

# The *Real World* Refinance Guide



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# **The Real World refinance Guide –**

## **How to avoid the biggest refinancing mistakes that can cost you thousands.**

The mortgage you started with when you first bought your home, may no longer suit your needs as time goes on. The markets change, and so does your personal situation, so it is important to look at your mortgage on a regular basis and make sure your financing works best for where you are now. Refinancing can save you money, increase your cash flow, help you build wealth and move you closer to your goals - if you approach it in the right way. Having the right information is the key. The goal of this guide is to show you ways that refinancing can help you, and alert you to the things you need to watch out for so you make the decision that is right for you.

Refinancing is simply taking on a new mortgage to replace your existing mortgage. The process of applying and qualifying is similar to what you went through when you bought your home, though it is often easier now that you are already a home owner. Some of the reasons to refinance include:

**To lower your interest rate and payments.**

**To shorten your loan term and pay your mortgage off early.**

**To take cash out for home improvement, college expenses, investments or whatever your needs may be.**

**You can restructure your debts with a refinance to get rid of your high interest credit card balances and save hundreds of dollars per month.**

**If you bought with a low down payment, you can refinance to get rid of mortgage insurance or your higher rate second mortgage.**

**To get rid of an adjustable mortgage and lock in a fixed rate.**

These are just a few reasons you may want to take on a new mortgage. It is important, though, to make sure you know why you are refinancing and to

make sure the new mortgage will fit in with your over all goals. I'll cover each of these situations and tell you some things to watch out for.

**Lower your interest rate and your payment** - One of the big reasons people refinance is when interest rates drop and you can get a lower rate than what you are currently paying. Getting a lower rate and a lower payment sounds like a great reason to refinance, and it can be. But you need to look a little deeper before pulling the trigger.

Whether refinancing makes sense for you, depends on 3 things:

How much will you save by refinancing?

How much will it cost to refinance?

How long do you expect to stay in the mortgage?

There used to be a rule of thumb that said that the interest rate needs to go down by 2 percentage points before it makes sense to refinance. This is no longer the case. The process has been streamlined, and closing costs are usually much less, so it may make sense to refinance even if you are only reducing your interest rate by a relatively small amount. (There have been periods when the rates were dropping, where I refinanced the same customer 3 times in a year, and they benefited more each time.) To find out you need to figure out your **payback** or **break-even point**. Let me work through the math to show you how this works.

The first step is to determine how much you will save. For an example, let's assume that you now have a mortgage with a \$200,000 balance and a 6.75% interest rate with a payment of \$1,297 per month. Let's say that rates have improved, and you can now get the same type of mortgage for 6.00% with a payment of \$1,199 per month. This is a savings of \$98 per month. Does it make sense to refinance? Maybe. We still need to know more, though.

The next thing you need to know is how much it will cost to refinance. This is where it gets interesting. If you have spent any time on the internet, you have surely seen lots of ads for mortgage companies claiming they offer the lowest rates. The rates can be extremely attractive, but you need to look at the closing costs too. I've seen closing costs vary by as much as \$6,000, so this is something that can make a huge difference. Closing costs include title fees and the amount the bank charges to process the loan, which includes fees for credit reports, appraisals, processing and underwriting charges as well as Points which are upfront financing charges.

To see how the closing cost can make the difference, let's assume that the cost to refinance is \$2,000. If you are saving \$98 per month and it cost you \$2,000 to close, that means it will take you just over 20 months of mortgage savings to pay off the upfront costs. Every month after that will be a true savings. If that same loan cost \$6,000 to close, then it would take over 60 months – 5 years before you would have any benefits from refinancing.

The next part is figuring out how long you expect to be in the mortgage. If you plan to stay in the home for at least 10 years, and you don't expect that interest rates will drop much lower than they are, then paying more to get a better rate may be the best strategy. Most people will either move or refinance sooner, though. The average 30 year mortgage is paid off in about 5 years. If you are like most people, you would be better served by getting a loan with lower closing costs. Even though the rate and payment may be a little higher, your savings will come quicker.

