offer on the home. It is up to the buyer, with the advice of a real estate agent, to determine an appropriate offer for the home. The buyer may choose to offer less than the asking price. At this time, the agents will deliver the offer and counteroffers between the buyer and the seller.

When a price is agreed upon by the buyer and seller, contracts are drawn up by the agent to be signed by both parties. This transaction usually involves a title search, a mortgage, and an escrow company.

Location, location, location

Of the many variables that go into selecting a home, choosing the location is an important first step. Knowing how far your commute will be to and from work, how much time you will spend in traffic, and when you need to leave to make it to work on time will help you decide whether your quality of life will be impacted by your choice.

You may want to start your family in the home you buy. If you are planning to have children, the location and quality of the schools in the area are a priority. Just like your commute to work, your children's travel — perhaps a bus or walking a long distance to and from school — could lead to problems that are easily avoided if the home you chose were closer to the school.

Remember, we are talking about choosing a place to live. If you can have all the things you want to enhance your quality of life, you owe it to yourself to make a list of what you want in a home. How far is it to the grocery store? Where are the shopping malls? How about movie theaters? Are you an active individual? Do you enjoy hiking, camping, swimming, bike riding, etc.? Where would you go for those things? What about pets? Is there a park nearby? All these things should be thought about before you make your choice.

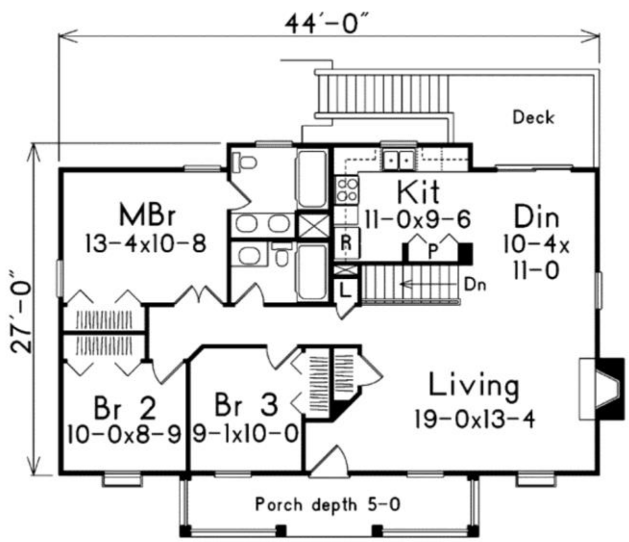
Once you have worked through these considerations, one more question remains. "How much are you willing to pay to live in a better place?" This does not mean, "How much house can you afford?" It relates to whether you want to spend money on a monthly basis to live in a community with gated entrances, security patrols, restrictive covenants, and homeowners' associations.

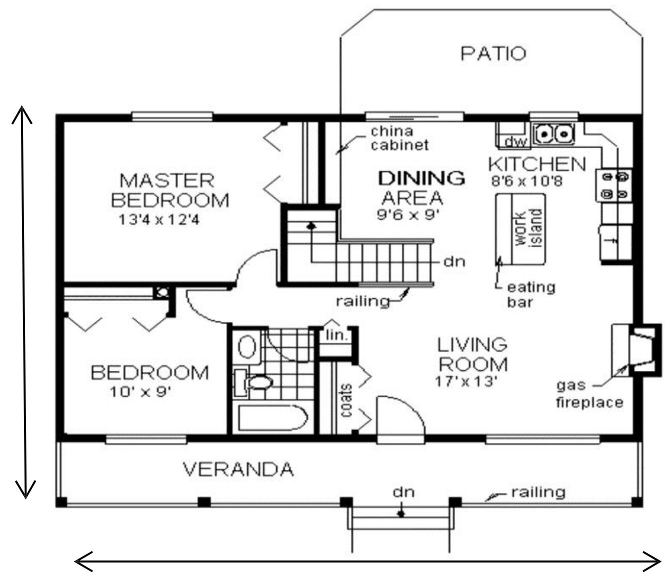
What do you want in a home?

Everyone enjoys getting something new. We are told each day that we need new clothes, a new car, and even the newest technology in cell phones. When it comes to owning a home, this is no exception. An argument could be made, however, on a newer vs. an older home, as to which one is more valuable. Ultimately, it becomes a matter of personal preference depending on the homes you are comparing. Sometimes, an older home is a better option. Modern construction technology and materials can bring the cost of a new home down in the short run. In many cases, however, the older, established house might have been better built by well-trained craftsmen. Don't allow yourself to be fooled by the shiny exterior of a newer home. What you need to look for is a house with a solid structure, built by a reputable contractor.

The cost of a home is based on three factors: The first factor is location, as discussed previously. The second factor is the actual size of the home. The third is optional add-on items.

