

## **Mortgage Loan FAQ**

### **(From a Customer's Point of View)**

**Q:** How do I know how much house I can afford?

**A:** Generally speaking, you can purchase a home with a value of two or three times your annual household income. However, the amount that you can borrow will also depend upon your employment history, credit history, current savings and debts, and the amount of down payment you are willing to make. You may also be able to take advantage of special loan programs for first time buyers to purchase a home with a higher value.

**Q:** What is the difference between a fixed-rate loan and an adjustable-rate loan?

**A:** With a fixed-rate mortgage, the interest rate stays the same during the life of the loan. With an adjustable-rate mortgage (ARM), the interest changes periodically, typically in relation to an index. While the monthly payments that you make with a fixed-rate mortgage are relatively stable, payments on an ARM loan will likely change. There are advantages and disadvantages to each type of mortgage, and the best way to select a loan product is by talking to us.

**Q:** How is an index and margin used in an ARM?

**A:** An index is an economic indicator that lenders use to set the interest rate for an ARM. Generally the interest rate that you pay is a combination of the index rate and a pre-specified margin. Three commonly used indices are the One-Year Treasury Bill, the Cost of Funds of the 11th District Federal Home Loan Bank (COFI), and the London InterBank Offering Rate (LIBOR).

**Q:** How do I know which type of mortgage is best for me?

**A:** There is no simple formula to determine the type of mortgage that is best for you. This choice depends on a number of factors, including your current financial picture and how long you intend to keep your house.

**Q:** What does my mortgage payment include?

**A:** For most homeowners, the monthly mortgage payments include three separate parts:

Principal: Repayment on the amount borrowed

Interest: Payment to the lender for the amount borrowed

Taxes & Insurance: Monthly payments are normally made into a special escrow account for items like hazard insurance and property taxes. This feature is sometimes optional, in which case the fees will be paid by you directly to the County Tax Assessor and property insurance company.

**Q:** How much cash will I need to purchase a home?

**A:** The amount of cash that is necessary depends on a number of items. Generally speaking, though, you will need to supply:

Earnest Money: The deposit that is supplied when you make an offer on the house

Down Payment: A percentage of the cost of the home that is due at settlement

Closing Costs: Costs associated with processing paperwork to purchase or refinance a house.

**Q:** Banks vs. Mortgage Companies

**A:** There has been a long running debate as to whether a borrower should use a Bank or a Mortgage Company to obtain the loan for their home purchase or refinance. The question of which type of lending institution would provide a better rate, better service or best advice is often a concern for most borrowers. Borrowers are also looking for high integrity and stability in the lending institution. Some borrowers are even worried that the company lending the money may go out of business and the consequences that such an event would have on their loan. Oh, and of course everyone wants the best price.

First let's dispose of the myths. After your loan has been settled and the check has been cashed, it doesn't matter if the lending institution goes bust. Someone else will takeover the servicing of your loan without any change to the terms of your loan. There is a concern however, if the lender were to go out of business prior to your closing. This event could jeopardize fees you've paid, the rate you have locked, the loan approval and the timing of your closing. Fortunately, this rarely happens since most states monitor solvency of lenders on a regular basis. Another myth is that the monthly payments will be made to the institution that "holds" the mortgage. In the vast majority of loans issued, the mortgage is sold off into a large pool of loans, called

“Mortgage Backs” that are sold back to the public as securities. The monthly payments on a mortgage are made to a servicing entity that collects the payments and allocates the portions for principal, interest, taxes and insurance. They also maintain the account and act as the borrower liaison. So unlike what most borrowers assume, they have no ownership position in the loan.

***Can a Bank be better priced?*** The answer is sometimes yes and sometimes no. Pricing structures and programs will vary greatly from bank to mortgage broker and from bank to bank as well. Pricing will not be as dependent on the type of institution as it will be on the programs the institution has available at that time. Sometimes a Mortgage Banker or Broker will be better priced than a Bank but then a few weeks later the one with the best pricing may flip flop. It is important for consumers to check all sources and not be limited because one is or is not a Bank. ***Do Mortgage Bankers and Brokers have a better product menu and greater expertise than a Bank?*** The answer again is sometimes. As in the scenario of price, service and competency are to be judged by the individual rather than type of institution.

