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### **Step 3: All About Financing**

Once you know what your cash flow is, you can get a general idea of what kind of loan you might require. Financing has evolved to provide benefit to both consumers and lenders.

Before the 1940s, the only kind of loan that banks offered was a **balloon loan**. A borrower received a loan and made interest only payments on it for the entire loan term. At the end of the loan term, the entire balance was due. It had the name of "balloon" because it was a **huge** payment at the end of the "string" or stream of comparatively smaller interest payments.

When the economy failed in 1929 and The Great Depression began, very few people were able to make the balloon payments when the loans came due. Banks responded by foreclosing on thousands of people.

At the end of World War Two, the Federal government offered a different kind of loan to returning servicemen to help them buy homes and revive the economy. This kind of loan required interest plus a portion of the principal to be repaid over time. At the end of the loan term, the loan was completely paid off instead of having a "normal" balloon payment left to worry about. When the nation's bankers figured out what the government was doing, they decided to do the same thing. Since then interest and principal repayment has become standard practice.



A loan is comprised of four elements:

- the down payment
- the loan amount
- the interest
- the loan term

The **down payment** is the cash you pay out of your own pocket to purchase a house. The higher your down payment, the more serious a potential borrower you appear to be. You are less likely to abandon the house because you have invested so much money in it yourself. The higher your down payment, the less you have to borrow.

The amount you borrow is the **loan amount**. Conventional first mortgages can be approved for up to 95% of the value of the house. The precise percentage a lender will allow depends on the creditworthiness of the buyer. Lenders generally prefer your down payment to be 20% or more, however, this preference can vary depending upon the value of the house. Co-op apartments may require an even higher down payment. For putting a large amount down, lenders may make a deal with you on the interest rate.

The **interest** is the extra money you pay for the privilege of borrowing money. The **interest rate** is the percentage used to determine how much interest you will pay. The interest rate is multiplied by the outstanding loan amount to determine your current charge for borrowing the money. The interest rate is set by the lending institution and depends on how long you will borrow the money and other economic indicators. Typically the rate is a set amount higher

than it would cost the lender to borrow the funds. The lender makes money on the difference between what it pays to borrow money and what it charges you to borrow money.

With houses as expensive as they are in some places, a 20% down payment is pretty difficult for many people. They may put down 5-10% instead. While a 10% down payment may still be a lot of money, lenders still perceive a risk that you might abandon the house. For putting less than 20% down, lenders might raise the interest rate slightly to account for the higher risk that they perceive.

What is also common is that lenders require borrowers to buy **private mortgage insurance (PMI)**. This policy protects the lender in the event that you stop making your normal monthly payments. The insurance is a monthly payment representing a certain percentage of the amount borrowed. The lender is listed as the beneficiary, and the policy states that if you fail to make your loan payments, the policy grantor will make them to the lender instead. It can be expensive, and it is not tax deductible (read on to find out how to avoid paying PMI).

Generally the PMI fee ranges .5-2% of the loan amount annually. Once your loan balance is 80% or less of the value of the house, you can ask for the PMI to be cancelled. Recognize that you must initiate the cancellation; the lender will not advise you on the subject of PMI. Therefore, it pays to keep tabs on both your mortgage balance and the current market value of your home.

Interest rate also varies by the **loan term**. The term is the amount of time required to repay the loan. All kinds of loan terms are available, however, common loan terms are 15, 25, or 30 years. The interest rate is slightly higher the longer the loan term. Where a 15 year loan might be 6%, the 30 year loan might be 7%. The longer the loan term, the more interest you pay over the length of the loan. To save on interest, choose a shorter loan term. However, a shorter term also means that the monthly payment is higher because you are repaying the loan faster. Monthly payments on a 15 year loan can be almost twice as much as on a 30 year loan. Both you and your lender may evaluate your cash flow to see if you can afford the monthly payment of a shorter term loan. A lender may only approve a longer term if it appears that a higher monthly payment would be harder for you to make.

If you want to build up **equity** in your house, you will choose a shorter term loan. Officially, equity is the difference between the market value of your house and the mortgage used to pay for it. Early in a loan term, you have little equity because interest is a substantial part of your monthly payment. The longer you own your house, the more of the mortgage you have repaid, and the more equity you have in the home.

You might choose a shorter term loan to build up equity so that you can borrow more against your house later. However, when choosing this approach, make sure that it represents the best use of your money and represents the best possible financial return. Remember that the equity you accumulate in your house is not a liquid asset. You can borrow against it, but you can't sell it for cash unless you intend to give up the house. By investing in some other financial asset besides your house, you may obtain a better financial return while accumulating more cash.

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