**Things to watch out for-** The idea that the lowest rate is the best deal can be a big problem. A few years back, rates dropped to the point where there was a huge refinance boom. One of my clients went to a neighborhood party, and the major topic of conversation was who was refinancing and how low their rates were. One lady was boasting about the great deal she got, a rate below anything available on the market. My client called Monday morning, and she wanted the same rate as her neighbor was getting. I did a little research and found out that her neighbor was paying 3 points to buy down the rate. On a \$300,000 loan that comes out to \$9,000 in extra closing costs! A low rate is great, but it's not going to help you if you have to pay so much extra to get it. Which brings up our next point. Refinancing doesn't have to cost a lot.

**No/Cost refinancing** - When rates are down, the biggest obstacle to homeowners lowering their payments and taking advantage of the low rates is the cost of refinancing. The more that the loan costs, the longer you will need to be in the new loan before refinancing makes sense. So if a loan costs a lot upfront, it takes a big improvement in the rates before it is worth doing. On the other hand, if there are no costs at all, a reduction of a small amount in the rates can save you a lot of money over time.

With a no-cost refinance, we are using the yield spread premium (the money that the lenders pay the mortgage broker or banker to bring them the loan) to pay for the closing costs. When I price loans I have several different options.

Every day the lenders we deal with send us new price sheets. These sheets have matrices which allow us (the mortgage banker or broker) to price the loan in different ways. It is common in the Chicago area to price a loan to show no points or origination fees, but with the customer paying the normal costs at closing. If someone wants a lower rate, I can price it so that they pay more money upfront (points) and get a lower interest rate. We can also do it the other way, offering them a slightly higher interest rate means that the lender pays us a higher premium, which can then be used to cover all of the loan costs. This program isn't available with all lenders, but is available with many mortgage brokers or mortgage bankers.

Here is how it works. Let's say you have a mortgage with a balance of \$250,000 and an interest rate of 6.75%. This loan would have a monthly payment of \$1,621 for principal and interest. Let's say that rates drop. If you are able to refinance at 6.0%, your new payment will be \$1,499, for a savings of \$122 per month with closing costs of \$2,000.

If 6.0% is available with closing costs, the rate with no closing costs would be around 6.125% - just an eighth of a percentage point higher. This means a payment of \$1,519 and a savings of \$102 per month. The monthly savings are lower, but you save \$2,000 up front. This works especially well for people who don't plan on being in their home or their mortgage forever, or if you think that the rate trend is going down and there may be more opportunities to refinance and lower the payments again down the line.

These loans are more attractive when the loan amount is higher. In many cases we can do a no-cost refinance for the same rate as other companies are doing full cost loans. Smaller loans, those under \$150,000 are harder to do without any cost. Depending on your situation, this could be the best option.

**Things to watch out for** – A true no/cost refinance means that you are not paying any fees or costs to get the loan. Many lenders tell you they will make a loan at no cost by adding the fees and costs back into the loan. This means that your mortgage will be larger, and you will be paying the costs of refinance over the years you have the loan. There is no money coming out of your pocket at closing but you are still investing money up. If you sold the home or decided to refinance again later, the money you paid will be gone. In some situations this could be the right way to go, but it is not a no-cost refinance. You need to know exactly what it is you are signing up for.

**Cash-Out And Debt Consolidation Refinancing** Once you have owned your home for a while, chances are that it is worth much more than what you originally paid. This means you have built up equity, and if you are like most people, the equity in your home may be your biggest asset, or source of wealth. If it makes sense, you can tap into this equity through what is called a cash-out refinance. The lender will not let you take out all your equity. The best interest rates are available at 70% of the appraised value, some loans will let you take out up to 95% of your value in a new loan.

Whether this makes sense or not depends on your financial situation, and what you are planning on doing with the money. By taking out some of your equity in cash, you are increasing your mortgage and your monthly payment. This can make sense if you are using the cash to better your financial situation or improving your property, but if you are using it to take a vacation, buy more stuff which won't go up in value, or other short term uses, you may regret your decision.

