4-6: Finance a Home with a Loan

Cast List
- Darryl
- Angela Robson, Realtor
- James Green, first-time home buyer
- Nicole Green, first-time home buyer

Synopsis: Darryl
- Darryl meets James and Nicole Green, a couple interested in buying a house.
- The Greens' realtor, Angela, helps them understand mortgage options.

Location
- At a fixer-upper the Greens are considering

A. How Home Loans Work
   a. Few of us have the money to purchase a home outright
   b. Borrowing to buy a home can be smart, if you are sure you can afford it
      i. Build credit
      ii. Build equity
      iii. Home mortgage interest deduction
   c. Down payment – generally need 20%
   d. Principal – balance of loan paid off, usually over 15 to 30 year time period
   e. Interest
   f. Equal payments (basic amortization) mostly interest at first, gradually involve more principal as balance declines
   g. Payment also involves monthly charges for taxes and insurance
   h. PMI may be required
   i. Closing costs can be substantial
      i. Points
      ii. Fees, transfers, taxes

B. Find Out How Much Home You Can Afford
   a. Visiting a bank for prequalification – informal; no paperwork; estimates how much you can borrow
   b. Getting preapproval – fill out application (pay stubs, W-2, tax returns, etc.)
   c. Homebuyer assistance programs
      i. IDA program
      ii. Government programs
      iii. HELP for FHA loans
   d. Risks of overbuying – being "upside down," foreclosure

C. Choose the Best Home Loan for You
   a. Size of down payment
   b. Term – 15, 30, or other – affects total interest paid over the life of the loan, but also size of payment
   c. Interest – fixed, adjustable, balloon, advantages of each
   d. Points – may affect terms

D. Understand the Escrow Account
   a. Required balance for taxes, insurance, PMI
   b. Annual accounting

E. Consider Mortgage Options
   a. Interest-only mortgage
      i. Interest, not principal, paid in initial monthly payments
      ii. Then must pay entire principal balance in lump sum or will pay regular mortgage payments
         1. Lower monthly payment, so can purchase home couldn't otherwise
         2. Interest rate usually adjustable
         3. May convert to conventional mortgage (will pay interest and principal)
   b. Bi-weekly
      i. Usually fixed rate
      ii. Pay off mortgage faster
   c. Adjustable (a.k.a. Variable)
      i. Requires additional disclosures
         1. How much rate could increase or decrease over periods of time

	F. Refinancing a. Replace existing home loan with new one with better rate/terms b. Reasons to refinance i. Better interest rate ii. Fixed interest rate c. Disadvantages of refinancing

Theme music up

DARRYL: Welcome to another edition of the "Money Smart Podcast Network, with Darryl" – gee, I like the way that sounds! Terri is on vacation, the slacker.

First-time homebuyer, Nicole Green, wrote in recently, looking for help financing a first home for her and her husband James. I'm catching up with the Greens and veteran real estate agent Angela Robson as they check out a bargain property. Let's see, 13 East Hill…uh, okay – should be right there!

Wow! Nicole was looking for a fixer-upper – I think this more than fits the bill.

SFX: Doorbell, then a very creaky door opens.

ANGELA: Darryl? I'm Angela Robson – welcome. The Greens are already here.

DARRYL: So, this looks like an… affordable house.

ANGELA: It needs some love – but the problems are all cosmetic.

DARRYL: That means it's ugly, right?

ANGELA: *(Laughs)* It means the house has a new roof, updated electrical, and recent heating. It also means that with some imagination, a lot of paint, and a few handyman touches, this will be a beautiful *and* affordable starter home.

SFX: Sound of footsteps and the Greens speaking at a half whisper in the distance. We begin to hear their conversation.

JAMES: No, you can't do that – it'll take forever and look awful.

NICOLE: Yes, we *can*… My friend at work did it!

DARRYL: Dare I ask what your friend did?

NICOLE: You're Darryl! From the podcasts! … My friend repainted her kitchen cabinets and tiled her own backsplash – and it looks *great*!

