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Beyond the Rate – Chapter 7

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 7 and we'll be looking at some remaining details to consider when planning for a purchase or refinance, namely Prepayment Penalties and indexes.

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 along with a bunch of related materials and resources. You can also sign up for my monthly email newsletter and/or a quarterly mailer at the site.

Okay. So, we talked about the source of mortgage money in Chapter 1. In Chapter 2, we introduced the hierarchy of loan programs; A-paper, Alt-A and Subprime. Chapter 3 discussed the 3 pillars of underwriting; credit, income and assets. We reviewed the various loan programs in Chapter 4, ranging from 30-year and 40-year fixed on the conservative end all the way to the more aggressive programs like Option ARMs. Chapter 5 covered closing costs on typical California transactions and looked at the potential benefits of paying extra points to buy the rate down. And last week in Chapter 6, we discussed credit scoring and what contributes to your credit score.

This Chapter – Chapter 7 – we'll look at some remaining details that are rarely discussed, but that can have a major financial impact if you're not careful. For starters, there's Prepayment Penalties. These penalties can cost you a bundle and they're often overlooked during the origination of the loan as well as the signing. Many mortgage brokers know perfectly well the program they're putting you in has a Prepayment Penalty and they avoid the topic as much as possible. So a lot of people have penalties and don't even realize it.

This situation just happened to a client of mine who wants to refinance OUT of an adjustable rate mortgage and INTO a fixed program. We sat down to review the options and I asked to review her existing mortgage Note and that's when we discovered the penalty. She had no idea. That Prepayment Penalty would cost her almost \$14K if we went ahead with the refinance. Now, in some circumstances, it may still be worthwhile doing the transaction. For example, if rates were rising quickly or if fixed interest rates took an unexpected dip, presenting an unusual opportunity, it might still make sense to do the deal. But in her situation, the breakeven would be too long to justify the added costs. I recommended she wait until her Prepayment Penalty expires next November and we'll do the refinance then. Now, let me guarantee you that most mortgage brokers would NEVER have that conversation with you. Most would only stress the risks of keeping the existing mortgage and push you to begin the refinance as soon as possible. That's why it's so important to find someone who's got your best interests in mind.

Let's take a closer look at these penalties. Fact is, lenders don't make any money if you get a new mortgage and then refinance out of it six months later. Lenders want you to stick around for a while. And they also know that some types of borrowers tend to refinance much sooner than others, so here's the basic structure. Remember the ladder of loan programs in Chapter 2? A-paper, Alt-A and Subprime? Well, here's how it breaks down. A-paper loans don't have Prepayment Penalties. It's not possible. They don't exist. So if you're getting into an A-paper loan, you don't have to worry about any Prepayment Penalties. And if you HAVE a Prepayment Penalty, by the way, you can rest assured you're NOT in an A-paper program.

Alt-A programs usually have OPTIONAL Prepayment Penalties. As always, these are generalizations and I'm sure exceptions exist but most Alt-A programs I've worked with have optional Prepayment Penalties. So that means you could CHOOSE to have one and there might be an advantage in doing so. The lender might give you a slightly better rate if you accept the penalty. In some cases, I've seen rate improvements as high as ¼% for accepting a 3-year Prepayment Penalty. That's pretty impressive and we'll talk about that decision in a minute.

Subprime programs come standard with Prepayment Penalties. They're there whether you like it or not. And if you want to 'buy it out', it'll cost you handsomely. It's expensive. In fact, it's almost like paying the penalty up front. So if you're getting into a Subprime program, you can expect a Prepayment Penalty in your mortgage. And if you buy it out, your interest rate will be significantly higher, sometimes 1% or even 1.5% higher. That's a big difference.

So, what will it actually cost you? Well, most Prepayment Penalties last for 2 or 3 years (some only last for 1 year but most last for 2 or 3). If you have to pay it, it's usually calculated as 6 months worth of interest on your loan balance. So you can calculate this for your own mortgage. Just take your loan balance, say \$400K and multiply it by your interest rate, say 6%. These are obviously just round numbers. But if you took those numbers - \$400K times 6% - you'd get \$24K. That's the

interest you would pay for a FULL year – 12 months. Take that number and divide it by 2 to get the amount you'd pay for just 6 months and you'll get \$12K. Well, that's it. That's the Prepayment Penalty you'd pay on a \$400K mortgage at 6%.

There are also OTHER formats. For example, some Prepayment Penalties are calculated as 2% of the loan balance. So using the same numbers, you'd have an \$8K penalty. There are yet others called 321s. These have a 3% penalty in the first year, 2% in the second and 1% in the third year. In that case, you'd have \$12K in the first year, \$8K in the second and just \$4K in the third year. And in commercial loans, there are even others that vary according to the prevailing interest rates at the time the penalty is incurred.

Now, keep in mind that these Prepayment Penalties don't affect you AT ALL unless you refinance the mortgage or sell the house. If you keep the mortgage for more than 2 or 3 years, you'll never have to pay ANY of that money. You would incur absolutely NO penalties. It's only if you decide to refinance or sell the house that you'd come across these issues. That's what I was alluding to earlier. If your loan program offers a ¼% interest rate advantage in exchange for a 3-year Prepayment Penalty, and if you're planning to keep the loan for more than 3 years, go ahead and take the deal. You'll save plenty with a ¼% lower rate and the Prepayment Penalty will never affect you.

