MORTGAGE INSURANCE 101

BY DAVID KATKOV

Low-down-payment loans are becoming an increasingly important part of the mortgage finance landscape. According to a recent study published by the National Association of Realtors® (NAR), Chicago, from mid-2005 to mid-2006 nearly half of all first-time homebuyers put no money down; another 50 percent put down 10 percent or less. The median down payment made by first-time homebuyers was just 2 percent. ● That's hardly surprising when you consider that over the past 10 years, nationwide, homes have appreciated 107 percent, according to data from the Office of Federal Housing Enterprise Oversight (OFHEO). During this same period, incomes have increased just 37 percent, according to Moody's Economy.com, West Chester, Pennsylvania. ● At $221,000, the median home is out of reach for many first-time homebuyers, and even those who are in a position to carry a mortgage often can't save up a down payment of $44,000. The recent slowing rate of appreciation in many areas should allow the market to come back into balance, but that will take time. In the meantime, all of us in the mortgage industry are looking for creative ways to grow our businesses. ● In my view, mortgage insurance (MI) should be thoroughly considered for every

With rates rising and appreciation slowing, now might be a good time to give mortgage insurance another look. Add to that the tax deductibility of borrower-paid MI premiums for some borrowers this year, and it becomes even more appealing.

low-down-payment transaction, especially for low- and moderate-income borrowers and first-time home purchasers. It's tax-deductible, affordable and cancellable, and it can help expand your business. What I want to do in this article is dispel some myths about mortgage insurance, cover the nuts and bolts of how it works, and offer some ways to think about it that may help you expand your ability to serve the growing low-down-payment market.

Myths and realities

MYTH NO. 1:

Mortgage insurance isn't tax-deductible.

Many people believe this, because until quite recently it was true for borrower-paid mortgage insurance. (Lender-paid mortgage insurance, in contrast, has always been tax-deductible—and still is.) However, borrower-paid mortgage insurance premiums are tax-deductible for the first time in 2007.

Borrowers closing loans to purchase homes or refinance in 2007 who have annual household incomes of $100,000 or less will be able to deduct the full cost of their mortgage insurance premiums on their federal tax returns. Borrowers with incomes between $100,001 and $109,000 can take advantage of a partial deduction. (This is based on transactions closed in 2007, and MI premiums paid between Jan. 1 and Dec. 31, 2007, and allocable to 2007. Deductions are phased out in 10 percent increments for borrowers with adjusted gross incomes between $100,000 and $109,000.)

THE OTHER CLEAR BENEFIT TO BORROWERS IS THE WORKOUT EXPERTISE THAT COMES WITH MORTGAGE INSURANCE.

Bankrate.com, North Palm Beach, Florida, a source of consumer financial information, estimates that with the new tax deduction a homeowner with a $180,000 mortgage would save about $351 in taxes.

As with many new tax provisions, this is initially in effect for one year, meaning for premiums paid in 2007 on mortgage insurance certificates issued between Jan. 1 and Dec. 31, 2007. However, if the legislation has the desired effect of helping low- and moderate-income Americans overcome barriers to homeownership without having to resort to potentially higher-risk loans, I believe there's a good chance Congress will be persuaded to extend the deduction or even make it permanent.

MYTH NO. 2:

A piggyback loan is cheaper.

A few years ago, this was true in many cases. Today, piggybacks can be riskier. Interest rates on seconds are often adjustable and float with the prime rate, so piggyback loans are more expensive than they were a year ago and payments can jump significantly if interest rates increase. In contrast, mortgage insurance premiums are fixed, so borrowers don't have to worry about their payments going up. The bottom line is that in today's climate of slowing home-price appreciation and higher interest rates, an insured loan is a simple, safe and smart way for people to get into a home and start building equity.

MYTH NO. 3:

Mortgage insurance is hard to cancel.

Again, not true. Most lenders have simplified the process and allow borrowers to cancel their mortgage insurance by obtaining an appraisal from an appraiser approved by the lender demonstrating that the home's value has increased to the point where the current loan-to-value (LTV) ratio is 75 percent or less, as long as their payments are current. In addition, the Homeowners Protection Act (HPA) of 1998 requires that mortgage insurance be canceled automatically once the borrower has paid down the loan to an LTV of 78 percent, based on the original value of the home.

