For Homebuyers, an Already Large Purchase Is Becoming More Expensive

Surging home prices and higher mortgage interest rates have made it more expensive to buy a home. Having a good handle on their whole financial picture can help consumers in the market for a home make choices that are right for them.

Only time will tell how rising prices and interest rates will impact the residential housing market.

Driven by limited supply and strong demand, U.S. home prices have been climbing steadily higher. Single-family home values rose 6.3% nationwide in the 12 months through February 2018, continuing the trend of year-over-year increases that has been ongoing since May 2012.[1] Meanwhile, the average interest rate on a 30-year fixed-rate mortgage has risen, reaching 4.58% as of April 26 -- the highest level in over four years.[2] For prospective homebuyers, the specter of rising prices and interest rates may be serving as something of a catalyst to act sooner rather than later. A record 7.8% of U.S. consumers polled by the Conference Board in April said they plan to buy a home in the next six months.[3]

Even in a robust economic environment, however, homebuyers will want to fully understand the financial commitment they are making and be confident in their ability to shoulder the costs before deciding which home they will purchase -- or whether they want to buy a new home at all.

How Much Will It Cost?

According to data from the National Association of Realtors,® the median price for an existing home in the U.S. was $250,400 in March. The median price was highest in the West ($377,100) and lowest in the Midwest ($192,200), with prices in the Northeast ($270,600) and South ($222,400) falling in between. Of course, these median sale prices represent midpoints only, and multiple factors determine what any given home will sell for in a specific area.

Before shopping for a home, prospective buyers might consider shopping for a mortgage and even seeking preapproval from a lender. Preapproval lets buyers know how much they will be able to borrow -- and therefore what price range is realistic. Preapproval can also provide a leg up in a competitive market since sellers may be more willing to entertain offers from those who show they can obtain the necessary financing.

How Much Is Affordable?

Mortgage lenders traditionally have used two ratios when evaluating a homebuyer's borrowing capacity. The "front-end" ratio compares the total monthly mortgage principal and interest payment (P&I), plus insurance and property taxes, to the buyer's monthly gross income. Ideally, this ratio should not exceed 28%. The "back-end" ratio, also known as the debt-to-income ratio, looks at the borrower's monthly debt payments (mortgage, credit cards, car payments, etc.) compared to monthly gross income. This ratio preferably should not exceed 36%.

The 28% and 36% ratios are rules of thumb, and lending standards vary. About one in five conventional loans made this past winter went to buyers who spent more than 45% of their monthly incomes on their mortgage payments and other debts, according to a *Wall Street Journal* report.[4]

Estimating Upfront Costs

Although no- or low-money-down mortgages are available to some homebuyers, typically a down payment is required. The higher the down payment, the less a loan is likely to cost. To secure the lowest interest rates, borrowers may need a down payment of at least 20% of the home's price. Buyers with a 20% down payment do not have to pay for private mortgage insurance (PMI), which is designed to protect conventional mortgage lenders in the event loan payments are not made.

In addition to a down payment, buyers should leave room in their budgets for closing costs, such as title insurance and appraisal fees. Closing costs vary, but typically range from 2% to 5% of a home's purchase price. Although sellers are sometimes willing to cover a portion of a buyer's closing costs to facilitate a sale, they typically expect to receive a higher price for their homes in return. Similarly, some lenders may be willing to roll closing costs into a mortgage loan, but the borrower eventually pays the costs as the loan is repaid.

A Word About Taxes

The Tax Cuts and Jobs Act of 2017 generally lowered the amount of home acquisition debt on which interest is deductible from $1 million to $750,000 and placed a $10,000 annual limit on the deduction for state and local taxes (SALT). Both the home mortgage interest deduction and the SALT deduction are claimed as itemized deductions on a taxpayer's federal income tax return. At the same time, the law increased the standard deductions available to non-itemizers, meaning that fewer taxpayers are expected to itemize their deductions. These tax law changes take effect in 2018, and the jury is still out on the effect they may have on the housing market going forward.

[1]As measured by the S&P CoreLogic Case-Shiller U.S. National Home Price Index, which tracks the value of single-family housing within the United States.
[2]Freddie Mac, April 26, 2018.
[3]Bloomberg.com, "U.S. Consumer Confidence Rebounds as Homebuying Plans Hit Record," April 24, 2018.
[4]WSJ.com, "Rising Home Prices Push Borrowers Deeper Into Debt," April 10, 2018, citing data from CoreLogic, Inc.