



UNIT 4 – 1

Some Borrowing Basics

Shopping for a home is an exciting experience! There are new homes and there are old homes, there are big ones and there are small ones. The problem with shopping for one is the same as shopping for anything else – even when you find something you really like, there is always another one that is bigger, nicer, and usually more expensive.

This is especially true with a home, whether it be a house in the suburb or a condo in the city, and in the process of looking you can assure yourself that you will find a bigger and better one whenever you look. The problem, then, becomes one of figuring out how much you can *afford* to pay.

Because of this, you'll need to do a lot of initial thinking about the purchase before you even go out to look for a home. For example, how many bedrooms and how many bathrooms do you really need? What about other features in the home such as granite or marble counter upgrades, kitchen and bathroom facilities, cars in the garage, concrete sidewalks around the entrances – not to mention other attractive features like wood decks and flower gardens, or maybe even a pool depending on the climate in your area.

The chances are good that the home you like the most may well be the one you can afford the least, and so it might be best to first think about how much you can afford and then limit your choices to those properties. The old saying that “if you can't afford something don't let yourself want it” is especially true when shopping for a home. Then, when you buy one you can afford, you'll get years of enjoyment out of it with out being stressed because of having spent too much in the first place.

Case Study Application

Before we begin our explanation of the topic, we'd like for you to review the case study at the top of the next page. The couple in the case study face many of the same problems that you will face, and so perhaps their solutions will be of some value to you.



CASE STUDY: BILL AND RHONDA'S DILEMMA

Bill and Rhonda have a combined income of \$86,000 and they are getting ready to shop for a home. One of the things they need to know is simply how much money they can borrow. For the most part, they think that they are in pretty good shape, but they don't want to be in a position where they fall in love with a home they can not afford.

They have heard a simple rule-of-thumb which states that people can borrow approximately 2½ times their annual earnings, which is about \$215,000, but they suspect that it's a bit more complicated than that.

They know, for example, that they have to account for their two new car payments which amount to \$450/mo, and there are the issues of daily living expenses, minimum monthly credit card payments (another \$200/mo), \$150/mo alimony – not to mention the monthly utility charges, taxes, and homeowner association fees on the new home or condo. Then there's that 19' bass boat that Bill always wanted to buy. He can get it for \$225 a month, but he hasn't bought it yet because of the pending home purchase.

Finally, they've been on the web and have seen that there a myriad of calculators designed to help them out – but they don't always get the same answer when they go from one site to another. They are beginning to realize that this is more complicated than they had imagined.

Thinking About the Basics

It helps to remember that a mortgage is a long term obligation, and that the lender wants some assurances that you are going to be able to make the payments over the long run. The lender also wants some protection in case you **default**, or stop making the agreed-upon payments.

Because of this, the lender would like to have a protective cushion by asking you to make a 30% down payment on the property so that the lender was only financing 70% of the home's value. If you should ever default on the payments, the lender – who retains the formal legal title to the property until it is fully paid off – could repossess the property and then sell it to someone else. If the lender could sell the house for 70% of its value, plus earn a few thousand more to cover the cost of selling it, the lender would not lose any money on the deal.

On the other hand, if lender makes a loan that is 100% of the value of the house, and if you default on it, the lender would take a loss on the deal even if could be resold for its original selling price. The loss, of course, would be equal to the cost of repossessing and then reselling the property, and this loss could be magnified if the house is resold at an even lower price.



In addition to the protection the lender gets from the size of the initial down payment, the lender is going to look at the mortgage from a cash flow viewpoint. So, if the monthly cash flow looks as if it is sufficient to make the monthly mortgage payment, the loan is more likely to be approved.

The problem, of course, is that it is virtually impossible to predict that an individual or a family will have an adequate future cash flow, so instead the analysis turns to whether or not the borrower is likely to have the *capacity* to maintain the cash flow. And, if you are the borrower, you want to do the things that will make things seem as good as possible.

- How big do you think a down payment should be to protect the lender?

Improving Your *Capacity to Pay*

There are a number of things that can be done to improve your capacity or ability to handle future monthly mortgage payments. Some may be easier than others, and some may not even pertain to your situation, but consider the following:

- **Make a larger down payment:** The logic of a larger down payment was discussed above, and if you can afford to make it you will usually qualify for a lower interest rate. Lower mortgage rates, of course, mean lower monthly payments.
- **Work to get your current debt down:** Remember that the lender is worried about your ability to make a long series of fairly steep monthly payments. Try to clean up some credit cards and reduce other obligations so that you look more attractive to the lender. This isn't a quick fix, and it may take some time to make it happen, but this is a necessary step.
- **Postpone some purchases:** Remember that you are trying to get your debt down, so if you are in the market for a home, this is a great time to forgo the new car, furniture, or that bass boat that you've always wanted. Think of the alternative – if you load up on debt now, then your ability to comfortably repay what will be the largest loan of your life will be in jeopardy.
- **Consider a longer mortgage:** While this is not an automatic saving, it turns out that the monthly payments on a 20-year mortgage will be lower than a 15-year mortgage, and that the payments on a 30-year mortgage will be lower than the payments on a 20-year one. When the mortgage gets longer than 30 years, however, the savings are going to be relatively small. For example, the monthly difference between two 7%, \$100,000 mortgages where one has a 30-year and the other has a 40-year duration won't be enough to treat your family to a snack at the local McBurgers.



