LIGHTBULB PRESS®

HOME FINANCE

VIRGINIA B. MORRIS AND KENNETH M. MORRIS

California Department of Business Oversight
Education and Outreach Program

DEPARTMENT *of*
BUSINESS OVERSIGHT
State of California · Business, Consumer Services and Housing Agency

About the DBO

The DBO regulates state-licensed financial institutions, products and professionals in order to provide accessibility to a fair and secure financial services marketplace.

The DBO serves the state by enforcing the state's financial service laws and providing resources to Californians to help them make informed financial decisions.

As part of its mission, the DBO strives to help consumers protect their personal finances from fraud.

For a list of licensees and industries regulated by DBO, visit **www.dbo.ca.gov**.

Consumer Services Office

The DBO's Consumer Services Office provides information and assistance to consumers. If you need help verifying the licensing status of a financial institution, service or professional call the DBO's toll-free number **1-866-275-2677** or **visit www.dbo.ca.gov/consumers** for help.

Office of Education and Outreach

The DBO's Office of Education and Outreach is committed to providing consumers with helpful information and materials on a variety of financial topics. The outreach programs empower Californians to make smart decisions about their finances.

This booklet's purpose is to help California's consumers understand the process of buying a home and some of the major responsibilities they will have as homeowners.

Informed and educated consumers are less likely to fall victim to financial fraud and scams.

DBO Outreach Programs

The Mortgage Education Outreach Program will expand consumer education and awareness in the areas of homeownership and the home buying process, preventing foreclosure, loan modifications, and mortgage fraud and scams.

Seniors Against Investment Fraud (SAIF)
Developed in 2001, the Seniors Against Investment Fraud (SAIF) Program alerts and educates California seniors about unscrupulous investment fraud. **The Protect Yourself from Fraud booklet** is designed to encourage Californians to "check before you invest" and provides tools to stop financial fraud before it happens.

California Troops Against Predatory Scams (TAP$)
This program alerts and educates California's military service members and their families about investment fraud, predatory lending and how to avoid being scammed.

Help us protect Californians from unlicensed or fraudulent consumer transactions.

Do you think you have been a victim of fraud or a scam?

How to File a Complaint with the DBO

1. Download the complaint form from our website. For the fastest response, we recommend filing online. **www.dbo.ca.gov/consumers/consumer_services.asp**

2. Call us toll-free **1-866-275-2677** to have a complaint form mailed to you.

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Buying a Home

To buy or not to buy? It may be more complicated than you think.

Is now the right time to buy a home instead of renting? Should you sell the home you're living in and buy another one? The answers to these questions are always a combination of financial and personal priorities, sometimes prompted by a new job or a growing family.

A BUYER'S CHECKLIST

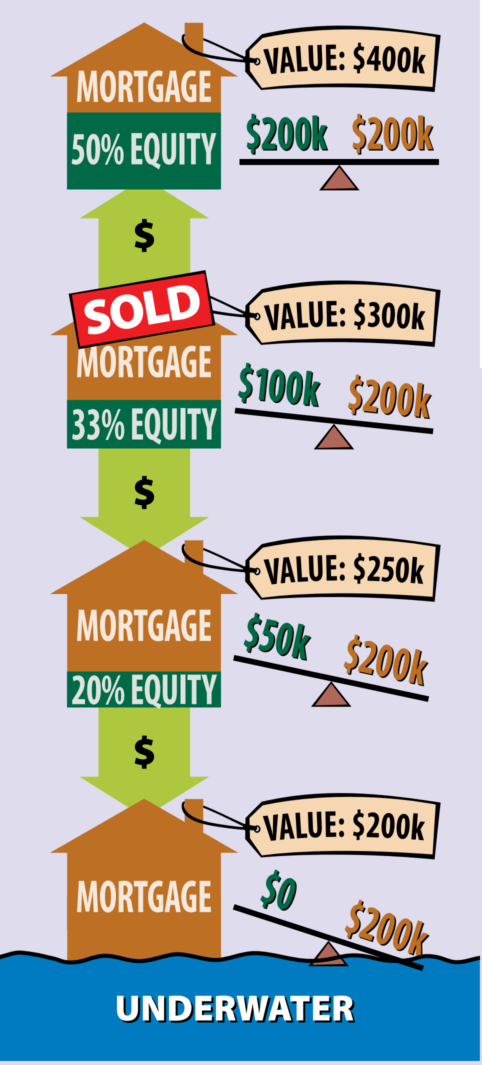
If you're thinking seriously about buying, you'll want to:

- Evaluate how much you have for a down payment, either from savings or potential profit from the sale of your current home
- Estimate what you can afford to spend by reviewing your budget, consulting with your financial advisers, and comparing the results of several online home-buying calculators — though the calculators may ask for information you don't have, such as estimated real estate taxes and insurance costs
- Start looking at homes in your price range in areas you have identified as places you'd like to live

Unless you qualify for a Federal Housing Administration (FHA) mortgage, a Department of Veterans Affairs home loan guarantee, assistance through the Community Reinvestment Act (CRA), or another government program—including people buying in rural areas and people with disabilities—you should expect lenders to require a 20% cash down payment.

When estimating what you can afford, remember that you have to include real estate taxes, which can vary dramatically from place to place. If you have children, remember that higher real estate taxes may be correlated with a good public school system. So paying higher taxes may be cheaper in the long run than paying for private school. The same is true about proximity to public transportation if you

EQUITY CHANGES



IT'S ALL ABOUT EQUITY

When you make a down payment on a home, that amount determines your equity, or the percentage of the property you actually own. The more you put down, the greater your equity. And, as you pay off the mortgage loan principal, your equity increases. When the loan is fully paid, your equity is 100%, and the home is yours, free and clear.

But there is another factor at work in building equity: the market value of real estate, which changes all the time. That means your equity can increase if the market value of your home increases. But, the reverse is also true. If the market value drops, your equity could shrink, a situation that a large number of homeowners faced during the fiscal crisis starting in 2008.

In a simplified example, assume that a home you bought for $300,000 with a $200,000 mortgage grew in value to $400,000. Your initial equity of 33%

commute. The catch is that good schools and good transportation don't necessarily go hand-in-hand.

In the final analysis, flexibility is key to finding a home that meets your financial and personal needs. So is waiting for the right opportunity.

THE BUYING PROCESS

Most homebuyers pay part of a home's purchase price, called the **down payment**, in cash, and use a **mortgage loan** from a bank, credit union, mortgage banker, or other lender to close, or finalize, the purchase.

