04/04/2007

How the 20% Down Payment Came to Be

While lending standards are different and there is a cornucopia of various financing programs available today, it is used to be that mortgage lenders required a 20% down payment from all homeowners before agreeing to loan the rest of the money. Have you ever wondered where this standard came from or why 20% is the 'traditional' amount for a down payment? Well, here's the story.

Mortgage lending is designed around risk. You do not have enough money to buy a house outright. You go to the bank and promise to repay them if they will just pay the seller the complete amount now. The bank must determine whether or not to lend to you based on how much they trust your promise to repay the loan and how much interest they can should charge you to balance out the risk.

The greatest risk to your mortgage lender is foreclosure. If you fail to make your monthly payments at least three times in a row, your lender starts getting nervous. At this point the lender has already lost those months' worth of interest charges, which might add up to several thousand dollars. At some point after you stop making monthly payments, the bank will assume you are never going to repay them, and they will repossess the house to try to recover their money.

At this point it is generally in your lender's best interest to sell the house to someone else as quickly as possible. The sooner the lender sells the house, the sooner he or she can start making money on interest payments again, instead of losing money as the house sits vacant.

In order to sell the house quickly, lenders must drop the price of the house. Somewhere along the line, they decided that lowering the price by 20% was the best way to go. Yet, lenders did not really want to sacrifice that 20% reduction, so they required the next buyer to put 20% down as an initial deposit. This became the rule for all mortgages as a way to protect the lenders against foreclosure losses. Now if a borrower defaulted, the bank would already have that 20% and would not lose out on the sale of the home at the cheaper price. The large down payment also made it a bigger commitment for the borrower, as he invested a huge chunk of money at the beginning of the purchase.

During the past several decades, as home prices have risen, many lenders have had to create alternate standards as many home buyers were not able to afford the 20% down payment upfront. Still, lenders did not want to increase their risk by letting borrowers put less than 20% down. For this reason, PMI or private mortgage insurance was created. If a borrower contributes less than 20%, he or she must pay a monthly or yearly PMI premium. This is not insurance for the borrower (the one paying for it) – this is insurance for the lender. It reimburses the lender up to that 20% if the borrower goes into foreclosure.

So that is the story and that is the way the system works today. Even though you will not have to pay 20% up front any more, you will still "pay" for it in PMI and/or higher interest rates and points. Still, at least there is a way for borrowers to get into the housing market with out have to save for decades for that 20%!