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Borrower's Essentials



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Points is Points



1. [Points is Points](#)

The best chance to waste money while getting a mortgage is to misunderstand the relationship between discount points, origination fee, and the interest rate on the loan.

2. [Real Time](#)

3. [It's the Principal of the Thing](#)

Borrowers carry the intuition that the lowest interest rate is always the best deal, and expect to pay some sort of loan fee and "point" along the way somewhere. This intuition is half right: the lowest rate is a good idea, but it's not worth paying for.

4. [Teach Your Children Well](#)

Mortgage jargon contributes to the confusion: "origination," "discount," and "point" require definition.

5. [Pre-Approval Push-Pull](#)

When a loan is created at an interest rate below the bond market's desired yield, the market value of the loan is less than its face value. Just like a bond, the loan is said to trade at a "discount."

6. [Two Time Loser](#)

If the market wants 8.00%, and you are determined to pay no more than 7.875%, you must make up the difference between the face value of the loan (100 cents on the dollar), and its market value. In the inexorable time value mathematics of the bond market, the 7.875% loan would be worth 99.50 cents on the dollar, and you would have to pay .50% in "point" to get your rate.

7. [DEE-fense! DEE-fense!](#)

8. [What It's Worth](#)

Before exploring the wisdom of paying such a fee for a lower rate, we still need to define this "origination fee" business.

In the dark ages of mortgage lending, back before 1983, origination fees were

9. [The Name Is The Game](#)

the primary compensation for mortgage people. Today, an origination fee is exactly the same thing as a discount point. (In the modern era, we get paid for creating and selling the right to service a loan: long story, separate column).
10. [Sources of Closing Funds](#)

Loan origination fees are still quoted separately from discount points out of historical habit, and perhaps the hope that borrowers will lose track of the real price. Worse, origination fees are often treated as automatic and inescapable (in the rate quotes near this column, note that origination fees are omitted altogether, thereby making the rates look lower than they really are).
11. [Score Trap](#)
12. [Teaser Turnabout is Fair Play](#)

This antique pricing system leads to the absurd mortgage patois of "pluses." Such and such a rate costs "a half plus one," while a lower rate might cost "two plus one," the first number referring to discount points, and the second to origination.
14. [Blink and Miss](#)
15. [Service? Hah!](#)

Ask your banker to quote total points. Any fee charged as a percent of the loan amount is a point, and present in the deal to buy down the interest rate.
16. [We Don't Care, Anymore](#)

Having defined terms, is paying points a good deal?

Nope.
17. [So You Want to Add On](#)

Never? Never is a long time. If you promise not to move, or refinance within six years, paying points will turn out okay.
18. [A Credit to Humanity\(?\)](#)

"Breakeven" or "recapture" math goes like this. On a \$100,000 loan, each one-eighth (.125%) in rate usually costs .50% in point (\$500). Each eighth in rate amortizes to about \$8.70 per month. If you divide the monthly benefit (\$8.70) into the cost (\$500), you get the number of months it takes to recapture the fee you paid. In this example, 57 months; but really closer to six years because you paid the fee in 1996 dollars, and 57 months hence, \$8.70 won't be worth \$8.70. If you sell or refinance in less than six years, you leave money on the table.

This inevitable point versus rate relationship is one of Wall Street's great self-fulfilling prophecies. In the 60 years since the FHA created the first 30-year loans, the average loan life has always been about six years. If the average loan lasts six years, the Street wants fee compensation for six years of deficient interest.

Always try for the lowest fee package at a given rate, clear down to "zero plus zero," if you can find it. See, in the mortgage business, the highest virtue is pointlessness.



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Real Time



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When interest rates move in the New York bond market, so do mortgage rates nationwide -- instantly. That's real time as in no down time, lag time, lead time, rag time, tea time, or tee time. Right now!

When rates rise during any business day, within minutes every mortgage lender in Boulder receives a pile of faxes with little sad faces drawn on them (which makes an already over-stressed mortgage lender turn homicidal).

Electronic money moves at the speed of light, and so does the price of money. This speed often causes confusion and bad feeling among borrowers and lenders.

Let's suppose you're looking for a house, and you have begun to shop for a mortgage. If you are a sophisticated shopper, you will soon figure out that newspaper lists of rates from different lenders are approximations at best. Most of the approximation problem comes from time lag: rates are surveyed on Wednesday and Thursday, and printed in weekend editions.

Internet postings remove the typical print media time lag, but net lenders are difficult to evaluate for quality and honesty, and rarely reflect intra-day price changes. Rates are still virtual time on the web, not real time.

Any time lag at all creates a terrible lender temptation to fib. Not misrepresent (certainly not that), but no rate is firm until locked (and sometimes not then...). "That was this morning's price; this is afternoon."

9. [The Name Is The Game](#)

If you run an ad for shoes you don't have in stock, or to sell them at an artificially low price, you go to jail. Offer a mortgage at 7.25% in a 7.50% market, and you get clients. Money is a sharp-elbowed game.

10. [Sources of Closing Funds](#)

The real estate industry is the nation's largest single business, and the mortgage business is its finance component. You would think that somebody would do a real time, honest pricing survey so that borrowers would have a reasonable benchmark for comparison shopping.

11. [Score Trap](#)

12. [Teaser Turnabout is Fair Play](#)

Nope.

The national news media rely on two survey sources for their interest rate stories: HSH Associates, Butler, NJ, and Freddie Mac (the Federal Home Loan Mortgage Corp.), Washington, DC. You will find these outfits noted as sources for nearly all newspaper charts or TV graphics.