Let's look at some ways that refinancing can make sense. What is your overall debt level? Are you feeling pressure making all the payment on your credit cards and other consumer debt? If this is your case, the equity in your home may be a tool to restructure your debt and give you a fresh start.

As an example, I recently helped out a homeowner who had lost his job and, without much in savings, lived off his credit cards for nearly six months. He ended up getting a new job in his field, but now he was saddled with a ton of debt. He did however, have a home he had bought years earlier with a good deal of equity built up. We refinanced the home, combining all his debts with the old mortgage into one new larger mortgage. By lowering the interest rates and extending the new loan over 30 years, the new mortgage reduced his total payments by more than \$800 per month, taking off his financial pressure. In this case it was just what he needed for a fresh start.

If all your money is going toward paying off credit cards, you never have a chance to get ahead. By restructuring the debt with a refinance, you can use the monthly savings to start a retirement fund, or maybe shorten your mortgage so you are debt free years faster. What is best for you depends on your financial situation and your long and short term goals. Refinancing, if done properly, can be a tool to eliminate your debt and build wealth.

There can be a danger in this strategy. First, you are paying the loan over a long period of time. But the bigger problem is that it is too easy to get back in the same trouble if you don't change your credit habits. I've seen too many people who used a cash-out refinance to consolidate their debts and get a new start, only to run up their credit cards and get right back in debt. For a long term solution you need to be able to change your outlook and credit habits, too.

Other good uses of you equity can be to put on an addition which will increase your enjoyment and the value of your home, or maybe you have a business opportunity where the equity can be put to better use.

Any time you take out a loan against the equity in your home, you are trading some security for the cash you need, but in the right situation it can be a great way to go.

**What to watch out for** – Home owners with high debts need to watch out for sharks. The idea of a consolidation loan is to lower your payments to better your cash flow. But if all you are looking at is the savings in cash flow, you could get taken. Some companies focus only on the payment, but charge a much higher interest rate than you could get elsewhere. I have seen many cases where homeowners over-paid by thousands of dollars. I'll go over some ways to make sure you don't get taken later in this guide.

Another thing to watch out for is what type of mortgage you are taking on. I have over a thousand different loan options available. These are mostly variations on two types, fixed rate mortgages, and adjustable rate mortgages (If you want to learn more about different loan types, I cover it in detail in *The Real World Home Buyer's Guide*). You need to make sure that your new mortgage matches up with your goals and needs.

Last year over 20% of the loans in this country, and a higher percentage of consolidation refinances, were made with what is called an Option ARM. You have probably seen ads for these loans, usually claiming a 1% or a 1.9% interest rate, or as a way to cut your payments in half compared to more traditional loans. The ads make these loans sound tempting, but when something sounds too good to be true, it probably is. These loans have become very popular, but too many people are taking these loans without really understanding how they work.

The advantage to these loans is flexibility. With these mortgages, the beginning period where the rates are fixed is a matter of months, not years. Your interest rate changes monthly, but the payment is set at the beginning and only changes once a year. These mortgages don't have interest rate caps; they have payment caps. That means that even though the interest rate is changing every month, your payment will stay the same for the whole year. If rates are going up, and your payment is staying the same, that means the balance you owe the bank increases. This is called ***negative amortization***. Like with a credit card, the extra balance is added back to the loan, and you pay interest on this, too. If negative amortization goes on for long, it can eat up your equity and leave you in a worse situation than when you started. With these loans you get a statement every month that tells you what the interest rate is, and gives you several options on how you can make your payment – you can make the minimum payment, you can pay enough to keep the loan balance current, or you can pay extra to pay the loan off quicker.

Option ARMs start out with low teaser rates, but the true interest rate you are paying is usually much higher than it would be if you took a fixed rate loan. These loans can be a good option for some people, but they aren't for everyone. In fact, they aren't the best option for most people. The key here is that you need to know what you are getting into, and match the program to your goals, and how you live your life.

