PAGE ONE Economics®
Middle School Version

Focus on FINANCE

On the Move: Mortgage Basics

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GLOSSARY

Budget: An itemized summary of probable income and expenses for a given period. A budget is a plan for managing income, spending, and saving during a given period of time.

Collateral: Property required by a lender and offered by a borrower as a guarantee of payment on a loan.

Credit report: A loan and bill payment history kept by a credit bureau and used by financial institutions and other potential creditors to determine the likelihood that a future debt will be repaid.

Default: The failure to promptly pay interest or principal when due.

Disposable income: The amount of a person's paycheck that is available to spend or save.

Down payment: A sum of money put toward the purchase price to reduce the amount of money borrowed.

Foreclosure: The legal process by which a property that is mortgaged as security for a loan may be sold and the proceeds of the sale applied to the mortgage debt. A foreclosure can occur when the loan becomes delinquent because payments have not been made or when the borrower is in default for a reason other than the failure to make timely mortgage payments.

Glossary is continued on page 4.

"Every radish I ever pulled up seemed to have a mortgage attached to it."
—Ed Wynn

Introduction

Taking out a mortgage for a home is a big decision. Typically a mortgage payment is a fairly large part of one's income. It can feel stressful to the person making the payment. In the above quote, actor Ed Wynn shared how stressful he felt about a mortgage even while gardening.

Most high school and college students are probably focused on shorter-term goals other than buying a home. Financial choices people make early in life can affect their future, though. It may be hard to imagine where you'd like to live. There are many options. Budgeting for a home may seem like a long time from now. It's still a good idea to familiarize yourself with some important concepts that can affect your future housing choices. To help you begin thinking about these choices, we'll discuss financial readiness, credit, and some mortgage basics.

Budgeting

As you ponder your future and the option of buying your own home, it will be helpful to start thinking early on about how to make it happen. Start by considering actions you can take to help you reach your goals. One might be saving for a **down payment** on your first home. Regardless of your place in life and your goals for the future, it's a good idea to know where you stand financially. You can do this with the help of a **budget**. A budget can help you avoid financial stress. It will help you set aside some of your **disposable income**. It will also help you set and achieve **savings goals**.

In addition to saving for goals like a down payment, it's a good idea to set aside income to help with emergencies. Most financial experts suggest having 3-6 months' worth of income for your expenses. These funds should be in an account you can access. Having emergency savings can help you because you could lose income or your job. There are emergency fund calculators online that might be helpful, too.[1] You can start using a budget now by keeping track of what you earn or receive and what you spend. Starting good money habits can open chances in the future. Even saving small dollar amounts can make a difference over time.

Budgeting and saving aren't guarantees that you'll never have stress over money. Those skills can help you plan for the future, though. Living below your means can help—that is, not spending as much of your income as you could. That raises the amount you can save. Get in the habit of using a budget and saving. You might be able to save up for some major purchase, such as a house. To buy a house with a loan, you'll have to establish credit.

A Quick Course on Credit

Using a budget is a great way to keep track of your income and spending. But for most people, buying a house requires more than a budget. It usually requires credit. What is credit? Credit is using someone else's money for a fee. The fee is **interest**, which is usually stated as a percentage. Banks and other institutions pay you interest when you keep money in accounts with them. They also make loans to other customers. People take out loans for many reasons, such as to buy cars and boats or pay for school expenses. People may also use credit to grow their business. You may be wondering how you get credit.

You get good credit when you pay your bills on time. Also, don't borrow more money than you can pay back. Good credit is one step in qualifying for future financing choices such as buying a home. Lenders use credit history to decide if they'll grant more credit. They also use credit to decide what **interest rate** to charge. Higher credit scores typically lead to better interest rates. This is because the **default** risk is lower. Lower credit scores typically lead to interest rates that aren't as good. This is because the default risk is higher. A bank looks at your credit history to decide. Credit history is your payment activity over time. It's a good idea to keep track of your credit history. There can be mistakes on your **credit report**. **Identity theft** is also common, so you have to watch your report. Federal law lets people see a free copy of their credit report each year.[2] Your credit report is a huge part of the home-buying process.