Actually, there are two different types of Prepayment Penalties. One's called a HARD Prepayment Penalty and the other one's called a SOFT Prepayment Penalty. The Hard Prepay would tick off if you refinanced OR sold the house. Either way, you'd have to pay the penalty. A Soft Prepay only ticks off if you refinance. In other words, a Soft Prepay would not cost you a penny if you SOLD the house during the first 2 or 3 years. It would only affect you if you refinance into a different mortgage. And with the lowest rates now behind us, the need to constantly refinance has faded.

Also keep in mind that you can still pay extra towards the principle, even if you have a Prepayment Penalty. These penalty clauses still allow you to pay extra. In fact, you can pay a whole bunch extra and it still won't count as a "prepayment". Generally speaking, you can pay back as much as 20% of the original loan balance in a SINGLE year and it still will NOT count as a prepayment. Using the same numbers we had before, with a \$400K mortgage, you could pay an extra \$80K each year (that's 20% of \$400K) and it would NOT count as a prepayment.

A lot of people have heard about the advantages of paying a little extra towards your mortgage each month. The difference can be dramatic. For example, if you had the mortgage we've been discussing - \$400K at 6% - and you paid an extra \$200 each month, you'd pay off your mortgage 5½ years early. If you paid an extra \$400, you'd pay it off 9 years early. 9 years! That takes a 30-year mortgage and shrinks it down to a 21-year mortgage. So it makes a huge difference. Well, don't worry if you have a Prepayment Penalty and you want to pay extra. It's no problem. Go ahead and pay more each month. But if you're considering refinancing the mortgage or selling the property, you need to take a closer look. If

you're in this situation, feel free to give me a call. I'd be happy to look at your paperwork and let you know if you've got such a penalty or not. My office number is 925-465-1223 and my email is patrick@beyondtherate.com.

Okay. Let's look at another issue; indexes (or I guess indices is the grammatically correct way to say it – but I'll be saying indexes anyway). In Chapter 4, we talked about different loan programs. If you've got any kind of Intermediate ARM or a straight adjustable product, you'll want to hear about the various indexes. And even if you have an Intermediate ARM – that's an ARM loan that has a fixed period at the beginning like a 5/1 or a 7/1 ARM – and you don't plan to keep the loan past that fixed rate period, you should STILL be interested in this discussion.

There are three primary indexes being used today. The first is the LIBOR. That stands for the London Inter Bank Offered Rate and it's probably the most common index being used in today's mortgages. Well, as it turns out, it's also the most volatile index. In other words, it goes up and down faster than any of the other indexes. The second most common index is the MTA, or the Monthly Treasury Average. It's also quite volatile but less than the LIBOR.

Then there's the COFI. It stands for the Cost of Funds Index. This index is very similar to the COSI – that's the Cost of Savings Index – and the CODI – that's the Cost of Deposit Index. These tend to move more slowly. For example, between January 2004 and January 2006 – that's a 2-year period – the LIBOR index went up by 238% - so it INCREASED by 238% – it more than tripled during that time, from 1.46% to 4.94%. In the same 2-year period, the MTA index increased by 205% - again, more than triple, from 1.23% to 3.75%. But the COFI index went up by just 85% - less than double, from 1.81% to 3.35%. Now, obviously these increases appear unusually large because we're coming off of historical lows where these indexes went all the way down to about 1%, but the difference is pretty clear. The LIBOR moves the fastest, then the MTA and the COFI index moves the slowest.

So does that mean the COFI index is the best? Well, not necessarily. For an Intermediate ARM product like a 5/1 or a 7/1, there's an initial fixed period (lasting either 5 or 7 years in the case of a 5/1 or a 7/1) and then the mortgage becomes variable. Well, if the mortgage is based on the LIBOR index, the starting fixed interest rate will be slightly lower than a similar mortgage based on the MTA index. It makes sense. The LIBOR is the most volatile index so it represents the highest risk for the borrower, and the LOWEST risk for the lender, so they'll give you an enticement to select that loan product. So, if you're only planning to hold on to the loan for 5 or 7 years OR LESS, you'll never see the variable interest rate structure anyway and you may as well select the LIBOR product.

Now, if you think you might still have the loan when it becomes variable, or if you select an Option ARM that's variable right from the start, you should probably consider the COFI index. Of course, the luxury of a more stable index will inevitably be reflected in the margin but the benefits could easily outweigh the costs over time, particularly when interest rates are rising. World Savings is well known in the mortgage business because their Option ARMs (actually, they call

them their Pick-A-Payment Loans) are based on the COFI index, but more and more lenders are starting to offer these more stable products as well.

I know this stuff can get confusing, perhaps even a bit overwhelming if it's all new to you, but that's why Mortgage Brokers exist. That's what we do. It's our job to know all this stuff and offer our clients advice on which program makes the most sense, given your objectives. Anyway, it's good for you to hear this information so you know what the issues are.

The most important thing is that the volatility makes NO difference if you plan to refinance or sell BEFORE the fixed period expires. The best strategy is to select a mortgage product that remains fixed for the length of time you intend to carry that loan. If you can achieve that, you'll never even see the volatility. That's why LIBOR products are so common. They offer the lowest starting rates and most people never get to the variable portion of the loan anyway. The only products where you're directly affected by the index are the Option ARM programs that are variable from the start.

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 8. We'll go through the entire loan signing process. There's a lot of paper involved and we'll point out which forms are the most important and what to look out for. Mortgage Brokers frequently sneak things in at the end and we'll make sure you know where to look. It's fascinating stuff. Stay tuned.

Bye for now.