



What You Should Know About...

Homeownership

- ▶ RENTING VS. BUYING
- ▶ MORTGAGES
- ▶ HOME EQUITY LOANS



Owning a home is sometimes described as the American dream, and it may be a dream you share. Homes can provide a sense of belonging and become the center of family traditions.

Owning your home—whether it’s a house or a condo—can also be a smart move financially, since you’re buying a valuable asset with the money you spend for shelter. Some day, if you decide to move, you may be able to make a profit by selling your home for more than you paid to buy it.

Because few people have enough money on hand to cover the full purchase of a home, most pay a portion with money they have saved and finance the rest with a mortgage, or long-term loan. The more you know about what mortgages cost and how to qualify for one, the more comfortable you’ll be about taking this big step.

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Renting vs. buying

If you're looking for a new home, your first decision is whether you plan to rent or you're ready to buy. Like many people, you may put

owning your own home at the top of your wish list. First, there's the emotional satisfaction of being a homeowner, and there are usually financial rewards as well. But buying is a big commitment. You'll want to be sure you're ready to make it.



Renting has some advantages

- When you rent, you usually prepay one or two months' rent as security. That amount will be much smaller than the 10% to 20% of a home's value that is typically required in cash for a down payment.
- You commit yourself to a lease for a year or two. If you want to move when the lease ends, all you have to do is notify your landlord. You don't have to find a buyer.
- The landlord is responsible for repairs and maintenance, at no added cost to you, and sometimes heat and utilities are included in the rent.



The advantages of buying

- With each monthly payment, you increase your ownership share of your home. This is called building equity. Your equity is the difference between what your home is worth and the amount you owe on your mortgage loan.
- If property values go up, your home will be worth more. That increases your net worth. Or, if you move, you may sell at a profit.
- You can usually deduct mortgage interest and property taxes when you file your income tax return, which can be a major savings.
- If you need a loan, you may be able to borrow against the equity you've built in your home at a lower rate than you may pay on other, unsecured loans.

The other half of the story is that both renting and buying also have some drawbacks. When you rent, you don't build equity and your rent may increase each time you renew your lease. When you buy, you have to expect increasing insurance and tax bills plus the regular—and sometimes the unexpected—costs of keeping your home in good shape.

What you can afford

If you've decided it's time to buy, you're ready to ask the crucial question: What can you afford?

First, you have to take a close look at your finances and ask yourself if you have enough saved for a **down payment**, which is usually 10% to 20% of the total cost of the home. For example, if the price is \$150,000, you'll need to come up with between \$15,000 and \$30,000. If you have the cash, it's time to see if you can borrow the rest with a **mortgage**.



House of dollar bills

Did you know that according to the Bureau of the Census, people in the US spend about 32% of their income on housing and related costs?



The mortgage test

Will you be eligible for a mortgage? You can think of that question as an open-book test. The two main topics on the exam are your income and your debt. You already have the answers—you just have to provide them to potential lenders.



**No more than
28% for mortgage**

Add up your income: Lenders who provide mortgage loans want to make sure they'll be repaid, so having a reliable source of income is critical when you're applying for

a loan. The general rule is that you spend no more than 28% of your gross income on your mortgage principal and interest, taxes and insurance (sometimes shortened to PITI). So if your annual household income is \$50,000, the amount lenders calculate you could pay for housing is about \$14,000, or \$1,167 a month.



No more than 36% for debt

Do you have debts? Lenders want to know about everything you owe, even if you pay all your bills on time. You can have a large enough income for a mortgage and still be denied a loan if your regular debt payments, including PITI, are more than 36% of your total income. Using this guideline, with an annual income of \$50,000, your total credit payments typically couldn't total more than \$18,000, or \$1,500 a month. If your non-PITI debts averaged \$500 a month, the amount you could qualify to pay for housing might be reduced to closer to \$1,000 a month than \$1,167.

Down payments scaled down

What if you haven't saved 10% for a down payment? Don't give up. If you can come up with just 3%, or even less, it still may be possible to find a mortgage. The Community Reinvestment Act (CRA) requires some banks to offer mortgages to people with incomes below what is normally required. If you're a first-time buyer you may also be eligible for some breaks. To find out what you qualify for, including programs in your own state, check the US Department of Housing and Urban Development (HUD) website at www.hud.gov.

