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The Advantages of Saving for a Down Payment

Even though today's consumer society has become one of "buy now, pay later," there are some things that may actually be better to save up for, instead of just rushing into with credit and loans. One such item is your down payment on your first home.

As unpopular as it is, and as difficult as it sounds, saving up for your first down payment, rather than financing close to 100% of your home purchase, may score you the best deals and save you the most money in the long run. Ideally, you should wait until you have a full 20% of the home's price saved up that you can contribute as a down payment.

To be sure, this is a lot of money. According to the National Association of Realtors, the median sales price for an existing home in 2006 was $220,000. A 20% down payment on such a sum would equal $44,000. If you buy a brand-new home, obviously 20% would come out to even more. For most Americans, saving up that kind of cash is no easy feat. Yet it can be done, especially if you have your financial goals clearly set and use them as motivation for scrimping and saving for a few years.

Consider these possible benefits as that motivation. First, realize that a 20% down payment used to be the standard, not the exception in the lending business. With 20% down, the lender considers the loan to have an extremely low risk factor. This is because he has already collected a sizeable sum from you that can help cover his losses if you go into foreclosure. At the same time, lenders have found that home buyers that put a full 20% down at closing are much less likely anyway to default on their loans. This may be in part because they have already invested so much in the house so they are willing to work extra hard to hold on to that investment. Whatever the reason, if you come to the closing table with 20% for a down payment, you have scored yourself important negotiating power. If your credit and income are relatively good, with such a large down payment, a lender is able to give you some of the best terms and rates available. This adds up to great savings for you over the course of the loan.

Also consider how much you will save in interest by saving up for a down payment first. Let's say you buy a house for $220,000. If you put 20% (or $44,000) down, then you are really only taking out a $176,000. That means you will pay a total of $203,875.60 during the entire term of the loan (assuming a 30-year fixed at 6%.) If you got the same terms but financed the whole loan ($220,000) you would end up paying $254,843.60 in interest. You should also factor in though that most likely your rate on a fully financed loan would not be nearly as good in reality, so you would most assuredly end up paying even more interest for the $220,000 loan. (At 7%, you would have to pay $306,921.2 in interest!) Just think what great investments or other purchases you could make with the money saved in interest!

Plus if you do end up financing all or most of your home purchase, you will be required to pay PMI or private mortgage insurance. This is a premium you will have to pay in order to insure the lender against the possibility of you defaulting on the loan. This could add hundreds to your mortgage bills.

Another benefit of putting down a huge upfront contribution is that you have instant equity in the home. Equity is the difference between how much the house is worth and how much you still owe on your mortgage. If you have to sell within a few years, whether for a planned move or because of an unexpected emergency, your equity might save you from having to sell at a loss. Plus if you need extra cash for an emergency, you could probably pull out that equity through another loan and avoid having to sell to come up with funds.

Of course, in some areas of the country housing prices have jumped up much higher than the national median in recent years. If you live in one of these former real estate hotspots, saving up a true 20% may not really be feasible. In the Los Angeles area last year for example, the median home price in 2006 was $584,800. A 20% down payment on that amount equals $116,960! Even if you cannot save up the complete, coming up with a sizeable sum at closing will still net you great deals and savings. The point is: you may want to consider waiting and saving now in order to save even more in the future on your first home purchase!