Mortgage Basics

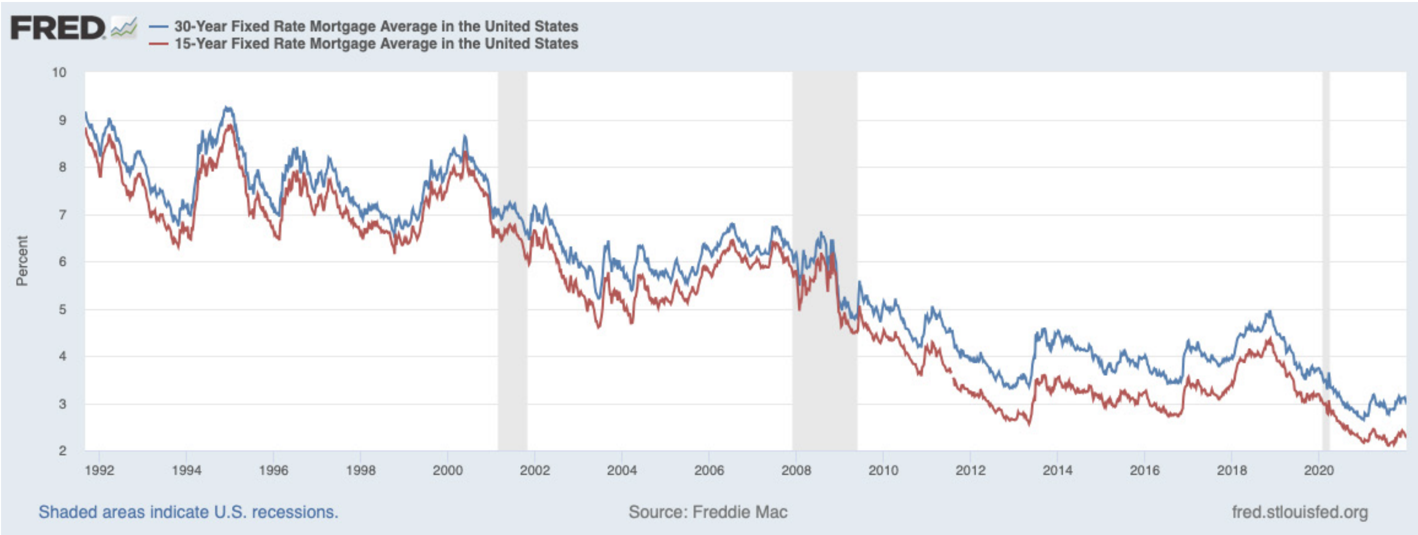
Just what is a mortgage? Don't let the word confuse you. A mortgage is a loan. It's used to buy a home or real estate. People want a place to live. Many people want to own a home. A lot of people think owning a home is important, for many reasons. Some want to be able to garden. Others want to build a deck or tear down a wall. If you are renting, you might not be allowed to do these things. Some people like the possibility of building equity. Equity is value in the home. With a mortgage, part of each monthly payment goes to interest, and another part goes to the principal. Principal is the sum first borrowed. The amount the borrower owes goes down over time, which happens as the borrower makes payments. House values can rise and fall, and this can also affect how much equity is in a home.

There are some key ideas to consider when thinking about a mortgage. When you apply for a mortgage, a lender goes through a process. Lenders look at your credit history and pay sources. They also check how much debt you have. Lenders use this data to decide if you qualify for a mortgage. It helps them set the interest rate you'll pay to borrow the money. Lenders might use credit to tell how much you'll need as a down payment. It's a good idea to plan on paying 20% of the sale price as a down payment. You can still get a loan if you don't have the 20%, though. Lenders would typically make borrowers pay for private mortgage insurance. This is insurance you pay monthly. It will partially pay back the lender if you don't pay your mortgage. Lenders offer different mortgage types and programs. These can help people buy a home.