A word to the wise

While the limits about how much debt you can carry might seem frustrating, they're in place to prevent you from taking on more debt than your income can handle. Not only would that be a problem for the lender, it would be very stressful—and possibly disastrous—for your own finances.

First-time homebuyers

Be sure to check with your local bank or lending institution, as many have programs designed to help first-time home buyers, including down payment and savings assistance, lower rates, longer terms, educational programs and other advantages.

Finding a mortgage

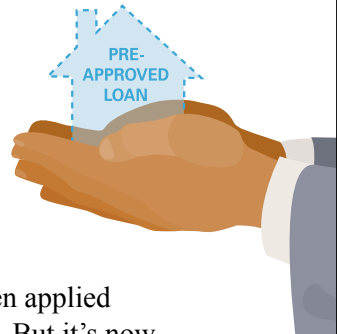
If you've never looked for a mortgage, you may be a bit intimidated by the process. And there's a good reason: You're about to make one of the biggest and most important financial decisions of your life. But it's actually easier to master than you might think.

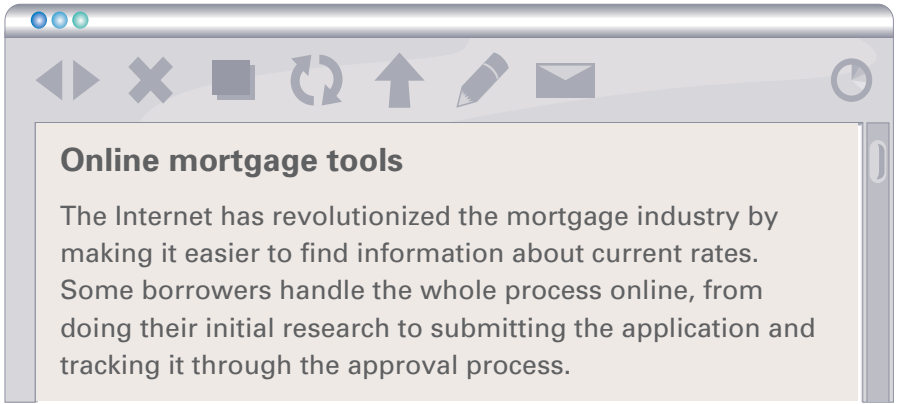


Many financial companies, including banks, savings and loans, credit unions and mortgage lenders, offer mortgages, and because they're competing with each other for your business, it's smart to shop around for the best deal. It's often a good idea to start with your current financial institution, since you might be offered a break as an existing customer—often a slightly lower APR, or annual percentage rate. Next, you should consider what's available through other banks and credit unions, mortgage or finance companies, brokerage firms and online mortgage companies.

Preapproval

In the past, homebuyers first chose the house they wanted and then applied for a mortgage. But it's now possible to be **preapproved** for a loan. This means you submit an application and go through the lender's qualifying process first—before you even choose a home. If you're approved, the lender guarantees you can borrow up to a specific amount. This allows you to enter the home-buying market





Online mortgage tools

The Internet has revolutionized the mortgage industry by making it easier to find information about current rates. Some borrowers handle the whole process online, from doing their initial research to submitting the application and tracking it through the approval process.

knowing exactly how much you have to spend.

Another advantage of being preapproved for a mortgage is that sellers may be more likely to accept your bid for their home if you can guarantee you have a mortgage. That's because sales contracts are often contingent on the buyer's ability to borrow and can fall through if a mortgage application isn't approved.

There is one caution: There's usually a fee for preapproval, as there is when you apply for any mortgage. So you'll want to ask about fees and take this step only when you're really ready to buy. Or you can ask about **prequalification**. In that case, a lender will give you a general sense of how much you're likely to be able to borrow, but does not guarantee you'll be approved.

Understanding the costs

Since buying a home is the biggest single investment you're likely to make—it's crucial to understand all the factors that affect the cost of a mortgage. With that information in hand, you can be more confident as you look for the loan that will work best for you.

What you'll pay over time if you take a mortgage depends on three things:

1. The **principal**, or the amount you borrow.
2. The **interest rate**, or percentage of the principal, you pay to borrow.
3. The loan's **term**, or how long you take to repay.