At least six months before you expect to apply for a mortgage loan, you should check your **credit report** using www.annualcreditreport.com to be sure there are no potential credit problems that might make it harder for a lender to approve your application. If you find a major error that could hurt your creditworthiness, try to have it resolved by following the directions on the credit reporting agency website.

Then shop around for the lowest **annual percentage rate (APR)** being offered for loan term you want. If you already have an account with a potential lender, you'll want to start there, asking if you would be eligible for a preferred rate.

ASKING FIRST

The customary approach to applying for a mortgage is to wait until you find the home you want to buy and then look for a lender. But you may want to investigate **preapproval**. This means you apply for a mortgage loan before you have chosen a property. The lender will let you know whether or not you're approved and how much you'll be able to borrow.

Preapproval is often a good idea since you can shop with more confidence when you know how much you can afford to spend. Preapproval can also make you a more attractive buyer, as the seller can be confident that you can get a loan. But there are fees involved, as there are with any loan application, so you don't want to take this step until you're serious about buying.

Another approach is to seek **pre-qualification**. In this case, a mortgage lender confirms that you will probably be approved and for how much but does not make a commitment to lend.

(your $100,000 divided by the $300,000 value) would increase to 50% (your $100,000 plus the $100,000 divided by $400,000). That is, you'd owe around $200,000 on a home worth $400,000.

But, if the home's market value decreased to $250,000, your equity would shrink to 20% if you still owed $200,000. And the value dropped below $200,000, as it could in a serious market downturn, your equity would drop to 0% and you would actually owe more than the home was worth. That's known as being underwater.

While real estate values don't change overnight, you don't pay off a loan's principal that quickly either. In fact, it takes more than 20 years of a 30-year loan to pay off even half the principal.

The prospect of price changes in the housing market shouldn't drive you away from buying. The changes often work in your favor. But the potential for a loss in value is worth considering.

Signing a Sales Contract

The terms of a purchase are spelled out in a legal contract the buyer and seller sign.

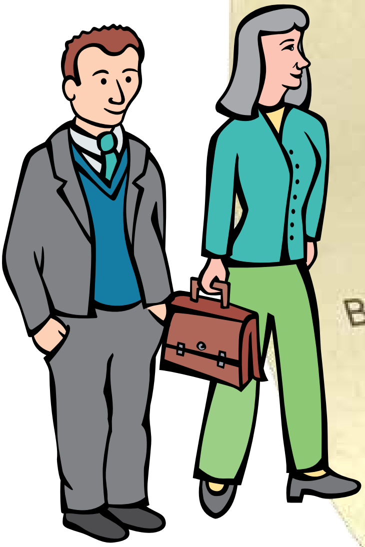
The Contract

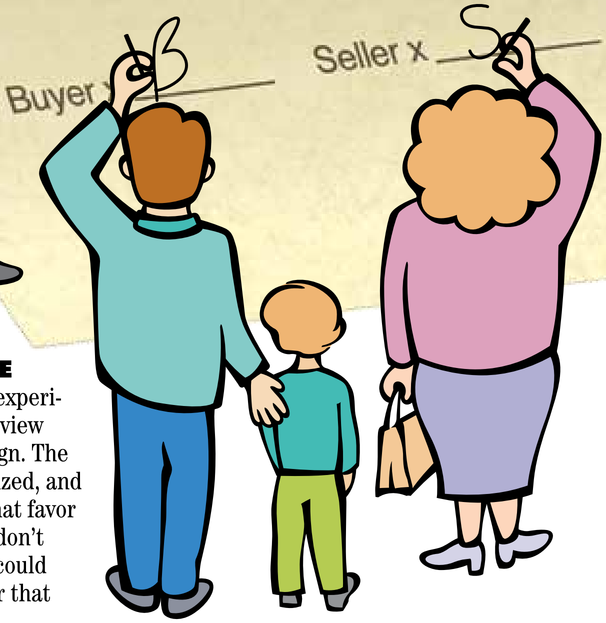
As soon as your offer is accepted, the seller's agent or lawyer will begin preparing a formal contract for you to sign. It will detail all of the key terms of the sale:

- The amount that is due
- The property that is covered by the price, including any appliances or furnishings
- When the sale will be finalized
- What contingencies, or situations, would void the agreement, such as your inability to get financing within a certain period

Most of the language in the contract is standard—commonly known as boilerplate—but there may be some very specific provisions as well. For example, the sellers may want to make the sale contingent on their being able to move into their new home on schedule.

THE BUYER'S AGENT & ATTORNEY





GETTING EXPERT ADVICE

It's important that you hire an experienced real estate attorney to review the sales contract before you sign. The document's language is specialized, and may include some conditions that favor the seller rather than you. You don't want to agree to anything that could cost you extra time or money, or that might limit your rights.

You may want to ask your financial adviser, real estate agent, or lender to recommend a real estate attorney. Or if you've worked with an attorney in a different capacity, you may want to ask him or her for a recommendation.

An attorney may charge an hourly rate or a set fee calculated as a percentage of the purchase price. Generally, one or the other approach is standard in the area where you're looking, and the amount may not be negotiable. You may also have to pay for the services of your financing provider's attorney, again depending on local custom. Using the provider's attorney may be a cost-saving alternative, but hiring your own legal representative is a better idea and worth the added cost.

DIFFERING VALUES
The **market value** of a property is the amount you're willing to pay to buy it. The **appraised value**, on the other hand, is what a real estate appraiser working for a lender believes it is worth, based on comparable houses in the community and his or her judgment and experience.

The appraised value determines the size of the mortgage loan a lender will provide. If it's less than you need to buy the home, you may need to increase your down payment, find another lender, or change your plans.

THE SELLER'S AGENT & ATTORNEY

FINALIZING THE CONTRACT
When representatives for you and the seller have agreed to the terms of the contract, you both sign the document. You typically make a cash down payment to the seller's agent, which is held in reserve in an **escrow account** until the sale is finalized. The amount of the required payment is stated in the contract, and varies based on local custom. The maximum is rarely more than 10% of the purchase price and may be less. The balance of the down payment is due at the closing.

If the sale falls through, you may or may not get the deposit back, depending on whether or not there is a contingency clause to this effect in the contract. Unless a contingency is standard practice, such as one voiding the contract if the buyer can't find a mortgage, one or the other party may not be willing to agree to including it.

