Understanding the Finance Basics of Buying a House

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Abstract:

Buying a house is a complicated decision that combines finance and personal considerations. While most people understand the personal implications of buying a house, many misestimate the financial mechanics at play. This guide will help you understand the basics of mortgages, other costs of owning a house, and negotiating a deal.

Mortgages

Unless you can buy a house entirely with cash, you will need a mortgage. A mortgage is simply a loan used to buy a house. The standard term for a mortgage is 30 years, but it can vary from 5 to 50 years. Mortgages include a down payment, followed by monthly payments determined by the size of the mortgage and the interest rate. The interest rate is determined by several factors, by far the most important of which is your credit score. The down payment you make contributes directly to your equity (a.k.a. ownership) in the house. Once you move into the home, the monthly payment consists of two parts: repayment of principal, and payment of interest. Repayment of principal is essentially returning the money you borrowed over time. Payment of interest is paying the bank extra over time to borrow their money–this is how the bank profits from issuing mortgages. The principal portion of the monthly payment contributes to equity (like the down payment), while the interest portion of the monthly payment does not. While your monthly payment remains fixed, the amount of your monthly payment that is principal versus interest will change over time. This is known as amortization. Over time, the principal portion of your monthly payment pays down the balance outstanding. This will lower the interest dollar amount for subsequent payments, since the same rate will be applied to a lower balance outstanding as time goes on. Since your total monthly payment does not change over time, an increasing amount of the monthly payment will be principal over time. This means equity often builds slowly at first (since much of the total payment is interest), and then quickly later (since much of the total payment is principal). This is also why it may make sense to pay extra if and when you can: paying extra can accelerate the snowball effect toward building equity more quickly. Paying extra on your mortgage (or any loan) is essentially an investment that earns you the rate of interest on the mortgage, since it will allow you to avoid future payments at that rate of interest. Thus, the higher your interest rate, the more financially attractive it is to pay extra if and when you can. This makes sense intuitively: the more expensive your mortgage is (higher interest rate = “more expensive”), the more attractive it is to get out of it early by paying extra.

Other Costs

When buying a house, several additional costs besides the down payment and monthly mortgage payment can significantly affect your decision. These include:

- **Closing Costs:** There are several closing costs associated with any real estate transaction. Generally, both the seller and buyer will pay some of these costs. The seller will often pay real estate agent commissions, which are often the single largest closing cost. The buyer may have to pay a loan origination fee on the mortgage, an appraisal fee, home inspection costs, legal fees, escrow fees, etc. In total, closing costs can range from 2-5% of the house’s value for the buyer.

- **PMI:** Private Mortgage Insurance is required if your down payment is less than 20% of the purchase price. This fee exists to offset the additional risk banks take when issuing mortgages with smaller down payments. It is usually around 0.5-1% of the house's value per year, depending on many factors, including credit score. As a rough estimate, PMI can usually range from under $100 to a few hundred per month. PMI is required until you reach 20% equity in your house, then it stops.

- **Maintenance:** This includes replacing appliances, repairing damage, replacing roofs and driveways, and more. If you are handy, you can reduce some of these costs by doing the labor yourself, but some appliances, materials, and labor costs are inevitable. As a rough rule of thumb, maintenance costs will be around 1-4% of the house's value annually. Note, however, that these costs can be volatile from year to year, so it's a good idea to stay prepared for a significant expense surprise at any time. Also, consider that newer houses will generally have lower maintenance costs, while older houses will generally be more expensive to maintain.

- **Insurance:** Homeowners insurance, while not required by law, will be required by your mortgage lender if you have a mortgage. The cost of insurance is greatly affected by the scope of the risks you want to be protected from. In low-risk areas, insurance may cost less than 0.5% of the house's value annually, while it may be several times more in high-risk areas. For certain areas, you may need to buy flood insurance as well, since homeowners' insurance does not cover flood damage. Note also that some types of houses, including condos, mobile homes, and very old houses, may require special types of insurance.

- **Property Taxes:** Property taxes fund local services, including schools, emergency services, parks, and more. The property tax rate varies significantly by state and municipality, with the lowest rates in the United States being around 0.5% annually and the highest rates being over 2%.

