



Chapter 5

What Mortgage Is Best for You?

When I began working in the Industry in the late '80s, there were just a few mortgage programs available to borrowers: a 30- or 15-year fixed-rate loan or a 1-year adjustable-rate loan. As we have seen over the past 10 years, more progressive, complicated, and riskier loan products have come about. The intention was to offer choices, which I am sure was a good idea at the time. However, greed got in the way and choice led to complication and then combustion. Now we are back to basics.

As I am very risk-averse and guide my clients down that same path, I always preferred the fixed-rate loan. Nevertheless, different strokes for different folks! Here, I will tell you about every possible loan product out there, whether it is currently available or not. Some of the products that are currently unavailable might return in the future.

I will begin this chapter with an overview of Private Mortgage Insurance (PMI) because it is an important topic for those borrowers who require it.

Private Mortgage Insurance (PMI)

The lender requires PMI if your loan-to-value (LTV) is greater than 80 percent of the home value or the purchase price, whichever is less.

LTV is simply a ratio representing the amount of financing you are requesting versus the value of the property (read more about LTV in Chapter 4). If you put 10 percent down, your LTV ratio would equal 90 percent. Therefore, if you do not put down at least 20 percent, you will have to pay PMI. The lender obtains the insurance on your behalf, but you will pay it monthly.

PMI insures the lender if the borrower defaults and there is not enough money from the foreclosure sale to pay off the loan. Do not think you can walk away from your home if the market plummets and your home is worth significantly less than your outstanding loan amount. PMI may not cover the entire loss, and the lender will come after you for the rest. Furthermore, a foreclosure will ruin your credit score.

Your PMI payment amount is affected by the following factors:

- Loan-to-value (the higher the LTV, the more the PMI will cost)
- Credit score (FICO—the higher it is, the better off you are)
- Purchase versus refinance (refis carry more risk if you take out equity)
- Owner-occupied versus second home (owner-occupied have less risk)
- Single-family versus two to four units (single-family homes carry less responsibility, thus less risk)
- Fixed-rate loans versus adjustable-rate loans (fixed rates pose less risk)
- Condo or co-op (condos have less risk)

The amount of PMI is calculated from a chart that all PMI companies and all the banks adhere to. Honestly, there will be a few dollars difference, but the range is close. You will receive an estimate for PMI costs prior to closing. That amount is added into your monthly housing expense when the lender qualifies you for the monthly payment.

The No PMI (Self-Insured) Loan

When a loan is advertised as *No PMI required*, it usually means it is self-insured. A self-insured loan has a higher interest rate to cover the cost of the mortgage insurance. With this type of loan, the lender pays the PMI premium out of the interest income made on the higher rate. When the LTV drops below 80 percent, the bank no longer has to pay the monthly PMI, drops the premium, and makes more net profit on your loan. Therefore, you are better off paying the PMI and saving the cost of the premium yourself when you become eligible. Why not save yourself the money?

PMI Is Tax-Deductible

PMI is now tax-deductible, where before it was not. So the idea of doing a self-insured loan so you can get the interest deduction is no longer applicable.

The following chart shows the difference in payment amounts for self-insured and PMI loans:

Self-Insured	PMI
Loan amount: \$108,000	Loan amount: \$108,000
Interest rate: 7%	Interest rate: 6%
Monthly payment: \$718.53	Monthly payment: \$647.51
	PMI: \$56.00
Total: \$718.53	Total: \$703.51

Removing PMI

The rule is that once your LTV goes below 78 percent of the current home value, you can get the PMI removed. Consumer advocates tried to get it so it would automatically be removed by the lender, but

lenders argued that it was too much work, and they would have no idea what the current value of the homes would be. Truthfully, the lender gets a piece of the PMI premium paid each month and hopes you forget you have it and continue paying it for the life of the loan.

So after years of struggle, they compromised. The lender now has to remind the borrower each year that she's paying PMI insurance, but it is the borrower's responsibly to get it removed.

The basic guidelines are as follows:

- An appraisal showing the current value must be provided and paid for by the borrower.
- The LTV must be under 78 percent.
- Each lender has their own guidelines, but at least 12 to 24 timely payments must have been made. Most lenders will require a minimum of 24 months regardless, but check with them if you think you qualify after 12 months.
- There cannot be *any* late payments.
- There can be no secondary loans bringing the combined LTV over 80 percent.