The important distinctions are, reputation, resources and accountability. Almost everyone knows a friend, relative, neighbor or co-worker who has recently had a mortgage borrowing experience. This is a great way to get gather the names of the better mortgage loan salesperson a/k/a originators in your area. Another source can be your local Realtor or your Attorney. Not only will they have multiple experiences with these loan originators, they will also act as a source of accountability for the loan originator. A mortgage loan originator will be very fearful of losing a valued referral source due to bad feed back from you. That fear stems from the fact that they probably receive other referrals from that source as well. The loan originator knows that most Realtors and Attorneys can be very influential in their marketplace so the originator is going to be accountable for his/her actions. This accountability will help keep them on their toes for you. Once you have a list of accountable, reputable loan origination candidates, you can see if the advice, programs and pricing they offer suit your needs. The result should be the best overall loan and mortgage experience for you.

**Q: Can I Ever Pay This Mortgage Off?**

**A:** When rates make a refinance seem favorable, a common question is, “should I save money on the interest rate even though I am starting my mortgage over from the beginning?”

The good news is that you can have your cake and eat it too!

Let’s start by looking at an example. Assume a borrower obtained a \$200,000 mortgage 4 years ago. Now say that interest rates have declined, offering them the ability to save 1% on the interest rate. The remaining balance is about \$192,000. They are thinking about refinancing because they will save \$189 per month. The only negative here is that they will be starting from the beginning on their mortgage payments and will now have 4 additional years before the loan is fully paid (30 years on the new mortgage instead of the 26 years on the current loan).

The borrowers like the savings, but wonder how they will ever get out of mortgage debt.

Some lenders suggest going to a 20-year term or even a 15-year term to solve this dilemma. The problem with either of these potential solutions is that the new payments will actually be higher than the original mortgage loan. In most cases the borrowers main objective is to reduce their monthly payments.

I have even heard and read many so called “sages” claim it is not worth refinancing because the sum of the payments for the new loan’s 30-year term will be greater than the sum of the payments on the current loans remaining 26-year term. This is a ridiculous argument and one that has prevented many borrowers from saving substantial dollars. Worse yet, some “crackerjack experts” say that since you are deeper in the amortization schedule there is some mystical transition that occurs. They claim you should be forced to pay a higher rate so not to give up the “magic” of the mid term amortization. They may also be the authors of emails that tell you to pass the Spam on to everyone you know in the next 45 seconds and you will get a check in the mail...yeah right. The fact is that the savings of \$189 per month could have been invested or utilized to created significant value.

But there is an even easier and safer way. How do we solve this problem? The solution is surprisingly simple. Instead of refinancing the remaining balance of \$192,000, the borrower should refinance the original loan amount of \$200,000. At the time of closing, the borrower receives a check for \$200,000 and pays off the old mortgage loan of \$192,000. This leaves the borrower with \$8,000 extra cash at the time of closing. The borrower then immediately pre pays the new mortgage by the \$8,000 cash they now have in hand. B

has a remaining time frame of exactly 26-years! The sacrifice is that the monthly savings is reduced from \$189 to a still respectable \$138.

Paying a lower interest rate will save you money unless the closing costs to do get the lower rate are too great to be recovered in a reasonable timeframe.

By Barry Habib

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**Q: Time Your Close for Cash Flow**

**A:** Can you really save money by closing on your house near the end of the month?

A little background first. You generally pay rent for the month just beginning. But your mortgage payment, including interest, generally takes care of the month just passed. You can close on a house any day during a month. Let's say you close on September 15; your initial mortgage payment would be due November 1. That payment includes interest for October. What about the rest? Did you pull a fast one? No. This "interim interest" is paid at closing. Obviously, the closer your closing is to the end of the month, the smaller this amount will be. This is what makes closing near the end of the month so appealing to homebuyers. You owe less up front. In many cases, homebuyers are really strapped for cash and they are counting every penny right around closing. Closing near the end of the month can help with your cash flow, and it can give the illusion of saving money – but you really don't save any money.

