Even in buyer's market, down payment myths persist

KAREN RIVEDAL | krivedal@madison.com | 608-252-6106 | Posted: Tuesday, October 11, 2011 5:45 am

This article first appeared in the Sunday edition of the Wisconsin State Journal newspaper.

To buy a house in this historically affordable market — and get today's best or near-best rates on a mortgage — you need a perfect credit rating and 20 percent down, right?

Well, no. Not really.

Despite news reports that banks have tightened lending standards since the financial crash of 2008, it's not necessarily as bleak as all that, industry and finance experts said.

In Dane County's housing market, which remains slow but was never hit as hard as other parts of the country, decent credit and a modest down payment, if that, may be enough to get loan approval.

"If you have a little bit of dinged-up credit, even if you have a late payment here or there on your credit report, you're still going to be able to get good rates," said Erik Sjowall, president of Madison-based Bunbury and Associates Realtors.

There are still incentives available for first-time buyers, and many state and federal programs aimed at low- to moderate-income people offer affordable, competitive mortgages for 5 percent down or less.

And if you don't fit those categories, local banks and mortgage brokers say they're ready to lend to any qualified borrower at good or great rates, even if your credit score doesn't top 740, which is generally the minimum needed to get the very best rates.

"You don't have to put 20 percent down," said Steve Jacobson, founder and CEO of Fairway Independent Mortgage Corp., a nationwide residential lender based in Sun Prairie. "Most people put 10 percent or 5 percent down."

Whether it's a good idea to get into a house that way, with little equity and likely a long loan to make payments affordable, is a different question, and the answer depends on individual circumstances.

Even with record-low interest rates, there are no shortcuts to making a smart home purchase, consumer finance advocates warn.

"Somewhere in the transaction, you're going to pay for it," said Kate Nardi Sullivan, housing counselor at the Dane County Housing Authority. "The best thing you can do is work on your credit score. That saves you money."

Zero down a 'misnomer'

Hidden costs of getting into a home with little or no money down include the private mortgage insurance charge that everyone who puts down less than 20 percent must pay.

And in a potential double-whammy, those with lower credit scores will pay more for that insurance, adding to the monthly payment.

Sullivan also noted that even with no down payment, buyers have other things they usually must pay for during the home-buying process. Those include a third-party inspection of the property, closing costs such as bank fees and other charges, and "earnest money" they must provide within days after getting an accepted offer.

"This notion of 'zero down' is a misnomer," Sullivan said. "To get a transaction done, you need to have $2,500 to $3,000 in cash, just to make it happen. So you need to be prepared."

Another concern of putting down little or no down payment is the lack of equity, or ownership stake, it provides in a house.

With no equity, homeowners have no ability to refinance and no built-in fund to borrow against to make improvements to the house. Buyers who don't start with a good-sized down payment also wind up paying more interest over the life of the loan.

"Building equity is the name of the game in homeownership," Sullivan said.

20 percent a 'myth'

David Simon of Veridian Homes, Dane County's largest home builder, agreed that relative ease of market entry shouldn't be the deciding factor in anyone's home purchase.

"People still have to make a decision about whether they feel it's a good investment to make," he said.

Geriann Schultz, a mother of two now renting on the West Side, had little trouble with the decision. She said she's buying a new home in Veridian's Hidden Oaks neighborhood in Middleton because it was cheaper than continuing to rent.

Schultz also was able to put down 20 percent and had a credit score of 811, on a scale that ranges from 350 to 850.

"The stars were aligned for me," she said. "I could get a nice-sized home and it was in my price range."

But Simon, who has watched the number of new homes built annually by Veridian plummet to under 200 the last few years — down from 550 a year during last decade's housing boom — believed there was a prevailing "myth in the marketplace" that buyers must put 20 percent down on a house.

That may be the case in places like Nevada and Phoenix, where home prices have seen very steep drops, said Simon, but it's a needlessly damaging assumption in a housing market like Madison's, where prices didn't rise and fall as dramatically.

"So many people in the Madison area have good jobs and good credit and good income," he said. "They just don't have much savings. A lot of the young professionals at Epic (Systems Corp.) are my customers. But sometimes at that age you're not thinking about saving 20 percent for a house."

Simon, who is president of operations for Veridian, said most of his buyers last year — 89.5 percent — put down less than 10 percent and nearly half of those people put down 5 percent or less.

Risks inherent

Government-sponsored financing options that require little or no down payment include the widely used FHA loan. That program requires at least 3.5 percent down, and it's not limited to first-time buyers or lower-income people.

There also are zero down payment rural housing loans and federal loans for military veterans that require no down payment. On the state level, WHEDA offers products including Fannie Mae Advantage loans, which have income limitations and generally are for first-time buyers or veterans but require only 3 percent down and a minimum credit score of 620, WHEDA spokesman Kevin Fischer said.

Conventional mortgages typically require at least 5 percent down. Veridian has a financing deal through the end of October with Wells Fargo in which buyers have to provide only 2 percent while Veridian pays the other 3 percent.

But putting down little or nothing — or financing the down payment as part of the loan — can be risky because of the potential for negative equity. That occurs if property values drop after a purchase and a borrower is left owing more than the home is worth.

"The question is, do you believe we're at the bottom (of a period of price drops) or is there more to go?" Simon said about the risk of negative equity. "I believe we're at the bottom."

Economists disagree over how much further home prices could drop. Some say they could keep falling for a few years, as short sales and foreclosures continue to keep prices down. Others believe they've already mostly bottomed out with modest price appreciation to follow.

Always 'ups and downs'

But no one really knows, especially if consumer confidence remains weak, unemployment stays relatively high and median household income in Wisconsin continues to fall.

Where property values are concerned, it's about supply and demand, location, and to some degree, perhaps faith and luck.

Wisconsin home sales in August were up 31 percent, while median price dropped 7.3 percent, compared to last August, indicating continuing price weakness. For the year through August, the statewide median trailed last year by 6.7 percent.

Wisconsin Realtors Association President Bill Malkasian estimated it could take three or four years for prices to strengthen in the state, as many foreclosures and short sales work their way through the system. In other parts of the country, he said, it will likely take longer.

Malkasian said the housing crash may have corrected for a situation during the boom in which too many people who "should have been renting" were able to purchase homes they couldn't afford. Going forward, he added, less of that will happen, while those who are qualified to buy and still want to will.

At his mortgage company, Jacobson said people with credit scores down to 640 could get good interest rates on a loan, with other factors such as a borrower's job stability, annual income and cash on hand also playing a role.

"They all have to make sense, and then they can get a loan," Jacobson said. "Three or four years ago, there were loans for everybody. It's not like that anymore, but there are loans."

Malkasian said he remained optimistic about Wisconsin's market, especially as time goes on.

"It's a challenged market right now," he said. "But in the end, the industry is not mortally wounded at all. People have to live somewhere, and (younger) generations still statistically believe very strongly that owning their own home is something that's important. We've gone through ups and downs before."