MYTH NO. 4:

Mortgage insurance doesn't benefit borrowers.

Mortgage insurance allows borrowers to purchase a home and begin building equity and wealth immediately. This is especially important for low- and moderate-income borrowers. Imagine two people, each with $15,000 in savings and an annual salary of $55,000 per year, with a 3 percent annual increase. Let's call one of them Stephanie. Say Stephanie purchases a $150,000 home today with a 10 percent down payment and mortgage insurance (we assume in this example that Stephanie obtains a loan with private mortgage insurance, but she could also obtain a low-down-payment loan insured by the Federal Housing Administration [FHA] or—assuming she is a veteran—a loan guaranteed by the Department of Veterans Affairs [VA]). The second borrower, we will call Sam. Sam takes a more traditional approach, saving 4 percent of his salary each year toward the old-fashioned 20 percent down payment.

Even at a modest annual appreciation rate of 4 percent, Sam would see house prices increase right out from under him while he's saving up his down payment. Five years out, he'd have saved $27,190, but the price of the $150,000 house would have increased to $175,479, so he'd still be almost $8,000 short of the 20 percent down payment, now $35,000. He'd also have paid out almost $60,000 in rent over that same time period.

Stephanie, in contrast, cancels her mortgage insurance after approximately four and a half years due to appreciation (at that same rate of 4 percent), reducing her monthly payment. At the end of five years, her net worth (value of home plus savings at 4 percent per year minus outstanding mortgage balance) is almost $60,000.

The other clear benefit to borrowers is the workout expertise that comes with mortgage insurance. No one takes on a mortgage intending to default, but bad things do sometimes happen to good people: Today, as ever, the leading causes of mortgage default are death, divorce and illness. At PMI, for example, working with our lenders, we were able to save the homes of nearly 3,000 families in 2006 whose PMI-insured mortgages were in default. I believe this commitment to sustainable homeownership is one of the things that makes mortgage insurance an ideal choice for first-time borrowers.

MYTH NO. 5:
A loan with mortgage insurance takes longer to close.

Actually, the opposite is true. Ten years ago, underwriting and obtaining mortgage insurance was a cumbersome paper process with a several-days turnaround. Today, it's typically done electronically and almost instantaneously: 90 percent of PMI's policies are approved within the same business day, and industrywide, single loans with mortgage insurance often close faster than piggybacks.

MYTH NO. 6:
Mortgage insurance is a one-size-fits-all product

In fact, mortgage insurance has kept pace with market innovation and is now available in a variety of flavors that can serve a wide array of borrowers, including expanding market products specifically designed to help lenders serve new borrower segments. For example, some borrowers may have less-than-perfect credit, but they can still be good lending prospects. With mortgage insurance, lenders can often approve mortgages to borrowers they believe are a good risk, such as borrowers with good credit but complex or unusual sources of income, even if they fall short of traditional underwriting standards.

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Depending on the program, the premium can be paid in full or financed into the loan amount, providing benefits similar to piggyback loans but without the risk of higher payments. Even cash-out refinancings can carry mortgage insurance, an important benefit with home prices slowing and many adjustable-rate mortgage (ARM) borrowers looking to refinance out of higher rates or loans whose payments have increased.

With traditional borrower-paid mortgage insurance, the borrower pays a monthly premium that is added to the monthly mortgage payment. This is still a common option, but today borrowers have the option to finance part or all of the premium into the loan amount.

With lender-paid mortgage insurance, the premium is paid by the lender, who charges the borrower a slightly higher interest rate to cover the cost. For a borrower with good credit (700+ FICO®), making a 5 percent down payment and utilizing a fixed-rate, fully documented mortgage, the premium is in the 0.5 percent range. For the borrower, lender-paid mortgage insurance is tax-deductible as mortgage interest and is cancelled when the loan is paid off.

