

Sean Pope & Zachary Taylor's

MORTGAGE UPDATE



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Consolidate Your Debt with a New Purchase Mortgage

Some home buyers try to kill two birds with one stone by consolidating their debts in a new purchase mortgage. Usually this is not a good idea, as in the case illustrated below from our fictitious Mr. Jones.

"I have \$30,000 in cash for a down payment on the \$300,000 house I am purchasing. I also have \$15,000 of credit card debt at 12% that I would love to get rid of. The loan officer says I can roll it into a new \$285,000 30-year mortgage at 6%. This cuts the rate on my credit card debt in half and makes it deductible. Further, my total monthly payment would be only \$1,891, compared to \$2,051 if I didn't consolidate and took a \$270,000 loan. Is there any reason I shouldn't consolidate?" — Sincerely, Mr. Jones

Yes, appearances to the contrary notwithstanding, this consolidation will only make Mr. Jones poorer.

True, the rate on the mortgage is well below the rate on his credit card debt, and mortgage interest is tax deductible as well. However, if Mr. Jones increases the size of his loan from \$270,000 to \$285,000, he will increase either the mortgage insurance premium or the interest rate on the purchase mortgage. It takes only a ¼% rate increase on \$285,000 to offset the savings from a 6% rate reduction (including the shift to deductibility) on \$15,000 of credit card debt.

Consolidation would also reduce Mr. Jones' total monthly payment, but that is mainly because he would be paying down his debt more slowly. If he consolidates, he will owe \$260,484 at the end of 6 years, which may be his best guess as to how long he will be in his new house. If he doesn't consolidate, he will owe only \$246,774.



These numbers and the others cited below are drawn from a simple calculator used to determine Mr. Jones' total costs over 6 years if he:

- a. *Doesn't consolidate*, which means he takes the first mortgage for \$270,000 and leaves the non-mortgage debt as is;
- b. *Consolidates in the first mortgage*, which means that he takes the first mortgage for \$285,000 and pays off the non-mortgage debt;
- and c. *Consolidates in a second mortgage*, which means that he takes out the first mortgage for \$270,000 to buy the house, and afterwards he take a second mortgage for \$15,000 to pay off the non-mortgage debt.

Continued on page 2

**On The
Inside:**

**Odds & Ends
Responsibility
How Can I Buy Before I Sell?**

RESPONSIBILITY

The power to fulfill our dreams is within each of us. We alone have the responsibility to shape our lives. When we understand this, we know that nothing, and no one, can deny us greatness. We are the ones pushing ourselves forward or holding ourselves back. The power to succeed or fail is ours alone.

Continued from page 1

For example, here are the terms at which Mr. Jones can borrow under all three options. The \$270,000 and the \$285,000 first mortgages are both “no-cost” at 6% for 30 years – they differ only in the mortgage insurance premium. The \$15,000 second mortgage is also “no-cost” at 10% for 15 years. Mr. Jones also happens to be in the 25% tax bracket and wants interest loss to be calculated at 2%.

The cost can be measured as total monthly payments over the proposed 6-year period; plus the lost interest on those payments (interest that could have been earned but wasn’t); minus the tax savings on interest, including the interest earnings on tax savings; minus the reduction in debt balances over the 6 years.

Mr. Jones’ costs are \$89,904 *without* consolidation, \$92,311 *with* consolidation into the first mortgage, and \$89,523 *with* consolidation into the second mortgage. While consolidation in the first mortgage rids him of the high payments on the non-mortgage debt and increases his tax savings, these are more than offset by higher mortgage insurance premiums and smaller debt reduction. Consolidation with the 10% second mortgage, on the other hand, turns out to be slightly profitable.

In making decisions about debt consolidation, borrowers generally make two kinds of mistakes. One is to base the decision on the monthly payment, ignoring what happens to the loan balance. This mistake pervades many financial decisions.

The second mistake is for borrowers to decide in advance that they are going to consolidate, and only price mortgages that allow it. Their focus is the cost difference between the non-mortgage debt and the mortgage that would consolidate that debt. They ignore the fact that if they don’t consolidate, their mortgage would be smaller and therefore less costly.

Learn to use your calculator! One benefit of using it to determine the overall costs and potential savings is the discipline it imposes. It should

force you to consider *all the options*, and to collect *all the data* required to assess each option.

Unfortunately, some borrowers are allergic to calculators and need a rule of thumb. Unfortunately, the common one that says “consolidation is profitable if the rate on the first mortgage is below the rate on non-mortgage debt”, is wrong most of the time. Replace it with “consolidation is profitable if the rate on the first mortgage is below the rate on non-mortgage debt, *and* if the rate or mortgage insurance premium on the first mortgage is no higher with consolidation than without.” This one will be right most of the time.

(See your local mortgage lender to learn what he may be able to do for you!)



News You Can Use

ELECTRONIC CLOSINGS

More efficient electronic closings – which will allow buyers, sellers, and “refinancers” to use their home computers – are on the horizon. In electronic closings, the homeowner will sign closing papers by entering a specific website that displays the images of the standard documents, and then keys in a privately selected pass code to indicate his or her signature. A notary public for the title company views the same papers from another secure website and electronically affixes a notarized stamp. The process promises to save time and money in document preparation and fees.

