Money Mechanics

Buying a House

THINKING ABOUT BUYING your first home? You may wonder if it's possible. This publication explores the advantages and disadvantages of home ownership and the costs that are involved.

Advantages, Disadvantages

Home ownership makes financial sense for many families. Property taxes and the interest portion of your mortgage payments are tax deductible. Paying off your mortgage may be a form of "forced savings," too. A portion of each mortgage payment increases your equity. For many people, home ownership brings personal benefits, such as establishing roots in a community.

But owning a home has disadvantages. A mortgage requires large payments for a long period of time. If payments take too much of your income, you may not have enough money to meet unexpected needs. It can take several months to sell a house. During tough economic times, property values may not rise, or they may even decline.

Consider All Costs

If you think home ownership is for you, stop and consider if you really can afford it. Look beyond the purchase price in your housing decision. It's possible that all the other costs of owning a home—taxes, insurance, utilities, maintenance, and, perhaps, additional transportation costs—could equal or exceed mortgage payments.

Consider All Costs

Before you start house hunting, decide how much house you can afford and how much you are willing to spend. Consider these four things.

- How much will a lender loan you?
- How much can you afford to spend?
- How much are you willing to sacrifice to buy a house?
- How much of your savings are you willing to invest as a down payment?

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It's a good idea to get "prequalified" for a loan by having a lender assess your income and existing debts before shopping for a house. This doesn't guarantee that your actual loan application will be approved, but the results will be a useful guide.

The maximum amount that should be spent on housing can be determined only by an actual loan application.

A house is a substantial investment. Investigate your options before you make a decision.

The Down Payment

The down payment represents the initial amount of cash you must provide to buy the property with a mortgage. This amount generally ranges from a minimum of 5 to 20 percent of the sales price. For example, a 10 percent down payment on an $85,000 house would be $8,500. Before settling on a down payment amount, be sure you have enough money to pay for moving, closing costs, and any necessary remodeling or appliances.

Accumulating a down payment can be a tough requirement. Here are several ways to deal with the down payment obstacle.

- **Save more of your current income.** By tightening the purse strings on other spending, you can accumulate the down payment over time. Payroll deduction of savings can help.
- **Cash in savings.** Sell a second car. But don't leave yourself without savings to cover emergencies.
- **Add additional income and save it until you have the necessary down payment.** Every family member can pitch in until your short-term goal is reached.
- **Consider a mortgage insured by a private insurer, the Veterans Administration (VA), or the Federal Housing Administration (FHA).** Investigate state and local first time homebuyer programs. These loans require a very low or no down payment, but you will pay a monthly mortgage insurance premium in addition to the principal and interest payment.

Closing Costs

At the time of purchase, you'll also need money for numerous up-front costs. These costs include.

- closing costs, such as appraisal fee and a credit report, and
- prepaid expenses for homeowner's insurance and property tax escrow.

Table 1

Money Needed at Closing[1]

Appraisal	$ 300
Credit report	60
Title guarantee	110
Abstracting	150
Title opinion	180
Flood determination	14
Recording fee	89
Processing fee	400
Down payment	4,250
Prepaid first-year homeowner's insurance	480
2 months mortgage insurance and property tax escrow[2]	260
Total	$6,293

1. Assumes $85,000 purchase price with 5 percent down payment
2. Varies by month in which closing occurs

Source: First National Bank of Ames, Iowa

Lending institutions may charge "points," which will be an additional cost. One point equals 1 percent of the mortgage loan. The buyer or seller can pay points; they are tax deductible if the buyer pays them.

Typical costs at the time of closing for a home with an $85,000 purchase price are shown in **table 1**.

Financing Alternatives

Most people will have to borrow money to buy a home. Today's first-time buyer faces a wide array of financing alternatives. In addition to the traditional fixed rate mortgage, there are many loans with variable terms.

Check with a number of sources when shopping for a home loan. Interest rates, down payment requirements, closing costs, and loan availability will vary. A difference of only a half percent in the mortgage interest rate can mean thousands of dollars over the life of a loan.

Lenders must provide an estimate of closing costs within three business days of a loan application. Don't be afraid to bargain. Closing costs charged by different lenders can vary widely.

Work with a trustworthy lender. Watch out for "predatory" lenders who use high-pressure sales techniques, encourage you to borrow more than you can afford and even more than the value of the house, and charge unusually high fees. Check with a nonprofit housing organization or a reputable financial institution if you are unsure about your decisions. Consult an attorney before signing a contract.

When evaluating a loan, ask these questions.

- What is the required down payment?
- What is the monthly payment, interest rate, and term? Can they change?

When comparing adjustable-rate loans, get answers to these questions.

