

Financial Literacy Capacity Assessment

LEARNING BOOK

PART II: ADVANCED LEVEL

Chapter 4: Housing

Housing has become a serious concern for people around the world, as prices and rents have risen steeply in recent years, making good housing in attractive locations increasingly hard to afford. Young people in particular worry about finding suitable accommodation and are keen to get a foot on the property ladder.

Buying a home is the single largest investment most people make in their lifetime. It should be planned and researched carefully. You should try to understand the main forces shaping the housing market and the main personal considerations that impact on the decision to buy or rent.

HOUSING DEMAND

Demand for housing depends on many factors, including:

- **Demography:** when population increases, for example because of immigration or because people live longer, demand for housing increases; on the other hand, falling birth rates reduce population growth and the demand for housing
- **Social trends:** if couples divorce more often, more housing units will be needed, though of smaller size
- **Economic growth:** rising incomes translate into greater willingness and ability to pay high prices or rents
- **Geography:** as growth industries tend to concentrate in clusters, property in or near these areas becomes more expensive

- **Interest rates:** since most buyers borrow to buy a home, the interest rate on mortgages is an important part of total housing cost
- **Taxation:** when mortgage interest is deductible from income tax, it can provide a strong incentive for people to buy
- **Investment demand:** factors like low interest rates or stock markets that seem expensive can raise demand for housing for investment purposes

Supply of housing normally tracks demand, but regulations like zoning laws or green belts can hamper construction, especially in areas where demand is strongest. This can further boost prices.

If prices keep rising, does it mean you should buy as soon as possible in order to get a “foot on the property ladder”? Perhaps, but you first need to assess whether you can afford it, whether it makes sense for you, and whether the market seems reasonably valued.

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A useful tool to assess market prices is to compare house prices to rents and salaries. If the ratio of house prices to rents and to salaries is significantly above the long-term average, it may mean that buying is no longer affordable nor attractive for the average wage-earner, especially compared with renting.

Whatever the state of the market, you must carefully assess the condition of any particular house or flat that strikes your fancy. Structural soundness, floor space, design, view, greenery, location, etc. are all important factors. And keep in mind that location is more than being close to Old Trafford or Madison Square Garden – proximity to things like jobs, schools, hospitals, and transport also matters! 😊

If you've finally found your dream home, you need to ask yourself some hard questions regarding your personal and financial situation:

- Am I likely to stay in this location in the medium to long term? Do I really like this town and will I be able to work there or within commuting distance?
- Is my family situation stable? Is my family size likely to increase so I'll need larger accommodation?
- Do I like to be a homeowner? Are repairing the roof or painting the walls things I enjoy doing on weekends?
- Is my professional and income situation reasonably stable and predictable?
- Do I have enough cash or other liquid assets to make a substantial down-payment, normally at least 10-20% of home value?
- Am I eligible to get a mortgage? Relevant factors include steady income, credit score, existing indebtedness, loan-to-value ratio (mortgage as a percent of home price), debt servicing ratio (mortgage payments as percent of income), etc.
- Can I afford monthly payments, i.e., will all my debt payments be less than 36% of my gross (pre-tax) income?

If the answer to all these questions is yes, you can start getting down to the fun part: negotiating a mortgage! 😊

MORTGAGES

Here are a few basic things you need to know about mortgages:

- A mortgage is a **loan** granted by a lender, like a bank, building society (UK), savings & loan (US), or other institution to a home buyer for financing part of the purchase
- Mortgages are **secured** against the value of the home; if you fail to repay, the lender can repossess the home, i.e., take ownership and force you to move out
- Mortgages can cover up to **80-90%** of home value, in some cases more (not that we recommend it)
- You also need to take into account **closing costs**, which includes legal fees, valuation, survey costs, etc., and can easily add 2-5% of home price to the cost
- Mortgages are repaid through **monthly payments** that include both a principal and an interest component
- The principal repayment goes toward reducing the amount of money you owe, hence it increases your **home equity** (the market value of your home minus the mortgage debt you owe)
- The mortgage **interest** depends on the general level of interest, the terms of the mortgage, quality of the collateral, and your personal creditworthiness
- Mortgages have different **maturities**, typically from 15 years up to 20 years (UK) or 30 years (US); longer maturities mean lower monthly payments, but also more interest paid over time
- Mortgages can have **fixed or variable** interest rates: fixed rates are set at the beginning and offer greater certainty; variable rates include a spread over a fluctuating government bond rate

While most people buy a home for residential purposes, you can invest in other forms of real estate:

- Vacation homes or time-shares
- Raw land
- Buy-to-let: these may be especially attractive when rental returns exceed interest on savings accounts or bonds, as they often have in recent years
- Commercial property: real estate used for business purposes, such as office buildings, retail shops, or warehouses
- Real estate investment trusts (REIT): mutual funds that own and manage property on behalf of investors

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A final word of advice: owning a home is a worthwhile objective. It can provide financial security and personal comfort, and unlike rents, mortgage payments help build your “home equity”, i.e., the value of your home minus the debt you owe. But while home prices have exceeded inflation over long periods of time, and risen particularly sharply in recent years, they offer no guaranteed path to riches and can tie you down in debt for many years. Study the market, analyze the implications, and consider all relevant factors before taking the plunge!