Whereas, other homebuyers aren't so sensitive to that one-time interim interest payment, and instead love the fact that their first mortgage payment isn't due for well over a month. If you are one of these people, then closing just after the month begins is right for you.

Interim interest can play a major role when it comes to refinancing a home as well. Many times a homeowner will calculate the amount needed on a refinance based upon their current mortgage balance plus costs involved. The one calculation we see borrowers miss time and again is the accrual of interim interest on the old mortgage.

Many times a borrower will call their current mortgage holder at the beginning of a month to find out the amount of their current principal balance. If they wind up closing on their refinance at the end of the month, they may be shocked to learn the amount needed to pay off the old mortgage is much greater than the original quote. What's more, many individuals who are refinancing won't make the mortgage payment that is due just prior to closing on a refinance. So if the closing on a refinance were scheduled for September 15, many borrowers do make the payment due September 1. Since that payment would pay interest due for August, they now wind up owing interest for the full month of August and half of September at closing. This can be an unpleasant surprise at the closing table. In order to avoid this, a good rule of thumb is to expect costs at the time of closing to be higher than expected by the equivalent of one monthly payment.

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**Q: Bi-Weekly Mortgage Plans Make Good Sense**

**A:** A home mortgage is the largest financial transaction many people make. There are many ways that the payment of that mortgage can benefit borrowers in ways they usually never imagine. The right payment plan can help you put your children through college or help you reach your retirement goals. And the right strategy up front can save thousands in non tax-deductible fees.

If you want an adjustable rate mortgage (ARM) for the lower start rate but are afraid of potentially higher monthly payments when it adjusts, a bi-weekly payment plan may be just what you have been searching for.

Mortgages are typically paid once every month, 12 times a year. A bi-weekly payment plan differs in that half of the normal payment is paid every other week. That means a bi-weekly contains 26 (52 weeks divide by two) half payments – amounting to 13 full payments each year. And that one extra payment per year can do some very important things. For instance, many families worry about how they can afford to save for their children's college education. If your mortgage amount were \$200,000 at 8.5 percent for 30 years, a bi-weekly payment plan could give you more than \$50,000 in additional equity to (This calculation assumes you make half of your normal monthly payment every two weeks, essentially kicking in an additional month's payment each year.)

This kind of savings can be a real help to families without a current college education savings plan for their children. That \$200,000 loan will be paid off in about 20 years instead of 30. Today, more than one-third of borrowers contribute a down payment of less than 20 percent. Most must pay an additional fee known as private mortgage insurance (PMI). This fee is non-tax deductible and on a \$200,000 mortgage costs about \$85 per month. This insurance is terminated once a borrower reaches a 20- to 22-percent equity position in the property. Most people don't

realize that it can take 16 years to reach that position. The bi-weekly plan can get you there in 6 years, saving 10 years and 120 payments of \$85. The total savings of \$10,200 is understated because of the tax consequences and the time value of money. In the 28-percent tax bracket the \$85 monthly savings is more like \$118 per month. If that money were invested back into the mortgage by prepaying it, there would be a guaranteed return on the additional payment of 8 percent. The total savings would be in excess of \$22,000. This is only the savings on PMI; there are additional savings on interest as well as home equity build up.

Many consumers today would like to use an ARM mortgage rather than a higher-rate fixed loan. The catch is that while ARM loans start off with a lower monthly payment, it is possible for them to rise above the current fixed-rate offering in the future. The bi-weekly program can give you the best of both worlds. In the example of a five-year ARM (in which the rate remains fixed for the first five years but can then adjust annually for the remaining term), a bi-weekly can build enough equity so that the payment may actually drop after 5 years even if the interest rate on the ARM goes up.