ANGELA: You're right, Nicole – there are a lot of simple projects you can do yourself.

JAMES: Installing tile? That's *if* you're handy. And even if we can do all of that, I don't know if we can afford this place. We don't even know where to start to get a loan.

DARRYL: Well, as a realtor, Angela has seen many first-time buyers steer through the loan process – I think she knows a few things.

ANGELA: I'm no financial expert, but I do understand the basics. I can help you and Nicole find more information, James.

JAMES: I don't like the idea of owing a lot of money.

ANGELA: You're smart to be concerned. I mean, it's important to be sure that you can afford a loan.

DARRYL: And afford one for the property you're interested in.

ANGELA: That's right. A home loan can be a smart move. For most people, a mortgage is what makes owning a home possible. Not many of us can buy a house outright.

DARRYL: Amen to that!

ANGELA: Having a mortgage loan and paying on time builds your credit. You may also qualify for a tax deduction on the interest you pay.

JAMES: You mean having a mortgage can lower our taxes?

ANGELA: It certainly could; talk with a tax advisor to understand more.

DARRYL: Double amen to that!

JAMES: How much down payment will we need?

ANGELA: That depends on your lender and the specific loan. It's usually around twenty percent of the purchase price.

JAMES: So, I put twenty percent down and make payments forever!

NICOLE: Not forever!

ANGELA: No, certainly not forever. It's usually fifteen or thirty years. And along the way, you're gradually paying down the principal, or the amount you've borrowed. Right now you're paying rent, right?

NICOLE: *(with displeasure)* Mmmm hmmm.

ANGELA: What will you have to show for it in five years?

JAMES: Uh, an apartment?

ANGELA: Right – but with a mortgage, after five years, you'll have a lot more equity in your house—

NICOLE: —equity?

ANGELA: Equity is the difference between what your home is worth and how much you still owe on the mortgage. So after five years of making mortgage payments, you'll have more invested in your home and your loan balance will be lower. So if you sell at that point, you could have a significant amount of money you could invest in your next home, or in your business.

NICOLE: James' friend told him that all the money goes to interest, and now he's wigging out.

JAMES: How can I not lose it when all we'll be paying in all that time is just *interest*?!

ANGELA: James, at first, more of your payment will go to interest, but each month a little more goes to repaying the money you borrowed – the principal - and less to interest – so you really do build equity.

JAMES: Will I have to pay insurance and taxes on top of that?

ANGELA: Yes, those often get wrapped into your monthly payment. We can go over that a little more later.

DARRYL: James, it sounds like you have cold feet on buying a house….

NICOLE: Oh, he just doesn't want to admit he doesn't understand all this stuff.

JAMES: Oh, like *you* understand it…

ANGELA: Let's break it down – there is a lot to understand.

DARRYL: That's for sure.

ANGELA: One thing to remember is that the more you put down on a home, the less you will have to borrow. That means the less you will have to pay to the lender in interest.

NICOLE: What if we cannot put down twenty percent?

ANGELA: Well there is hope! Depending on your circumstances, there may be a mortgage loan program that allows you to purchase with a lower down payment. Remember, when you take out a loan, you'll want to have money set aside for closing costs.

DARRYL: What exactly are closing costs?

ANGELA: Those are costs that cover the completion of the real estate transaction itself. So it's money paid for things like the appraisal, title insurance, taxes, and possible fees for preparing and processing all kinds of paperwork.

DARRYL: Sounds expensive!

ANGELA: It can be fairly expensive, depending on the house and the loan.

NICOLE: And the appraisal?

ANGELA: Well, the lender will require an appraisal to be completed on the property to assess its value. The appraisal will be one factor that helps determine the maximum amount that the bank will lend for the property. It protects the buyer and the lender. There are also fees for the property, such as title, deed transfer, and other processing costs. The good news is that your lender has to give you a loan estimate within three business days of getting your application. The Loan Estimate itemizes the costs and fees associated with your loan. You can use it to help you understand the potential costs and terms of loans you are considering.

JAMES: So how do we figure out if we can afford all this?

