

How To Avoid First-Time Buyer Prison



By Donna Werbner | Motley Fool 8 October 2007

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Ever tried to walk up an escalator the wrong way? It will cause havoc and garner you some strange looks. But, if you use your imagination, it should also give you a valuable insight into what's it's been like for first-time buyers trying to get a foot on the housing ladder this year.

Recent research by Nationwide showed that, to keep pace with house prices over the first six months of this year, you would have had to save £50 a day. Few first-time buyers can afford to scrimp and save nearly £10,000 in six months - and yet, even if they managed it, they would have been in the same position they were in on January 1st.

In other words, if you're a first-time buyer, no matter how hard you may have tried to move onwards and upwards this year, you have probably ended up standing still, at best.

Depressing, isn't it? No wonder Fool.co.uk has discovered that one in 20 first-time buyers turn to so-called '100% mortgages' in desperation to get on the property ladder. These [mortgages](#) - which cost around 1% more than other deals - allow homebuyers to borrow 100% of the price of the property, instead of needing to put down a deposit. This means a first-time buyer can effectively get on the ladder without any savings whatsoever.

In the past, this strategy has worked out reasonably well (as this thread on our [mortgages discussion board](#) demonstrates). As long as house prices rise at around 5% a year, you can remortgage from a 100% mortgage to a more competitive deal in a couple of years' time. This is because you will have built up around 10% of equity in your home.

The question is: what if house prices do not rise so quickly - or if they start to fall? What will happen to the first-time buyers who have taken out 100% mortgages then? Are these mortgages really as safe as they seem?

Worst case scenario

In your opinion, is the glass half-empty or half-full? Personally, I say it always depends who's paying for the next drink. But when I'm not being nasty and cynical like that, I'd say I was an optimist. For example, when I leave my flat in the morning, I very rarely take an umbrella. Unfortunately, I live in a dreary, overcast country called England and this means I often get wet.

Taking out a 100% mortgage which relies on house prices increasing is another such optimistic, but risky, strategy. And, instead of risking looking like a drowned rat, you'll be risking your most important possession: your home.

So, just to be on the safe side, let's look at the worst case scenario. If house prices fall, and you have got a 100% mortgage, you may find yourself in negative equity. This means you will owe more to your mortgage lender than your home is worth.

That sounds scary, but as long as you don't need to move home, you should be OK. You can sit tight and hope that prices will start to rise again in a few years (as they almost certainly will).

But, sadly, negative equity is a huge problem if you suddenly find you need to sell your property and move. Unless you are prepared to downsize to a cheaper property, you will, effectively, be imprisoned in your home by your mortgage.

So the next question is: what's going to happen to house prices?

Stay safe

No doubt partly because I'm an optimist, I don't think we're heading for a house price crash. But I can't deny that, after five consecutive interest rate hikes, demand from buyers seems to be easing off. In other words, prices are not likely to rise in the future as quickly as they have in the past.

What does this mean for first-time buyers on 100% mortgages?

If you are on a repayment mortgage, you will only have paid off around 3% of the loan in two years' time. So in a stagnant housing market, when your current deal finishes, you may find you will have to pay higher lending charges and an expensive rate when you remortgage. It could be four years or more before you can get a cheaper deal.

If you are on an interest-only mortgage, the situation is even more dire, as you will not have repaid any of the loan. This means that, if prices stagnate at current levels, you will be forced to take out another 100% mortgage when you remortgage. And, as lenders are expected to tighten their lending criteria or stop offering these deals altogether, you may find you have even less choice than you do at the moment, pushing costs up even further.

The solution

In my opinion, the only safe solution is to save up for that crucial 10% deposit. This will give you a buffer zone of equity in your home if prices do start to fall, which, all being well, should allow you to sell and move whenever you want to.

The sad fact is, in a slowing housing market, taking out a 100% mortgage is simply asking for trouble. And you really don't want or need such trouble in your life. I should know. I go up escalators the wrong way.