**Get out of an adjustable and lock into a fixed rate** – A few years back when interest rates were dropping down near their all time low levels, many consumers chose to get even lower rates by going with adjustable rate mortgages (ARMs). ARMs are loans that start out at a lower rate than you could get with a fixed rate, for a specific period of time, after which they float up or down depending on what is happening with overall interest rates. (If you want more information on ARMs, how they work and when they make sense, go to [Ptmortgage.com](http://Ptmortgage.com) and download The *Real World* Home Buyer's Guide) The rates at the time were a half a point or more below the rates for fixed loans. If you weren't planning on staying in the home for a long time, or you were willing to take the risk that rates would still be affordable when the loans adjusted, this was a way to save a good deal of money. Many people took adjustable's that were fixed for the first 3 or 5 years, and became adjustables after that. Now these loans are coming due.

If you have an adjustable rate loan, chances are that the interest rate has gone up sharply, or if it hasn't adjusted yet, it is due to go up. Most ARMs have caps on how much the loan can go up in any year, and how much it can go up over the lifetime of the loan. But even with the caps in place, the first adjustment can mean a payment of several hundred dollars more per month than what you have been used to. The interest rate will continue to change every year, again, up or down depending on the market. This means you are taking on more risk that the payment will continue to rise. Is this loan still the best option for you?

To find out, you need to know the terms of your loan and how much it can go up from year to year. You will find that information on the mortgage note, which was part of the closing package from when you took out the mortgage. The next question is, how much longer do you plan on staying in your home? If you intend to be in your home for a long time, it probably makes sense to consider refinancing. If you are only going to stay in your home for another year or two, it may not make sense. The last question to ask is how do current interest rates compare to where you are now?

Once you have answered these questions, you need to compare how a new loan will stack up against what you currently have. If rates are lower and you are planning on staying in your home for a while, the decision is a no-brainer. On the other hand, if you are not going to save much and you don't plan on staying long, it probably makes sense to just keep the mortgage you have now. The harder decision is when it won't save you a lot, and you aren't sure how long you will stay in the home, but you are concerned that the rate and payment will continue to go up to the point where you can't afford to live in your home any longer. If your adjustable mortgage is keeping you up at night, it is worth refinancing just so you have the security of knowing exactly what your payment will be as you go forward.

**Things to watch out for** – As with other refinances, you need to do a payback calculation to see how long it will take to pay off the closing costs. Also, if it makes sense to refinance, but you are sure you won't be in the house for ever, it may make sense to take out a new adjustable rate mortgage. The key here is knowing how long you plan on being in your home, and whether the difference in payment between the ARM and the fixed rate is worth taking the risk.

**Refinancing to get rid of mortgage insurance or a high rate second mortgage** – If you bought your home with little or no down payment, and your home value has gone up, you may be able to refinance to get rid of the mortgage insurance or eliminate the second mortgage.

One thing to keep in mind, if you have private mortgage insurance now and your home has increased in value so that the loan is less than 80% of the home's current value, you don't have to refinance to get rid of the PMI. In a case like this, you should contact your loan servicer (Whoever you are making payments to) and tell them that you want to get rid of the mortgage insurance. The first step is to get a current appraisal (the servicer may have a list of appraisers you need to go through). If the home appraises high enough, you have been in the loan for at least 2 years and you have been current with your payments over the last 12 months, the servicer is required by law to eliminate the mortgage insurance.

In other cases it comes down to whether or not eliminating the PMI or the second will lower your payments, and whether it is enough to justify the cost. If rates are the same or down from the time you first bought, it will probably make sense. If rates are higher though, even dropping the extra charge may not be enough if your over all payment will be higher. Again, the best thing you can do is to run the numbers and see how a new loan compares to your current situation.

### **Shopping for your loan:**

Once you have decided that refinancing makes sense, it is time to compare rates and prices to make sure you are getting the deal that is right for you. Ads for mortgages are everywhere: on the internet, over the TV and radio, and in the newspaper. The focus of most of these ads is that they can get you the lowest rate. Many people think of loans as a commodity, and that one lender is the same as another, so the decision should be made strictly based on who has the best rate. This can be a big mistake.