Terms

Lenders might offer mortgages with different **terms**. Most offer 10-, 15-, 20-, or 30-year mortgages. The mortgage interest rate you pay depends on many factors. This includes the mortgage term. The down payment might also affect the interest rate. Your credit history and credit score matter, too. Shorter-term loans tend to have lower interest rates. A 15-year mortgage is a shorter-term loan. You save money on these because you pay off the loan faster, but your monthly payment will be higher. This is because you pay more of the loan principal with each payment. You'll pay the whole loan back in 15 years rather than 30. A 30-year mortgage is a longer-term loan. Longer-term loans typically have higher interest

Average Interest Rates for 15-Year and 30-Year Fixed-Rate Mortgages



SOURCE: FRED®, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/graph/?g=JaWj, accessed November 18, 2021.

rates. This is because the loan is stretched over a longer time. Your monthly payment will be lower on a 30-year loan. Here's an example: Let's say you borrowed $100,000 at 3.5% interest. Your monthly payment would be $449.04. Over 30 years the loan would actually cost $161,656.09. Now say you borrowed $100,000 at 3.5% interest for 15 years. Your monthly payment would be $714.88. The total loan cost would be $128,678.86. That is less than half the interest of a 30-year mortgage.[3] This is a simple example. It does not include every part of a mortgage, so it's very important to understand the type of mortgage you are applying for. This includes knowing the interest rate as well as the term.

Interested in Interest?

Some loans have fixed interest rates. Some interest rates are variable, or adjustable. It's vital to know the difference. A fixed rate means the interest rate won't change. It will stay the same for the loan term. Your monthly payment will not change with a fixed interest rate. It will stay the same for the whole loan. A variable rate could go up or down. Changes in the interest rate can change your monthly payment. The FRED® graph shows the 15-year and 30-year fixed-rate mortgage averages in the United States. You can see the rate changes over time. It's important to understand interest rates. They can affect the total loan cost. This affects your home cost in the long run.

The lower the rate, the less interest you'll pay. The opposite is also true. And the shorter the loan term, the lower the interest rate. Remember, the average interest rate on a 15-year mortgage tends to be lower than the average interest rate on a 30-year mortgage (Figure).

In checking out interest rates and types of mortgages, look at many parts. Don't just look at the monthly payment. Here's why: There are different types of loans. An interest-only mortgage[4] is one. There are pros and cons to loans like this. Borrowers should understand these. The loan principal doesn't go down if the borrower pays only interest. A person could owe almost the same amount from the time they purchased the home to the time they sell it. There may be some plusses of an interest-only loan. The borrower might be able to live in a different style house or live in a higher-priced home. Living in a better location may be possible because of a lower payment. Paying only interest may make sense for some situations. There could be problems if the house value goes down, though. A person could make payments but see no change in the amount owed. One possible result of an interest-only loan could be costly. A drop in the home value could cause problems. A person could owe more than the house is worth. That is called "being underwater."[5] Borrowers need to understand the loan terms and conditions before they agree to make house payments for 15, 20, or 30 years.

Making it Official

An actual home purchase takes place at a closing. This is where the buyers and sellers sign forms. These papers include a buyer's promise to insure the property. The lender will insure it otherwise, but they will make the owner pay. The buyer also promises to make house payments, and the house is used as **collateral** on the loan. If buyers stop paying, the lender can take the home back. They do this through **foreclosure**. All terms and disclosures are discussed at the closing. This includes the loan terms and conditions. It also includes consumers' rights.

Conclusion

Buying a home is a long way off for most young people. There are still many steps to take now that will help prepare you to make good mortgage decisions. And there are many options for mortgages, as people have different needs and situations. Various types of loans offer different loan terms and conditions. You can start to prepare for a major purchase by using a budget. You can establish credit and start saving, and you can learn about application and lending processes. By doing these things, young people can be ready to own their own home, when the time is right. ■

Notes

[1] Mercadante, Kevin. "Emergency Fund Calculator." *Money Under 30*, modified December 21, 2021; https://www.moneyunder30.com/emergency-fund-calculator.

