



# EXPLAINING PRIVATE MORTGAGE INSURANCE TO YOUR BROKER

With the cost of purchasing a home as high as it is, the “American Dream” of home ownership would be well out of reach for many prospective buyers were it not for private mortgage insurance. Pre-qualifying the financial status of your potential buyer will determine whether or not you and the potential loan originator will have a discussion about private mortgage insurance with your client. The purpose of this article is to give you, the real estate agent, a basic understanding of private mortgage insurance, sometimes referred to as MI or PMI, and its implications with regard to your client and the buying process. It is wise to educate yourself on the subject.

In the past, prior to the availability of MI, the average homebuyer was typically required to make a down payment of 20 percent of the value of the loan. On a home with the market price of \$150,000, a 20 percent down payment would be \$30,000, a sizable sum for nearly everyone. MI allows the homebuyer to borrow more than 80 percent of the cost of the home, thus reducing the requirement of a 20 percent down payment. Unless your buyer has the 20 percent of the purchase price available in cash, or can borrow from an alternative source, count on the loan originator possibly discussing the subject of mortgage insurance with your buyer — hopefully well before the closing date.

Mortgage insurance protects the lender from loss due to foreclosure. The borrower pays the premiums and private mortgage insurance companies provide the policies. Have your loan originator explain how the private mortgage insurance premiums are to be paid. MI is not to be confused with mortgage life insurance, which is a life insurance instrument usually sold by traditional insurance agents for the purpose of protecting the family and home due to death of the borrower. Make sure your buyer knows the difference.

The cost of private mortgage insurance is determined among a number of criteria — by the amount of down payment and type of loan. In this example of a fully amortizing 30-year fixed loan, with a 10 percent down payment,

the MI premium may be around 0.5 percent. Thus, if the loan amount is \$100,000, the MI payment would be  $\$100,000 \times (.5/100) \times 1/12 = \$41.67$  per month.

As an alternative, “Piggy Back” loans are sometimes used to avoid MI. The idea behind the “Piggy Back” loan is to borrow the traditional 80 percent and then take out a second loan for up to the remaining 20 percent. This method results in two concurrent loan payments, and separate costs for closing the second loan. The second loan is often an adjustable rate loan with fluctuating payments. This makes it hard for the borrower to budget the total monthly mortgage costs, especially in a market with interest rates on the rise. Also, some second loans cannot be cancelled and must be paid off with the proceeds when the home is sold in the future.

The most common “Piggy Back” loan combinations are:

- 80-10-10: 80 percent first loan, 10 percent second (“Piggy Back”) loan, 10 percent cash down payment.
- 80-15-5: 80 percent first loan, 15 percent second loan, five percent cash down payment.
- 80-20: 80 percent first loan, 20 percent second loan, no cash down payment.

Lender Paid Mortgage Insurance is another alternative. In this case, the lender pays for the mortgage insurance, but the downside is often a slightly higher interest rate, usually a quarter percent, or a slightly higher origination fee. This method is, however, less expensive than the cost of closing two loans, which is usually the case with a “Piggy Back” loan, and often may provide a lower monthly payment than the total monthly payment of the two loans.

VA and FHA loans carry government-backed insurance policies and offer additional alternatives for homebuyers who have less than the traditional 20 percent down payment and can meet the qualifications.

Another consideration is that mortgage insurance may be tax deductible. Congress recently passed legislation allowing mortgage insurance premiums to be tax-deductible on refinances and purchases. If your borrowers

have a household adjusted gross income of \$100,000 or less, purchasing a home and having a mortgage with MI, may allow your buyer to deduct the full cost of the mortgage insurance premiums they pay during the tax year.

At the end of the year, the lender has the responsibility to provide your buyer with a year-end statement reflecting total mortgage interest and insurance premiums paid. Your buyer may then be able to deduct the mortgage insurance portion of their payments as well as their mortgage interest. Always direct your buyer to seek out professional and licensed tax consultation to get a complete understanding of the tax advantages and impact of MI and mortgage interest.

MI can be cancelled when certain criteria are met. Under the Homeowner’s Protection Act (HPA) of 1998, your buyer can request that the MI be cancelled when the value of the loan drops below 80 percent of the value of the home. Your buyer can use the original appraisal, or reappraise the home if sufficient equity has built up. In some cases, this can occur in as little as two years. If the value of the home increases enough and the premium is paid down enough to get the value of the loan below 80 percent of the market value, then your buyer can have their MI cancelled. Also included in the HPA is the mandatory cancellation of MI on most loans when the loan value drops below 78 percent. A requirement for this is a good payment history with no payments over 30 days late.

In addressing general MI information with your buyer, remember to point out that MI is a short-term solution that increases your client’s buying power and allows a more creative financing alternative to traditional lending practices. This information will prepare your buyer for further discussion when meeting with the loan originator, as MI is a financing issue and the specific details are best left to the loan originator to explain.

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