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Beyond the Rate – Chapter 5

Is anyone telling the TRUTH in the mortgage business??

Hello and welcome to Beyond the Rate, a series of podcasts that are designed to educate the listener on the world of finance and in particular, the mortgage business. This is Chapter 5 and we'll be looking at various closing cost structures and how they affect the other aspects of the loan, including your interest rate and your monthly payment.

My name is Patrick and I'm a Mortgage Banker here in the San Francisco Bay Area. I'm your host and I really encourage you to subscribe to this series for an informative and detailed account of how the mortgage industry operates and how to navigate through all the confusing programs and deceptive marketing techniques being used by some of today's Mortgage Brokers.

Please note that the text versions of these podcasts are now available for free download at my website at www.beyondtherate.com.

So, should you pay points? What are "points"? Is that money just going directly into the pocket of your Mortgage Broker? Well, that depends. But this Chapter's gonna look at these questions and some others to see which strategy makes the most sense in the long run. We're gonna look at the math behind these questions and I know some of you will probably cringe at that thought but I'll do the best I can to keep it straight forward.

Let's start with the definition. A "point" is 1% of the loan balance. So if you're getting a \$500K loan, one point is \$5000 – 1%. Now, when you do a purchase or a refinance, the "standard closing cost structure" will include one point. In fact, the first point – the first 1% - is referred to as the "origination". The origination is the fee to 'originate' the loan. So that first 1% goes directly to the broker's company. And depending on your broker's volume, he or she will get some percentage of that money.

In the industry, it's called the "split". And these splits vary widely, by the way. Some broker companies pay as much as 95% of that origination money to the broker. Others pay as little as 25% or 30%. The difference usually boils down to who's paying for the marketing. If the broker company is paying for some

extensive marketing campaign to find leads for their brokers, they'll generally pay a lower split. If the individual brokers have to bring in their own clients, the company will generally pay a higher split. That's not true for everyone but it's a good rule of thumb.

Anyway, the remaining portion – the percentage of the origination that does NOT get paid to your broker – pays for the lights, the office space, the furniture, photocopier and so on. So part of that money goes to the broker and the rest pays for the office. And that explains the origination; the first 1%. Anything beyond that is referred to as "points" and points are actually prepaid interest; money that goes directly to the lender. And in exchange for that prepaid interest, the lender offers a lower interest rate. With a lower interest rate, your payment also drops. So now, we can calculate the breakeven for the deal. You either pay MORE up front and get a lower payment or you pay LESS up front and get a higher payment.

Before we look at the math, we have to address a couple of issues. For starters, the points and origination are tax deductible so that means it doesn't cost you as much as it may appear at first blush. If you're getting a \$500K loan so one point is \$5000 – and depending on your tax rate – that point may only cost you about \$3000 or \$3500. Because you would've spent the remaining money anyway – in taxes. So you're either paying that money to the government or you're using it to buy down your interest rate. When you're calculating the breakeven point, you should always use the AFTER tax cost.

Secondly, one point buys different amounts depending on what loan you're getting. If you're getting a 30-year fixed mortgage, one point will probably only reduce your interest rate by about 0.25%. With an intermediate ARM (discussed in Chapter 4) like a 5/1 or a 7/1 – so those are loans that are fixed for 5 years or 7 years respectively – one point will reduce your rate by about 3/8%; that's 0.375%. It's important to clarify here. These are NOT exact figures. They vary by lender and by program but they're fairly good estimates. If you're getting a 2-year fixed loan, one point would probably reduce your rate by a full 1/2%; that's 0.5%. So the shorter the fixed period, the more one point – that's 1% of your loan balance in prepaid interest – will buy.

Think about this from the lender's perspective. By giving you this opportunity to BUY what's called a "below market rate" – that's a rate that is BELOW the current market rate – they're really giving you an incentive to keep the loan longer. With a lower rate, they're hoping you'll keep the loan for a longer period of time. They DON'T want you to refinance. Lenders do NOT want you to refinance out of their loans. They would prefer to keep their clients as long as possible – nice steady reliable money coming each and every month. That's what they like.

