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The Ins and Outs of Mortgages and Refinancing

There was a time when mortgages were a fairly straight forward instrument. There were 30-year, fixed rate mortgage and nothing else. Today, however, there are more than 200 different types of mortgages, including those with adjustable-rates, according to a recent *Journal of Financial Planning* article written by George Collis, CFP®,

According to Collis, financial planners must now view mortgage fact-finding, analysis, and recommendations as a central aspect of comprehensive financial planning, not as an afterthought. “Mortgage options have direct implications for cash flow, risk management, asset accumulation, retirement, and legacy planning,” Collis wrote earlier this year.

And part of the fact-finding includes helping those seeking a mortgage or refinancing to navigate the tricky shoals of applying for and securing the best possible terms, according to David Reed, author of “Mortgages 101,” and “Mortgage Confidential.” Here, according to a recent release, is what Reed and other planners say homeowners and would-be homeowners need to know about mortgages and refinancing:

To get the best deal on a mortgage, planners recommend working with a lending officer who understands your needs. Spend time getting clear on the difference between features and benefits; choose the loan that offers you 1) the greatest benefit for you, 2) at this time, and 3) in these circumstances. Be very clear about that, and be prepared to ask for options that address your agenda, not the loan officer’s. If the lending officer can’t address your questions and needs, find another lending officer.

Don’t wait until rates are 2 percentage points below your current rate before you refinance. While the “2 percent rule” seems to have been around forever, Reed suggests that it simply doesn’t make sense. To determine whether or not a refinance is worth your while, consider both the new monthly payment and the associated closing costs that will accompany the new loan, he says. You do this by taking the difference between the current payment and the projected new payment, and dividing the closing costs (exclusive of amounts to fund the new escrows) by the monthly savings. If you plan to hold the mortgage for more months than that number, you’re ahead by refinancing. A more refined analysis will use the after-tax cost of the monthly payments instead of the nominal costs. There are, of course, many factors beyond the loan interest rate that should be considered when making a decision to refinance. Often, the most significant factor is cash flow.

Cash-out refinancing can cost you more than you think. Typically, a homeowner might refinance their current mortgage and pay off their credit cards, car loans, or other debts. But Reed suggests that doing so only works on paper. To be sure, the homeowner has gotten rid of their car payment. But what was once a four- or five-year note is now stretched out over 30 years. The bottom line is this: Consider a cash-out deal only if you were going to refinance your mortgage anyway because of the lower rates available. Don’t do it because some loan officer showed you how much lower your payments would be if you consolidated your bills, unless short-term cash flow is one of your concerns going into the refinance conversation. For the purpose of tax deduction of mortgage interest expense, IRS classifies two types of mortgage: acquisition and home equity. Converting an acquisition mortgage into a refinance changes the classification and that may impact what amount of interest can be deducted.

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Reed also recommends learning what the mortgage lingo means. Know, for instance, the difference between loan prequalification, pre-approval, and approved with conditions. A loan prequalification, or “prequal,” letter simply states that you’ve had a discussion with a loan officer. Pre-approval letters are issued after *credit approval* has been obtained either from an automated underwriting system (AUS) or from a human underwriter. This is a pre-approval because a full approval is not issued until a full loan package is submitted for review—which includes an acceptable property appraisal and a ratified contract. Some realtors will accept a prequalification letter, while others want a pre-approval letter.

Know the difference between “clear to close” and funded. When all the conditions have been signed off on, everything is in order, the property has been evaluated, and your loan papers have been printed, you’re clear to close. Your new home isn’t officially yours, however, until your loan has been funded, and the deed has been recorded. Typically, the funds aren’t wired to the borrower. They are wired to the closing agent, who brings the funds to the closing where they are then given to the seller upon completion of the signing. Of note, the terms are not universal. In some states the language would be as follows: When all “prior to” conditions have been met the loan is characterized as “clear to close.” That means the closing department can draw loan documents and transmit them to the title company for the closing.

Lastly, ask your lender about your loan’s “yield spread”. Yield spread is a commission paid to the loan officer by the lender, and it can amount to thousands of dollars. Knowing that the loan officer stands to receive a large yield spread will give you more room to negotiate lower closing costs such as origination fees and document preparation fees. These fees, called “junk fees”, often provide tremendously high margins, and therefore may be negotiated if the loan officer is getting paid elsewhere.

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