Of course, the more you borrow, the more you'll have to repay. But you might be surprised at the difference that the interest rate and the term have on the cost of your mortgage.

Tip number 1: Longer terms mean lower monthly bills, but significantly larger total costs.

Tip number 2: The higher the interest rate, the more the loan will cost.

In this example, you can see how those rules work. Take a look at two \$100,000 mortgages with different terms—15 years and 30 years—and different interest rates.

Amount of monthly payment		
Term	6.5% rate	8.0% rate
15-year	\$871	\$956
30-year	\$632	\$734
Total of payments		
Term	6.5% rate	8.0% rate
15-year	\$156,780	\$172,080
30-year	\$227,520	\$264,240

Shopping

While it's suggested you shop around with various lenders before deciding which one may get your business, it's likely the lender may not be able to provide you with a firm rate quote until you actually apply for a loan—so the lender can request your credit report and see your credit profile and score.

If this is the case, be sure to do as much comparison on other features, including application costs, fees and services, before you narrow down your choice of lenders. If you decide to apply with more than one lender, concentrate your applications within a fairly short time frame, say two weeks, so the multiple requests for your credit report don't hurt your score.

Understanding interest rates

You may be a little perplexed about how mortgage interest rates are set. For one thing, you'll discover that the cost of borrowing may vary from lender to lender. Each lender determines the interest rate it charges on a loan—just as two grocery stores might charge different prices for an apple. Further, a lender may change the rates charged frequently, though the day-to-day or week-to-week movements may not be very noticeable.

Why rates change

The big reason rates change is that they reflect the cost of borrowing in the economy as a whole. Typically, when interest rates in general are low, lenders also pay lower rates on the money they have to borrow to lend to home

buyers—these lower rates are then passed on to you. Alternately, when rates in general are higher, the lenders' costs to borrow money (to lend to home buyers) also are higher, which are then passed on to you. That matters to you, because the rates that are available when you're ready to buy make a difference in the home you can afford.

If you can spend around \$950 on principal and interest each month when rates are 6.5%, you can probably borrow \$150,000 for 30 years. But if the rate was as high as 9%, that same \$950 would let you borrow closer to \$115,000. Lower rates typically mean you can buy a more expensive home.

The other thing that affects the rate you're offered is your **credit score**. Lenders take your borrowing record into account when they offer you a mortgage. If you have great credit, you're likely to receive the lowest rates the lender has to offer. But you may find a lot of variety in the rates you're offered. So to get the best deal, you may need to shop around.



1 POINT = 1%

Prepaying interest

Sometimes lenders offer you the option to prepay some of the interest on your mortgage at the time you buy. Prepaying interest sometimes takes the form of paying a **discount point**, or prepaid interest that results in a lower interest rate, in addition to or instead of an **origination point**, which is usually a fee paid to a lender or mortgage broker for setting up your loan. Often, these terms are shortened simply to **points**—and each point is 1% of the principal. So if you were taking a loan of

\$125,000 with two points (one discount point and one origination point) you'd prepay \$2,500.

Prepaying may sound like a bad thing, but that's not really the case. Each discount point you pay typically reduces your long-term rate by a fraction of a percentage point. A lower rate means you can actually end up paying less to borrow if you keep your home for a number of years. (The actual time required to break even and begin to save will vary based on the number of points and the reduction in rate.) And you may be able to deduct the prepaid interest when you file your tax return for the year in which you buy your home.

What is APR?

Are you just a little uncertain about what the terms interest rate, annual percentage rate (APR) and finance charges mean? You're not alone—and one reason is that while each term means something a little different, they tend to be used interchangeably.

Interest rate is the percentage of principal you pay to borrow money from the lender. For example, you may borrow at a rate of 6.5%.

APR is the total cost of borrowing for one year, including interest, application fees and other charges, expressed as a percentage of principal. A loan's APR may be different than its interest rate alone, and it's the number to use when you compare loans.

Finance charge is the expense of borrowing money from the lender, expressed in dollars (vs. interest rate, which is expressed as a percentage of the loan amount). It's calculated by multiplying the APR times the principal. If you borrow \$100,000 for 30 years with an APR of 7%, your finance charge will be \$139,508.