As the rules are not federal, each state is a little different in guidance. In addition, each lender has its own process to remove the PMI. Therefore, the borrower will have a bit of a runaround to find the right department to deal with. There will also be some fees and time involved, but it is worth the savings in the end. Sounds easy, but it is a real pain in the neck!

Fixed-Rate Mortgages

With a fixed-rate mortgage, your monthly payment (principle and interest) will be the same every month until you pay off the loan. The term of the loan may be amortized over 30, 25, 20, 15, or 10 years. As the chosen term to pay off the mortgage decreases, the interest rate

offered also decreases. However, the monthly payment will be higher, because the mortgage is being paid off faster with bigger payments.

This is the most stable option because your interest rate is the same for the entire loan period, regardless of what the global economy is going through. If you do choose to make larger payments, or pay down a chunk of the principle, it will only reduce the total amount you owe and not your monthly payment. I suggest you notify the lender that you are paying additional money and you want it applied toward principle only. You can verify this by getting a payment history online or over the phone. Your total principle amount will be reduced, the total interest you pay over the life of the loan will be reduced, and the loan will be paid off in less time. *However, your monthly payment will be the same dollar amount.*

When you are deciding the length of your mortgage, remember that the lower the term, the higher the payment.

Years	Rate	Loan Amount	Monthly P&I	Total Interest Paid
30	6.000%	\$100,000	\$599.55	\$115,838.45
25	6.000%	\$100,000	\$644.30	\$ 93,290.89
20	5.750%	\$100,000	\$702.08	\$ 68,500.81
15	5.250%	\$100,000	\$803.88	\$ 44,697.82
10	4.750%	\$100,000	\$1,048.48	\$ 25,817.19

40-Year Loan

A 40-year mortgage is the same as a 30-year mortgage, but your payments last 10 years longer, so your monthly payments are smaller.

However, the lender will charge up to 1.5 percent of the loan amount for this privilege or increase the interest rate by approximately 1 percent for this loan, because you are holding its money longer.

While it may appear to have lower monthly payments, in the end the total amount you pay will be more than with a 30-year mortgage because of the higher interest rate and longer payoff. Don't do it!

Here is an example of the difference in monthly payment between a 30- and 40-year mortgage:

30-Year Mortgage	40-Year Mortgage
Loan amount: \$100,000	Loan amount: \$100,000
Monthly payment at 6%: \$599	Monthly payment at 6%: \$550
Total interest: \$115,838.45	Total interest: \$164,107.57

Adjustable-Rate Mortgages (ARMs)

With an adjustable-rate mortgage (ARM), the interest rate will change/adjust on the same date each year or period as indicated in the loan documents. The rate change is based on a chosen economic indicator (1-year T-Bill or 6-month LIBOR will adjust once a year or every six months depending on what you choose) plus a predetermined margin. There will be two caps (or limits): a term cap and a lifetime cap. The term cap places a limit on how high the lender can raise the rate each time it changes. The lifetime cap limits the maximum interest rate forever.

The choice to take an adjustable-rate over a fixed-rate mortgage should be made based on length of time the borrower will be keeping the property and difference in monthly payment. If a person knows that he will only be staying in a home for two years because he is being transferred, and the monthly savings is \$200 a month, then it would be a good idea. However, if someone just assumes she will be moving in a few years or the savings is only \$75 a month, then she might choose to get a fixed-rate loan. Remember, life gets in the way of your plans, so your short-term plan might get longer.

What Is Recasting?

As you pay down your principle, the interest payment is based on the lower amount owed. The monthly payment will include more principle than interest over time. This is called *recasting*.

If you have a loan where your monthly payment reflects this change, then your monthly payment will go down, or recast, with it.

Hybrid ARMs

A hybrid ARM is one in which the rate is fixed for a set period and then becomes an adjustable rate for the rest of the term. The monthly payment is still based on a 30- or 15-year term loan, with the most common initial lock periods of 10, 7, 5, 3, or 1 year(s), or 6 months. The longer the initial rate period, the higher the start rate will be. Therefore, a rate that is fixed for the first 10 years will be higher than a rate fixed for 3 years. You are reducing the risk of your payment increasing for a longer time, but the lender will have the risk that rates will go up and they will lose income because your rate stayed low.

In deciding between a hybrid ARM and a fixed mortgage, calculate the difference between the monthly payments for the hybrid ARM and the fixed-rate loan. If there is no significant difference in the dollar amount of the initial payments, then stick with the fixed rate. Always try to look to the long term rather than short, because you just never know what is going to happen.