A bi-weekly payment plan can be added to any loan. There is no approval process, but there is usually a nominal fee. It is important to note that unless your mortgage has a prepayment penalty you can do this yourself by making one additional payment per year. That takes a lot of self-discipline since spare cash in great amounts can be tough to come by. Additionally, there is no immediate gratification for making the payment. The reward comes years later when you look at the additional tens of thousands you have added to your net worth.

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#### **Q:** Refinance with a Purpose

**A:** So many homeowners rush to refinance when rates decline. They shop, look for the lowest rates and lowest fees but while wrapped up in all the shopping frenzy, they could be missing the big picture. A home mortgage is typically the largest financial transaction that individuals make in their lifetime. While price is important, the paramount element of securing a home loan is the strategy of the program and how it fits into your life plan. The vast majority of homeowners will secure their mortgages based solely upon the interest rate then wonder how to work their financial goals around it. Since there are literally hundreds of mortgage plans to choose from, the far wiser approach would be to begin with the end in mind.

First, have a long-term financial strategy in place. Then you can find a mortgage that fits into and helps achieve the goal of that plan. Just like the lost driver who refuses to ask for directions, most families do not have a financial roadmap to reach their goal or destination. They just “hope” that things will “work out”. When your children’s college education, your financial freedom or quality of life after retirement hangs in the balance, you can’t afford to just “hope”. Let’s take an example:

We often see someone refinancing to save \$200 per month. They decide to do this not because they are struggling to make ends meet but because it simply would be foolish to throw that money away. After figuring the after tax effect of the \$200 savings, the net for most families would result around a savings of \$140 per month. Unfortunately, there isn’t a lot you can buy today with that. Most borrowers would simply spend the additional monthly savings and not have much to show for it in the long run.

Consider that many long-term professionally managed financial plans can achieve a long-term rate of return of 12%. This rate of return would cause a lump sum to double every six years. Okay, back to our borrowers who would save \$200 (\$140 net of tax benefit) per month by refinancing. Let’s assume they have a very young child and have not yet put together a college savings plan. They could, at current rates, borrow \$30,000 more and still keep the same monthly payment that they currently have. If invested with a professional money manager or financial planner, that money could double in six years bringing the total to \$60,000 (assuming a 12% rate of return). Six years later, the total would double again equaling \$120,000. Add another six years and the total would be \$240,000 in 18 years. Now that’s a great way to get your child off to college!

The above example, while realistic and based upon historic returns, does not provide a guarantee that the results will be as illustrated. But even if only half of the sum were achieved, the total would still be a handsome \$120,000 accumulation. That’s still far better than the net \$140 per month that would likely be spent without a plan.

It seems so obvious to have a solid financial plan before deciding on such a large monetary undertaking such as a home mortgage. If you are not a Dentist, would you attempt to perform a Root Canal on your spouse? (I am not asking if you want to). The obvious answer is no. Why

then do so many homeowners go so for such a long period of time without consulting a financial planning expert before making major financial decisions?

That financial planning expert can sometimes be your Mortgage Loan Representative, but check first to make sure they have the expertise to help guide you along the way.

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**Q: Credit: Know the Score**

**A:** A good credit history is more important than ever. Solid credit keeps down the cost of consumer financing, and it can be the deciding factor in whether an auto or home loan application is approved. In today's fast-paced, high-tech age, your credit history will be reviewed more often by artificial intelligence than human intelligence. This computerization has made the loan process much more efficient. That's a good thing. But computers take all the subjectivity out of credit evaluation, and that means you have to take ownership of your own credit standing to make sure you're not blindsided by any stain on your record.

It is important that everyone know his or her credit score. Everyone is entitled to one free credit report a year. Various companies, including Experian Consumer Relations (888-397-3742), can show you your credit profile. Fairly frequently, erroneous information appears on a credit report. This can take a few months to correct, which might mean the difference between being able to purchase your dream home or not.