ANGELA: You can visit your financial institution. They could help you with what's called pre-qualification for a loan. They'll ask basic questions about your income and any outstanding debts and help you figure out how much you can borrow.

NICOLE: Do we have to go with them if we get a loan?

ANGELA: No, there's no obligation. You can shop around for rates, and then get pre-approved by the lender you choose. In fact, it's a very good idea to shop around for the best deal rather than make a decision based on say who has the funniest advertisements! Ha.

DARRYL: Can you explain the difference between getting pre-qualified and getting pre-approved?

ANGELA: Sure. With pre-approval, you fill out an application, and you'll need to provide proof of income – your pay stub or W-2 form, tax returns, and other information.

DARRYL: Folks, we're going to take a quick commercial break to highlight some of the programs available to help homebuyers.

…and whad'ya know?! The commercial break is being brought to you by…yours truly.

(he puts on an "announcer" voice)

There are several programs available to help homebuyers.

Individual Development Accounts (IDAs) are special savings programs for people with low to moderate incomes. An IDA can be used to fund a long-term investment, such as a home.

Through the program, an individual's savings are matched, helping them save quicker. A local NeighborWorks America affiliate may be able to help you find programs in your area. Go to www.nw.org to learn more. You can learn about Federal Housing Administration loans that offer low down payments and low closing costs at www.fha.com/fha_loan_requirements.cfm. The site also has information on the loan process and loan calculators.

Veterans may qualify for loans through the Veterans Administration. To learn more, visit www.benefits.va.gov/homeloans/

Programs that allow you to purchase a home with less than a twenty percent down payment generally require an up-front and/or annual mortgage insurance premium to protect the lender in the event you do not repay the loan.

And now, back to the Money Smart Podcast with…*(back to his regular voice)* still yours truly.

So, realtor Angela Robson was just telling us about using a mortgage to buy a home. The Greens – James and Nicole Green – are looking at a place with lots of potential.

<u>ANGELA</u>: James, are we drowning you in information, or helping you get more comfortable with the idea of a mortgage?

<u>JAMES</u>: I was starting to feel over my head, but I'm glad to hear that some programs can help.

<u>ANGELA</u>: You're smart to be cautious – people who "overbuy" can end up in trouble if their home loses value or they can't make their payments. That's how some people end up "upside down" – which means that the amount of their loan is more than the home is worth.

<u>JAMES</u>: Yeah, one of Nicole's friends had that happen… and then they lost their house.

<u>ANGELA</u>: I think that's one reason Nicole wanted to see houses that are "fixers."

<u>NICOLE</u>: That and I love "Design with Dan" – they have such fantastic ways to redo rooms on a budget!

<u>JAMES</u>: You just like watching Dan!

<u>DARRYL</u>: Dan? Oh! That's the dude that Terri is always going on about…

<u>NICOLE</u>: Oh, yeah!

<u>ANGELA</u>: Okay – back to mortgages… there are a number of things that affect how much you pay. We talked a little about the size of your down payment – the more you put down, the less you have to borrow, so the lower your payment.

<u>JAMES</u>: I still don't like the idea of being in debt for so long. Everyone I know has a thirty-year mortgage, but you said there's one for fifteen?

ANGELA: There are 15-year loans available. You'll pay more per month than with a thirty-year loan – but you'll pay less interest over time, and you may get a better rate.

NICOLE: So different kinds of loans have different interest rates?

ANGELA: Right. You probably know about fixed-rate loans, where the interest rate stays the same throughout the life of your loan. That can be a great deal when interest rates are low.

JAMES: So I could get a fixed rate loan for fifteen years?

ANGELA: That's one option, if you qualify. Then there's an adjustable interest rate loan.

NICOLE: How exactly does that work?

ANGELA: Let's say you get a loan that has a rate of three percent to start, maybe for a year or two years. After that period, the interest rate can adjust up *or* down. So if rates rise, your mortgage payment would increase as well. But if rates were to fall, your mortgage payment would decrease.