14. [Blink and Miss](#)

15. [Service? Hah!](#)

HSH is trying hard, but suffers from a three-day, survey-to-publish lag which is never mentioned by the media running the survey as "news". Keith Gumbinger, HSH's publisher and a good guy, knows when he writes his Friday report that the bond market has made his survey obsolete, and often concludes, "We expect rates to be higher next week" when he knows they already are.

16. [We Don't Care, Anymore](#)

17. [So You Want to Add On](#)

HSH also shares a traditional problem with pricing methodology. Should a mortgage survey include an origination fee, and hence report rates on the low side? How should a surveyor account for higher rates on Jumbo loans (bigger than \$300,700), and lower rates on smaller ones? HSH's current solution is to average rates for all loan sizes. While the HSH reports are useful for week-to-week trend, its single reported "rate" has no market meaning at all.

18. [A Credit to Humanity\(?\)](#)

Freddie's Thursday news release also suffers by lagging its Monday-Tuesday survey. In addition -- worse -- Freddie's weekly "rate" is based on an antique assumption: that everybody still pays a one percent origination fee and about three-quarters of a discount point. The fee business means Freddie always announces a rate which is .25-.50% under the "zero and zero" pricing most borrowers prefer.

"Mr. Barnes, I think you're lying to me. Why, Tom Brokaw told me I could have 6.75%."

Imagine if the national media reported the Dow Jones Average three days late, and got it wrong every time.

If you are net-savvy, Countrywide.com will give you a reasonable benchmark:

they are honest, and set their prices near the lowest level at which rates can be delivered without sacrificing quality.

If you are determined to compare, pick a few well-recommended local lenders, and then call 'em all within a 15-minute span on a stable bond market afternoon. If you can find one, real time



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It's the Principal of the Thing



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In a good sign for the economy, the Baby Boom generation is gradually switching from consumption to saving. Spending begins to give way to saving in any 35-44 age group, and the average Boomer is just now turning 42. Leading edge Boomers (one is turning 50 every seven seconds) are near the panic saving stage.

However, some popular vehicles for savings are poor ideas, and a leader in the bad deal category is the 15-year mortgage. The sales pitch is often irresistible: interest savings, free and clear ownership, and equity buildup.

"Look at all the interest I can save -- that's not a 'sales pitch!'"

No, it's not; it's a half pitch. The missing half includes news that the interest savings aren't worth as much as you think, and you have to give up investment earnings worth more than the savings.

The half pitch standard example goes like this: the total interest paid over thirty years on an 8.50%, \$100,000 loan is \$176,808; on the same \$100,000 for 15 years at 8.25%, the total interest is only \$74,625.

A \$970 payment instead of \$770 -- an extra \$200 each month -- and you save a hundred grand in interest.

"What's wrong with that?"

The missing half of the pitch.

9. [The Name Is The Game](#)

If you add up all the interest paid over the life of a loan, you assume a dollar paid 30 years from now is worth the same as one paid today. Today's dollar is worth less than one fifth its value 30 years ago: under reasonable inflation assumptions, the astronomical interest "savings" in the 15-year pitch shrink by half or more.

10. [Sources of Closing Funds](#)

11. [Score Trap](#)

Worse, the half pitch treats these interest savings in isolation, as though you had no other use for two hundred bucks each month for thirty years. "Opportunity cost" analysis asks the question, "what else could I do with my money?" What would happen if I saved the extra \$200 each month, instead of sending it in to the lender? Which would bring me the greater return?

12. [Teaser Turnabout is Fair Play](#)

14. [Blink and Miss](#)

If you pay your lender back early, you save the after tax cost of the interest. Mortgage interest is deductible, and assuming a 33% total bracket (28% federal and 5% Colorado), only two-thirds of your interest payments are "real." The same is true for rate: two-thirds of 8.50% is a 5.70% after tax cost.

15. [Service? Hah!](#)

16. [We Don't Care, Anymore](#)

If your after tax savings pay more than 5.70%, feed \$200 each month into savings. If your long term savings earn less than 5.70%, don't send \$200 each month to your lender; shoot your financial planner.

17. [So You Want to Add On](#)

You can't earn 5.70% after taxes at a bank, but a conservative pool of mutual funds will earn nearly double that rate over time. You'll do 'way better with any tax-deferred account for which you are eligible: IRA, 401K, 403B, Keough, ESOP, PERA, or TIAA. There may not be a 401K in Boulder County which has failed to compound at 10% in the last couple of decades.

18. [A Credit to Humanity\(?\)](#)

"But I want to own my home free and clear!"

Not really. Houses make good investments, but modest leverage puts them in the "great" category. For example, if you own a \$100,000 house free and clear, and its value rises \$10,000, you have a 10% return on equity. If you had a \$50,000 mortgage on the same house, and the same \$10,000 appreciation, your return on equity would be 20%.

"But I don't want to have a house payment when I retire!"

Okay, if you have diligently saved and managed your \$200 each month until retirement, you'll likely have a much larger pile of a savings socked away than the mortgage balance. If you want to pay it off, go ahead. Of course, if it turns out later that you need some cash, you'll wish you had kept your own instead of having to argue with a banker to get it back.

"But the lender told me a 15-year loan would build up equity so fast."

My favorite fib. If you have \$200 in the bank, and send it in to your lender, your loan balance will fall by \$200, and so will your bank balance. Your net worth increases by... nothing. You have shuffled your balance sheet, but the hand you hold is the same.

There are borrowers who really could benefit from a 15-year loan. People who are afraid adjustment at the end. By then you will probably have refinanced anyway. The high caps allow the lender to make up for a big mistake in the first five years; in return, the lender gives you a cheaper first five than tight caps would allow.

Trade away the periodic cap for a low life cap. You can still find ARMs with a life cap in the elevens if you'll shoot craps from year to year.