Source: www.chicagotribune.com

PMI TIMELINE CUT IN HALF

Five million property owners currently pay for Private Mortgage Insurance (PMI), which can add \$50 to \$150 a month to mortgage payments for about 10 years.

Radian Guaranty Inc, headquartered in Philadelphia, is offering homebuyers a plan that will lower PMI payments, and automatically terminate the payments after five years, with little added paperwork.

Slightly higher payments

For example, if you had purchased a \$200,000 home with 10% down on a 30-year mortgage at 6% interest, you would only pay between \$7 and \$8 more a month on PMI through year five.

Radian’s “Free-After-Five” plan requires on-time payments during the first five years, a FICO credit score of 660 or more, and a slightly higher monthly payment. This plan is almost certain to be matched nationally by competing mortgage insurers.

Tax code unchanged

A proposed tax code change would have made PMI premiums tax deductible for households that had annual incomes of up to \$100,000. However, this highly popular tax code change was omitted when the bill was signed into law on Oct. 22, 2004.

Currently, the Homeowners Protection Act of 1998 mandates cancellation of PMI only under certain circumstances.

Go to www.ftc.gov, click on “For Consumers,” then on “At Home,” and scroll down to “Cancellation of PMI” to learn more.



Every effort has been made to verify the accuracy of the information herein, but it is not guaranteed and should not be relied on without specific advice from a professional.

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Q
& A

How Can I Buy Before I Sell?

"I need to use the equity in my existing house to buy a new one, but it looks like I am going to have to close on my new house before I am able to close on my old one...HELP! How do I handle this?"

I am assuming you have exhausted all possibilities of borrowing from family, friends or retirement accounts. The next best options are a swing loan from a bank or a home equity loan on your current house.

If you have a contract of sale on your current house, many banks will make a "swing" or "bridge" loan for the period between the closing on your new house and the closing on your old house. I used a swing loan on my last purchase, and it was relatively simple and hassle-free. While the rate may be high, the interest payment won't amount to much if the period is short.

Banks aren't crazy about swing loans because they realize they are one-shot affairs and they are unlikely to see the borrower again. For this reason, you should go to the institution where you currently hold your deposit, whether it is a commercial bank, savings and loan association or credit union. If they gave you any flak, let them know (in a polite way) that as a customer, you expect this service, and if you don't get it you have lots of other choices as to where you hold your account.

A home equity loan is likely to be more costly than a swing loan, although the cost will be influenced greatly by the amount of equity you have in your current property, and on how astute you are in your shopping. What you need to avoid are points (an upfront charge expressed as a percent of the loan amount), other upfront fees, and prepayment penalties. Bear in mind that on a 3-month loan, you can afford to pay an interest rate up to 4 percentage points higher to avoid paying a fee equal to 1% of the loan.



"The ability to accept responsibility is the measure of the man."

— Roy L. Smith

ODDs & Ends

In George Washington's day...

...Americans had the highest standard of living and the lowest taxes in the Western World (as of 1776)! Farmers, lawyers and business owners in the Colonies were thriving, with some plantation owners and merchants making the equivalent of over \$500,000 a year. Times were good for many others too. The British wanted a slice of the cash flow and tried to tax the Colonists. They resisted violently, convinced that their prosperity and their liberty were at stake. Virginia's Patrick Henry summed up their stance with his cry: "Give me liberty or give me death!"

...Benjamin Franklin, disgusted with the arrogance of the British and appalled by the bloodshed at Lexington and Concord, wrote the first Declaration of Independence (in 1775). Thomas Jefferson was enthusiastic. But, he noted, many other delegates to the Continental Congress were "revolted at it." It would take another year of bitter conflict to persuade the Congress to vote for the Declaration of Independence written by Jefferson — with some astute editorial suggestions by Franklin.

...John Adams defended the British Soldiers after the Boston Massacre! Captain Thomas Preston led some British Soldiers to aid another British Soldier who was having things thrown at him and was also hit several times with a board. After their arrival, the people continued to pelt the soldiers and finally shots were fired and the infamous "Boston Massacre" was over. Captain Thomas Preston and eight soldiers were charged with murder. Future President John Adams took up the defense of the soldiers. He, along with Joshua Quincy, was able to get all but two acquitted by a local jury. Those two were found guilty of manslaughter, but claimed benefit of clergy. This means that they were allowed to make penance instead of being executed. To insure that they never could use benefit of clergy again they were both branded on the thumbs.

...The first submarine attack in history occurred in New York Harbor! The Connecticut inventor David Bushnell called his submarine the Turtle because it resembled two large tortoise shells of equal size joined together. The watertight hull was made of 6-inch-thick oak timbers coated with tar. On September 6, 1776, the Turtle targeted the HMS Eagle, the flagship of the British fleet. The submarine was supposed to secure a cask of gunpowder to the hull of the Eagle and sneak away before it exploded. Unfortunately, the Turtle got entangled with the Eagle's rudder bar, lost ballast and surfaced before the gunpowder could be planted.





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