So, what's the breakeven point for buying the interest rate down. Well, for a 30-year fixed mortgage, the breakeven is usually between 3 and 4 years. So, in other words, if you sold the property or refinanced the mortgage within 3 or 4 years, you would've actually LOST money by buying the rate down. Since you would be getting a lower monthly payment because of the lower interest rate, you would be

saving some money each month. And it would take between 3 and 4 years – that's between 36 and 48 months – to get the initial investment back. But if you kept the house for longer than 3 or 4 years and if you kept the same loan without refinancing, you would've paid back the entire initial investment and you would then be saving money each month for as long as you keep the mortgage. Over time, those savings can be huge.

Okay. So for a 5/1 ARM or a 7/1 ARM, the breakeven is usually about 18 months to about 2 years. That's a much shorter period of time. That means you would get all your original investment back within 2 years and then you'd be saving money each month thereafter. And for a 2-year fixed, the breakeven is usually just 14 or 15 months – just over one year. So if you kept the mortgage for the first two years, you would've already saved money by buying the rate down at the beginning. Mathematically speaking, most people are actually better off buying the rate down at the beginning.

The problem is that "points" don't sound very good. Right? It sounds like you're getting ripped off. Brokers know this so they generally don't tell you the reality because they're worried it'll make their quote appear less competitive. Points don't sound good. True. But the reality is that they can help you save a bunch of money if you don't refinance every year or two. And with the lowest interest rates now behind us, the refinance boom is definitely over and people who refinance now should plan to keep their mortgages for as long as possible. Remember, it doesn't matter what anybody tells you, refinancing costs money and you should try to do so as little as possible. Find a good loan and do it right the first time.

The industry has gone beyond avoiding "points". They're actually avoiding the origination as well. Again, the "origination" is the first 1% and most people mistakenly refer to it as a point, even though it's not technically a point. Anyway, the industry's been marketing "zero point" loans for a few years already and most people jump at it, thinking they're saving money. Well, the same math is true for the first 1% as for the second or even the third. If you're not paying the 1% origination as a closing cost, rest assured, it's hidden in a higher interest rate. Nobody's doing loans for free out there and most banks have a minimum 1% origination anyway so you're paying for it one way or another. Again, if the 1% origination is NOT included in the closing costs, you are paying it through a higher interest rate.

The reason this works is because lenders pay brokers a rebate whenever they get a loan with a rate that's HIGHER than the current market rate. So, if given a certain set of circumstances regarding credit, income and assets (that's discussed in Chapter 3), the current market rate is 6.5% and if the broker puts the loan together with a rate of 7%, then the lender will pay the broker a rebate on that loan. So if the closing costs do NOT include the 1% origination, the broker just needs to raise the interest rate high enough so they get at least a 1% rebate from the lender. And if they want to make more than 1%, they only need to raise the interest rate a bit more.

This goes even a step further when brokers market “no cost loans”. Again, refinancing costs money and the fees associated with a purchase or refinance are gonna get paid one way or another so if they’re not itemized in the closing costs, they’re hidden in a higher interest rate. In today’s lending environment, you can mark up a loan so high that you get 2 or even 3% rebate after the loan closes. So don’t get fooled by “no cost loans”. It’s just a marketing gimmick.

That being said, let’s take a closer look at closing costs and see what they should add up to in a standard transaction. To do so, I’ll assume a standard closing cost structure including 1% origination. That means you’ll be getting the market interest rate, not below market, not above market.

For our purposes here, there are four main categories of closing costs. First, you get the origination and any points you pay to buy the rate down. The second is the lender fees including underwriting and processing. Third, you get all the third-party fees like the credit report, appraisal, flood certification, notary and tax service. The fourth category includes the escrow and title fees such as recording, settlement, courier and title insurance. For purchase transactions, there’s one more category for transfer taxes. In California, transfer taxes range from \$1.10 per \$1000 to almost \$15 per \$1000 in some municipalities. Some may be even higher.

We’ll take a second to go through each category to give you some expectations. For origination and points, you can calculate it yourself. The origination will be 1% of the loan balance. If you’ve got two loans – a first AND a second mortgage, it will be 1% of the combined mortgages. If you’ve decided to buy the rate down with extra points, just add an additional 1% for each point you’ve decided to buy. If you’ve got two loans, the points probably only apply to the first mortgage. You could buy the rate down on the second mortgage as well but it’s less common.