Credit scores usually range between 400 on the low side to 800 on the high side. On rare occasions these ranges can be exceeded. Sometimes a score cannot be obtained for factors like lack of credit history or too few lines of credit. If you know your score, then you can see what the creditors see and have the ability to get a jump-start. Here is a quick breakdown of what a score means to a creditor:

800 and over

Congratulations, you are at the top!

700 – 799

Excellent score. You are a very desirable borrower.

660 – 699

Strong credit. You should have lots of options.

620 – 659

Usually good credit. A- programs are available ( No Ratio, NINA, NoDoc, etc) Fannie Mae & Freddie Mac usually use 620 as a min score.

600 – 620

Better. You begin to have options here. 100% financing becomes possible. Don't expect the lowest rates.

580 – 599

OK. The rest of your file needs to be strong

550 – 579

Difficult. Needs some work or a special program.

Below 550

Trouble. Try to fix up your credit.

<\*\* The above chart is heavily altered from the original to reflect reality\*\*>

- Dan

If you would like to improve your credit, there are a few things you should know. An easy way to start is by increasing your credit limits. If the ratio between the amount of credit you owe and the maximum credit limit increases, the computer views it as a plus in scoring. Try to avoid frequent inquiries into your credit history. This can trim your score a few points. The good news is that the negative effect of multiple inquiries only lasts about 30 days. Keep in mind that you have a right to an error-free credit report. For instance, if your profile shows a late payment without a specific month of delinquency, that item can be removed. This is a great tool, but you need to check your credit and make the requisite phone calls.

Remember, it may take a couple of months for your credit score to reflect the changes. There are three credit bureaus that report a score, so in essence you will get three scores for your credit. And creditors usually take the median of the three scores.

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#### **Q: Seller Contribution Packs a Punch**

**A:** A "seller contribution" is one of the best-kept secrets in the home-buying process. That's when the seller of a home puts up some of the money needed toward the buyer's closing costs. It can mean the difference between a sale of a home and no sale. Seller contributions can be negotiated at the time of a home purchase by having the seller pay closing costs rather than or in addition to a reduction of the home sales price.

A seller contribution can seal a home purchase in some cases where the buyer does not have enough cash for both the down payment and closing costs. Many people can qualify for the payment on a home mortgage but encounter challenges in gathering the necessary cash. Often people worthy of a mortgage don't have a lot of ready cash sitting around at the moment they find their dream house. Don't let the idea of a seller contribution scare you. An experienced mortgage broker or banker can help you figure out the best way to put a deal together.

He or she should also be able to help you understand the details well enough to be comfortable with the purchase structure. There are many other benefits of utilizing a seller contribution. Using the money from a seller contribution for the closing costs can free up more cash for a larger down payment. This can reduce or eliminate the need for private mortgage insurance (PMI) and can thereby save the borrower anywhere from \$50 to \$200 each month in PMI charges. This can also be used to achieve better price break points in the loan to value ratio to help the borrower get a better interest rate. Another benefit is the improved pricing or accessibility of "no income verification" mortgages. This is where the borrower cannot verify the income needed but may still obtain the mortgage by increasing the amount of down payment. If the borrowers have consumer debt with high monthly payments, preventing them from qualifying, they can use the seller contribution to pay off some or all of those debts. This allows them to now qualify or significantly reduce their overall monthly payments. Also, closing costs are virtually non-tax deductible. However, points are still tax deductible. If paying points, it is very smart to use a seller contribution because while the seller pays the points, they are still tax deductible to the buyer.

A Seller contribution is easy to implement. There are no negative tax consequences to the seller except for a negligible real estate transfer tax in some areas. A seller contribution must be fully disclosed. The amount of seller contribution must not exceed the actual amount of closing costs. The buyer or real estate agent should check with the lender to make sure that they are within allowable limits, normally 3 to 6 percent of the of purchase price.