There's no way to predict how long contract negotiations may take. They can move along briskly, but they can also be stalled if you, the seller, or your representatives can't agree on all the details. And since there are a number of people involved—the seller, the seller's agent, the seller's attorney, you, your agent, and your attorney—making even minor changes to the agreement and getting them approved can take time. One risk you face is that until the contract is signed, the seller may receive a higher offer and reject yours.

The period before you sign is probably the last opportunity you'll have to revise your offer if the inspection has turned up any problems with the home. This means you'll want to have the report in your hands before the contract discussions end.

NEGOTIATION UNDERWAY
Sellers may be willing to accept a reduced price or to hold part of the mortgage if you're unable to borrow the full amount, especially if they're eager to sell. Real estate brokers may agree to a reduced commission if a sale is stalled over price, especially if a representative from the listing firm is handling the transaction.

SETTING THE RULES
Buyers or sellers can add contingencies, or conditions, to a real estate contract that must be met if the agreement is to be finalized. Buyers may demand that certain repairs or improvements be made. Sellers may want the right to sell to another bidder after a specific date if financing is not final.

FREE AND CLEAR TITLE
You, as the buyer, must be able to obtain a **free and clear title** to the property. The title provides assurance that no other person, organization, or government has any legal or financial claim that would limit ownership rights. Without this title, you take the risk of losing the money invested in the property should there ever be a court-imposed settlement requiring the new owner to make good on a claim.

To obtain this title, you pay a title company or title attorney to examine the public record for any outstanding claims against the property and provide title insurance to protect your lender's interest in the property. You can also protect your equity by buying owner's coverage for an extra charge.

Qualifying for a Mortgage

Being able to buy a home usually depends on being able to borrow.

Lenders evaluate, or underwrite, your mortgage application to decide if you're a good risk. In general, what they want to see is:

- ✓ A down payment, or initial cash payment, of 20% or more of the purchase price
- ✓ No more than 28% of your gross annual income needed to pay PITI—principal, interest, homeowners insurance, and property taxes
- ✓ A strong credit report, without late payments or defaults
- ✓ A debt-to-income (DTI) ratio of no more than 43%, which means that you need no more than 43% of your gross annual income to pay your mortgage plus your other debts
- ✓ A history of regular employment at a full-time job

MEETING LENDER STANDARDS

You may hear the criteria that lenders use in evaluating your application for a mortgage loan described as the big three.

Capacity addresses your ability to have enough cash for the down payment and closing costs, keep up with the loan payments, and still have some assets in reserve. In general, capacity depends on your current monthly income, your investment assets, and your other financial obligations.

Collateral is the value of the property that you plan to buy. A lender requires that it be worth at least as much as you're borrowing to buy it. To make that judgment, the lender hires a professional appraiser to evaluate the property both on its own merits and in relation to comparable properties.

Creditworthiness depends on how you have used credit in the past, including loans and lines of credit. Lenders use both a credit report and a credit score based on the report to make this assessment.

Some lenders may use information on your rent and utility payments and other contractual spending to evaluate the risk you pose. This is known as alternative documentation. They may also use automated underwriting systems, which are software programs that use

OTHER ROUTES TO OWNERSHIP

There are other ways to buy. You may want to investigate a rent-to-own arrangement or consider buying at auction.

When you rent-to-own, you sign a contract with the owner that gives you an option to buy, with some or all of your lease payments being credited toward the agreed-upon sale price. There are potentially some drawbacks, though, including the possibility the sellers will change their minds if real estate prices go up, so be sure to have an experienced local real estate lawyer review the contract before you sign.

Auctions, where you can buy homes that have been repossessed or are being sold to settle an estate, can help you find a great house at a great price. But there are serious risks for inexperienced buyers. Unless you're serious about becoming an auction expert, you may do better looking for short sales — homes that are being sold below value so that the sellers can pay off their loans at a price their lenders have agreed to accept.

statistics from comparable purchases by comparable buyers to provide an objective measurement of the risk of approving your application.

IF YOU'RE TURNED DOWN

If your application is turned down, there are a number of steps you can take.

- You might apply to a different lender, as loan criteria vary among lenders
- You might look for a less expensive home that will still meet your needs
- You might work with a mortgage broker to find a lender, though there will be a fee

REVISED RULES

The Consumer Financial Protection Bureau (CFPB), acting on the changes mandated by Congress in the Dodd-Frank Act, prohibits qualified mortgages from including negative amortization provisions, interest-only payments, balloon payments, terms longer than 30 years, or points and fees in excess of 3% of the loan amount—though third-party costs, including title insurance, taxes, and filing fees are exempt from the 3% rule. Negative amortization occurs when interest you haven't paid is added to your outstanding principal.

There are exceptions, including those for mortgages in rural areas. And different rules apply to subprime loans, which have higher-than-market APRs. But if you have questions about the terms of a mortgage you're offered, consult your lawyer and contact the CFPB at www.consumerfinance.gov.

THE WAITING GAME

Within three days of applying for a mortgage loan you should be mailed a **good faith estimate (GFE)** of what the closing, or settlement, fees will cost you if you use that lender. In addition, you'll receive a **Truth in Lending (TIL)** form that states the APR and other details about your costs.

You may want to apply to two or perhaps three lenders and use the GFE and TIL forms they provide to compare the offers and potentially negotiate a lower rate or lower fees. Remember, though, that these numbers are estimates, and they could change somewhat by the actual closing.

It can take up to 30 days after you've submitted a completed application to get an answer from a lender, though the wait may be shorter. If you're approved, you'll get a written commitment letter stating the terms of the loan agreement and how long you have to set a closing date.

If your application is successful, you should try to lock in the interest rate that's available at the time it's approved, with the understanding that if rates drop you'll actually finalize the purchase at the lower rate. Some lenders charge a fee for a lock-in, which you can ask about when you do your initial research.