Fixed vs. adjustable interest rates

When you're buying a home, you'll want to investigate differ-

ent types of mortgages, including **fixed-rate**, **adjustable-rate**, **hybrid**, which combine elements of fixed- and adjustable-rate loans, and **balloon mortgages**. Each type has some real advantages and some potential drawbacks.

Type of Mortgage	Advantages
Fixed-rate mortgage	<ul style="list-style-type: none"> • Your interest rate and monthly payments are fixed for the term. That means you can budget exactly how much your housing costs will be each month. • Your payments won't increase even if interest rates go up.
Adjustable-rate mortgage (ARM)	<ul style="list-style-type: none"> • ARMs have lower initial rates, which means it may be easier to qualify for a loan, since your monthly payments will be lower. • If interest rates go down, your mortgage payments will probably drop.
Hybrid loans (Fixed for a number of years and then adjustable)	<ul style="list-style-type: none"> • You can usually get a lower rate on the fixed-term portion of the loan than if the rate were set for the entire 15 or 30 years. • The lower rate also means it may be easier to qualify, since your monthly payments will be lower. • If you plan to move before the loan adjusts, you don't have to worry about interest rates going up.
Interest-only loan or Balloon mortgage	<ul style="list-style-type: none"> • For a fixed term, usually five to seven years, you pay only the interest on the loan in monthly payments that are smaller than the average mortgage payment. • Smaller payments may allow you to afford to purchase a home, or to buy a more expensive one.

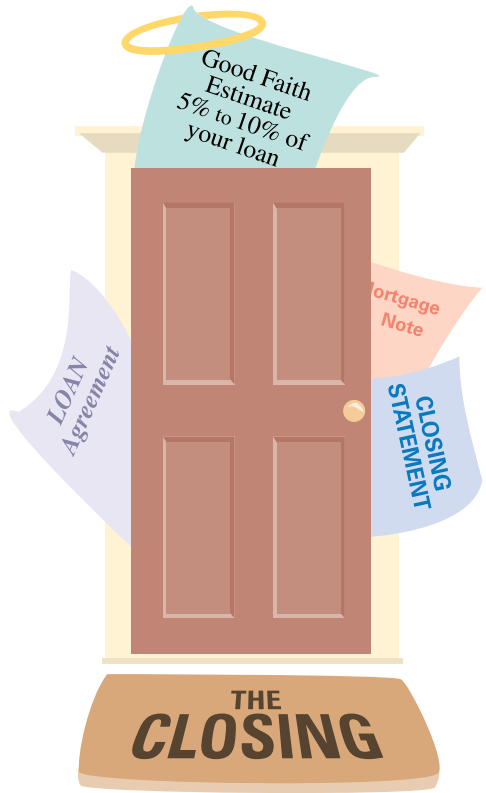
Type of Mortgage	Cautions
Fixed-rate mortgage	<ul style="list-style-type: none"> • If interest rates go down, your payments will remain the same—you'll have to refinance to benefit from the lower rates. • Your interest rate and closing costs may be higher than they may be with an ARM
Adjustable-rate mortgage (ARM)	<ul style="list-style-type: none"> • If interest rates go up, your payments will probably increase. • The changing monthly payments may make it difficult to budget for housing costs.
Hybrid loans (Fixed for a number of years and then adjustable)	<ul style="list-style-type: none"> • When the fixed-rate period ends and the loan becomes an ARM, your payments will reflect the current rates. If interest rates increase, your payments may increase. • The changing monthly payments may make it hard to budget for housing costs. In most cases, the interest rate on an ARM is adjusted once a year, though some may change more often.
Interest-only loan or Balloon mortgage	<ul style="list-style-type: none"> • The final payment will likely be much larger than the monthly payments you made. • In some cases, the entire principal is due in the last payment, or balloon payment. You can then refinance at current rates, pay the balance in a lump sum or start paying off the principal, in which case your payments will increase.

Closing on the house and loan

Once you've scheduled and had a **home appraisal** done, along with a **title search** on the property you're interested in buying, the final step in buying your new home is called the **closing**, or **settlement**.

The closing statement

Before the closing, you'll receive a **good faith estimate** in writing from the lender listing the settlement costs you can expect to pay at the closing—usually adding up to anywhere from 2% to 10% of your loan, depending on the rate you're paying and where you live. On a \$150,000 loan, this means you'll need between \$3,000 and \$15,000 for closing costs. At the meeting, the lender will provide the **closing statement**, or **settlement statement**, itemizing all of the final costs. By law, you have the right to see the statement one day before the closing to avoid any mistakes or surprises.



