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Focus on FINANCE

On the Move: Mortgage Basics

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"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 relatively large portion of one's income, and it can feel stressful to the person making the payment. For example, in the above quote, actor Ed Wynn expressed the weight of a mortgage even while gardening.

While most high school and college students are probably focused on shorter-term goals other than buying a home, financial decisions made early in life can affect a person's future. It may be hard to imagine where you'd like to live, but know that there are many options. While it may seem like a long time from now, it's 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 preparedness, credit, and some mortgage basics.

Budgeting

As you ponder your future and the possibility 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, such as 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, set aside some of your **disposable income**, and 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 in an accessible account as emergency savings. Having emergency savings can help if you experience a loss of income or job. There are resources online, including emergency fund calculators, that might be helpful.[1] You can start using a budget now by keeping track of what you earn or receive and what you spend. Establishing

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.

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good money habits can open opportunities 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 financial stress, but these can help you plan for the future. Living below your means can help increase the amount you can save, too—that is, not spending as much of your disposable income as you could. By getting in the habit of using a budget and saving, you might be able to save up for a major purchase, such as a house; but to buy one of those, 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 expenses. 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, usually from a bank or another institution, for a fee. The fee is **interest** and is generally expressed as a percentage. Banks and other institutions pay you interest for keeping money in accounts with them, and they make loans to other customers. People take out loans for all kinds of reasons, from buying cars and boats to paying for education and business expansion. You may be wondering how you get credit.

You can establish good credit by paying bills on time and not borrowing more 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 whether to extend credit and at what **interest rate**. Higher credit scores typically lead to more favorable interest rates because the risk of **default** is lower, and vice versa: Lower credit scores typically lead to less favorable interest rates because the risk of default is higher. When you make credit decisions, like buying a home, a bank will examine your credit history—your payment activity over time. As you use credit, it's a good idea to keep track of your credit history, too. With the possibility of inaccuracies on your **credit report** and even **identity theft**, you have to monitor your report. Federal law allows people to see a free copy of their credit report annually.[2] Your credit report will be a huge part of the mortgage process.

Mortgage Basics

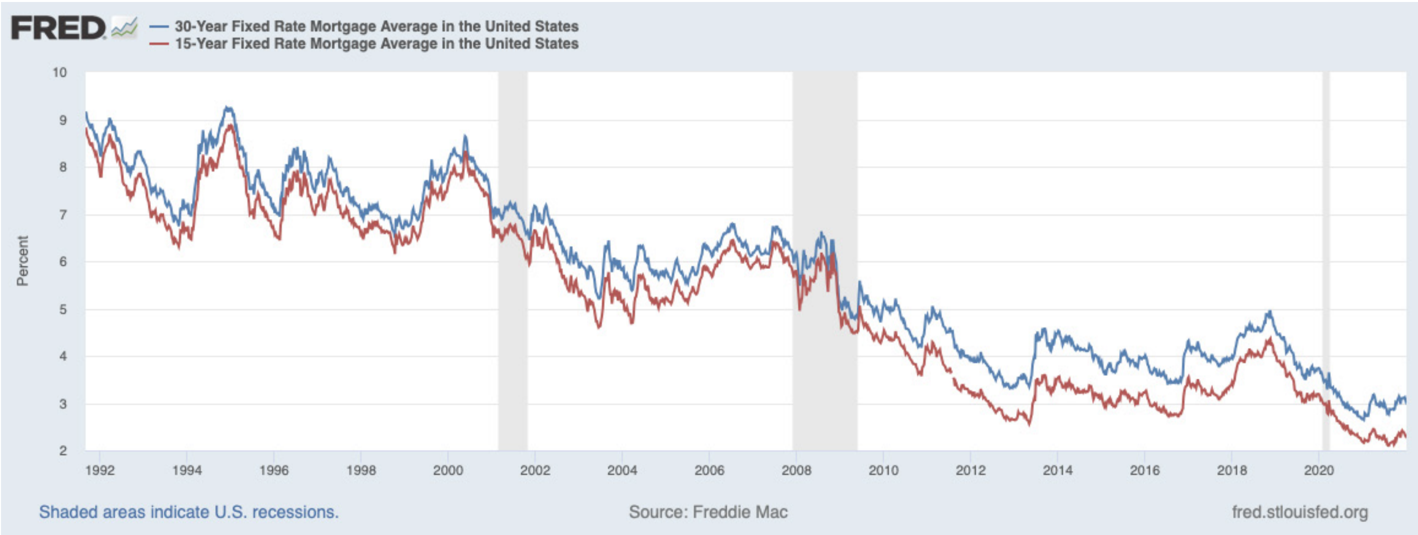
Just what is a mortgage? Don't let the word confuse you. A mortgage is a loan for the purchase of a home or real estate. First and foremost, people want a place to live, and many people want to be homeowners. Home ownership is important to people for a variety of reasons: Some want to be able to garden, build a deck, or tear down a wall, which may not be possible if you are renting. Some people like the possibility of building equity, or value, in the home. When you take out a mortgage, part of each monthly payment goes toward interest and part goes toward the principal—the amount originally borrowed. As a result, when the borrower makes payments over time, the amount owed decreases. The value of houses can rise and fall, though, and that can affect the amount of equity in a home, too.