The Cost of a Mortgage

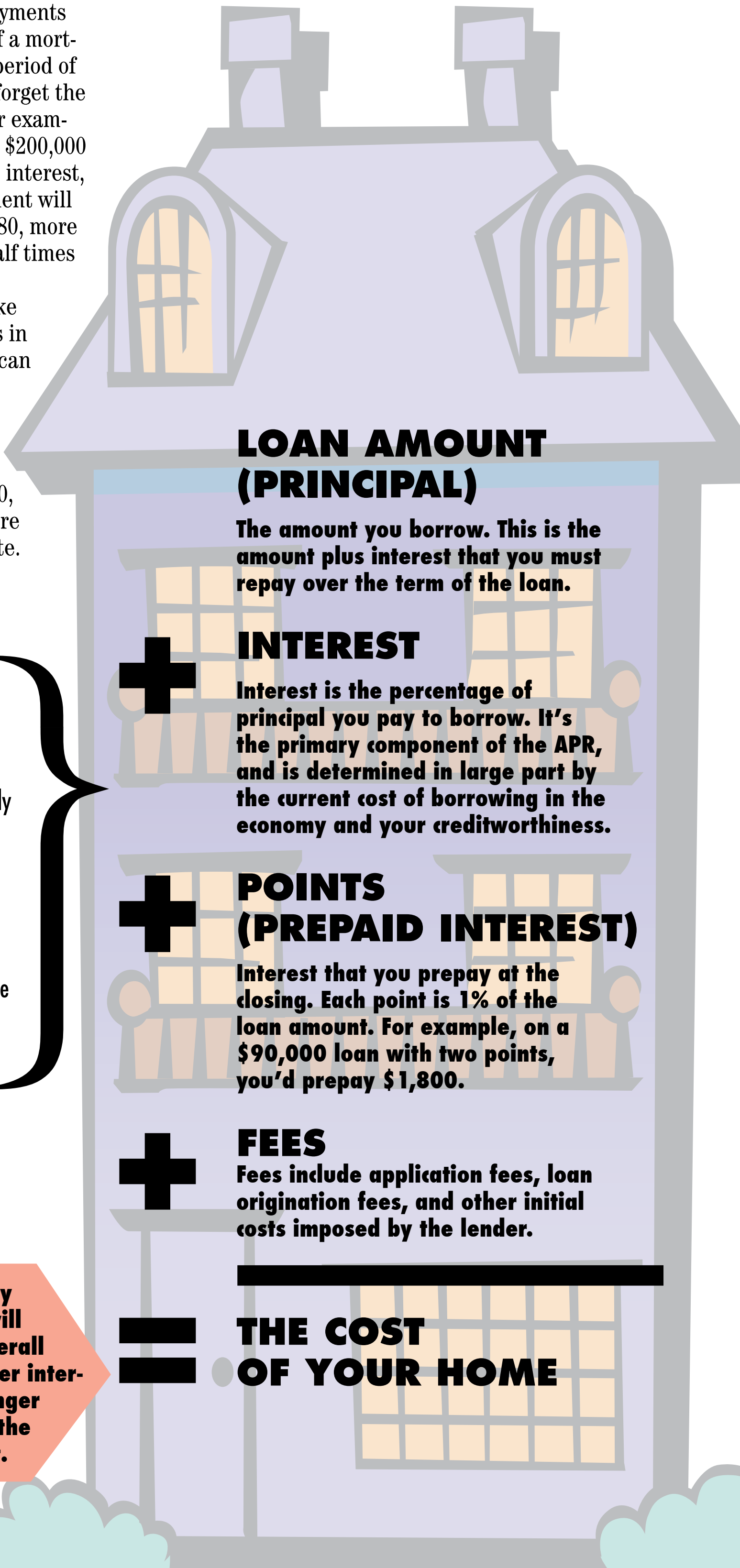
The cost of a mortgage depends on the amount you borrow, the APR, and how long you take to repay.

Since monthly payments spread the cost of a mortgage over a long period of time, it's easy to forget the total expense. For example, if you borrow $200,000 for 30 years at 6% interest, your total repayment will be around $431,680, more than two and a half times the original loan.

What seems like minor differences in the interest rate can add up to a lot of money over 30 years. At 7% the total repaid would be $479,160, about $47,480 more than at the 6% rate.

TERM (LENGTH OF THE LOAN)
The longer the term, the lower the monthly payments, but the more you'll pay in total.

RATE
Over time, a lower interest rate will have the greatest impact on overall cost.



Bottom line: Any of the factors will increase the overall cost, but a higher interest rate and longer term will have the greatest impact.

PAYING OFF YOUR LOAN

You repay a mortgage loan in a series of monthly installments over the term, a process known as **amortization**. Over the first few years, most of each payment is allocated to interest and only a small portion to paying off the principal. By year 20 of a 30-year mortgage, the amounts allocated to each equal out. And, by the last few years, you're paying mostly principal and very little interest.

CUTTING MORTGAGE EXPENSES

The amount you borrow, the finance charges—which combine interest and fees—and the time it takes you to repay are the factors that make buying a home expensive. So finding a way to reduce one or more of them can save you money.

1 **Make a larger down payment.** The less you borrow, the less interest you'll pay. Since the interest is calculated on a smaller base, your payments will be lower. And if your down payment is at least 20% of the purchase price, you won't be required to purchase private mortgage insurance (PMI), which adds to your borrowing costs.

The primary drawback to a larger down payment may be cutting too deeply into your savings, making it difficult to cover other expenses.

2 **Consider a shorter loan.** With a shorter term, you pay less interest overall on the same principal. You may also qualify for a somewhat lower APR, which would reduce your total cost even more. But your monthly payments are higher than if you choose a longer term. So you run the risk of committing yourself to larger payments than you can afford.

3 **Make more payments.** You can pay more than the amount required by your contract, either by making more payments or paying an extra amount with each regular payment. If you do the latter, be sure to make it clear that the extra amount should be used to reduce principal, not prepay interest. Lenders may offer a bi-weekly payment plan, but managing the extra payments yourself gives you more flexibility and may reduce the loan faster.

However, you might earn more by investing the money than you would save by paying off the principal faster, particularly since you'd still end up paying most of the interest.

THE EFFECT OF THE TERM ON A $100,000 MORTGAGE

	Monthly amount at different interest rates			
Term	**6%**	**6.5%**	**7%**	**7.5%**
15-year	$1,688	$1,742	$1,798	$1,854
30-year	$600	$632	$665	$699
	Total payment			
Term	**6%**	**6.5%**	**7%**	**7.5%**
15-year	$303,840	$313,560	$323,640	$333,720
30-year	$431,640	$455,040	$479,160	$503,280

A POINT WELL TAKEN

Lenders might be willing to raise a loan's interest rate by a fraction (say ⅛% or ¼%) and lower the number of points—or the reverse—as long as they make the same profit. The advantages of fewer points are lower closing costs and laying out less money when you're apt to need it most. But if you plan to keep the house longer than five to seven years, paying more points to get a lower interest rate will reduce your long-term cost.

OTHER COSTS OF OWNING

Principal and interest are major components of the cost of buying a home, but they aren't the only ones. You'll also owe real estate taxes, which can vary dramatically from state to state and from region to region within a state.