- **Spend some time on the web:** Visit some websites (see the next section) to see what kinds of questions about your financial situation are being asked. Depending on your situation, you may be able to take some steps now to correct or even eliminate something that could turn out to be a real problem later on.
- **Be wary of anything other than a standard fixed-rate mortgage:** While the topic of different types of mortgages such as variable rates, interest-only, graduated payment mortgages, and other “boutique” mortgages are not discussed until chapters 6 and 7, all of these variations have some drawbacks. Many of these mortgages were part of the recent sub-prime mortgage crisis because they made it *appear* as if someone could afford to borrow when in fact they could not cope with the payments in the long run.

The last point above is not meant to imply that the typical fixed-rate, 30-year mortgage is the only one that you should consider as some other variant might work out quite well for you. However, if you can qualify for the standard fixed-rate one, you will probably qualify for one of the others as well, so the fixed rate version is a logical place to start. The problem with the recent mortgage crisis was that brokers were collecting fees for originating mortgages, and so the more mortgages they approved the more fees they collected. And since many of the brokers then sold the mortgages to another buyer, they didn't have to worry about whether the mortgage would ever be repaid. The result was that many families were talked into signing mortgages that they couldn't really afford – and so foreclosure was the final unfortunate result.

- Is there anything else that you can do to enhance your capacity to pay?

Estimating the Size of the Mortgage You Can Afford

There are any number of worksheets that will help you compute your capacity to borrow for a mortgage, but one popular way is to simply go to the Internet and try out some of the pre-qualification calculators. Some calculators are fairly simple, and some are more complex, but they all have one thing in common – they all give different answers to the same situation.

For example, we'll visit several sites to show you what we mean, and in each case we'll enter the same information presented the case study on page 2 – annual income of \$86,000, monthly credit card and other obligations of \$800. Some sites ask for more information than do others, especially when it comes to monthly property taxes and insurance rates in the area, but we used relatively low estimates for each so that the comparisons would not be too distorted.

The results, as you will see below, are all over the board – ranging from a low of 60.0% of the lender's annual income to a high of 417.4%:



Mortgage-X Pre-Qualifier¹

Total amount that can be borrowed: \$237,505
Duration and annual rate 30 years @ 7.0%

The Home Source Mortgage Calculator²

Total amount that can be borrowed: \$259,050
Duration and annual rate 30 years @ 7.0%

VMBS Mortgage Pre-Qualifier³

Total amount that can be borrowed: \$359,085
Duration and annual rate 30 years @ 7.0%

BrokerBret.com Mortgage Qualifier⁴

Total amount that can be borrowed: \$222,499
Duration and annual rate 30 years @ 7.0%

CompareLenders.com Mortgage Prequalifier Calculator⁵

Total amount that can be borrowed: \$218,965 - \$254,562
Duration and annual rate 30 years @ 7.0%

Donna O'Kelly Realtors, Inc. Mortgage Pre-qualifier Calculator⁶

Total amount that can be borrowed: \$51,625
Duration and annual rate 30 years @ 7.0%

Not only are these estimates all over the board, they don't even include two sites that said we would qualify – one for a loan of \$1.2 million and the other for \$4.7 million. Our conclusion, then, is that the old rule of thumb of getting a mortgage that is about 2½ (or maybe even 3) times your gross income is not all that far off.

While the sites listed above offer their calculators as public service (or as part of their advertising), none of them harvested personal information such as your social security number, email address, or home telephone number. There are

¹ Available at <http://mortgage-x.com/calculators/Pre-Qualifier.htm>

² Available at <http://www.homesourcepc.com/calculators/mortgageprequal.aspx>

³ Available at <http://www.vmbs.com/site/vmbs/rates/mortgage/vmbs-mortgage-pre-qualifier-calculator-principal.html>

⁴ Available at <http://www.brokerbrett.com/MortgageQualifierCalc>

⁵ Available at http://www.comparelenders.com/help/mortgage_prequalifier.asp

⁶ Available at <http://www.donnaokelly.com/CalculatorPreQualifier.html>



plenty of other sites that do that though, so proceed with caution if you visit the web.

- What other sites can you find on the web that will help estimate the size of the mortgage you can afford?
- What is the range of answers they give to the information in the case study?