It is very desirable and very expensive to buy down the margin. Margin is a big deal because it's a fixed cost in each adjustment. Breakeven for buydown tends to be three and a half years -- when it's allowed.

Keep your intentions clear about how long you will own the house, how long it may be until the next refinancing window, and what the Fed is up to. Don't ever be tempted into an ARM at a bottom in rates, or frightened away at the best time -- at a high in rates, or rising into one.



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Teach Your Children Well



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If there is one hopeful financial plan described by Baby Boomers these days, it is the uniform, unanimous thinking out loud about owning a home free and clear someday.

Everybody makes sure there is no penalty for early repayment (there hasn't been a penalty on any Federal agency loan since 1983), most inquire about 15-year loans, and many want us to run some amortization math: "If I send in an extra thirty-two dollars a year, how much sooner will my loan be paid off?"

There is a certain allure to the thought of no house payment, but not enough to explain the blind allocation of resources to mortgage repayment.

Alternatives fill a spectrum all the way from blowing the cash in favor of a higher immediate standard of living to saving the money instead of sending it in to the lender. Saving the money is not only better finance for several investment and tax reasons, but also safer than free and clear ownership. Disbelievers, read on.

The free and clear instinct had a sound financial basis 60 years ago, but modern finance long since made the drive obsolete. I believe the rigid, free and clear reflex persists because it has been taught generation unto generation, but the reason for the teaching long gone and forgotten.

The parents of the average Baby Boomer were young teenagers during the heart of the Great Depression. Their parents, the Boomers' grandparents, were trying to hold on to houses and farms at the time, and losing more often than

9. [The Name Is The Game](#)

keeping.

10. [Sources of Closing Funds](#)

Prior to 1935, borrowers were wise to fear their mortgages, and their bankers. Then, mortgages were short term, one to three year rolling, renewable "balloon" notes. Long term loans were unknown. "Renewable" meant you had to go back to the banker and reapply.

11. [Score Trap](#)

If in the time since the original loan was made your financial condition had deteriorated, or the value of your home had fallen, the banker would refuse to renew, and take your keys in lieu of payment.

12. [Teaser Turnabout is Fair Play](#)

Mortgage lending on these terms was one of the main things that made the Great Depression great. As more people lost jobs, and could not re-qualify, more loans were called. As more properties were seized and liquidated, values fell, and more loans were called -- even those made to people who still had jobs and could make payments. Banks obeyed their orders in a regulation-driven suicide pact, and loans cascaded into foreclosure.

14. [Blink and Miss](#)

15. [Service? Hah!](#)

This snowballing disaster caused the grandparent of the Baby Boomer to tell the parent, who told the Boomer: "Mortgages are dangerous. Own that house free and clear!"

16. [We Don't Care, Anymore](#)

17. [So You Want to Add On](#)

However, this thinking became obsolete before the Depression was over. One of FDR's most important "alphabet agencies" was the FHA, which introduced the first 30-year, fixed rate mortgages in a successful effort to stop the waves of foreclosures and bank failures.

18. [A Credit to Humanity\(?\)](#)

If you get a thirty-year loan, nobody can foreclose on you just because the value of the house falls during a tough couple of years. Nor will you have to re-qualify every year or three. If you lose your job, and have enough savings to make the payments until you get a new job, it hurts, but nobody can take the house. You can play defense by renting out rooms (as one of my grandmothers did to survive the 1930's), or putting that lazy husband to work.

If something goes wrong in your financial life, and you don't have savings, then you are in trouble.

Let's say you have diligently prepaid your mortgage for ten years, and fifty percent of the home's value is equity. You have some savings, but they are locked up in a "can't touch" retirement account.

Then your employer goes on a restructuring binge, and you and your salary are structured out. No banker will loan you a dime against your carefully hoarded equity. (Did you know that your "equity line of credit" is annually cancelable if

your income falls apart?) Maybe you could sell a car to buy yourself another few months' time before foreclosure.

In the modern era, one of the few goodig adjustment at the end. Bythen you will probably have refinanced anyway. The high caps allow the lender to make up for a big mistake inthe first five years; in return, the lender gives you a cheaper first five than tight caps would allow.

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Pre-Approval Push-Pull



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Many buyers entering the home-shopping market are surprised when their Realtor tells them they have to go get a "pre-approval letter" from a mortgage lender.

There are a few markets left in the U.S. where the seller is delighted to hear from a buyer, any buyer, even a poorly-qualified one (Buffalo, NY, I've heard); but most places, sellers are drunk with power, and demand a financial undressing by any buyer intending to make an offer.

Naturally, most buyers would rather undress in private, in a mortgage lender's office, and have the banker describe the scene in professional language, omitting unsightly but irrelevant details.

A pre-approval letter is supposed to tell the seller that the buyer can do what the buyer intends to do. That is, the buyer is all-but-guaranteed to be approved for the loan described in the contract. Pre-approval letters can be anything from a single sentence to pages of lender CYA. Simplicity ends right there.

From a simple beginning, efforts to procure and present pre-qualification letters often deteriorate into ambiguity, invasion of privacy, and bad feeling between the parties of a real estate transaction.

Most people seem to understand that a pre-approval letter is not a formal approval, or commitment to lend. However, Realtors and sellers who have been burned in dealings with pre-approved but ultimately un-closeable buyers want to

9. [The Name Is The Game](#)

push the limits of the process.

10. [Sources of Closing Funds](#)

The first push to the limit involves credit. Many Realtors and sellers want to know that a credit check has been run on the buyer, and often demand to know the details. However, it is a Federal crime to disclose credit information to anyone. In the new era of credit scores (the semi-notorious "FICOs"), we can use an adjective, like "high", but seller desires for more intimate information should remain frustrated.