There are some important concepts to consider when thinking about, or applying for, a mortgage. When you apply for a mortgage, a lender examines your credit history, income sources, how much debt you have, and so forth; they use this information to decide if you qualify for a mortgage, what interest rate you'll pay to borrow the money, and how much you'll have to pay as a down payment. A good rule of thumb is to plan on paying 20% of the purchase price as a down payment. If you don't have the 20%, lenders typically require borrowers to pay for private mortgage insurance. This is insurance you pay monthly that will partially compensate the lender if you fail to pay your mortgage. Lenders also offer different types of mortgages and programs to help borrowers buy a home.

Terms

Lenders might offer mortgages with varying **terms**, such as 10-, 15-, 20-, or 30-year mortgages. The mortgage interest rate you pay depends on factors like the term of the mortgage, your down payment, your credit history, and your credit score. Shorter-term loans, such as 15-year mortgages, tend to have lower interest rates, and you will save money because you end up paying off the loan faster; but your monthly payment will be higher because you are paying off more of the principal with each payment (and the entire loan in 15 years rather than 30). Longer-term loans, such as 30-year mortgages, typically have higher interest rates, but because it is stretched over a longer time your monthly payment will be lower.

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.

Here's an example: Let's say you borrowed $100,000 at 3.5% interest. Your payment would be $449.04 per month, and over 30 years the loan would actually cost $161,656.09. If you borrowed $100,000 at 3.5% for 15 years, your payment would be $714.88 per month, and the total cost of the loan would be $128,678.86, with less than half as much interest as you would pay by taking out a 30-year mortgage.[3] This is a simple example and does not include every aspect of a mortgage or the payment, so it's very important to understand the type of mortgage you are applying for. This includes understanding the interest rate along with the term.

Interested in Interest?

Some loans have fixed interest rates, but some are variable, or adjustable. It's important to know the difference. A fixed rate simply means the interest rate won't change during the loan term, which means your payment will not change much, if at all, over the course of the loan. On the other hand, a variable rate could go up (or down) and cause changes to 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 fluctuations in the rate over time. Interest rates are important to understand because they can affect the total cost of the loan—and your home—in the long run. The lower the rate, the less interest you'll pay, and vice versa. In addition, 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 researching interest rates and the type of mortgage that will meet your needs, don't just look at the amount of the monthly payment. Here's why: Among other types of loans, there is a type called an interest-only mortgage,[4] and there are pros and cons to a loan like this that a borrower should really understand. For example, if a person is paying only interest, the loan principal doesn't go down, and a homeowner could end up owing close to the same amount on the loan at the time they sell their home as they did when they purchased it. Some positives of having an interest-only loan might be the ability to live in a home with a different style, higher price range, or better location because of the lower payment. Paying only the interest may be effective for some situations, but in the event the house's value goes down, the borrower may not have reduced the amount owed on the home despite having made payments. In fact, a possible consequence of an interest-only loan and a reduction in a home's value could mean a person could owe more than the house is worth, a condition commonly referred to as "being underwater."[5] The point is that borrowers need to understand all the terms and conditions before agreeing to 15, 20, or 30 years of payments.

Making it Official

An actual home purchase takes place at a closing where the buyers and sellers sign the paperwork. These documents include a buyer's promise to keep insurance on the property and make house payments. Otherwise, the lender will insure it—and charge the owner. The house is used as **collateral** to secure the loan. If buyers stop making payments, the lender can take the property back through a process called **foreclosure**. All terms and disclosures are discussed at the closing, including the terms and conditions of the loan and the rights of consumers.

Conclusion

Buying a home may be a long way off for most young people, but there are many actions to take now that can help prepare you to make sound decisions about mortgages. And there are plenty of options when it comes to mortgages, as different loans, terms, and conditions serve people's different needs and circumstances. By using a budget, establishing credit, saving, and developing an understanding of the application and lending processes, young people can set themselves up to own their own home when the time is right for them. ■

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**________

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"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.