While it is true that many lenders may have the same loan programs, there are other factors you need to compare to make sure you are getting exactly what you think you are. Besides the rate, you need to compare a company's fees, the terms, the quality of their service, and the company's reputation. Getting a good rate is important. But if the company you choose is not able to close on time, or doesn't deliver at the terms you expected, a low rate is no bargain.

In order to know how to compare loan offers, it helps to understand how the mortgage market operates. The truth is, nearly everyone borrows money from the same sources. Outside of government loans and loans for higher priced homes (currently loans of more than \$417,000), the majority of loans end up in the portfolio of one of two organizations, FNMA or FHLMC, often called Fanny Mae and Freddy Mac. These organizations are government sponsored corporations that are charged with buying up mortgages in the aftermarket, packaging them into investments that are sold on Wall Street, and making sure there is always money available to lend for mortgages.

These companies set the standard for qualifying, and they also establish a base for the prices that all of the end lenders charge. Lenders price their loans with the expectation that they will be selling their loan, and eventually delivering it to one of these organizations.

What all this means to you is that the true rates on mortgages are usually going to be close to the same from one lender to the next. The range in rates for the same product is typically going to be only 1/8 to 1/4 point difference among most lenders. But if you are looking at the newspapers, or searching the internet, you may see advertised rates that are much lower. These look attractive, but you need to know exactly what you are getting. What makes this complicated is the way that lenders show their prices to their customers. Because most consumers are looking for the lowest rate, it's easy for unscrupulous companies to manipulate the fees and the terms in order to appear to offer a rate lower than it actually is. When comparing mortgages, you need to compare apples to apples. Too often, you think you are comparing apples, but you are really getting baloney.

### **Borrower Beware! What to watch out for**

The number one complaint regulatory agencies receive regarding mortgages, is that the terms they ended up with weren't what they were promised. There are lenders who will promise whatever it takes to get the customer in the door, but don't deliver on that promise. Here are some of the areas you need to watch to make sure you are not being quoted an artificially low rate.

***Locking In*** – When you find a property and apply for a mortgage, you have a choice between ***locking in*** or ***floating*** the rate. Locking in means that you are guaranteed that the rate you choose will be good for a certain period of

time. If you choose this option, make sure that the period you lock in for is long enough to approve the loan, and that it extends through the closing date in your contract. Floating means that you are taking a chance. If the rates go down, you will get the lower rate; if rates go up, you will end up with a higher rate than you had planned on. Interest rates go up and down based on what's happening in the financial markets. The markets tend to overreact to both good and bad news, so lenders try to price according to the market, which means they can change every day – sometimes more than once a day. Because the market is so volatile, rates are priced based on how long they are guaranteed for – the shorter the time period, the lower the rate.

Some lenders take advantage of this system in several ways. One way is to quote a very short-term lock period, which means a lower interest rate. But it doesn't help you to lock into a 15-day rate guarantee if you aren't closing for 45 days. Another twist on this is to quote you based on the short-term rate but then to encourage you to float. Or they claim that you can't lock in until after you have been fully approved, or right before closing. These techniques are unfair because all the risk is put on you. If rates go up, you are stuck with the higher rate. Floating is always an option, but it should be your decision, not something that is forced on you.

A more sinister version of this is when the lender tells you that you are locked into a rate, but doesn't lock you in with an investor. If rates stay the same or go down, you will close at the rate that was quoted and never know that you hadn't been locked in. If rates go up, however, you may find that you are rejected for a mortgage at the last minute, or are forced to take a higher rate in order to close your loan. This is not only unethical, it's illegal. But it happens. Every time that interest rates move up sharply, there are businesses that close their doors for good because they couldn't honor their lock commitments, leaving their customers without the financing they had relied on.