A Few PITfalls with ARMs (Get It?)

The exact terms of the start rate, index (economic indicator), caps, and margins must be disclosed prior to the closing and then are all listed in the body of the Note. Make sure you read the disclosures

when they come in the mail and bring them to the closing to compare with the loan documents. There are such things as errors in loan documents, and you want to make sure you are getting what you understood to be the terms.

Some ARMs have pre-payment penalties in case you pay it off early. This penalty can be a dollar amount or a percentage of the outstanding principle amount. Either way, it can be thousands of dollars and be a real bummer to pay, so try to avoid this. In some states, this is an illegal charge, but you would have to know this.

Make sure you are educated in the choices of economic indexes to choose from. As an example, an MTA will typically vary less than a LIBOR. (If you have no idea what I just said, perhaps you should re-search your economic indexes.)

Caps, Indexes, and Margins, Oh My!

Caps: Typical annual caps are 2 percent and lifetime caps are 6 percent. This means that your interest rate cannot go higher than 2 percent over your previous year's interest rate, and will never be more than 6 percent over the initial interest rate. If you have a loan product where the interest rate changes monthly or every six months, the chosen (time) caps should be no more than 1 percent, and there should be a lifetime cap of 5 percent. *Be wary of loans with only lifetime caps because your interest rate can reach the max immediately.* Make sure your cap is what they told you your cap would be! Bring all your loan disclosures to the closing!

Index: The index is an economic indicator chosen to dictate what the interest rate will be when it changes. It is the base number that changes each time your interest rate is due for a change. Common Indexes are 1-year T-Bill, Cost of Funds District (COSI), London Interbank Rate (LIBOR), and Monthly Treasury Average (MTA). You want to pick an Index that does not fluctuate terribly over the years. Historically, the MTA is the most stable index, but it is hard to

figure out. If you really want one of these loans, then get some specific professional advice.

Margin: Your adjustment in interest rate is set by the index plus a margin. The margin is established at the beginning of the loan and never changes. An average margin on a residential loan is around 2.75 percent and will be the same for the entire loan. The margin is almost never negotiable for residential loans, but can be for commercial mortgages. The higher the margin, the more interest the lender can earn over the life of the loan. If there is a mortgage broker/banker involved, then the higher the margin, the higher the fee the lender will pay them for the loan.

Take a look at this example to see how your new interest rate will be figured:

Your loan is a 1-year ARM, with monthly payments based on a 30-year term.

Initial rate of 5 percent

Index is 1-year T-Bill (as quoted in *The Wall Street Journal*)

Loan margin is 2.75 percent

Caps are 2 percent annual and 6 percent lifetime

At the first anniversary of your interest rate change, the index for 1-year T-Bill is 6.17 percent. So the new rate based on the index plus the margin is this:

$$6.17 + 2.75 = 8.92 \text{ percent}$$

However, the annual cap is 2 percent over the prior year's interest rate, so the rate will be less:

$$5 + 2 = 7 \text{ percent}$$

Also, because there is a lifetime cap of 6 percent, the highest your interest rate can go over the life of the loan is this:

$$5 + 6 = 11 \text{ percent}$$

Option ARMs

Like other ARMs, the interest rate for an option ARM is tied to an economic indicator (MTA, LIBOR, or COSI) plus a margin. What makes the option ARM different from other ARMs is your choice in payments. Each month, depending on your financial condition, you can choose a payment option that best fits your needs.

Typical options are *minimum payment due*, which is a very small amount set by the lender; *interest-only payment*, which is based on the actual interest rate; the *fully amortized principle and interest*, which is the real payment as if you had a normal fixed-rate loan; or *any amount* you want to pay without penalty. This type of loan is best for people whose income fluctuates due to commission or bonus payments. Qualification for the loan is based on the fully indexed rate plus principle.

This loan is also referred to as a negative amortization loan. If you only pay the least amount allowed, you do not even cover the minimum interest due. The unpaid portion of the interest is tacked on to the total loan amount, thus increasing your original loan amount. So instead of your loan getting smaller each month, it is getting bigger, thus negatively amortizing. Your interest is calculated on the bigger loan amount each month to boot.

This loan can be deadly! One big problem is that most people opt to make the minimum payments. (It is only human nature!) The borrower will promise the lender and himself that he will pay down the mortgage in chunks but might never do that for this, that, or another reason. It is very easy to say you'll pay more next month.