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#### **Q: Don't Forsake Retirement for Home**

**A:** Homebuyers frequently use retirement money toward the down payment on a house. But think before you leap. Buyers justify this by saying they want to cut the monthly mortgage payment and have a smaller mortgage. Buyers also use this tactic to avoid having to take out what's known as a jumbo mortgage, which generally comes with a modestly higher interest rate. Jumbos tend to be classified as exceeding \$300,700. Buyers may also use retirement funds to avoid private mortgage insurance, PMI, by placing at least a 20% percent down payment on the home right off the bat. These are all valid reasons. But do they really justify borrowing from your future? When it comes to saving for retirement, you usually end up with more if you defer taxes until you need the money. So the more tax-deferring you can do, the better. The funds for your home, if possible, should come from elsewhere.

An example brings the point home:

Take a penny. If you double it, you get two cents, if you double it two more times you get eight cents. After 30 times, you end up with a tidy little \$5.37 million. Now do the same exercise, and impose a 28 percent tax on the gain after each doubling. You end up with \$1.32 after 10 doublings and \$67,659 after all 30. That's a nice sum, but not quite \$5.37 million.

Unfettered growth really pays off. This isn't the only drawback of breaking into the retirement nest egg. If you take money out of an IRA or 401(k) plan, before age 59 ½, you likely face a 10 percent penalty from the IRS on top of whatever the normal taxes are. You can borrow from these plans, and that may make sense at times, but you have to pay it back. What's more, your mortgage lender may restrict your borrowing ability as a result.

So tinkering with your mortgage may not justify cutting into one of your most-important employment benefits, which is your 401(k) plan. You may other more-attractive alternatives to improve your mortgage. Investigate the possibility of using a "seller contribution." Here, the seller can pay your closing costs or build these costs into the purchase price. This may reduce your need to pull money from a retirement account. If you cannot put enough money down to avoid paying PMI, then consider paying the PMI premium rather than tapping your future. With some appreciation in the value of your home and/or prepayment of your loan, you can eliminate this fee quickly. If you want to avoid the slight rate increase that comes with a Jumbo mortgage, consider taking a second mortgage for the difference.

You should try to max out your 401K, SEP and IRA every year. After all, you'll enjoy that new home even more knowing that your retirement years will be comfortable.

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#### **Q:** Look Beyond APR in Mortgage Hunt

**A:** The "annual percentage rate" (APR) listed with any mortgage generally causes more confusion than it's worth for most homebuyers. Making matters worse, most mortgage professionals don't really understand it. An APR calculation is required on mortgage offers to help people make sense of all the figures flying around. The ultimate goal is accurate comparative shopping. Unfortunately, some lenders can and will manipulate APR; and the assumptions used generally make APR estimates unrealistic.

APR is at best a theoretical statistic. Your mortgage carries a stated interest rate. But it actually costs more, when you account for points paid up front and closing costs imposed by the lender. APR tries to take all this into account. Unfortunately, it usually does little more than confuse homebuyers. In fact, the calculations associated with APR frequently scare homebuyers. Under APR math, you take the loan amount, which is easy for anyone to understand, and turn it into the "amount financed."

Let's look at an example: If you put 10 percent down on a \$200,000 home, the loan amount is \$180,000. Let's say you pay \$5,000 in points and closing costs. That means the amount financed is \$175,000. Homebuyers panic when they see the \$175,000, thinking that they suddenly have to come up with another \$5,000 at the last minute to pay the seller. But in fact, that figure comes up merely to calculate APR and has no real barring on the transaction.

Another source of confusion and misleading comparisons stems from what is known as "interim interest." For various reasons, mortgage payments are almost always timed with calendar months. So if you close sometime during the month, then you have to pay that little bit of extra interest until the first payment is due. Interim interest can alter the APR calculation by several basis points, but that does not really mean one mortgage is better than another. It merely means that one closing date is further away from the end of the month than another. Lenders can play games with interim interest to get lower hypothetical APRs on advertised loans. Laws regarding APR actually allow some wiggle room for this sort of thing. A lender can be off by as much as 1/8 of a percentage point.