The taxes, which are based on the **assessed value** of your property and the municipality's tax rate, typically pay for public schools, police and fire protection, highways, and a raft of other government services. Assessed value, which is determined by an assessor working for a particular municipality, usually differs, at least to some extent, from both the market value and the appraised value.

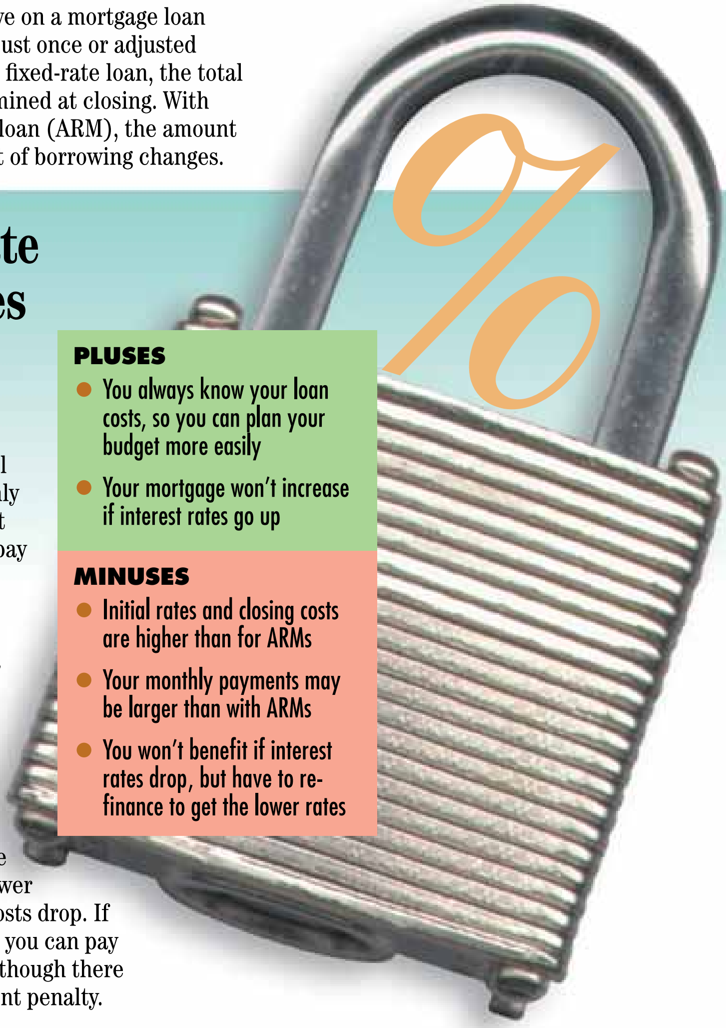
There is also the cost of homeowners insurance, which your lender will require to protect its investment and which you should have to protect your equity. You may also be required to have flood insurance, which is separate.

In most cases, your monthly mortgage payment includes all four costs, typically shortened to PITI, for principal, interest, taxes, and insurance.

Mortgage Rates

Mortgages can have either fixed or adjustable rates, or sometimes a combination of the two.

The interest you owe on a mortgage loan may be calculated just once or adjusted many times. With a fixed-rate loan, the total you'll owe is determined at closing. With an adjustable-rate loan (ARM), the amount changes as the cost of borrowing changes.



Fixed-Rate Mortgages

Fixed-rate or **conventional** mortgages have been around since the 1930s. The total interest and monthly payments are set at the closing. You repay the principal and interest in equal, usually monthly, installments over a 15-, 20- or 30-year period. You know from the start what you'll pay and for how long.

In most cases, you can renegotiate the loan to get a lower rate if borrowing costs drop. If you sell your home, you can pay off your loan early, though there may be a prepayment penalty.

PLUSES

- You always know your loan costs, so you can plan your budget more easily
- Your mortgage won't increase if interest rates go up

MINUSES

- Initial rates and closing costs are higher than for ARMs
- Your monthly payments may be larger than with ARMs
- You won't benefit if interest rates drop, but have to re-finance to get the lower rates

HYBRID MORTGAGES

Choosing between a fixed-rate or an adjustable-rate mortgage isn't an all-or-nothing proposition. In fact, there are hybrids that offer certain advantages of each type while softening some of their drawbacks.

Among the most popular are mortgages that offer an initial fixed rate for a specific period, usually five, seven, or ten years, and then are adjusted. The adjustment may be a one-time change, to whatever the current rate is. More typically, the rate changes regularly over the balance of the loan term, usually once a year.

One appeal of the **multiyear mortgage**, as these hybrids are often called, is that the borrower can get a lower rate on the fixed-term portion of the mortgage than if the rate were set for the entire 30 years. That's because the lender isn't limited by a long-term agreement to a rate that may turn out to be unprofitable.

The lower rate also means it's easier to qualify for a mortgage, since the monthly payment will be lower. That's a real plus, especially if you're a first-time buyer.

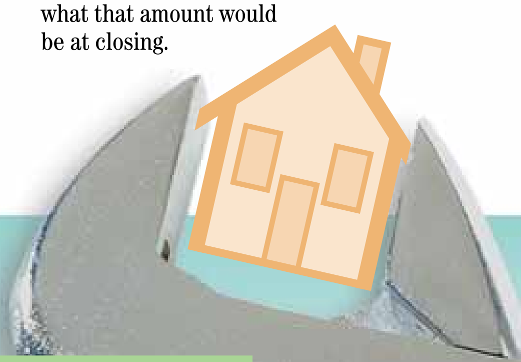
For people who plan to move within a few years, especially if it's within the period during which they're paying the fixed rate, there's the added appeal of paying less now and not having to worry about what might happen when the adjustable period begins. In fact, the typical mortgage lasts only about seven years. Then the borrower moves or refinances and pays off the balance.

TEASER RATES

The introductory rate you pay for the first months of an adjustable-rate mortgage is almost always lower than the actual cost of borrowing the money. What it means for the borrower is not only a few months of relief but also lower closing costs. The effect is to make mortgages more accessible to more people.

What it means for the lender is being able to adjust the rate upward when the introductory period ends, while staying competitive with other lenders.

However, in evaluating whether you'll be able to afford the mortgage, the lender must calculate your monthly payment at the highest amount it could possibly be within the first five years of the term, not what that amount would be at closing.



Adjustable-Rate Mortgages

ARMs were introduced in the 1980s to help more buyers qualify for mortgages, and to protect lenders by letting them pass along higher interest costs to borrowers.