11. [Score Trap](#)

12. [Teaser Turnabout is Fair Play](#)

Law aside, the more pedestrian problem with the demand for a credit check is that initial, "in file" reports (of the kind used to make car loans) are notoriously inaccurate. These reports too often omit some crash landing not held in electronic record, and found in a courthouse somewhere after a ten-day search.

14. [Blink and Miss](#)

Late-appearing crash landings can include foreclosures, bankruptcies, old divorces commanding payments to exes, and a long list of horrors with the IRS and State departments of revenue.

15. [Service? Hah!](#)

16. [We Don't Care, Anymore](#)

Other agents and sellers roasted in the past want a disclosure of the rest of the buyer's financial life: salary, work history, savings, debt, marital status, and so on. This information is protected by law, also, and disclosure without permission is verboten.

17. [So You Want to Add On](#)

The modern era of underwriting by computer is a help here, as well: lenders now can achieve a fairly reliable approval at either Fannie's or Freddie's website, formal documentation and property to be attached later.

18. [A Credit to Humanity\(?\)](#)

The greatest vulnerability to the buyer happens after all the credit, asset, and employment history has been established: what will the pre-approval letter say?

Many lenders try to help the buyer's offer gain acceptance by indicating great financial strength, but that effort can encourage a seller to insist on a high price. If you have just disclosed excess purchasing power, your agent can hardly insist that "this is as high as they can go."

So, many experienced Realtors ask the lender to write a pre-approval corresponding to a specific price, trying to head off a higher counter-proposal from the seller. However, on a typical home-search weekend in a hot market, the last thing Realtor and buyer want is to be confined by a too-low price in a pre-approval letter.

Some Realtors ask for a sheaf of pre-approval letters at ascending prices, to cover any eventuality. Even this tactic can run aground in an exchange of offer, counter, and re-counter. I have heard this exasperated listing agent voice on the phone: "Your first letter, this morning, said \$210,000; this afternoon it's

\$215,000.... Lou, which is it?"

It is risky for a lender to use the following approach, but the more you know what you're doing, the less the risk: in a short letter, state any material or unusual contingency (home sale, availability of divorce proceeds), and then state that the buyer is approved at any price he or she or they may offer to pay, followed by a commitment to confirm to listing agents or sellers that the buyer can indeed perform at such a price immediately after such a price has actually been offered.

This approach means that the seller has no idea what the ultimate purchasing power of the buyer may be, and the buyer may operate without the confinement of specific "pre-approved" terms.

As a practical matter, if the banker can't be found for confirmation at 9:00PM on a weekend, most sellers will wait until Monday. Most listing agents in a given sub-market know the selling Realtor and the banker, and know they would not submit an "any price" pre-approval unless they both trusted the buyer's judgment and self-control; and despite the seller's need for some pre-approval reassurance, most know intuitively that few buyers sign contracts at prices they can't afford to pay.

And that's perhaps the best element in the "any price" pre-approval letter: it injects trust in a usually adversary proceeding.



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Two Time Loser



1. [Points is Points](#)
2. [Real Time](#)
3. [It's the Principal of the Thing](#)
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6. **Two Time Loser**
7. [DEE-fense! DEE-fense!](#)
8. [What It's Worth](#)

In the last year, just about every homeowner in America with a long-term mortgage has received a solicitation offering to collect the mortgage payments in twenty-six bi-weekly installments instead of twelve monthly ones.

The pitch: the conversion to bi-weekly will help you to pay off your loan several years earlier than scheduled, save tens of thousands of dollars in interest, and the new payment program will cost only a small set-up fee and service charge.

It's a great country, isn't it?

There are two separate issues in these solicitations. Do these bi-weekly systems perform as the solicitations say, at reasonable cost? And second, is faster payoff a good idea, or just a feel-good idea?

As to the first issue, the math is correct. Twenty-six one-half payments are the same as thirteen whole ones, which means that any switch to bi-weekly payments will result in an extra annual principal payment equal to a regular monthly payment. If you send in that amount of extra principal each year -- whether bi-weekly, semi-annually, annually, thrice monthly, or in 52 increments on Tuesdays -- you will shorten a 30-year loan by seven years or so (the exact number of years varies with how soon after closing you begin to make the extra payments).

The fee structure?

North American Mortgage Company, a large servicer of mortgages (remember:

9. [The Name Is The Game](#)

the people to whom you send your payment do not own your loan, nor are they a "lender"; they are all contract servicers, mere conduits for your payments) charges a one-time fee of \$379 for its "Bi-Saver", and another \$1.00 per payment. Washington Mutual Bank (actually a Savings & Loan which has fallen in with bad company) wants \$320 to start its "Equity Accelerator" and \$2.50 per payment. Chase, Norwest, Bank of America... all the big loan servicers are selling the same basic deal.

10. [Sources of Closing Funds](#)

11. [Score Trap](#)

The reasonableness of the fee versus the service?

12. [Teaser Turnabout is Fair Play](#)

P.T. Barnum would be pleased. A new fool may not be born every minute, but they are not in short supply. And, it's nice to know that so many have found work -- though personally embarrassing, as so many seem to have gravitated to the banking business.

14. [Blink and Miss](#)

15. [Service? Hah!](#)

For the fee you get the extra payments yanked electronically from your bank, and nothing else. The servicers don't even bother to credit your account at mid-month, so you are still paying interest for an extra two weeks on each extra payment. The servicer no longer has to open envelopes containing your messy, hard-to-read, expensive-to-process, and possibly rubber checks.

16. [We Don't Care, Anymore](#)

17. [So You Want to Add On](#)

I don't know why servicers think enough people will sign up for these deals to recoup the postage for the mailings. Two possible motivations come to mind. First: one marketing theory holds that consumers think free services have no value; therefore charge a few hundred bucks and people will think the bi-weekly service is worth something.