Unfortunately, in a competitive mortgage market that can mean the difference between winning and losing a customer. Homebuyers generally aren't aware of the faulty assumptions that go into APR calculations. These assumptions can lead to people taking on the wrong kind of mortgage. APR math relies on two very bad assumptions:

APR assumes zero inflation. In other words, \$1 today equals \$1 30 years from now.

APR assumes the homebuyer will never move, prepay, or refinance.

In fact, a typical family stays in the same house about nine years, and refinances once. That brings the average mortgage duration down to less than five years. So most APR assumptions are grossly unrealistic. Adjustable-rate APR calculations are based on even more assumptions, making them even less meaningful. So what do you do? Take a look at the APR

and then forget about it

Don't pay points, unless you plan to stay in the house for at least 10 years and won't refinance. Chances are good you will move before 10 years is up, or you will refinance. It is much easier to compare different offers if they don't include points. You should focus on the type and amount of the mortgage, and on the quality of service of the lender.

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#### **Q: PMI MAGIC**

**A:** Nearly 50% of all homebuyers today have less than a 20% down payment. That means they will be required to pay an extra fee known as Private Mortgage Insurance or PMI. PMI protects the lender because the lower amount of down payment puts the loan in a slightly higher risk class.

While most borrowers today are familiar with and understand the rationale for PMI, they still don't enjoy paying the additional premium. There is some very good news for these borrowers. Thanks to a slew of new PMI options, there are ways to make the costs almost negligible. Add in a little creativity and PMI can become quite friendly.

Let's look at an example. Assume a homebuyer wanted to purchase a home with only a 10% down payment. The loan amount we'll use in this example is \$200,000 with a fixed interest rate of 7.5%. The mortgage payment for principal and interest is \$1,399 per month. The standard cost for PMI, which is non-tax deductible, is an additional \$86 per month. This brings the monthly mortgage payment plus PMI to \$1,485 for a typical \$200,000 loan with 10% down.

A different way of paying PMI is by doing so "up front" or with one single premium. This way the PMI is paid in one shot and can usually be built into the loan or financed. That dramatically reduces the payment and makes it tax deductible as well. There are some even more creative and interesting options. According to Mortgage Guaranty Insurance Corporation (MGIC), the level of MI coverage and thus the cost of this "up front" PMI can be significantly reduced if the Banker or Broker receives an automated approval through Fannie Mae or Freddie Mac. Even better, the premium is slashed if the loan term is reduced from a 30-year to a 25-year. So the same homebuyer in the previous example can use a bit of creativity and take a 25-year term with "up front" PMI. The cost for the "up front" PMI is a one time fee of 0.75% or \$1,500 in this example. The loan amount would then be \$201,500 (\$200,000 loan plus \$1,500 PMI up front cost) if the fee were financed. The result is a mortgage payment for principal and interest of \$1,489 per month. This is only \$4 more per month for a 25-year loan than for the previously discussed 30-year loan!

Moreover, since the PMI on the 30-year was not tax deductible, the payment for the 25-year loan with "up front" PMI is actually cheaper by \$20 per month, after tax deductions are considered (assuming a 28% tax bracket). Wow, save 5-years and \$20 per month! Be sure to ask your mortgage originator about this if you are buying a home with less than 20% down.

There are a few things you should know about up front PMI. If you do not receive an automated approval, don't panic, the cost is \$5 per month higher. If you can't finance the "up front" PMI into your loan, you can pay it in cash, negotiate to have the seller pay for it, or build it into the transaction with a seller contribution. Since the "up front" PMI requires you to pay the fee at the beginning in a lump sum, borrowers fear losing this investment if they sell or refinance shortly after closing. There is more good news here too. A portion of the premium will be refunded to you if you prepay early in accordance with a published sliding schedule.

You don't have to wait 25-years to see the benefits of this option; you'll be building equity more quickly from the start. In fact, using the above example, you will have about \$15,000 additional equity (because you will owe less on your mortgage) after 10-years by going with the 25-year term with lower net payments!

