

## A Series on the Keys to Homeownership



## FHA

### THE Low Down Payment Mortgage Option

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Down payments remain the biggest hurdle for most homebuyers. Interest rates are still very low, and home prices have come down to affordable levels for many people who were shut out in the last six to 10 years. These prospective homebuyers are now facing much larger down payment requirements than were required just two years ago and thus need to explore all options to get the cash needed for their down payment and closing costs.

The Federal Housing Administration (FHA) provides an option to purchase a home with 3.5 percent of the sales price as a down payment from the borrower. That is \$7,000 on a \$200,000 home or \$10,500 on a \$300,000 home. FHA provides the mortgage insurance on these loans. Veterans eligible for VA mortgage benefits can purchase a home with no down payment required using the VA's guaranty program.

All other loans, called "conventional loans," require a 20 percent down payment, which would be \$40,000 on a \$200,000 home or, with private mortgage insurance (PMI) to protect the lender, as little as 5 percent down. The 20 percent down payment could be provided by a government second mortgage such as that available through DC's Home Purchase Assis-

tance Program (HPAP). Alternatively, a borrower could make a less-than-20-percent down payment by purchasing PMI to protect the lender. With PMI the minimum down payment would be 5 percent of the purchase price for houses (\$10,000 on a \$200,000 home) and 10 percent for condominiums (\$20,000 on a \$200,000 condominium) in the DC metro area.

In addition to the down payment requirements, buyer's have closing costs of 2-3 percent of the purchase price, adding up to an additional \$5,000 to \$10,000 in cash needed for homes in even the low or moderate price range. Homebuyers need to plan ahead and develop savings plans or arrangements with family members who could gift them the money. Buyers and family donors must understand that this money is invested for the longer term. Home prices have a good chance of staying soft for a number of years. It is likely to take five years or more for today's buyer to get their investment back on a future sale.

The FHA mortgage, with its lower down-payment requirement, has become the primary loan for first-time buyers, growing in volume from 3 percent of all loans in 2007 to close to 33 percent of all loans in 2009 and more than half of all first-time buyer mort-

gages. Real estate professionals and lenders have had to relearn the rules of the FHA program, which had provided the dominant mortgage in the 1980s. Homebuyers should also spend time to understand the requirements and options available under FHA loans.

The first challenge for homebuyers to address is where to obtain the minimum 3.5 percent down payment required by FHA plus the closing costs. FHA allows the 3.5 percent down payment funds to come from a buyer's own savings, including loans against their retirement funds or from a family gift if the family member is a parent, brother, sister or grandparent. The funds can only come from a loan if they are provided by a government entity such as the DC Home Purchase Assistance Program (HPAP) or, for DC Government employees, the DC Employer Assisted Housing Program (EAHP). HPAP provides to current DC residents, after a minimum \$500 borrower cash contribution, a zero percent interest second mortgage for up to \$40,000. The DC Government's EAHP program provides a \$10,000 loan at zero percent interest. Contributions from the seller or lender cannot be used to pay the FHA 3.5 percent minimum cash contribution.

Closing costs can come from sellers or lenders. The FHA program allows the seller to contribute up to 6 percent of the sales price toward closing costs, which is up to \$12,000 on a \$200,000 home. Sellers must sell their home at a higher price to recover such contributions. Real estate agents and sellers realize that in a weak sales market they need to help buyers with closing costs. The HPAP loan offers buyers up to \$4,000 for closing costs.

Buyers obtaining FHA mortgages need to understand how they pay for mortgage insurance (MI), which is insurance against borrower default. FHA borrowers pay an upfront MI premium which is financed into the loan and a monthly MI premium. The FHA loan itself is a combination of the sales price less the down payment plus the upfront MI premium which is 1.75 percent of the base loan amount. For example, a \$207,253 purchase with a \$7,253 down payment has a \$200,000 FHA base loan and a \$3,500 upfront MIP. This MIP is added to the base loan, making the total FHA loan \$203,500. Adding the upfront mortgage insurance premium to the base FHA loan keeps FHA closing costs to a minimum.

The FHA also charges a monthly mortgage insurance premium of 0.55

percent of the base loan amount if the down payment is 5 percent or less. In the example mortgage above of \$203,500, with the minimum down payment of 3.5 percent, the monthly mortgage insurance is \$93 per month on top of the principal, interest, taxes and insurance payment. The monthly mortgage insurance payment is similar to the PMI premiums for a conventional loan. When looking at an interest rate, such as 5.50 percent on an FHA loan, the interest payment will be 5.50 percent plus the mortgage insurance premium of 0.55 percent. A conventional loan with a 5 percent down payment would have a monthly mortgage insurance payment of 0.70 percent to 0.90 percent.

The other key to qualifying for an FHA loan is meeting the credit standards and income affordability requirements. FHA historically was a good choice for buyers with marginal or weak credit, but FHA underwriting has tightened up and now is close to the standards for conventional loans. The credit scores for FHA generally have to be over 620 on a scale of 400-800 and must be based upon at least three accounts which each have at least two-year histories. PMI companies have even tougher credit standards on conventional mortgages with most requiring scores over 700 for loans with the lowest down payments.

The FHA loan program also requires income to be fully documented. The total payment for the mortgage, MIP, taxes

and insurance plus any borrower debt payments (car note, student loans, credit cards and other loans) cannot exceed 41 percent of gross monthly income (as distinct from take-home pay). This is more restrictive than for some conventional loans but similar to requirements of conventional MI companies.

The FHA loan presents opportunities for moderate-income households to take advantage of today's lower interest rates and lower home prices but still requires buyers to meet down payment and credit requirements that take time to understand and fulfill. Homebuyers, especially first-time buyers, should take advantage of free HUD-approved housing counseling services available across the city.

For housing and mortgage counseling, call Housing Counseling Services, 2410 17th St. NW, 202-667-7006; Latino Economic Development Corporation, 2316 18th St. NW, 202-588-5102; Lydia's House, 3939 South Capitol St. SW, 202-373-1050; Marshall Heights Community Development Organization, 3939 Benning Road NE, 202-396-1200; or University Legal Services, 220 I St. NE, 202-547-4747 and at 3220 Pennsylvania Ave. SE #4, 202-581-0600.

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