Closing day

Usually what happens at closing is that the parties involved in the transaction, or their representatives, meet—though the actual process varies from state to state. This can include the home's buyer (you), the seller, their attorneys, representatives from the title company and possibly others. If you're at the closing, you and the seller sign the documents that legalize the transfer of property, and you sign the mortgage note and loan agreement. Then, you'll write what

may seem like a huge number of checks for the balance of the selling price and the closing costs, including:

- Title searches and title insurance, to protect the lender and you against any potential legal claims to the property
- Attorney fees
- Property taxes to reimburse the seller for amounts that have already been paid



Checklist for homebuyers

Once you've decided that it's time for you to buy a home, the process may seem very complicated, but this suggested checklist might help make the tasks more manageable.

- Assess your financial situation and calculate
 - What you can afford to pay in principal and interest each month
 - What size mortgage that amount, given a few different interest rates, will allow you to obtain
 - Whether you have enough cash on hand to cover a down payment, usually 10% to 20% of the home's total cost
- Begin to search for homes in your price range, either on your own or with the help of a real estate agent
- Compile a list of potential mortgage lenders and visit each to compare the style of mortgage, interest rates, terms and costs you're offered
- Take one of the loans you've been offered, if you feel it meets all your needs
- Agree to purchase one of the homes you've seen, if you feel it meets all your needs
- Complete the closing process with lender and with seller of the home, paying for title searches, attorney fees, property taxes, transfer taxes and homeowners insurance
- Sign all documents and move into your new home!

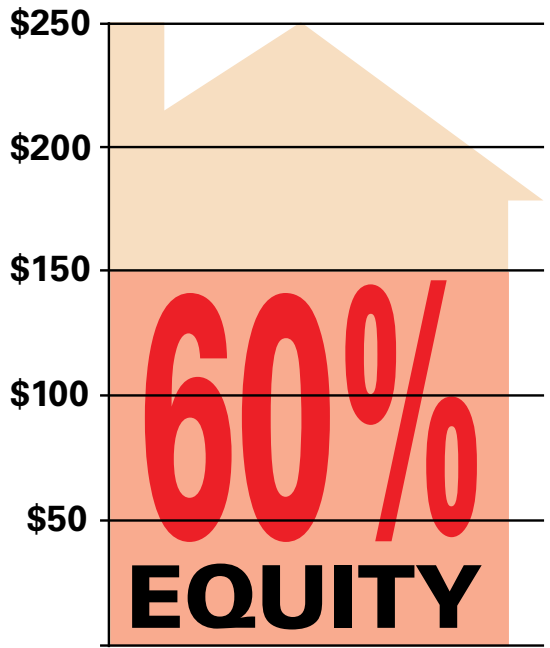
- Transfer taxes
- Prepayment of property taxes and homeowners insurance to lender so that money is available to pay these bills as they come due

If an **escrow agent** handles your closing, representatives for you and the seller sign the papers, handle the payments and then mail you the documents once the transaction is completed.

Borrowing against your home

Since so much of your **net worth** is likely to be invested in your home, you may, at some time, want to borrow against its value with a **home equity loan** or a home equity **line of credit (HELOC)**. You can often borrow more money at a lower rate than with other types of loans and may be able to deduct the interest paid on such loans on your tax return. But there are risks involved, including a possible **foreclosure**, or the loss of your home, if you can't repay on time.

When you obtain a new home equity loan, your home serves as



collateral for the loan. Equity is the difference between the current value of your home minus the amount you owe on your mortgage or any liens against your property. For example, if your home is currently valued at \$250,000, and you owe \$100,000 on your mortgage and there are no liens on your home, your equity is the difference between \$250,000 and \$100,000 or \$150,000. Expressed as a percentage, you have 60% equity in your home ($\$150,000/\$250,000$).

Second mortgages

With a home equity loan, sometimes described as a **second mortgage**, you may be able to borrow up to 80% of your equity (or more), either at a variable or fixed rate of interest. Typically, you'll receive a check from your lender in the amount of your home equity loan, and begin repayment right away. This loan works just like any other one—you make a series of monthly payments over a fixed term.