HOW ARMs WORK

An ARM has a variable interest rate: The rate changes on a regular schedule—such as once a year—to reflect fluctuations in the cost of borrowing. Unlike fixed-rate mortgages, the total cost can't be figured in advance, and monthly payments may rise or fall over the term of the loan.

Lenders determine the new rate using two measures:

- **An index**, which must be a published figure, like the rate on one-year US Treasury securities or the cost-of-funds indexes. Be sure to check the index. Some fluctuate more—and change more rapidly—than others
- **The margin**, a predetermined percentage, such as 1.5%, which is added to the index to determine the new rate

CAPPED COSTS

All ARMs have **caps**, or limits, on the amount the interest rate can change. An **annual cap** limits the rate change each year, usually to two percentage points, while a **lifetime cap** limits the change over the life of the loan, typically to five or six points.

Be careful: Lifetime caps are based on the actual cost and not on the introductory rate. For example, with a 4% teaser rate and a 6.5% actual interest cost, your rate could go as high as 12.5% with a six-point lifetime cap.

PLUSES

- Low initial rates (sometimes called **teaser rates**) reduce your closing costs and early monthly payments
- Your interest rate will drop if interest rates go down

MINUSES

- It's hard to budget housing costs, since monthly payments can change at adjustment
- Interest costs rise after the teaser rate expires
- You may have to pay more interest if rates go up

A WORD OF WARNING

The size of your down payment, your employment history and earnings record, your credit score, and the amount you want to borrow all affect the interest rate you're offered. If that rate is higher than the rate the lender is advertising, ask for an explanation. If you're not convinced, you may want to apply to a different lender or complain to the Consumer Financial Protection Bureau (www.consumerfinance.gov) if you suspect discrimination.

Home Equity Borrowing

If you need to borrow, a home equity loan usually offers the best rates, plus the advantage of tax savings.

Home equity loans let you borrow using the equity you've built up in your home as **collateral**. You can often borrow more money at a lower interest rate than with other types of loans. And, in many cases, you can deduct the interest you pay on the loan when you file your tax return, reducing the actual cost of borrowing still further. Most of the other interest you pay, on car loans or personal loans, for example, isn't deductible.

You can choose between:

- **Home equity loans, sometimes known as second mortgages**
- **Home equity lines of credit**

ATTRACTIONS

- **They are easy to get**
- **The rates are usually lower than on unsecured loans**
- **The interest is tax deductible, though there may be a cap and other restrictions. Check with your tax adviser**

HOME EQUITY LOANS

With a home equity loan, you borrow a lump sum, usually at a variable rate of interest, although some fixed-rate loans are available. You pay off the debt in installments, just as you repay your mortgage, with some of each payment going toward the interest you owe and the rest toward the **principal**, or loan amount. At the end of its term, or payment period, the loan is retired.

You may have to pay closing costs on your loan, just as you did for your first, or primary, mortgage. But lenders may offer loans with no up-front expenses as part of a promotional deal. You might also be offered a **teaser rate**, or a period of low interest, as an incentive to borrow. If that's the case, the lender has to tell you the actual cost, or **annual percentage rate (APR)**, and when the temporary rate ends.

HOME EQUITY LINES OF CREDIT

Home equity lines of credit are actually revolving credit arrangements, which you can use in much the same way you use a credit card. Your **credit line**, or limit, is fixed, and you can write a check for any amount up to that limit. Whatever you borrow reduces what's available until you repay. Then you can use it again.

The terms of repayment vary, and are spelled out in your agreement. In some cases you begin to repay principal and interest as soon as you borrow, or **activate the line**. In others, you pay interest only, with a **balloon**, or one-time full payment of principal due at some set date. Or, you may make interest-only payments for a specific period, and then begin to pay principal as well.

Most credit lines have an access period, often five to ten years, during which you can borrow, and a longer payback period. The longer you take to repay, the more expensive it is to borrow.

WHAT YOU CAN BORROW

As a general rule, you can borrow up to 80% of your equity in your home with a home equity loan. For example, if you owed $75,000 on a home appraised at $250,000, your equity would be $175,000. In most cases, you'd be able to borrow up to $140,000, or 80% of $175,000.

Some home equity lines of credit, especially those offered without closing costs or other up-front expenses, are capped at a fixed amount, often $50,000.

While you use the loan, your equity is reduced by the amount you owe. When it's paid off, your equity is restored. However, if your home loses some of its value during the loan period, you still owe the full amount you borrowed.

BEWARE THE RISK

While home equity borrowing has many advantages, it has one serious drawback: If you **default**, or fall behind on repayment, you could lose your home through **foreclosure**. That means the lender takes over the property and sells it at auction. That's true even if you've made all the payments on your first, or primary, mortgage.

That risk is the chief reason to be very cautious about using home equity borrowing—lines of credit in particular—to pay ordinary expenses. If you're using the money to make improvements in your home, pay tuition bills, or meet other major expenses, and include loan repayment as a regular item in your budget, home equity borrowing can be a wise choice. But if you're in the position of not being able to repay, you're exposing yourself to losing everything you've invested in your home—and having no place to live.

DANGERS

- **They can be very expensive when you consider total cost**
- **You risk losing your home if you default on the payments**
- **Even if the value of your house decreases, the amount of your loan stays the same**

FINDING A LOAN

Home equity loans are generally available. Banks offer them, and so do credit unions, mortgage bankers, brokerage houses, and insurance companies.

You can start by checking rates and terms advertised in the newspaper and making some phone calls to see what's available. But before you commit yourself, you should get a description—in writing—of the rates, the term, and the other conditions of the loan.

SETTING THE RATE

Each lender sets the terms and conditions of loans it makes, though the basic elements are usually similar. If the loan has a variable rate, it must be tied, or pegged, to a specific public index. The lender adds a **margin**, often several percentage points, to the index to determine the new rate each time it's adjusted. It may happen once a year or sometimes more often.

REVERSE MORTGAGES

For older people with lots of equity but limited income, a **reverse mortgage** may seem to be an appealing alternative to selling their home. A reverse mortgage allows owners to borrow against the value of their home, so that they can continue to live there. The loan does not have to be repaid until the home is no longer the borrower's primary residence. However, the borrower must pay insurance premiums and real estate taxes to keep the loan in good standing.