The price of a home is determined by the amount of living space in the home. This is referred to as the **square footage**. Calculating the square footage is done by taking the measurement of each room (length x width) and adding all the room measurements together. This normally includes only heated spaces and does not factor in garage size or storage space outside the house. Understanding that adding square footage will drive up the cost of the home will help you decide what you can ultimately afford.





31' – 0"

House Plan 1

House Plan 2

1. In the above floor plans, calculate the square footages of each house.

Answer:

House Plan 1 — 1188 square feet (44'-0" x 27'–0")

House Plan 2 — 663.4 square feet (31'-0" x 21'– 4")

2. If the cost of the two houses is the same, say $158,000, which home is the better value? Explain:

The final factor to the cost of a house relates to optional items. Front and backyard landscaping, fireplaces, high-end kitchen appliances, hardwood or tile flooring, and expensive bathroom fixtures can dramatically change the value of a house. Establishing a budget and a must-have option list prior to shopping for a house will help you determine ”the extras” you must absolutely have and the items you could potentially live without.

Find a loan

One of the major obstacles you face when deciding to buy a home is finding the money to pay for it. Today, there are several places to secure the financing needed to purchase a home. The most common place to get a home loan is a bank. Banks make money by lending money. Historically, banks were eager and willing to give loans to just about anyone who wanted one. Instability in the housing industry, however, has forced banks to become more cautious when approving loans. Individuals asking to borrow money must now provide documentation proving their eligibility for a loan.

Other institutions that offer loans are credit unions and lending companies that can be accessed through the Internet. Regardless of the source of financing for your loan, the two most common types of mortgages are **FHA** and **VA**. **FHA** stands for the Federal Housing Administration, which offers government-insured loans with flexible credit guidelines. **VA** stands for Veterans Affairs, which offers loans to help veterans and their families obtain home financing.

How much home can you afford?

Now that you have chosen everything you want in a home, it's time to calculate how much you can afford. In most cases, people wanting to own a home must borrow the money to pay for it. The term used to describe this borrowed money is called a **mortgage**. In its simplest form, a mortgage is defined as **principal** (actual amount borrowed) x **interest** (usually an annual percentage rate) x **the length in years of the loan.**

1. Calculate what your mortgage would be for a home costing $275,000 with an interest rate of 4.5% for 30 years.

Answer: ($275,000 x .045 x 30 years) = $371,250

Once you know the amount of the mortgage, determine how much your monthly payment will be by multiplying the number of years of the loan by 12 and dividing the mortgage by this number. The resulting monthly payment is a combination of the principal and interest of the loan. Simply stated, each month you pay off a portion of the principal and a portion of the interest for the life of the loan.

However, there is one more wrinkle added to this process. Lending institutions want more of their interest paid back during the first years of the loan as a safeguard against borrowers not honoring their debts. This is accomplished using a payment schedule that separates the payments based on principal and interest and applying a greater portion of your monthly payment toward the interest during the first half of the loan period. This is amortization, as defined earlier.

How is an amortization schedule calculated?

An **amortization schedule** is a table or chart showing each payment on an amortizing loan and including the amount of the payment, interest, and the amount toward the principal balance. Thankfully, there are many free websites and calculators that create amortization schedules automatically. The downside to this is that people are less informed on the mathematical calculations involved in creating the schedule. The following example below provides step-by-step calculations for a simple, fixed-rate mortgage.

> Let's say you are purchasing a new home for $280,000 with a $30,000 down payment. Your bank agrees to provide you with a $250,000 mortgage at a fixed interest rate of 5% for 30 years.
>
> What is your monthly payment? How much money are you paying toward interest and principal each month?

Let's find out.

Determine the total number of payments

In this example, you must make one payment per month for 30 years. This means you will make 360 payments over the course of the mortgage

(12 x 30 = 360)

Determining a monthly payment

If there were no interest rate, determining your monthly rate would be simple. Divide the loan amount by the number of payments:

$250,000 / 360 = $694.44

Obviously, the bank has to make money, so the mortgage includes a 5% interest rate (to provide profit for the bank).

It is important to note that 5% is an **annual** interest rate. Since all of the following calculations are based on a monthly payment schedule, the annual rate needs to be converted to a monthly rate as follows:

5% / 12 = 0.416%

Determining the monthly payment to account for interest requires a complicated formula shown below:

$$A = \frac{i \times P \times (1 + i)^n}{(1 + i)^n - 1}$$

A is the monthly payment; **P** is the loan's initial amount; **i** is the monthly interest rate; and **n** is the total number of payments.

Using our numbers **(P = $250,000; i = 0.416%; and n = 360),** the formula yields a monthly payment of **$1,342.05.**

Determining the total interest

The total cost of the loan can now be calculated; there will be 360 payments of $1,342.05. The total cost is approximately **$483,139** (actually $483,139.46 if you don't round the monthly payment to whole numbers). Subtracting the original loan amount ($250,000) leaves the interest: approximately **$233,139**. Even though the interest rate is only 5%, the interest paid is almost as much as the purchase price!