**Hidden Fees:** There is a relationship between the rate that is quoted, and the amount of fees that are charged. The lower the rate is, the more money you will have to pay to get it. It costs a certain amount of money to process and fund a mortgage. Mortgage companies are in business to make a profit, so they know that they need to bring in enough income to pay all their expenses and earn a reasonable profit. There are two ways to do this. First through the rates – the investors pay lenders for bringing them loans. The second way is through fees that are charged to you, the borrower. Either way is fine, as

long as you know exactly what you are getting. Where it gets tricky is when the lender hides fees in order to make the rate seem better than it is.

There are a number of fees that are normally paid as part of getting a mortgage (I'll go into more on this later). But sometimes the fees can get excessive. Look for things like origination fees, warehouse fees, document preparation, administrative fees and the like. Ask what each of the fees goes for. Chances are there will be no specific service linked to it. Again, there's always a trade off between rates and fees. But if you are paying thousands of dollars in fees upfront, it will take you years before you've broken even by getting the lower rate.

**Pre Payment penalties:** Another thing to watch out for is a pre-payment penalty. This is when the mortgage contains a clause that states that you will have to pay an extra penalty if you get out of the mortgage within a certain period of time, either through selling the home or refinancing. Some mortgages, usually those that are aimed at solving a specific situation like bruised and damaged credit, may have pre-payment penalties built in. But many more conventional loans offer the penalties as an option. That is, you can get a lower rate if you agree to take a pre-payment penalty. If you know that you won't be moving, and you're convinced that rates won't drop and give you an opportunity to refinance at a lower rate, this can be a fine decision. Where it becomes a problem is when you are quoted with a built-in pre-payment penalty in order to show the lower rate, but the terms are not disclosed to you. This can cut off your options, and cost you thousands of dollars in the long run.

### **How to protect yourself:**

Knowing what to look for, and what questions to ask, puts you in a position where you can make an informed decision.

**APR:** The APR, or Annual Percentage Rate, is a measure used to compare different loan options. It is an attempt to express the total cost of credit over the life of the loan, taking into account the costs to take out the loan. It is required by law that any time a rate is advertised, the APR also has to be shown.

This concept is a step in the right direction; unfortunately it doesn't work nearly as well as it should. There are a couple of problems with it. First, there is no one precise formula for determining the APR. Some costs are

included in the calculation, and others aren't, and there are some costs, such as application fees, that can be considered a cost under some circumstances, but not under others. This means that the same loan, with the same closing costs, can show different APRs with different lenders.

Another problem with the APR is that it balances the cost over the entire loan period. For example, the closing costs on a 30 year loan would be averaged over the entire 30 year period, even though all the costs are paid up front. In the real world, very few people stay in a loan for the entire time. Let's say you were comparing loans between two lenders and the closing cost on one was two thousand dollars higher than the other. Because you are averaging the costs over a 30 year period, the APRs would be very similar. But if you only stayed with that loan for seven years, it would turn out to be much more expensive than the lower cost loan.

**The Good Faith Estimate:** Many people focus on the loan's APR, but the best way to shop is to directly compare the costs of one loan against another. To do this we use a form called **The Good Faith Estimate of Closing Costs**. This needs to be sent out to you after you've applied for a loan, but it makes sense to ask for it before you have committed to a lender. This form will show you the interest rate and program you are considering, a breakdown of your payment, a list of all the closing costs and pre-pays associated with the loan and a tally sheet showing the amount you will need to bring to closing.

The Good Faith is an estimate, but it should be very close to the final numbers. Comparing offers takes more time, but it gives you a truer picture of what each lender is proposing. If a lender will not put his offer in writing, that should be a red flag that something may be wrong.

In order to know what to compare, you need to understand what closing costs are spent on, and what to expect. I will go into this more in a minute. If you would like to see a copy of a Good Faith Estimate, contact me and I will send one over.

**Reputation:** The last thing you should compare may be the most important. The reputation of the company, and loan officer you are dealing with, will go a long way toward predicting what kind of experience you will have. Does the company have a reputation for meeting its commitments and closing on time? Is the loan officer experienced and able to answer your

questions? Does the company have the financial stability to stand behind its commitment? Do they have the resources to meet the deadlines in the contract? Do you feel comfortable with your loan officer? Does he get back to you quickly, and does he follow through when he says he will do something?