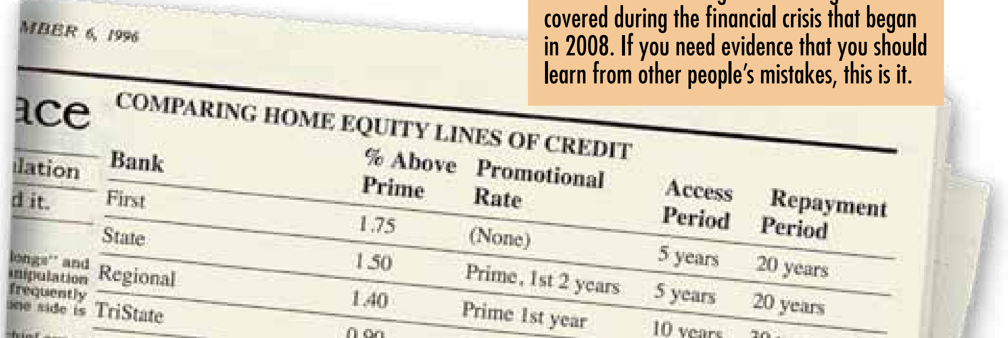
You can apply for insured reverse mortgages through lenders who are approved to offer Home Equity Conversion Mortgages (HECMs) backed by the Federal Housing Administration (FHA) or from a limited number of other private lenders. The amount you can borrow depends on your home's appraised value, the current interest rate, the age of the youngest borrower, and the amount of the initial mortgage insurance premium. In addition, FHA lenders impose caps on the amount they will lend.

While interest rates quoted on reverse mortgages can be similar to those for other mortgages, there are additional fees and charges that can make them more expensive than other types of loans. Lenders must provide a "Total Annual Loan Cost" disclosure that estimates the average annual cost as a percentage of the loan, and borrowers must be counseled by a HECM approved counselor. You can find a list at www.hud.gov or by calling 800-569-4287.

Regulations enacted in 2013 to protect both borrowers and the FHA require a financial assessment before a loan is approved and an escrow account in some cases. They also limit the amount that can be withdrawn in the first year of the loan.

BORROWER BEWARE

Tapping your home's equity to pay down debt or purchase things you couldn't otherwise afford is usually a recipe for disaster, as many homeowners with large outstanding loans discovered during the financial crisis that began in 2008. If you need evidence that you should learn from other people's mistakes, this is it.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COMPARING HOME EQUITY LINES OF CREDIT

Bank	% Above Prime	Promotional Rate	Access Period	Repayment Period
First	1.75	(None)	5 years	20 years
State	1.50	Prime, 1st 2 years	5 years	20 years
Regional	1.40	Prime 1st year	10 years	[illegible]
TriState	0.90			

Adjustable rate mortgage (ARM) is a long-term financing arrangement to buy a home in which the interest rate fluctuates over time, based on the changing cost of borrowing in the economy as a whole.

Annual percentage rate (APR) is the cost of borrowing for one year, including interest, fees, and other charges for arranging the loan or line of credit. Except in the case of credit cards, the APR is always higher than the nominal, or stated, interest rate.

Bid is an offer to purchase a home or other real estate, based on the seller's asking price. The initial bid is typically lower than the asking price, but may be negotiated.

Closing is a meeting at which a buyer and seller, their representations, and other concerned parties finalize the sale of a home or other real estate.

Collateral is something of value that a borrower uses to help guarantee repayment of a loan. If the borrower defaults, or fails to pay in full and on time, the lender has the right to take the collateral. The collateral for a mortgage loan is the home you are buying.

Creditworthy describes a borrower that lenders believe can be trusted to repay a loan in full and on time, based on that person's previous use of credit.

Debt-to-income (DTI) ratio is what you owe divided by your gross income. When you want to buy a home, a lender considers two different DTI ratios: your proposed housing costs in relation to your income and your total debt, including the mortgage, in relation to your income.

Down payment is the amount you must pay in cash to purchase a home. Most lenders require buyers to pay 10% to 20% of the purchase price in order to qualify for a mortgage loan to finance the rest. Some programs require smaller down payments.

Finance charge is the amount, expressed in dollars, that you pay for access to credit. Finance charges are calculated by multiplying the interest rate that applies times the principal.

Fixed-rate mortgage is a long-term financing arrangement to buy a home, in which the interest rate is set at the time of closing. As a result, you know when you buy what you owe each month over the loan's term.

Interest rate is a percentage of loan principal used to calculate the finance charge you pay to borrow.

Lender is a financial institution, such as a bank or credit union, that makes loans available to borrowers for a fee known as a finance charge.

Mortgage loan is a long-term financing arrangement you use to buy a home. Banks, credit unions, and other financial services companies offer mortgage loans to qualified borrowers.

PITI is the acronym for principal, interest, taxes, and insurance, which are the four components of most monthly mortgage payments.

Preapproval means that a lender agrees to provide a mortgage loan of up to a specified amount before you have actually chosen the home you wish to buy. The approval is contingent on the appraised value of the property.

Prequalification means that a lender indicates it is likely you will qualify to borrow up to a certain amount on a mortgage loan. However, it is not a commitment to make such a loan.

Principal is the amount you borrow when you take a mortgage loan.

Title insurance guarantees that there are no outstanding claims on the real estate you wish to buy, giving you as the new owner a free and clear title to the property. Lenders require borrowers to obtain title insurance to protect their interest in the property until the mortgage loan is repaid.

Underwriting is the process of investigating your creditworthiness and approving you for a mortgage loan.

