Case 12

Buying a Dream

Ms. Sally Firth has worked as a design engineer since graduating from North Central State. She has shifted jobs twice, and she expects to shift again in the near future. All of these jobs are in the same area where she has decided she wants to live for at least the next five years. Thus, she is ready to buy herself a *small* home and move out of her rented apartment.

Ms. Firth has found a home she likes, and she believes that she should buy it before she changes jobs. If she waits to buy, some financial institutions may down rate her due to a short of time on the job in spite of the salary increase she expects. She knows she could get a mortgage, but difficulties in qualifying might restrict her choice of home.

This really concerns her because the home she wants to buy will cost about $96,500 plus closing costs. In fact, the current owner has accepted her offer and given her six weeks to finalize the financing and arrange for closing. He also provided details on the upkeep costs of the house, which she included in her budgeting.

She has set aside about $7500 for a down payment, and she has budgeted for a monthly payment of $900. She expects that her salary will increase about 5% per year in real terms, but she would like to use that increase for “fun” purposes. Until last year, she was still paying off her student loans, and she has not been able to live in the style to which she would like to become accustomed.

She has identified three financing possibilities, but she must compare their effective annual interest rates and other differences to determine which is best.

Current mortgages cover a 30-year period and are available at 10% interest rates with a 5% down payment. With new financing, title insurance is 0.5% of the property's value, and the loan origination fee is 1% of the loan's face value.

However, when the current owner purchased the home, interest rates were only 7%. That mortgage has 25 years to run, with a remaining balance of $68,747.38. The monthly payments also include a reserve allowance for fire and liability insurance and for property taxes. Annually these total $675 for insurance and $850 for taxes.

While the mortgage can be assumed, with the only cost being a $350 charge for credit checks and paperwork, the current owner's equity has to be covered somehow. The bank with the original loan will issue a second mortgage at 12% for a term to match the first mortgage. The requirements for down payments, title insurance, and loan origination fees match those for new first mortgages.

The current owner is also willing to accept a second mortgage directly. While the up-front fees can be omitted, the loan has a 12% interest rate and a 10-year term.

Use annual payments to simplify the analysis.

Options

1. The loan office of the bank has just called Ms. Firth to mention another financing possibility—the graduated payment mortgage. Terms, interest rates, and fees are the same as a normal mortgage. However, by lowering the payments in the early years, it is somewhat easier to qualify for and to afford the home of your dreams. For the first 4 years, the payments are only 80% of the level of a normal mortgage; then for the next 6 years, the payments for both mortgages are the same; and then for the last 20 years, the graduated payment mortgage has higher payments.

2. Although she ignored inflation initially, Ms. Firth recognizes that the rates of the various mortgages include allowances for expected levels of future inflation. This was really made obvious when a friend, George, described his new variable rate mortgage. Everything was similar to what she was used to except that the initial rate (last month) was only 6%. In turn, he agreed that once a year the bank could adjust his rate according to movement of the "prime rate." Thus if inflation is high or money is "tight," his rate could rise as much as 1% per year. There is a lifetime cap of 5% on these increases.

3. Sally is also wondering whether she is better off using some of her “extra” savings to reduce the loan by increasing her down payment, or whether she should use it on early payments.
4. Instead of using the interest rates in the case, research current interest rates and calculate how expensive a home Sally could afford. How do programs such as the Nehemiah Program or state programs for first-time home buyers in your state influence your answer?