18. [A Credit to Humanity\(?\)](#)

A second marketing theory: when selling a scam, always try to get your hands around the victim's emotional throat, or appeal to greed, or both. In this case, feed the desire to own a home free and clear, painlessly.

"Ladies and Gentlemen, hurry along, right over here... this way to the Egress!"

The fees in these bi-weekly deals are bad enough, but the deep scam -- where consumers lose the really big money

-- is in the prepayment of principal. Any form of prepayment: fifteen year loan, Christmas bonus shipped in lump sum, two, three, four extra monthly payments - all are bad deals.

Space doesn't allow for the mathematics of the argument (though you can find the whole story at www.boulderwest.com, "Essentials" numbers 3 & 4).

However, the basic idea: almost any form of savings wisely invested will earn more than the mortgage interest saved by prepayment. Don't send in spare cash

to the lender, invest it. Start with the tax-advantaged stuff (IRA, 401K, 403B, PERA, TIAA, Keogh...), then hello, Vanguard!

Free and clear ownership may make sense when you buy the last house, all on one level, when the kids are gone, and your income and tax bracket are way down. But in the meantime, cash paid to "build equity", doesn't change your net worth -- your wealth -- by ten cents. It just turns a flexible, investable financial asset into rigid, can't-get-it-when-you-need-it home equity; and turns the house into an under-leveraged and under-performing real estate investment.

There are only two kinds of mortgage borrowers who should commit to programmatic prepayment. Those who are too nervous about investment to buy anything riskier (and higher yielding) than a CD or T-bill, and those who would blow the extra cash instead of saving it.

But, even for these groups, why pay somebody to help you send in more money?



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DEE-fense! DEE-fense!



1. [Points is Points](#)
Whenever mortgage rates rise quickly, most borrowers are tempted by adjustable rate loans and their lower starting rates.
2. [Real Time](#)
The strategy has merit, but often not as much as asserted by some mortgage salespeople. Herewith a guide to terms and tactics, and a simple equation to help you decide if an ARM is an appropriate defensive tool in your particular situation.
3. [It's the Principal of the Thing](#)
The first adjustable mortgages were invented in 1980. In the first dozen years, the one-year ARM was predominant, carrying a starting "teaser" rate typically two percent or more below current fixed rates. Borrowers gradually learned to take advantage of a weakness in the product- if I can save two percent in the first year, why not refinance every year?
4. [Teach Your Children Well](#)
Borrowers should take advantage of lenders whenever they can, of course, but lenders countered, demanding prepayment penalties or mandatory origination fees, and the one-year ARM has fallen into disuse.
5. [Pre-Approval Push-Pull](#)
Enter the "hybrid" ARM. Hybrids are fixed for an initial multi-year period, and then convert automatically to one-year adjustables. (Note- hybrids should not be confused with the dangerous five- and seven-year balloon loans, known as "5/25s and 7/23s".)
6. [Two Time Loser](#)
7. **DEE-fense! DEE-fense!**
8. [What It's Worth](#)

In mortgage slang, hybrid ARMs are identified as "three-ones, five-ones, seven-ones, and ten-ones." The first number refers to the length of the fixed interval, which is priced with a modest teaser rate below fixed rates available at the same

9. [The Name Is The Game](#)

time; and the "one" refers to the conversion to one-year ARM status.

10. [Sources of Closing Funds](#)

The initial hybrid rate advantage over fixed loans -- the spread -- changes every day with changing short- versus long-term spreads in the credit markets. The wider the fixed-to-hybrid spread, the more useful the hybrid.

11. [Score Trap](#)

There are four distinct circumstances where borrowers should consider a hybrid.

12. [Teaser Turnabout is Fair Play](#)

First, when you're sure you won't own a home longer than the fixed interval in one of the hybrids, the planned sale will protect you from the risk of upward adjustment.

14. [Blink and Miss](#)

In this case, when choosing the length of the fixed interval, remind yourself that not all housing markets are as hot as this one has been, and it can take a year or more to get your price. Many a family has acquired an unintended rental property when transferred, and it's embarrassing to have the mortgage rate adjust upward in such a predicament. Note also the correlation between rising interest rates and lousy markets for homes.

15. [Service? Hah!](#)

16. [We Don't Care, Anymore](#)

The second opportunity for a hybrid is when the fixed-to-hybrid spread is very wide -- for any reason. Overall interest rates were dead low in 1993, but hybrid spreads gaped canyon-wide, as much as two whole percent.

17. [So You Want to Add On](#)

The third useful spot is for big loans. Higher, "jumbo" costs kick in at \$240,000 for today's fixed-rate loans, but not until \$350,000 for hybrids.

18. [A Credit to Humanity\(?\)](#)

Fourth, on every borrower's mind in 1999, is defensive use of hybrids to avoid a sudden spike in fixed rates.

There are days when I think more consumers are losing money while playing defense than are saving any. The shock from a rapid rise can cloud the mind, and encourage a borrower to take a hybrid beginning with seven-something because eight-something fixed is too painful to contemplate, no matter what the real economics of the deal may be.

For open-ended ownership of a home, defensive use of an ARM by definition requires a refinance when rates come back down. If not refinanced, the ARM presents more risk than the rate spike in the first place. Unlike normal, optional, fixed-to-fixed refinances, the required refinance from the defensive hybrid may not save any money at all.

Example- if I took a 7.50% five-one today instead of an 8.00% fixed, I should surely refinance to a fixed any time rates again fell near 7.00% -- the long-term low, aside from that V-shaped bit last fall. This refinance, a rate improvement of

.50% or less, would not be economical in itself, as it would take several years to recapture costs.