Determining the breakdown of each monthly payment

Even though the monthly payment is fixed, the amount of money paid to interest varies monthly. The remaining amount is used to pay off the loan itself. The formula above ensures that after 360 payments, the mortgage balance will be $0.

For the first payment, we know the total amount is $1,342.05. To determine how much goes toward interest, multiply the remaining balance ($250,000) by the monthly interest rate:

$250,000 x 0.416% = $1,041.67

The rest goes toward the mortgage balance:

$1,342.05 - $1,041.67 = $300.39

After the first payment, the remaining amount on the mortgage is **$249,699.61**

($250,000 - $300.39 = $249,699.61)

The second payment's breakdown is similar except the mortgage balance has decreased. The portion of the payment going toward interest is now slightly less:

$1,040.42 ($249,699.61 x 0.416% = $1,040.42)

Monthy Amortization Schedule

Payment	Amount	Principal	Interest	Balance
1	$1,342.05	$300.39	$1,041.67	$249,699.61
2	$1,342.05	$301.64	$1,040.42	$249,397.97
3	$1,342.05	$302.90	$1,039.16	$249,095.08
4	$1,342.05	$304.16	$1,037.90	$248,790.92
5	$1,342.05	$305.43	$1,036.63	$248,485.49

This process of calculating interest based on the remaining balance continues until the mortgage is paid off. Each month, the amount of interest declines, and the amount paid toward the loan increases. After 360 payments, the mortgage is paid in full.

356	$1,342.05	$1,314.44	$27.61	$5,312.76
357	$1,342.05	$1,319.92	$22.14	$3,992.84
358	$1,342.05	$1,325.42	$16.64	$2,667.43
359	$1,342.05	$1,330.94	$11.11	$1,336.49
360	$1,342.05	$1,336.49	$5.57	$0.00
Totals	**$483,139.46**	**$250,000.00**	**$233,139.46**	

It is important to note that our calculations do not include any additional fees, such as closing costs.

Create an amortization schedule for purchasing a motorcycle.

The cost of the motorcycle is $6,000. The loan is for four years at an interest rate of 5%. Search the Internet for an amortization calculator to assist you.

To honestly know how much you can afford to pay for a house, additional expenses must be factored in with your monthly mortgage payment. Other expenses include **homeowner's insurance, property taxes**, and **utilities** (gas, electric, and water). **Property taxes** are paid annually and are based on the assessed value of the property and improvements. In addition, other costs must be considered, including maintenance, repair, and possibly monthly or annual fees paid to housing associations if you live in a gated or protected community.

Real estate agents

In today's real estate market, finding the right person to represent you during the various stages of buying a home can be the difference between a good experience and a bad one. The people who do this work are a very diverse group with differing approaches to their jobs. Try to find someone you believe to be honest and a good communicator. Remember, real estate agents work for you and are contractually obligated to represent your interests. This means they are your paid employees throughout the purchasing process.

> **How do you decide which agent to contract to help buy or sell your home?** Investigate the track record of the agents you select. Ask them to provide a list of their recent house sales from the past six months. It doesn't matter whether the agent works for a large national real estate firm or is a part of a small local office. The agent should have a strong understanding of the housing market in the area you are interested in living to get the results you are looking for at a price you can afford.

Real estate agents use several tools in locating homes for a potential buyer. Almost all agents are part of or have access to national databases that track home sales in the U.S. This is a huge advantage when trying to locate homes that are selling in your area. Available houses can be sorted based on price range or other attributes, like square footage, garage space, or style of the home. Agents also gather data related to recent home sales to use as a comparison to the available homes for sale to provide an idea of the true value of the houses in a certain area. These comparisons, or **comps,** help buyers and sellers settle on a reasonable price for their homes. Of course, this does not mean a seller won't ask a high price. The comps will help protect you as a buyer from paying too much for a house based on the average price of other recently sold homes in your area.

The services that a real estate agent provides make the process of finding, negotiating a price, and closing on a house easier and quicker for you as a buyer. However, this service is not free. Agents charge a fee based on the final sale price of the house. This fee is usually split between buyer and seller and is paid at the time of final signing of all the mortgage and title documents (also known as "the time the sale is closed" or "at **closing**").

Typically, agents charge a 6% fee for their services. This fee can be negotiated (under certain conditions) but as a buyer, you can expect to pay at least 3% to an agent once the house is bought. Be diligent with your agent, and make sure he or she is working hard for the money. Realtors have established a fixed rate for their services; therefore, it is possible to employ an agent who is not as motivated as others might be. As someone using their services, it is important for you to know how long an agent has been working as a realtor and his or her home sales record. Any prior client referrals would also be helpful.

