

REAL ESTATE



THE FINANCE LADY
 ~ Problem Solver ~
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PRE-PAYMENT PAIN

More and more these days, I'm running into folks concerned with increasing payments caused by their adjustable rate mortgages. Typically, the client went into an adjustable rate loan

one, two or more years ago because the interest rate and payments were lower than those of a fixed rate mortgage.

Today's interest rate environment is radically different than the recent past. The Federal Reserve has raised its rates 16 times in a row as of the date of this writing. All fixed and adjustable rate mortgages are up, too. Insurance costs are causing panic and real estate taxes are no bargain. Not to mention the cost of gas!

So what do you do if you're afraid of not being able to afford your home? If you want out of an adjustable rate mortgage, you may go to a mortgage broker or bank. Or you may decide to sell your house. But many times, a rude surprise, more jarring than a Simon Cowell comment is waiting for you at the closing table—the pre-payment penalty. The penalty can layer on several thousands of closing costs to the transaction and sometimes prevent it from happening. Ouch!

What is a pre-payment penalty?

A pre-payment penalty is a device that serves two purposes – it ensures

that the lender makes money and it lowers the mortgage interest rate for a borrower.

Lenders make money by lending. (I realize this statement will not nominate me for a Pulitzer Prize in the mortgage expose category, but bear with me.) Lenders borrow money themselves and then turn around and lend it out to folks like you and me at a higher rate. So if a lender borrows at 4% and lends at 6.5%, it's making the spread, or difference.

But there are other costs involved at the lender's operation just like any business, such as staffing, compliance, rent, etc. And there are costs incurred with each loan they create. In order to make a profit on each loan, the lender has a minimum amount of time it needs for the loan to be outstanding. During the recent refinancing and flipping booms, it was common for lenders to

lose money because they were repaid too soon. They only were able to collect interest for a year, sometimes barely months, before the borrower paid the loan off.

In exchange for this guarantee of interest, most lenders will offer a rate lower than a loan with no pre-payment penalty. The rate reduction can be 3/4 of one percent. Think of it as a "thank you" to the borrower for accepting this term.

How much can a pre-payment penalty cost and how do I know if I have one?

Prepayment penalty formulas vary, depending on factors such as the credit profile of the borrower. Your loan officer should explain that you have one and go over its terms. When you signed the loan payments, the closing

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