Six Reasons To Avoid Private Mortgage Insurance

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If you're thinking of buying a home, remember you're going to need to save up enough money for a 20% down payment. If you can't, it's a safe bet that your lender will force you to secure private mortgage insurance (PMI) prior to signing off on the loan. The purpose of the insurance is to protect the mortgage company if you default on the note.

Private mortgage insurance sounds like a great way to buy a house without having to save up the cash for a down payment. Sometimes it is the only, or even the best, option for new homebuyers. However, there are several reasons would-be homeowners should try to avoid paying this insurance. In this article, we'll examine the six common problems with PMI and then explore a possible solution that allows homebuyers to avoid it altogether.

Six Good Reasons To Avoid PMI

1. **Cost -** Private mortgage insurance typically costs between 0.5% to 1% of the entire loan amount on an annual basis. On a $100,000 loan this means the homeowner could be paying as much as $1,000 a year, or $83.33 per month - assuming a 1% PMI fee. (Calculated as: $100,000 x 1% = $1,000 / 12 = $83.33) By itself that's a pretty hefty sum. However, the average home price, according to the National Association of Realtors is about $240,000, which means families could be spending nearly $200 a month on the insurance. That's as much as a car payment! (To learn more, see *Understanding The Mortgage Payment Structure*.)

2. **May Not Be Deductible** - Private mortgage insurance contracts generated in 2007 are tax deductible - that is, if the married taxpayer earns less than $110,000 per year (in adjusted gross income). For married couples filing separately, that threshold is $55,000. This means many dual-income families with a combined income just above the threshold will be left out in the cold. While there are rumors this "income cap" could be raised in the future, there is no guarantee it will happen. Many homeowners (particularly those just above the threshold) may be better off making a larger down payment where at least they'll have the peace of mind that the interest on the loan is be deductible. (For more on this important deduction, read *The Mortgage Interest Tax Deduction*.)

3. **Your Heirs Get Nothing -** Most homeowners hear the word "insurance" and assume that their spouse or their kids will receive some sort of monetary compensation if they die. This is simply not true. The lending institution is the sole beneficiary of any such policy, and the proceeds are paid directly to lender (not indirectly to the heirs first). If you want to protect your heirs and provide them with money for living expenses upon your death, you'll need to obtain a separate insurance policy. Don't be fooled into thinking PMI will help anyone but your mortgage lender. (To learn more about additional coverage, check out *How Much Life Insurance Should You Carry?*.)

4. **Giving Money Away** - Homebuyers who put down less than 20% of the sale price will have to pay mortgage insurance until the total equity of the home reaches 20%. This could take years, and it amounts to a lot of money the homeowner is literally giving away. To put the cost into better perspective, if a couple who own a $250,000 home were to instead take the $208 per month they were spending on PMI and invest it in a mutual fund that earned an 8% annual compounded rate of return, that money would grow to $37,707 (assuming no taxes were taken out) within 10 years.

5. **Hard To Cancel** - As mentioned above, usually when a homeowner's equity tops 20%, he or she no longer has to pay PMI. However, eliminating the monthly burden isn't as easy as just not sending in the payment. Many lenders require the homeowner to draft a letter requesting that the PMI be canceled, as well as receive a formal appraisal of the home prior to its cancellation. All in all, this could take several months depending upon the lender.

6. **Payment Goes On and On -** One final issue that deserves mentioning is that some lenders require the homeowner to maintain a PMI contract for a designated period of time. So, even if the homeowner has met the 20% threshold, he or she may still be obligated to keep paying for the mortgage insurance. Check with your lender and read the fine print of a PMI contract for more specifics.

It's Not All Bad

For many Americans PMI is deductible.Those families who itemize their deductions and earn less than $110,000 per year, will find that their PMI is deductible. For a couple with a $250,000 loan and a $2,500 annual PMI payment (1% of the outstanding loan), this deduction could translate into savings of $300 to $400 dollars or more (depending upon the couple's tax bracket).

Also private mortgage insurance often can be paid up front. For those people that don't want to work the cost of PMI into their monthly budgets, some lenders will allow for the payment to be made up front, in cash, at the time of mortgage origination. In some cases the lender will even offer the homeowner a discount for paying up front. Another option that many lenders offer is to add the one-time upfront fee to the outstanding loan balance. The advantage to this is that, amortized over a period of 25 or 30 years, the monthly cost is fairly low.

A final "benefit" of PMI is that once you have finished paying off your insurance policy, the mortgage itself may seem easier to pay down. Of course, this is more of a psychological benefit than a financial one, but it can be a nice feeling to suddenly have a couple of hundred extra dollars coming in each month. Savvy homeowners would be wise to reinvest the money they are accustomed to budgeting for PMI, or apply the funds toward the principal balance on the loan. Remember the compounding mutual fund example from earlier.

How To Avoid PMI

In some circumstances PMI can be avoided by using something called a piggy-back mortgage. It works like this: Assume that a prospective homeowner wants to purchase a house for $200,000, but he or she only has enough money saved for a 10% down payment (not enough to avoid PMI). By entering into what is known as an "80/10/10" agreement, the individual will take out a loan totaling 80% of the total value of the property, or $160,000. A second loan, referred to as a piggyback, will also be taken out totaling $20,000 (or 10% of the value). Finally, as part of the transaction, the buyer puts down the final 10%, or $20,000.

By splitting up the loans, the homeowner may be able to deduct the interest on both loans, and avoid PMI altogether. Of course, there is a catch. Very often the terms of the piggyback loan are risky. Many are adjustable-rate loans, may contain balloon provisions, and are due in 15 or 20 years (as opposed to more conventional loans which are due in 30 years). (For more on the risks of adjustable-rate mortgages, see *ARMed And Dangerous*.)

Incidentally, many lenders also offer a similar loan arrangement for buyers only able to put down 5% toward a down payment. It's called an "80/15/5" arrangement. It works exactly the same way.

The Bottom Line

Private mortgage insurance is expensive. Unless you think you'll be able to attain 20% equity in the home within a couple of years, it probably makes sense to either make a larger down payment, or consider a piggyback loan. While often more risky than a conventional mortgage, piggyback loans are deductible, and are a terrific alternative for those unable to afford a larger down payment.

For more money saving tips, see *Fifteen Insurance Policies You Don't Need*.

By **Glenn Curtis**

Glenn Curtis started his career as an equity analyst at Cantone Research, a New Jersey-based regional brokerage firm. He has since worked as an equity analyst and a financial writer at a number of print/web publications and brokerage firms including Registered Representative Magazine, Advanced Trading Magazine, Worldlyinvestor.com, RealMoney.com, TheStreet.com and Prudential Securities. Curtis has also held Series 6,7,24 and 63 securities licenses.

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