MYTH NO. 7:
Mortgage insurance is expensive.

Like any financial transaction, there's a cost for utilizing mortgage insurance—but the cost is modest when compared with the benefit of getting into a home and starting to build equity. For a ballpark cost, let's use the same example of a $100,000 house where the borrower is making a $5,000 down payment (for a loan-to-value ratio of 95 percent) and getting a 30-year, fixed-rate mortgage (FRM). With standard mortgage insurance coverage, the rate would be 0.78 percent. Simply multiply the loan amount ($95,000) by the mortgage insurance rate (0.78 percent), which is $741, and divide by 12 months in a year to get the monthly premium of $61.75—less than the cost of a monthly cable TV bill.

The cost of mortgage insurance increases with risk: A higher LTV, a lower credit score or an alternative-A or low-doc loan instead of a loan with full documentation will all result in a somewhat higher cost, but the price is still reasonable when compared with the benefits of homeownership.

Market expansion opportunities

Let's move from the myths about mortgage insurance to how it can help you expand your business. Mortgage insurance allows lenders to expand their product offerings for high-LTV loans and further develop the market for first-time buyers, low- to moderate-income borrowers and minorities who may not qualify under traditional FICO, LTV and credit guidelines. This is particularly important in a shrinking market, as the majority share of future market growth is forecast to come from these segments.

How mortgage insurance works

Although consumers sometimes confuse it with products such as credit life insurance or hazard insurance, mortgage insurance does not pay the mortgage in the event the borrower dies, becomes disabled or loses his or her job. Neither does it protect against losses due to fire, liability and theft, or cover fraud in the loan origination or assure the value of the property given in the appraisal. Its purpose is to facilitate the availability of low-down-payment loans by sharing the risk of loss

Take the MI Quiz

Which of the following is true of mortgage insurance (MI)?

- ❑ It's hard to cancel.
- ❑ It's more expensive than a piggyback.
- ❑ It's not tax-deductible.
- ❑ It benefits the lender, not the borrower.

If you checked any of these boxes, it's time for a refresher course.

should the borrower default.

Mortgage insurance exists because, while loans with an LTV ratio of more than 80 percent are statistically more likely to result in losses, there's a continuing—indeed, increasing—demand for them.

In the United States, if a borrower can't or doesn't want to make a 20 percent down payment, he or she generally has two choices: a piggyback loan (taking out a second mortgage to cover the difference between the 80 percent first mortgage and the down payment) or mortgage insurance. Because of the higher likelihood of default, the government-sponsored enterprises (GSEs) will not purchase a high-LTV loan unless the loan is insured or the selling lender retains a participation interest or accepts full recourse in the event of default.

Given these options, lenders typically choose to sell loans to the GSEs with mortgage insurance. Mortgage insurance protects the lender against losses associated with borrower default, up to the limits of the policy.

Here's how it works. Take a $100,000 loan with a balance of $95,000. Mortgage insurance coverage of 25 percent shields the lender from the first $23,750 of losses plus a portion of the past-due interest and foreclosure expenses. By reducing the exposure to loss, mortgage insurance gives the lender the confidence to make the loan and the GSEs the confidence to buy it. This helps to keep high-LTV loans in circulation and available to first-time and low- to moderate-income homebuyers. Mortgage insurance has played a key role in expanding the U.S. homeownership rate to almost 69 percent.

The bottom line

In the early years of this decade, the combination of rock-bottom interest rates and double-digit home-price appreciation meant that piggyback loans often beat mortgage insurance to the lowest payment. As a result, many of those who have joined the industry in the last several years don't know that much about mortgage insurance, and even veterans may be surprised by some of the positive industry successes, such as the development of single and split-premium products and the fact that MI premiums are now tax-deductible.

Today, however, interest rates are higher, and a single loan with mortgage insurance is often cheaper than a piggyback—especially now that premiums for some are tax-deductible. With home prices slowing and 2007 originations forecast to be 7 percent less than 2006 levels, according to Fannie Mae, mortgage insurance is something that should be in every originator's and lender's arsenal. **MB**

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