**SECOND MORTGAGE
= EQUITY LOAN**

Home equity lines of credit

If you arrange for a line of credit on the equity in your home, or



HELOC, the lender establishes a **credit line**, which is similar to the borrowing limit on your credit card. You can write checks for any amount up to that limit as you need the money.

You aren't charged interest on the line until you actually borrow against it—and when you do, you pay off the balance over time just as you would with a credit card. Once you repay the amount you've borrowed, you can borrow it again, up to your available credit limit. The terms of repayment vary, but are spelled out in your loan agreement.

Insurance

When you own a home, you need homeowner's insurance so that you and the lender will be protected against financial loss if there's damage or loss of property.

Homeowner's insurance covers your home's structure and your possessions. The basic standard policy, or **named perils policy**,

offers limited protection, to cover damage that results from fire and theft. More comprehensive plans with broader coverage are available, but have higher premiums, or payments.

How do deductibles work?

Every policy has a **deductible**, which is the amount you pay for a

loss before the insurance company covers any of the remaining damage. Deductibles can vary from a few hundred to a few thousand

dollars, and there's a direct relationship between the size of the deductible you choose and what you pay for insurance.

The smaller your deductible

The higher your premiums

The less you'll have to pay after a loss.

The higher your deductible

The lower your premiums

The more you'll have to pay after a loss.



How much insurance?

As a general rule, you should insure your home for at least 80% of its **replacement value**, or what it would cost to rebuild your home in today's dollars. You might sleep better, however, if you insure your home for 100% of its replacement value. Keep these two things in mind, though:

- Be sure you understand what your insurer means by replacement value. Some insurers will cover the cost of replicating your current home as it was before the loss, including special details and features. Others will cover the cost of building a home of the same size but not necessarily with the same features. There may be a noticeable difference in price between the two levels of coverage.

- When you're calculating your home's value for insurance purposes, you usually don't include the value of the property on which it's built although the land is a factor in the price you pay to buy. That's because the land usually retains its value and can be sold even if the home is damaged.

What's not covered?

Things that aren't covered in basic plans: losses resulting from riots, police actions, war, nuclear explosions or "Acts of God." You can sometimes add a rider, or an amendment to your policy, which will cover selected situations that normally are excluded, such as wildfires and earthquakes.



Responsibilities of owning

By keeping your home in good condition and being aware of potential problems, you can make the experience of homeownership both personally and financially rewarding.

Making payments

Your home is likely your most valued asset. If, for some reason, you know that you won't be able to make a mortgage payment on time or in full, don't let it slide in the hope that your lender won't notice. Instead, talk to your lender to figure out another solution. You don't want to **default** on your loan, as it could lead to the **foreclosure**, or repossession, of your home, something neither you nor your lender wishes to occur.

Home improvement

You want your home to be well maintained. That will help ensure its value, and help to protect your investment. It's a good idea to have yearly check-ups on the major mechanical and structural areas of your house, such as the heating, plumbing, stairs and roofing. Catching and fixing a problem when it's minor is better than

ignoring it until it becomes major and more costly to repair.

Whether more luxurious home improvements are worth the cost is something you'll have to decide for yourself. But once you've learned the ins and outs of finding a home and closing on a mortgage you're better equipped to make smart homeowner decisions.

TIP

Experts recommend budgeting 1% of your home's value for yearly maintenance costs.

Escrow

Escrow is a way to help both the homeowner and lender pay bills on time. Escrow accounts are typically set up by the lender, with monthly deposits taken from your monthly loan payment to help pay for items such as property taxes, mortgage insurance payments, fire and hazard insurance premiums and other items. Having your lender pay for such items—on their different payment due dates—removes the risk of not having these bills paid on time, which could ultimately lead to foreclosure on your property. Escrow also helps you budget for these items, as the



amounts are typically spread out over 12 months of the year.

Not all lenders escrow for their borrowers. You need to verify with your lender that escrow items are included in your monthly loan payment. If not, you'll need to be aware of all the bills that will be due, how much they are and make necessary adjustments to your budget. That might mean setting aside enough each month to cover such expenses, or being sure you have enough in a savings or other account to pay the bills in full when they come due.

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