The second category is lenders fees. These fees vary widely. Some lenders have underwriting fees as low as \$350. Others are as high as \$1300 or even higher. Also, if you have a second mortgage, there may be a second underwriting fee and I’ve seen those as high as \$600. Another fee you’ll see is processing. That’s another lender fee and I’ve seen those range from about \$250 to \$1000.

Here’s my opinion on lender fees. If they’re charging a lot for underwriting, they’re probably using that revenue to help subsidize competitive interest rates. It’s just a different strategy. It’s not like some lenders are making huge profits while others are making nothing. The lending community has become extremely competitive and individual companies will try to get their revenue from different places. At the end of the day, these fees will be fully disclosed through the APR and we’ll be discussing that in Chapter 8.

As for processing, I think anything over \$500 is a rip-off. All brokers have processors. They’re actual people who process the loan file and chase all the conditions required by the lender. It’s a tedious job and these people have to get paid somehow. Beyond that, someone has to pay for their desk, computer, phone and fax, so I’ve got no problem with a processing fee as high as \$500. Personally,

I generally charge \$400 for processing. But a processing fee of \$1000 is a complete rip-off and I would push back hard on anyone trying to charge me that much.

Third party fees are next. Here in California, you can expect to pay anywhere from \$350 to \$500 for your appraisal, depending on what format the lender is requiring. You can expect \$15 or \$20 for your credit report, \$25 to \$40 for tax service, \$10 to \$20 for your flood certification and \$60 to \$200 for your notary. Why such a big variance for notary? Because you can have a mobile notary come to your home for the signing. That's a lot more convenient but it'll cost you, usually \$150 for a single mortgage and \$200 for a first and second combo. I should know. I had a signing service before I started originating loans. If you sign at the Title Company, the notary fee is usually \$60.

The fourth category includes your escrow and title charges. Escrow fees will range from \$250 to \$650 for a refinance and between \$400 and \$900 for a purchase, depending on the size of the transaction. You can expect between \$100 and \$140 for recording and \$35 to \$80 for courier services, depending on how many times the documents have to be couriered around. Title insurance is frequently the second largest fee on the closing statement, next to the origination. Title insurance can run you anywhere from \$500 all the way to \$3000 or more, depending on the value of the transaction.

All of these fees constitute what's called "non-recurring" closing costs. That means they're all one-time fees. There's another category of fees called prepaid items or "recurring" closing costs. These charges are bills you would've had to pay at some point anyway. But because of the transaction, some of those bills are collected ahead of time. These generally include some prepaid interest, property taxes, hazard insurance and, in some cases, HOA dues.

A major distinction with prepaid items is whether or not you have an impound account. An impound account allows your property taxes and hazard insurance to be collected at the same time as your mortgage payment. The obvious advantage is that you don't have any surprise bills during the year and your monthly housing payment includes everything. But the downside is that you have to put some money aside in a reserve account at the time the transaction closes. That means you have to bring MORE money in at closing and it gives the illusion of higher closing costs. The reality is that it's your own money and you'll eventually get it back, but some people are still a bit shocked when they first see it and it's worth discussing with your broker BEFORE you get to the signing.

Overall, if you decide NOT to have an impound account, you can bank on closing costs and prepaid items of between 2% and 2.5% of the loan in a refinance and same percentage range of the purchase price in a purchase transaction. If you decide to include an impound account, you can expect between 2.5% and 3% in total closing costs and prepaid items. These are generalizations to be sure but they give you a fairly good idea of what to expect. For specifics, give me a call.

Okay, so if you like what you hear on this podcast, please tell a friend about it. My goal is to become a recognized authority in my field without having to sacrifice my freedom to tell the truth, even if it reflects poorly on my industry. Technology like podcasts can help elevate new and innovative thinkers but we all have to play our part to help spread the word for those who deserve our endorsements. If I am deserving of yours, my thanks.

If you are considering a purchase or a refinance, please call me to discuss the options. I'm a Mortgage Banker. It's what I do for a living. Interest rates change everyday but I'll promise you two things; I'll tell you the truth and I'll do the best I can. My office phone number is 925-465-1223. Again, that's 925-465-1223. You can also reach me by email at patrick@beyondtherate.com.

See you next time for Chapter 6. We'll be discussing credit and credit scoring. We'll identify the three major credit repositories and how they calculate their scores. We'll also look at things you can do to improve your credit score. It's fascinating stuff. Stay tuned.

Bye for now.