- What is the "cap"—the maximum increase in the interest rate over the life of a variable loan?
- What options are available to deal with changes in the interest rate (increase monthly payments or extend the term of the loan)?
- Could the amount you owe increase above the original loan?

For more information and links to financial calculators and financing options, visit **www.extension.iastate.edu/housing/financial/financial.html**.

Investigate, Then Invest

A house is a substantial investment—probably the largest you'll make. Make your decisions only after extensive investigation. Realistically consider total housing costs, financing arrangements, and housing alternatives. You'll be much happier with your housing decision in the long run, if it reflects both your needs and your financial situation.

For First-Time Homebuyers

The Iowa Financial Authority, in cooperation with participating lenders, offers low and moderate-income first-time homebuyers below-market interest rates, and assistance with down payments and closing costs. For more information, call **(800) 432-7230** or see **www.ifahome.com**.

USDA Rural Development also provides a number of home ownership programs to rural low and moderate income Iowans, including no-down-payment loans for qualified borrowers, as well as programs for home renovation and repair. For more information, call **(515) 284-4663** or see **www.rurdev.usda.gov/ia**.

What Is Your House-Buying Power?

This worksheet will help you estimate the maximum loan you can afford and illustrates how existing debts can reduce that amount. For example, the Smiths and the Riveras both have $2,500 monthly gross (before-tax) income. The Smiths make $300 monthly payments on consumer debt; the Riveras have no debts. The examples use a 6 percent interest rate on a 30-year, fixed-rate mortgage.

Housing Expense Ratio	The Smiths	The Riveras	Your Figures
1. Monthly gross income (before-tax income)	*$2,500*	*$2,500*	________
2. Multiply line 1 by 0.28	x 0.28	x 0.28	x 0.28
3. **Monthly mortgage payment (PITI)[1] should not exceed this amount**	*$700*	*$700*	________

Housing Expense Ratio	The Smiths	The Riveras	Your Figures
4. Monthly gross income (before-tax income)	*$2,500*	*$2,500*	________
5. Multiply line 4 by 0.36	x 0.36	x 0.36	x 0.36
6. **Total monthly payments on all debts (including mortgage) should not exceed this amount**	*$900*	*$900*	________
7. Subtract current monthly payments on other debts	*-$300*	*-0*	________
8. **Monthly mortgage payment should not exceed this amount**	*$600*	*$900*	________
9. **Choose the lower of line 3 or line 8; this figure estimates the maximum mortgage payment (PITI) given your current income and debts**	*$600*	*$700*	________
10. Multiply line 9 by 0.80	x 0.80	x 0.80	x 0.80
11. This estimates the portion of the mortgage payment (PITI) that represents principal and interest only	*$480*	*$560*	________
12. Use **table 2** to figure the **size loan that could be obtained with this monthly mortgage payment**	*$80,000*	*$95,000*	________

1. Principal, interest, taxes,insurance

Table 2

Monthly Payment on a 30-Year Fixed Rate Mortgage

Select a current interest rate for 30-year, fixed rate mortgages; go down the column to the amount nearest the number on line 11 of the worksheet. This is the monthly payment on a mortgage loan amount in the corresponding first column. For example, the Smiths estimate that the maximum monthly payment they can afford is $480—the monthly payment on a 30-year, $80,000 loan at 6 percent interest.

	Interest Rate						
Loan Amount	5%	5.5%	6%	6.5%	7%	7.5%	8%
$ 50,000	268	284	300	316	333	350	367
$ 55,000	295	312	330	348	366	385	404
$ 60,000	322	341	360	379	399	420	440
$ 65,000	349	369	390	411	432	454	477
$ 70,000	376	397	420	442	466	489	514
$ 75,000	403	426	450	474	499	524	550
$ 80,000	429	454	480	506	532	559	587
$ 85,000	456	483	510	537	566	594	624
$ 90,000	483	511	540	569	599	629	660
$ 95,000	510	539	570	600	632	664	697
$100,000	537	568	600	632	665	699	734
$110,000	591	625	660	695	732	769	807
$120,000	644	681	720	758	798	839	881
$130,000	698	738	780	822	865	909	954
$140,000	752	795	840	885	932	979	1027
$150,000	805	852	900	948	998	1049	1101
$160,000	859	908	960	1011	1065	1119	1174
$170,000	913	965	1020	1074	1131	1189	1247
$180,000	966	1022	1080	1138	1198	1259	1321
$190,000	1020	1079	1140	1201	1264	1328	1394
$200,000	1074	1136	1200	1264	1331	1398	1468

For more information, visit **www.extension.iastate.edu/finances** *or* **www.extension.org/personal+finance** *or the Iowa State University Extension office in your county.*

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