DARRYL: I know people who got burned when rates went up when they took out their mortgage loan at a time when interest rates were low.

ANGELA: That's the risk of a variable rate loan.

DARRYL: I've heard that balloon loans can be really risky.

ANGELA: They can be. With a balloon loan, you don't pay off the full amount of the loan during the term. Instead there's a large "balloon" payment at the end. Let's say you borrowed $50,000. You might pay off twenty thousand over a seven-year term, and then pay the remaining thirty dollars at the end – or get a new loan.

DARRYL: So if you couldn't pay, that balloon could pop, so to speak… .

ANGELA: *(groans)*… Darryl. Balloon loans could be an option in some circumstances, because the payments are significantly less. I've never had a client use one...

DARRYL: People are always talking about points for a mortgage loan – what does that mean?

ANGELA: Buyers often have the option to pay an additional percentage of the loan to get a lower interest rate. If you plan to live in the same home for many years, then paying that money up front may save you in interest.

JAMES: You said before that taxes and insurance can be combined with the loan payment – how does that work?

ANGELA: Usually, the lender will require you, as part of your monthly payment, to include the estimated amount for taxes and home insurance. They set that money aside in a special account that's set up specifically for paying your taxes and home insurance.

DARRYL: An escrow account?

ANGELA: Right! It's called an "escrow account." Actually, for some types of loans, an escrow account is required by law.

JAMES: So what happens if their estimate is too high – does the bank just keep my money?

ANGELA: Not at all! They're only allowed to collect a certain amount, and if they do overestimate, they'll refund the excess or they'll keep it in your escrow account to go toward the following year's taxes and insurance – and the amount of your monthly payment might get adjusted as well.

NICOLE: James can get a little hyper about that kind of thing.

ANGELA: Can't say I blame him for wanting to know what's going on with his money! You can rest easy, James. The law requires lenders to provide an accounting of what goes into and out of your escrow account every year.

JAMES: Ok…but what if the estimate is too low?

ANGELA: Then they'll increase the monthly escrow payments – and your mortgage payment will go up to reflect that. The actual loan payment itself won't go up, assuming you have a fixed-rate loan.

JAMES: It sounds like everything with a lower rate is risky.

ANGELA: Well, no – remember those government programs that help you get lower rates. You can also make your loan payment every two weeks instead of once a month. You pay off your mortgage faster, saving you money on interest. Sometimes there's a fee to do that – check with your lender before you close your loan to explore that option.

DARRYL: Any last words of wisdom for first-time homebuyers?

ANGELA: If you're considering an adjustable rate or variable loan, be aware that the lender must disclose to you how much the rate could increase or decrease over time. Understanding what your monthly payment could rise to will help you decide if that's a good option for you.

DARRYL: A last question for some of our fans – I'm sure we must have some fans… don't we? Anyhow for people who are already homeowners. When is it smart to refinance?

ANGELA: Most people choose to refinance to get a better interest rate or terms. For example, if you had a variable loan, and the interest rates came down, you could lock in a lower rate with a fixed rate loan.

DARRYL: Or if you had a high fixed rate loan, you might refinance to get a lower rate?

ANGELA: Exactly!

DARRYL: Are there any down sides to refinancing?

ANGELA: Well, you're starting the clock again in terms of paying interest. And you're often lengthening the amount of time that you make payments – if you were fifteen years into a thirty year loan, and took out another thirty year loan, you'd be making payments for forty-five years…

DARRYL: At my age, I'd be dead before I paid the loan off!

ANGELA: But seriously, there are also loan fees for refinancing. If you're planning to live in your home only a couple more years, chances are the fees would offset what you save by refinancing.

DARRYL: So, as always, you have to do the math – or find one of those great loan calculators to help you figure it all out.

Angela, thanks for helping us out today!

Nicole and James, I hope you lovebirds can settle on a house.

Folks, thanks for joining us!

Theme music up

DARRYL: This has been the "Money Smart Podcast Network, with yours truly…Darryl." Terri will be back next time, but between you and me, I'm enjoying the quiet while it lasts!

Music fades