Since the costs of the ultimate hybrid-to-fixed refinance are not self-supporting adjustment at the end. By then you will probably have refinanced anyway. The high caps allow the lender to make up for a big mistake in the first five years; in return, the lender gives you a cheaper first five than tight caps would allow.

Trade away the periodic cap for a low life cap. You can still find ARMs with a life cap in the elevens if you'll shoot craps from year to year.

It is very desirable and very expensive to buy down the margin. Margin is a big deal because it's a fixed cost in each adjustment. Breakeven for buydown tends to be three and a half years -- when it's allowed.

Keep your intentions clear about how long you will own the house, how long it may be until the next refinancing window, and what the Fed is up to. Don't ever be tempted into an ARM at a bottom in rates, or frightened away at the best time -- at a high in rates, or rising into one.



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What It's Worth



1. [Points is Points](#)
A given piece of real estate has a different worth to different people at different times.
2. [Real Time](#)
One of those times is when you are trying to buy a house, and one of those people is the loan underwriter.
3. [It's the Principal of the Thing](#)
Real property is tough to value because all parcels are unique. By definition, all real estate is. What appraisers are really doing is separating a spot on the planet, and no two parcels can have the same legal description. You can't look up the value of a lot like a share of IBM, all of which are exactly the same.
4. [Teach Your Children Well](#)
Another unique aspect of real estate is its immobility. Unlike art, or gold, or bonds, you cannot move a piece of real property to a healthier market to get a better price.
5. [Pre-Approval Push-Pull](#)
Real estate value changes with the interests of the beholder. Future development value of land can be rather more in cash than an existing prairie or alfalfa patch. Liquidation value is lower than long term value (What can I get for this place if I have a year to sell it? Six months? A week? An hour?). A seven bedroom house has more value to a family with six kids than to a retired couple.
6. [Two Time Loser](#)
7. [DEE-fense! DEE-fense!](#)
8. **What It's Worth**
Lenders have their own green eyeshade view of value. Though I would not dream of justifying the pessimistic foolishness often applied to people trying to buy homes in Boulder County, some explanation may help.

Lenders think collateral- if I have to foreclose, will I get my money back?

9. [The Name Is The Game](#)

That's all. No other agenda. But the number of different ways to torture buyers is matched only by the variation in the character of property.

10. [Sources of Closing Funds](#)

In Boulder County, the leading arguments involve in town versus in the country, and land parcel size versus house size.

11. [Score Trap](#)

Properties in towns have the easiest time. There are lots of similar houses in towns, and lots of buyers. Similarity means more accurate analysis, more buyers means a faster post-foreclosure sale.

12. [Teaser Turnabout is Fair Play](#)

Mountain properties get the worst treatment. The houses are heterogeneous, and the supply of buyers much smaller. Does that mean they are "worth" less?

14. [Blink and Miss](#)

No way- sellers demand good prices, and buyers will pay them, but some lenders will not loan at all in the mountains for fear it will take too long to get the money back if they have to foreclose.

15. [Service? Hah!](#)

It is large parcels near town where reasonable underwriting judgment turns to lunacy. "We're only going to loan 70% of that sales price because the lot's too big."

16. [We Don't Care, Anymore](#)

17. [So You Want to Add On](#)

Say again? This 30-acre site is risky to loan on? The wife and I have been looking for a big lot for ten years, and you are telling us it's not worth what we're paying? Do these idiots know about growth control? Don't they know there are only 14 sites like this on the whole of Davidson Mesa?

18. [A Credit to Humanity\(?\)](#)

Conversations like this make local lenders wish they did something else for a living.

The worst part of the collateral exercise is that the buyer and seller are not out of the woods when the appraisal is done. Low appraisals are relatively rare. The moment of truth is at the very end when the underwriter decides whether or not she "likes" the appraisal.

Heard all over the county these days are the following- "I need another log home comparable on more than 20 acres." "I don't think the hot tub really adds \$5,000 in value; cut the loan amount." "Can't get mortgage insurance if it's more than ten acres." "You have to use two bedroom comparables; that basement room isn't a bedroom because the window is too far up from the floor. Besides, there's no closet."

"If it has two kitchens it's an illegal duplex; take one out." "I won't loan on the landscaping; half my equity disappears if they don't water the lawn."

And, in numbers increasing every day, "We're nervous because your market is

so hot."

Wait. I thought you wanted to be sure the place would re-sell if you had to foreclose. We needed guard dogs to keep the buyers under control the day this place went on the market. Doesn't your underwriter know we had six offers over list price, and two backups?

The last two markets to be as hot as Boulder County is now were Texas and New England, where lenders lost a buck or two. While pointing at those two examples, every underwriter in the country is told "don't loan at the top."

That Boulder is nowhere near its price top doesn't guarantee a happy underwriter.



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The Name Is The Game



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8. [What It's Worth](#)

The operations of the financial world change over time along with everything else, but many labels for financial practices are "sticky" -- still in use, but with long-lost descriptive relevance.

Mortgage lending, tied inextricably to real estate and Middle English (deed, fee simple, encroachment, foreclose), is especially vulnerable to obsolete terminology. Dated terms are confusing to consumers, and handy tools for marketers seeking not-so-fair advantage.

In the mortgage world the most misleading single term is the oldest: "lender". Today, that antique usage is about as relevant to mortgage consumers as "slide rule" is to senior high school math students.

A mortgage lender is an institution which loans money in exchange for a promise of re-payment, the promise secured by a claim on real estate. A true lender sets the terms of its loan, retains the promissory note until paid, and then releases its claim on the real estate.

In the case of large "first" mortgages, there may be fewer true lenders of mortgage money today than slide rules still in use.