Resources

Government Mortgage Modification Programs

Keep Your Home California
www.keepyourhomecalifornia.org

Making Home Affordable
www.makinghomeaffordable.gov

Foreclosure Mitigation Assistance and Counseling

Department of Housing and Urban Development (HUD)
www.hud.gov

Government Financing

California Housing Finance Agency (CalHFA)
www.calhfa.ca.gov

FDIC Foreclosure Prevention

www.FDIC.gov/foreclosureprevention

Other Resources

Bureau of Real Estate (BRE)
www.bre.ca.gov

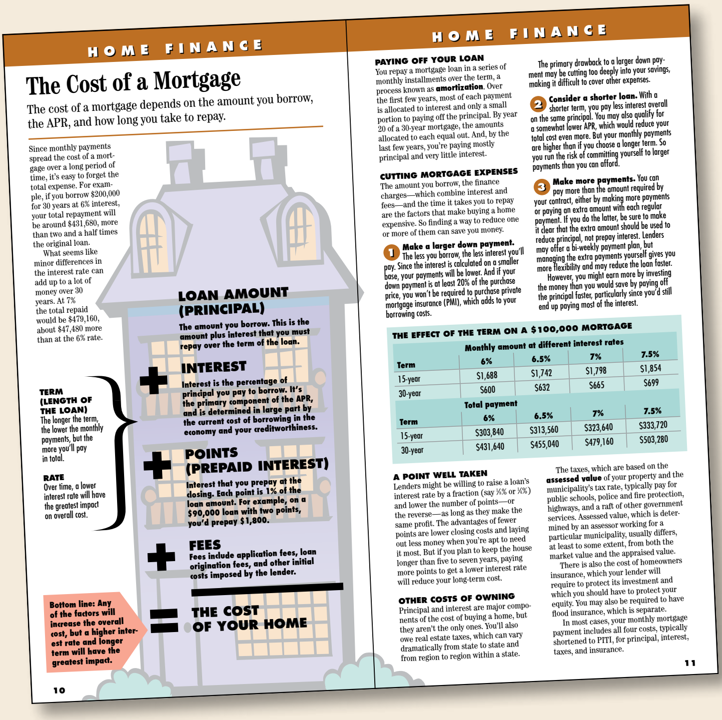
Consumer Financial Protection Bureau (CFPB)
www.consumerfinance.gov

LIGHTBULB PRESS
Project Team

Design Director Kara W. Wilson
Editor Mavis Wright
Production Thomas F. Trojan

www.lightbulbpress.com
Tel. 212-485-8800

Home Finance walks you through the process of buying a home—from the initial decision to buy, through finding an affordable mortgage, and choosing which kind of mortgage will work best for you. Other topics include what happens at the closing, insuring your home, some of the major responsibilities you'll have as a homeowner, refinancing, and home equity borrowing.



HOME FINANCE

The Cost of a Mortgage

The cost of a mortgage depends on the amount you borrow, the APR, and how long you take to repay.

Since monthly payments spread the cost of a mortgage over a long period of time, it's easy to forget the total expense. For example, if you borrow $200,000 for 30 years at 6% interest, your total repayment will be around $431,680, more than two and a half times the original loan.

What seems like minor differences in the interest rate can add up to a lot of money over 30 years. At 7% the total repaid would be $479,160, about $47,480 more than at the 6% rate.

TERM (LENGTH OF THE LOAN) The longer the term, the lower the monthly payments, but the more you'll pay in total.

RATE Over time, a lower interest rate will have the greatest impact on overall cost.

LOAN AMOUNT (PRINCIPAL) The amount you borrow. This is the amount plus interest that you must repay over the term of the loan.

\+ **INTEREST** Interest is the percentage of principal you pay to borrow. It's the primary component of the APR, and is determined in large part by the current cost of borrowing in the economy and your creditworthiness.

\+ **POINTS (PREPAID INTEREST)** Interest that you prepay at the closing. Each point is 1% of the loan amount. For example, on a $90,000 loan with two points, you'd prepay $1,800.

\+ **FEES** Fees include application fees, loan origination fees, and other initial costs imposed by the lender.

= **THE COST OF YOUR HOME**

Bottom line: Any of the factors will increase the overall cost, but a higher interest rate and longer term will have the greatest impact.

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HOME FINANCE

PAYING OFF YOUR LOAN
You repay a mortgage loan in a series of monthly installments over the term, a process known as **amortization**. Over the first few years, most of each payment is allocated to interest and only a small portion to paying off the principal. By year 20 of a 30-year mortgage, the amounts allocated to each equal out. And, by the last few years, you're paying mostly principal and very little interest.

CUTTING MORTGAGE EXPENSES
The amount you borrow, the finance charges—which combine interest and fees—and the time it takes you to repay are the factors that make buying a home expensive. So finding a way to reduce one or more of them can save you money.

1. **Make a larger down payment.** The less you borrow, the less interest you'll pay. Since the interest is calculated on a smaller base, your payments will be lower. And if your down payment is at least 20% of the purchase price, you won't be required to purchase private mortgage insurance (PMI), which adds to your borrowing costs.

   The primary drawback to a larger down payment may be cutting too deeply into your savings, making it difficult to cover other expenses.

2. **Consider a shorter loan.** With a shorter term, you pay less interest overall on the same principal. You may also qualify for a somewhat lower APR, which would reduce your total cost even more. But your monthly payments are higher than if you choose a longer term. So you run the risk of committing yourself to larger payments than you can afford.

3. **Make more payments.** You can pay more than the amount required by your contract, either by making more payments or paying an extra amount with each regular payment. If you do the latter, be sure to make it clear that the extra amount should be used to reduce principal, not prepay interest. Lenders may offer a bi-weekly payment plan, but managing the extra payments yourself gives you more flexibility and may reduce the loan faster.

   However, you might earn more by investing the money than you would save by paying off the principal faster, particularly since you'd still end up paying most of the interest.

THE EFFECT OF THE TERM ON A $100,000 MORTGAGE

	Monthly amount at different interest rates			
Term	6%	6.5%	7%	7.5%
15-year	$1,688	$1,742	$1,798	$1,854
30-year	$600	$632	$665	$699
	Total payment			
Term	6%	6.5%	7%	7.5%
15-year	$303,840	$313,560	$323,640	$333,720
30-year	$431,640	$455,040	$479,160	$503,280

A POINT WELL TAKEN
Lenders might be willing to raise a loan's interest rate by a fraction (say ⅛% or ¼%) and lower the number of points—or the reverse—as long as they make the same profit. The advantages of fewer points are lower closing costs and laying out less money when you're apt to need it most. But if you plan to keep the house longer than five to seven years, paying more points to get a lower interest rate will reduce your long-term cost.

OTHER COSTS OF OWNING
Principal and interest are major components of the cost of buying a home, but they aren't the only ones. You'll also owe real estate taxes, which can vary dramatically from state to state and from region to region within a state.

The taxes, which are based on the **assessed value** of your property and the municipality's tax rate, typically pay for public schools, police and fire protection, highways, and a raft of other government services. Assessed value, which is determined by an assessor working for a particular municipality, usually differs, at least to some extent, from both the market value and the appraised value.

There is also the cost of homeowners insurance, which your lender will require to protect its investment and which you should have to protect your equity. You may also be required to have flood insurance, which is separate.

In most cases, your monthly mortgage payment includes all four costs, typically shortened to PITI, for principal, interest, taxes, and insurance.

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Lightbulb Press, Inc.
www.lightbulbpress.com
info@lightbulbpress.com Phone: 212-485-8800

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California Department of Business Oversight
Toll-Free 1-866-275-2677
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