These are all questions that should be part of your decision. Until you close, you will rely heavily on your loan officer. If you have a loan officer who doesn't return phone calls, or one who doesn't provide information, or doesn't communicate well with you, getting your loan will be a frustrating experience. If someone is not responding during the process, can you be confident that you will close on time and with the right terms? Keep this in mind when choosing who you want to work with.

**Closing costs:**

You will need to understand what you are paying for not only so you can compare programs, but so that you will know how much money you will need to close. As explained before, all the costs will be laid out on the Good Faith Estimate. There are three different types of expenses: *lender-related expenses*, *title and non-lender-related expenses* and *pre-paids*.

**Lender-related costs:** Lender related expenses are charges that are either required for services needed to process the mortgage, or are part of that company's pricing model. At the beginning of the process, you will usually need to pay an *application fee*. This will usually cost around \$350. For most lenders, this fee will include two services that are required for the mortgage – the *credit report*, and the *appraisal*. (Watch out if a lender is charging you an application fee **and** the credit report and appraisal fees separately!) These are usually the only charges that you will be required to pay upfront; everything else will be paid at the closing. The credit report is simply the cost for running your credit. The appraisal goes to pay for a licensed appraiser who investigates the house you are buying, compares it to similar properties, and makes sure that it's worth the amount you are paying for it.

A *flood certification fee* is paid to make sure you are not in a flood plain. If you are, you will need to get an extra insurance policy to cover yourself and your lender from possible flood damage down the road. There are other lender-related fees like *underwriting fees*, that some consider junk fees, or fees that don't go for a particular function, but may actually be charged by a third party investor. Most of the other lender-related charges are going to be

things like warehouse fees, administrative fees and the like. No matter what name they go by, they are really part of the lender's pricing strategy, not necessarily fees that the lender will be charged for. Most lenders will have some of these fees built in to their closing costs. Typical fees for lender related costs can run as low as \$600 and as high as several thousand. When a lender quotes you on a rate, they are doing so based on the fees that they charge. You may be able to get some of these fees removed, but doing that may change the pricing on the loan.

There are other lender-related cost, *origination fees* and *discount points*, which in most cases should be an option, not a requirement. A point is one percent of the loan amount. So if you were borrowing \$100,000, 1 point would be \$1,000. A point is really interest paid in advance, so by paying the point up front, you should receive a lower interest rate. It depends on the product, and what is happening in the market, but typically one point paid up front will reduce your interest rate by about  $\frac{1}{4}$  percent over the lifetime of the loan. So if your rate was at 6.5% without the point, it would be 6.25% if you paid the point. On the \$100,000 loan this comes out to a difference of \$16.35 per month. Whether it makes sense to pay an extra \$1,000 to save \$16 depends on a lot of things. One way to look at it, is to determine how long it will take before you break even, that is how long before the \$16 you are saving equals the \$1,000 you paid up front. To do this you divide the cost by the savings, and that tells you how many months it will take to break even. In this case you would break even in 61 months, or just over 5 years.

If you aren't planning on being in the house for a long time, it obviously doesn't make sense to pay points. But even if you do plan to stay long-term, you should consider this option carefully. First of all, is this the best way to use your money? In many cases you would be better off paying down your credit cards, using it to increase your down payment, or just put the money in your bank account and save it for a time when you may need it more. Also, what happens if interest rates drop down the line? If rates drop enough, you will be able to refinance your mortgage at a lower rate. That means the points you paid up front would be wasted.