The last of the old mortgage lenders were the Savings and Loan Associations, which could not survive in the modern world of de-regulated interest rates, and disappeared (painfully) fifteen years ago. No modern financial institution can afford the risk of holding long term mortgage notes in its vault; effectively all

9. **The Name Is The Game**

mortgages are instantly re-sold in the general direction of the global financial markets.

10. [Sources of Closing Funds](#)

When a consumer "locks in" the rate on a mortgage loan a month before closing, that loan is committed for inclusion in a mortgage-backed security which in turn is committed for sale to a Wall Street firm at a price established upon lock-in, and to be assembled and delivered a few weeks after closing. No institution in that chain is a lender interested in holding the promissory note any longer than a few days.

12. [Teaser Turnabout is Fair Play](#)

The terms of modern mortgage loans -- underwriting requirements, payment structure, and approximate interest rates -- are determined by the eligibility requirements and hour-by-hour market values of mortgage-backed securities.

14. [Blink and Miss](#)

The only substantial exceptions in the mortgage world: second mortgages and lines of credit, which are the shorter term, higher risk, higher rate loans granted by banks and credit unions in traditional real estate lending behavior, and a few kinds of adjustable-rate first mortgage loans.

15. [Service? Hah!](#)

16. [We Don't Care, Anymore](#)

Yet today, many mortgage market analysts and market surveyors persist in the notion of the old-style lender, aided by advertisers. HSH Associates claims to survey "2,000 lenders" each week, while E-loan purports to offer loans from "Over seventy lenders." Many commentators advise consumers to pick mortgage lenders over "brokers", though the distinction is meaningless. And, heaven knows, many sources of mortgage credit try to sell consumers on the advantage of their particular institutional setup, or size, large or small.

17. [So You Want to Add On](#)

18. [A Credit to Humanity\(?\)](#)

We need some new terms... good, basic terms which are consistent with the rest of the world of commerce.

The place you go to get your mortgage, whether self-described bank, mortgage bank, broker, or website is a "retailer," pure and simple.

The bundler of mortgages into large blocks headed toward global financial markets, the securitizer, is a separate operator whether contained in the same corporation as the retailer or independent, and should be called the "wholesaler".

While awkward, the industry term "servicer" accurately describes the outfit to which we send our monthly payments post-closing. The servicer may be a part of the same corporation as the retailer or wholesaler, but it is not a lender and does not own the loan: it is a contractor-for-fee forwarding the monthly payment to the holder of the mortgage-backed security.

Retail is retail: you can no more get a better price for a pair of Nikes by contacting Nike wholesale headquarters in Washington than you can get a better mortgage deal from Chase Correspondent Lending in Florida. They may answer the phone, but they won't give you a wholesale price.

It is commonplace for a small, independent mortgage retailer selling loans through a wholesaler to deliver better prices and services than the wholesaler's own retail arm in the same town.

Loans from websites are cheap right now (though not arranged and closed with great skill), but those cheap prices are "loss-leaders" -- market-building concessions -- not some electronic breakthrough. E-loan's back office looks like the typical one at a "brick" retailer, and costs as much.

Most consumers begin to get the correct idea after making a dozen phone calls and visiting a few websites, but ancient terminology, bad advice, and slippery marketing conspire to make consumer shopping much harder than it needs to be.

While mortgage products are uniform, the prices do vary from retailer to retailer, and there is great value to consumers in shopping among different levels of retailer skill, reliability, knowledge, and communication.

The particular corporate shell surrounding the mortgage retailer isn't worth a nickel.



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Sources of Closing Funds



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8. [What It's Worth](#)

The following advice prevents horror stories.

One requirement for mortgage approval demands more precision than any other, and is also more surprising to borrowers than any other-

WE MUST PROVE WHERE YOUR CLOSING MONEY HAS BEEN IN THE LAST 90 DAYS, AND TRACK IT ALL THE WAY TO THE CLOSING TABLE. Any large deposit, transfer, or new account opened in the 90 days before loan application will be challenged.

The purpose of this strange and insulting exercise is to demonstrate that you have not secretly borrowed your down payment -- an incredible proposition to most borrowers, but all too common. The only way to prove that your money is really your money (!) is to prove that it has been in your accounts for 90 days.

GIFTS-

Gifts from family (only) are allowed (some wrinkles- check with us). All lenders require an original gift letter signed by the donor stating (1) the donor's relationship to the recipient, (2) the amount, (3) that it is an irrevocable gift, and (4) the donor's address.

"As your Dad, I'm delighted to give you \$13,000 to help you buy a house, and you don't need to pay the money back." That one sentence, plus an address, is an acceptable gift letter because it includes all four components (we also have form letters).

9. [The Name Is The Game](#)

Necessary documents for gifts-

10. Sources of Closing Funds

1. The ORIGINAL gift letter, and
2. The money (this is the crazy part....)

11. [Score Trap](#)

-- NEVER (please) use a PERSONAL CHECK to move gift money. If you do, we must find the canceled check at the donor's bank, and your closing may be delayed for several years. (Exception- FHA and VA, where they are always OK.)

12. [Teaser Turnabout is Fair Play](#)

-- DO ask the donor for a certified check made payable to the title insurance company handling the closing, or to you. DON'T DEPOSIT the check! Send us a copy, and just bring the check to the closing.

14. [Blink and Miss](#)

-- OR (inferior, but workable) wire the gift funds to your bank or to the title company, and send us copies of both the sending and receiving wire receipts. We will spend any amount of time necessary on the frontend to rehearse a gift plan with you and your donor.