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#### **Q: Weighing Fees vs. Rate**

**A:** There's lots of ways to select a mortgage loan today. With current rates so low, many individuals are in the market for a home or refinance. Everyone wants the best rate but few properly weigh in the costs. Sometimes the lowest rate is not the best deal.

Once you have found a program that best suits your personal financial needs and goals, here are the top ways to shop for your home mortgage:

Forget APR – It is meaningless, can be easily manipulated, and assumes that the loan will never be prepaid, refinanced or that the home will never be sold. APR is worthless.

Get real rate quotes – Make sure you can get approved for the rate you are being quoted. Do you need a Jumbo loan, a no income loan or one that will allow for credit history issues? Will the rate lock provide protection through the date you are closing?

Most importantly, find out the fees. Fees are almost never tax deductible so they can be very costly. Find out the fees that are specific to the lender (ignore the costs for your attorney and title because they would be the same for any lender you choose).

Once you have the rate & fees, you can do a little calculating. Let's say we have a \$200,000 loan. Lender "A" has a rate of 6.75% with \$300 in lender fees. Lender "B" has a rate of 6.5% but with \$1,850 in fees. Is it worth paying the additional \$1,550 in fees to save 0.25% in rate? In this example, the monthly payment difference is \$33 per month. Most people will make their decision by taking the cost of \$1,550 and dividing it by the \$33 monthly savings.

Based upon this calculation it would take just over 4 years to break even. If the borrower is planning to live in the home for 4 years or more they will probably decide to "pony up" the costs for a lower rate. But this typically used calculation is greatly flawed. First, we need to account for the value of the \$1,550 additional cost. The way to do this is to take that money and find out what kind of return it can generate for you if you didn't pay the fees. Since you would be saving the money by taking the higher rate, you can use it to reduce your loan amount by the \$1,550. So instead of needing a \$200,000 loan, you can take a loan of \$198,450. This causes a drop in monthly payment of \$10 per month. Now the difference between the two is reduced from a \$33 savings to a \$23 savings. Wait, there is one more step. The fees are almost never tax deductible but the monthly payment differential almost always is. So we need to apply a tax deduction to the \$23 difference. That brings the real monthly difference down to about \$16. Finally, take the additional cost of \$1,550 and divide it by the real savings of \$16 and you will see that it will take more than 8-years just to break even. Chances are that you will either move or refinance by then. It is typically better to save up front costs even if the rate is a little higher.

By Barry Habib

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#### **Q: Alternatives to Large Down Payments**

**A:** The good news is you have many mortgage options. That's also the bad news. Selecting a mortgage is one of the biggest financial decisions an individual or family can make. So it's crucial to see how your choice affects your total financial picture. Too many borrowers shop just for the lowest rate. The Internet has further turned mortgages into a commodity. The lowest rate on the wrong program is far more costly than a competitive rate on the program that best suits your needs.

Rates are important, but you also need to consider a host of other variables, including taxes, term, fixed vs. adjustable, rate locks and, perhaps most importantly, the loan amount.

The size of the loan is perhaps the most frequently neglected question. Buyers commonly shy away from larger mortgages because they don't understand the alternative uses of their money. Most people fear debt, sometimes to a fault. Homebuyers often have better alternatives for their money than putting it toward the purchase of a house merely to cut the size of their mortgage. For example, many relatively safe tax-exempt bond funds pay a better after-tax return than you would get from paying down your mortgage.

A family in the 28 percent tax bracket actually earns 9.44 percent (after taxes are figured) on a municipal bond fund paying 6.8 percent. So at mortgage rates below 9.44 percent, you should take out the biggest mortgage possible.

Home prices have escalated in recent years. Many homeowners find themselves with relatively small mortgages relative to the market value of their homes.

An example here helps bring the point home.

You buy a home valued at \$250,000. You can afford to put \$150,000 down. That leaves you with a \$100,000 mortgage at say 7.5 percent. You could also put \$50,000 down and take out a \$200,000 mortgage. You could take that \$100,000 of free cash and put it into a municipal bond fund yielding 6.8 percent. You'll probably end up making more that way in the long run.