The last thing to know about real estate agents is that they perform only one function in the overall process of buying a home. **Real estate brokers** are required to complete the legal documents necessary for a closing to be legitimate and final.

Find your dream home

Finding your dream home takes a lot of time and “leg work.” The easiest way to do this is to drive around the area you wish to live and look for homes for sale in the neighborhood. You can also search the Internet and newspapers. Professional marketing materials, available in stands at many grocery stores, restaurants, etc., will help target homes before you ever get in the car.

What is the home worth?

What is a home worth? This is not an easy question to answer. The seller of the home will have an asking price, but that is not necessarily the actual worth of the home. The age, condition, and size are components in determining a home’s worth. Appraisal companies are in the business of viewing homes and evaluating them against a defined set of criteria to better define their worth. Another way to evaluate a home is to compare it to other homes of similar age, size, and in close proximity; remember, this process is known as “comps.” **Buyer inspection services** are involved in home transactions to help protect consumers from major defects or deficiencies, such as structural, roof, plumbing, and HVAC issues that could result in major repair or replacement costs. Purchasing a home will almost always involve negotiation, which is why it is smart to work with competent and trustworthy inspectors and real estate agents. Your real estate agent will negotiate effectively on your behalf. Just like any item for sale, the worth of a home is “what someone is willing to pay for it.”

Insurance and taxes

Homeowner's insurance is often required; it covers the house (structure) replacement due to fire or other hazards. It also covers belongings inside the home in the event of disaster or burglary. The premiums for this insurance are usually paid monthly with the mortgage payment. Real estate taxes are required; they are computed and held in escrow as a part of your monthly mortgage payment.

Closing on a home

Closing on a home involves a meeting at the **title company**. It is during this meeting that you are required to produce funds for a down payment, the appraisal reports, escrow, and fees for closing your loan. The title company representative will review the details of the loan, including your monthly mortgage payment and all of the components that make up that payment. At the end of this meeting, you will be given the keys, and you officially take ownership of your home!

Last things to know

Many of the fees associated with purchasing a home, such as closing costs, appraisal reports, etc., can be paid by the seller or the buyer or split between the two parties. You do not need a real estate agent to buy a home, but a good agent can be extremely helpful in negotiating the price of the home; determining who pays the costs; and in the end, help you realize a significant savings. A home is usually an appreciating (goes up in value) asset, in contrast to renting an apartment, where you pay a monthly rent. Regardless of how long you stay in an apartment, you never build equity.

The biggest saving tip when buying a home

As mentioned earlier, the length of a mortgage is normally 30 years, though you can negotiate a 15-year mortgage. The difference is that your monthly payment will be higher for a 15-year mortgage because you are borrowing the same amount but paying it off in less time. Borrowers who pay monthly are required to make at least 12 payments a year. Another option is to pay **bi-weekly** (every two weeks), where you make 26 payments; each payment will be half of what you pay on a monthly basis. You end up making one extra payment per year by paying bi-weekly.

Example:

Let's say your monthly payment is $1,000 per month and the loan is for 30 years.

In a year, you will pay:

$12,000 = ($1,000 x 12 months).

For 30 years, you will pay

$360,000 = ($1,000 x 12months x 30 years).

Now let's say you pay bi-weekly.

In a year you will pay

$13,000 = ($500 x 26 bi-weekly periods in a year)

Note: Every two weeks, you will pay half of what you would've paid during the month; however, there are 26 two-week periods in a year (52 weeks / 2).

This extra payment made every year means that you will pay off the house sooner, thus saving thousands of dollars in interest.

The next table shows that if you borrowed $100,000 at 5% interest for 30 years and made bi-weekly payments, you will pay off the loan in 303 months instead of 360 months (4.75 years earlier) and save $17,163.97 in interest.

Tip: Make bi-weekly payments or make an extra payment at the end of each year to save thousands of dollars in interest.

Enter the principal balance owed:	100,000
Enter the annual interest rate percentage:	5%
Enter the number of months:	360
Here is your monthly payment amount:	$536.82
Here is your bi-weekly payment amount:	$268.41
This is how much interest you will pay using monthly payments:	$93,255.78
This is how much interest you will pay using bi-weekly payments:	$76,091.82
Bi-weekly mortgage interest savings:	$17,163.97

In the table below, list all of the expenses that you might incur with owning a home. Use the following website to determine your monthly/bi-weekly payments.

http://www.webwinder.com/calculators/biwk_vs_month_loan.html

Cost of home	$200,000
Interest rate on loan	4%
30-year loan	
Expenses:	
Monthly payment amount	
Bi-weekly payment amount	
Other expenses: (list and estimate each amount)	