[2] For an annual credit report, see https://www.annualcreditreport.com/index.action, accessed November 19, 2021.

[3] See Bankrate's loan calculator at https://www.bankrate.com/calculators/managing-debt/annual-percentage-rate-calculator.aspx, accessed November 29, 2021.

[4] Fontinelle, Amy and Witkowski, Rachel, eds. "What Is An Interest-Only Mortgage?" *Forbes*, updated April 21, 2021; https://www.forbes.com/advisor/mortgages/what-is-an-interest-only-mortgage/, accessed November 20, 2021.

[5] Lee, Jeanne. "Risks of Walking Away from an Underwater Mortgage." *Bankrate*; https://www.bankrate.com/finance/mortgages/risks-of-walking-away-from-mortgage-debt-1.aspx, accessed November 22, 2021.

GLOSSARY continued

Identity theft: A form of stealing that results in someone gaining access to another person's personal information (such as name, address, driver's license number, credit card numbers, date of birth, birthplace, or Social Security number) to commit all or any of the following crimes: gaining access to bank accounts to steal money, making purchases with credit or debit cards, opening credit, or engaging in other criminal behavior.

Interest: The price of using someone else's money. When people place their money in a bank, the bank uses the money to make loans to others. In return, the bank pays interest to the account holder. Those who borrow from banks or other organizations pay interest for the use of the money borrowed.

Interest rate: The percentage of the amount of a loan that is charged for a loan.

Savings goal: A good or service that you want to buy in the future.

Term: The amount of time it will take to repay a loan.

Name____ **Period**________

Federal Reserve Bank of St. Louis *Page One Economics*®:

"On the Move: Mortgage Basics"

After reading the article, answer the following questions.

1. Which of the following is a plan for managing income, spending, and saving in a given time period?
   a. Budget
   b. Collateral
   c. Disposable income
   d. Term

2. Which statement is true?
   a. The better your credit score, the higher the interest rate you'll pay.
   b. The better your credit score, the lower the interest rate you'll pay.
   c. The shorter the loan term, the higher the interest rate.
   d. The longer the loan term, the lower the interest rate.

3. How many months' worth of expenses do financial experts recommend people save for emergencies?
   a. 1-2 months
   b. 2-4 months
   c. 3-6 months
   d. 8-10 months

4. What percentage is a good rule of thumb for a mortgage down payment?
   a. 10%
   b. 15%
   c. 20%
   d. 25%

5. Which of the following is the best example of how to establish a good credit history?
   a. Borrow as much money as possible without concern of how to pay it back.
   b. Pay your bills on time and don't spend as much money as you could.
   c. Don't worry about saving; rather, spend more to establish credit.
   d. Take out the type of loan that guarantees the lowest payment.

6. Which of the following means the failure to promptly pay interest or principal when due?
   a. Collateral
   b. Default
   c. Term
   d. Disposable income

7. According to federal law, which of the following statements is true?
   a. Interest-only loans are not permitted for a mortgage.
   b. The government can initiate the foreclosure process, not lenders.
   c. There are no programs available to buy a home if you don't have a 20% down payment.
   d. People may obtain a free copy of their credit report annually.

8. Which of the following is true of a fixed-rate mortgage?
   a. The payment will go up and down with housing market conditions.
   b. The interest rate will not change over the entire loan term.
   c. The amount of equity in the home will not change.
   d. The principal will not change over the entire loan term.

9. If a borrower fails to make payments, the lender can't take the collateral.
   a. True
   b. False

10. Which of the following statements is correct?
   a. Shorter-term loans, such as 15-year mortgages, tend to have lower interest rates.
   b. You save money with a longer-term loan because your monthly payment is higher.
   c. Longer-term loans, such as 30-year mortgages, typically have lower interest rates.
   d. Shorter-term loans mean your monthly payment will be lower.