- **Miscellaneous:** There can be numerous other minor expenses that can add up to a significant amount. Such expenses can include HOA fees, landscaping expenses, security systems, cleaning expenses, and more.

Between the down payment, monthly mortgage payments, and all of the other costs listed above, owning a house is often as or more "cash expensive" than renting per month. However, remember that when owning a house with a mortgage, much of this cash will contribute to equity in the house, meaning that this portion of the total cost is not a cost at all–from a financial perspective, it is an investment into a real estate asset.

Negotiation

There are many parts of a deal that can be negotiated over. Parts of the deal that are commonly negotiated over include:

- **Price:** Perhaps the single most crucial part of the deal. You can always make an offer below the asking price and negotiate from there.
- **Closing Costs:** You can request that certain costs be covered by the seller.
- **Inspection Results/Repairs:** If the inspection discovers an expensive problem with the house, or a known expense is imminent (like an old roof needing to be replaced soon), you can request that the seller cover or contribute to the cost, or lower the price to compensate for it. A warranty can also be negotiated, meaning the seller will cover all or certain repair expenses that arise for a period of time, depending on the terms of the deal. This can be especially valuable for older houses vulnerable to expensive repairs.
- **Inclusions:** This means that the seller will "include" other property in the deal, such as furniture, appliances, decorations, etc. Inclusions are usually included in "as is" condition.
- **Seller Financing:** This is a special arrangement between the buyer and seller to replicate the structure of a mortgage, without a bank. Essentially, the buyer will make monthly payments directly to the seller. This arrangement can benefit both parties, including a faster process, and more flexible terms of the deal that can be tailored to the parties' needs. Seller-financed deals usually involve shorter terms and higher interest rates, though these factors are all subject to the specifics of the deal. Buyers who struggle to qualify for mortgages may find this option more available.
- **Other:** Just about anything can be negotiated for.

In the real estate market, you often hear about "buyer's markets" and "seller's markets." These terms refer to market conditions that favor buyers or sellers in a certain area for a period of time. These market conditions are the result of supply and demand in a given market. If more houses are being listed for sale, then houses are being bought; this creates a buyer's market, meaning buyers tend to have more leverage in negotiations. Because of the surplus of houses on the market, buyers have a wide selection and the constant threat of walking away from the deal, allowing them to negotiate the terms of the deal more easily. Conversely, if there are more buyers than current owners willing to sell, this creates a seller's market, where sellers tend to have more leverage, since many buyers will often compete over a house. These market conditions can have very significant effects on the success of negotiations.

A real estate deal is not a zero-sum game where one party's gain is the other's loss. Instead, a primary objective of proper and honest negotiation is to maximize the net value of the deal for both parties. The opportunity to maximize value arises from different parties having different priorities and thus valuing certain parts of the agreement differently. For example, if the seller intends to try a new style of furniture in their next house anyway, and the buyer likes the existing furniture and doesn't want the hassle and expense of shopping for new furniture, then the parties might negotiate over a furniture inclusion for a slightly higher price. In this case, the inclusion is directly beneficial to both parties, since the buyer gets to buy furniture at a lower price and avoid the process and costs of shopping for furniture, while the seller can avoid the process and costs of selling or transporting old furniture, and gains some money to spend on new furniture. This is an easy example with an obvious way to increase the value of the deal for both parties. However, negotiation can increase the net value of the deal in less obvious ways. Since each party values certain parts of the deal differently, any trade between parties where both parties feel they have received more than they have conceded leads to an increase in the net value of the deal.

Conclusion

When considering whether to buy a house, there are many non-financial factors that are just as important. The freedom to do as you please on your own property, or the confidence and stability of having a place you can truly call your own, are factors that are hard to put a price on, but are extremely important. Conversely, when buying a house, you give up some flexibility to move frequently, since the high fixed costs and long process involved with buying and selling make frequent moves impractical. As a rough rule of thumb, it generally makes sense to consider buying if you plan to stay in the area for at least 3-5 years. Buying a house is a huge decision and a milestone in anyone's life. Understanding and considering both the personal and financial implications of this decision are critical to making the decision and process as easy and advantageous as possible.