**Title and other non-lender related charges:** These are the charges that are part of your closing costs, but will not change based on which lender you choose. The biggest items here are title charges. *Title Insurance* insures both you and the lender against any defects in the title. To do this, the title company searches the public records and pulls a history of who has owned

the property and determines if there are any unsatisfied liens or judgments which are still owed against the property. If they do their job right, there will be no need to pay any claims down the road. Title companies also provide the ***closing agent***, who makes sure that all the papers are signed correctly and the title transfers at the right time. For this service they charge a ***closing fee***. The title company also collects the ***recording fee***, which is the cost to record the documents with the county courthouse, showing you are the new owner. Title charges can differ depending on the loan amount, but you should figure that these fees will run several hundred dollars at least. We have special pricing from our title companies, so the prices charged are lower than what you would get if you ordered it yourself.

**Escrows and Pre-paid:** This is an area of refinancing that most people don't consider. In most cases you will need to establish an ***escrow account***. This is money that your lender holds to pay for your tax and insurance payments when they come due. As part of your mortgage payment you will pay 1/12 of the real estate tax and insurance bills each month. When the payment comes due, the lender will automatically pay it from your escrow account. You can pay this upfront, or roll it into the new mortgage. Though you are paying the money upfront, it's still your money. If you have an escrow account on your current mortgage, you will get that back after the closing (usually within 2 weeks, by law within 45 days).

Insurance is paid once a year, but property taxes come due in two installments. The first payment in Cook County is due in March and the second is due in September. In Dupage and the other collar counties, the due dates are in June and September. When you pay your tax bill you are really paying for the prior year. Your lender will set up the escrow account to make sure there is enough money to pay the taxes when they come due, plus a cushion in case the taxes go up.

The other item is ***pre-paid interest***. This is really just a bookkeeping expense. The mortgage takes effect the day that you close, but you skip a month before the payments start (That means that if you close in March, you will skip your April payment and your first payment comes due May 1<sup>st</sup>). To make up for the time between the day you close and the end of the month, you will be charged pre-paid interest for each day. Some people think that you save money by closing at the end of the month, but that is not really true. If you close on the last day of the month you will only pay 1 day of pre-paid interest at closing, but after you skip the next month's payment,

your first payment will be due in 31 days (if the month is 30 days). If you close at the beginning of the month you will pay all the interest until the end of the month, figure 30 days, but after skipping the payment, you won't have to make another payment for 60 days. So it works out the same, no matter what day of the month you close.

**After the closing:** If I've done my job right, the closing won't be the end of our relationship, but the beginning of a new phase. Your home is your single biggest investment, and the mortgage is your largest debt. If managed correctly, it can go a long way toward helping you meet your long term financial goals. Going forward, I will be watching the trends in interest rates. If rates drop, you may have an opportunity to refinance your mortgage, allowing you to lower your rate and payment again.

In most situations I can refinance with no closing costs, so you save money right away. I watch for these opportunities, and I'll try and contact you as soon as the timing makes sense. If your goal is to build equity in the property, or to use your equity as a basis for investment, I can help you there, too. As time goes on and your needs change, I want to be a resource for you, an advisor to help you manage your debt, and make the best use of your equity.

**What's next?** I hope you have found this guide interesting and informative. I've tried to give you a realistic account of what happens when people shop for a mortgage in the real world – both the good and the bad. I know that the information is valuable, and if you use it, it will help you to understand your options, and save you money. But now the next step is up to you. I would like the opportunity to work with you. I'm committed to providing the best service throughout the transaction, and a rewarding experience dealing with a knowledgeable professional who cares about your needs.

My company is a mortgage banker, not a broker. This means that we act as a correspondent for over 70 lenders, so I can shop around to get you the best rates and programs available, but we will handle all the processing and underwriting and we will close with our own money. The advantage to this is that I have control over the entire loan process, and because of our size we can keep our rates and fees low. In a sense, we offer the best of both worlds.

Be sure to use [www.ptmortgage.com](http://www.ptmortgage.com) as a resource. We have calculators to help you figure out different payment scenarios and help you find out how

much you can afford, and how a new mortgage will affect you. When you are ready, please let me know and we will set up a convenient time for an over the phone consultation. At this point I will go over your needs and goals and, together, form a plan to move forward.

Thank you in advance. I look forward to working with you.

*Peter Thompson*

**Pete Thompson**

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