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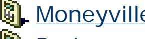

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Six dirty secrets of mortgage loans

Today's low interest rates make borrowing money cheap. But watch out for those mortgage fees.

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By Annelena Lobb, CNN/Money Staff Writer

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NEW YORK (CNN/Money) - If low mortgage rates have motivated you to invest in a picket fence of your own, you're in good company. Homes continue to sell at breakneck speed, and rising property values have homeowners feeling flush.

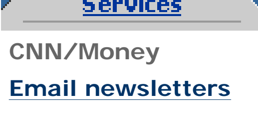
But before you bid on your piece of the American dream, it's important to remember that mortgages still come chock full of fees, surcharges and closing costs. Lenders, after all, are in the business of making money.

There are lots of sneaky ways mortgages can end up costing more than you think. Take a look at these 6 dirty secrets of mortgage loans, and make sure no one's taking you for a ride.

1. Banks don't always tell you about the 80-10-10 option.
The average down payment on a home by first-time buyers stands at around 10 percent of purchase price, according to Freddie Mac. And whenever your down payment is below 20 percent of the purchase price, you must pay private mortgage insurance (PMI) to your lender, along with principal and interest payments. Besides adding another $100 to $150 to your monthly payment, here's another downer -- PMI can't be deducted from your taxes come April, unlike mortgage interest.

What you may not realize, or may not be told, is that you can take out two mortgages and avoid PMI altogether. Assuming you put 10 percent down, the first mortgage would cover 80 percent of the home's cost, and the second would cover the remaining 10 percent. In effect, that second loan bumps your down payment to the magic 20 percent threshold. Bingo: no PMI. (Sometimes, people use an 80-15-5 setup, with 5 percent down and a second loan for 15 percent of purchase price.)

Of course, that means you now pay two mortgages each month, not one, and the 10 percent mortgage will have a higher interest rate than your 80 percent loan, said Frank Nothaft, chief economist at Freddie Mac.



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Still, you'll avoid PMI and you may save come April 15th, when you deduct mortgage interest. It depends on where interest rates stand and your tax situation. Ask your lender to crunch the numbers to see which method puts money back in your pocket. And check their math!

2. Close at the start of a month and your closing costs climb. With any mortgage, you are obligated to pay interest until the principal on your loan is repaid in full, starting with the date you close on your home.

But it's conventional in the mortgage business to set up interest payments in arrears, to coincide with complete calendar months, said Doug Duncan, a spokesperson for the MBAA. That means any time between your closing date and your first full monthly payment on a purchase mortgage is "extra" time, and you'll pay interest on those days up front at the closing table. That can sting.

Keep in mind, though, that when you close at the start of the month, your closing costs are higher, but your first mortgage payment isn't due until a month later than it would be if you closed at the end of a month. So you won't save any money overall by closing later, but you do have to cough up less cash up front.

"If you pay on a monthly basis, and close on the 25th of the month, then you have about five or six days of extra interest payments," Duncan said. "But if you close on the 5th, you'll pay 25 or 26 days' worth of interest."

3. Lenders may try to muscle you into an ARM. Consumers often qualify to borrow much more money with an ARM, or adjustable-rate mortgage, than with a fixed-rate mortgage, said Eric Tyson, author of "Mortgages for Dummies." That's why lenders and brokers often push ARMs aggressively -- larger loans make for larger commissions, after all.

But many consumers don't realize the risk inherent with ARMs. The loan has an extra-low, fixed interest rate for a short, set period of time -- one or two years for an ordinary ARM, and five or seven years for a 5:1 or 7:1 ARM. Sure, introductory rates are enticingly low -- last week, they clocked in at 4.34 percent, hitting an 8 year low, according to Freddie Mac.

But after the honeymoon is over, the loan rate may balloon -- it will then fluctuate in tandem with mortgage rates, which bob up and down according to the whims of the economy and the Federal Reserve. Each ARM has a rate cap, so there's a ceiling on the interest you might have to pay -- but that cap can be set unaffordably high for the borrower.

Generally, it's advisable to opt for a 30-year fixed-rate mortgage over an ARM if you plan to stay in your home for more than five-to-seven years.

4. PMI laws are picky. Private mortgage insurance on any mortgage issued after July 1999 automatically cancels when you

reach 22 percent equity in your home, in accordance with the Homeowners Protection Act of 1998. You can also request in person to stop paying it when you hit the 20 percent threshold.

On many private loans, you must have that equity because of payments you've made toward the principal, not because of appreciation in the value of your home. But if you have a loan owned by Fannie Mae or Freddie Mac, the guidelines are more consumer friendly. You can reach 20 percent equity through principal payments and home value appreciation, which makes it easier to dump your PMI.

The Homeowners' Protection Act also specifies that lenders must notify homeowners when their equity reaches 20 percent -- but the law applies *only* to mortgages issued after July 1999. Mortgages issued before that don't require notification so it's up to you to remain vigilant.

5. You might not have to pay for a jumbo mortgage. The Federal Housing Finance Board raises the maximum allowable size for a standard mortgage each year, known as the "conforming loan limit." Currently, the conforming loan limit stands at $300,700.

Any loans larger than that, which are becoming more common in today's hot housing market, are considered to be a non-conforming or jumbo loan. Thing is, jumbo loans generally force you to add 20 to 25 basis points to the interest rate you'd pay on a standard-sized loan, said Jay Brinkmann, a financial economist at the Mortgage Bankers Association of America (MBAA).

That's because such loans can't be bought by Freddie Mac or Fannie Mae and because high-cost properties have more volatile prices, so homeowners must compensate the bank for that risk.

But there is one way to work the system.

The conforming loan limit rises at the end of each calendar year, using a formula -- which makes the change relatively predictable. Your loan gets classified as a standard or jumbo loan when you *close* -- typically 60 days or so after you make an offer on the house. If your loan amount is on the edge, and the new limit lets you take a standard rather than a jumbo loan, you might consider waiting to buy until November (the idea being that you probably won't close until the new year).

6. Broker fees may be negotiable. Mortgage brokers are a bit like used car dealers -- they buy mortgages at wholesale prices and mark them up to retail prices.

Brokers must by law disclose what they make in commissions in a good faith estimate before you sign on the dotted line. But if you're willing to play hardball, there is room for negotiation.

On a standard-sized loan, a reasonable markup ranges between 1 and 1.5 percent, Tyson said. On a jumbo loan, you may have more leeway to negotiate that down. ■

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