15. [Service? Hah!](#)

16. [We Don't Care, Anymore](#)

CONSOLIDATING OR TRANSFERRING MONEY, OR LIQUIDATING INVESTMENTS, OR BORROWING YOUR DOWN PAYMENT-

17. [So You Want to Add On](#)

In the ninety days prior to buying a house, try not to transfer money from institution-to-institution (internal transfers, say savings-to-checking are rarely a problem). If you have done so before being warned, please begin to assemble a paper trail to recreate the transfers.

18. [A Credit to Humanity\(?\)](#)

In that same 90-day interval, save all bank, mutual fund, brokerage (whatever) statements (all pages) for accounts which will be used for down payment and closing funds. While not always true, you should assume all lenders will require three monthly or two quarterly statements for all such accounts.

Once you are under contract to buy (preferably before), we will spend any amount of time with you to develop a plan to get your closing funds to the closing table. This money must be presented at closing by certified (also "guaranteed" and "cashier's") check, or sent by wire.

Liquidation of stocks, bonds, mutual funds, or money market accounts, or bank-to-bank transfers are opportunities for disaster. We must have (1) evidence of sale of the asset (a trade confirmation), and (2) proof of funds transfer.

Other than for earnest money, DON'T MOVE MONEY WITH PERSONAL OR MONEY MARKET CHECKS (please). If you do, we have to have a copy of the canceled check, and finding it may delay your closing for several years.

Instead, while collecting closing funds at a bank or credit union-

-- Ask your broker/mutual fund to send you THEIR check, and give us a copy of the check and your deposit receipt. These firms will NOT issue certified checks acceptable at closing.

-- Or, wire funds to your bank, or directly to the title company, and give us copies of the sending AND receiving wire receipts

As you may have guessed, it's a good idea to accomplish these transfers a couple of weeks before closing. If you intend to sell any physical property to raise closing funds (cars, jewelry, art, gold coins, boats...), it can work, but check with us early in the process.

Inheritances- if you are named in the will, the money is your money. However, if the inheritance came to you through a named parent or relative, it's a gift requiring the gift paper trail on page one.

Disbursements or bonuses from a company you own are rarely acceptable unless they show on a prior year tax return. Lenders' fear of concern here- worry that a borrower will strip too much working capital from a firm.

Joint accounts with people not a party to your loan will require acknowledgment from the joint account holder that the money is really your money. If the joint partner is not family, we'll need a good explanation of the arrangement signed by you and the joint holder. "Cash," in the sense of folding greenbacks, will not be approved by any lender for closing use, if for no other reason than no title company will accept cash at closing. Cash should be deposited in a bank at least 90 days before signing a purchase contract.

If you intend to BORROW to raise a portion of down payment or closing funds-

1. Unsecured loans -- personal, credit card advance, line of credit, even from family -- are not acceptable. 2. The following secured loans are acceptable, but you must qualify for the monthly payment in your underwriting ratios (we, know, we know... even though it's your money)-

--Bridge loans secured by other real estate.

--Loans from financial institutions secured by an asset with a demonstrated value and title (car, boat...).

--401k or other loans secured by retirement accounts.

--Insurance policy loans.

--Family or other private party (seller?) second mortgages, if documented by note and deed of trust, and not in excess of loan-to-value guideline (usually total loans cannot exceed 90% of purchase price).

3. These loans are acceptable, and do NOT count in ratios (Please do not ask why. We don't know.)-

--Margin loans.

4. Loans to you from a business you own ought to work, but don't.

5. "Equity advances" from corporate buyouts are very tricky. Okay if the relo company takes responsibility for the house; troublesome if the advance looks like a loan you might have to pay back if the house doesn't sell.

IN ALL CASES OF BORROWED CLOSING FUNDS, WE MUST HAVE A COPY OF THE NOTES SHOWING REPAYMENT TERMS, AND A FUNDS TRANSFER PAPER TRAIL (as above).



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Score Trap



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Many consumers have learned that their credit records have been reduced to three-digit scores, and that these scores now determine the fate of most loan applications. The higher the score assigned to you by each of the three, giant repositories of credit information (Transunion, Experian, and Equifax), the loCredit scores, and how to manage your credit reportwer your presumed risk of default.

These scores, known as "FICOs" (after Fair Issac, Co., which invented the scoring software), are well-intended efforts to simplify the old-style black art practiced by loan underwriters: reading each line in an entire, ten-year credit history, and then making a subjective go, no-go decision.

Like so many computerized developments in our bright, shiny New Economy, this credit-scoring development is still developing. The current situation described below is frustrating and a little frightening, but is a rapidly evolving -- and hopefully passing -- horror story. There may be substantial improvements as early as year-end.

Here's the story. If you have a high set of credit scores, terrific; you're home free. If you have low scores, at best you and your lender will have to operate within the confines of the old debt-to-income ratio straightjacket, and at worst... no loan. (High is 720 or more; good is 720-680, okay-you'll-get-your-loan is 680-620, a strong maybe from 620-580, and under 580... stay on good terms with your landlord.)

9. [The Name Is The Game](#)

At really worst -- the scary part -- even if your low scores are based on errors in your credit report, you still won't get your loan.

10. [Sources of Closing Funds](#)

When your mortgage lender runs your report, it hires a local credit bureau to contact all three of the repositories. In the old days, like 1999, if the report showed an erroneous entry, and you could prove to the local bureau that the entry was a mistake, the local bureau would delete the error on its report, and your loan would be underwritten without damage from the error.

11. **Score Trap**

12. [Teaser Turnabout is Fair Play](#)

Meanwhile, in the old days and in the new ones, the error lives on forever at the repositories.

14. [Blink and Miss](#)

Enter credit scores. Your credit is scored at the repository level, not at the local bureau; and you'll be underwritten based on scores, not a local-bureau report with errors cleaned.

15. [Service? Hah!](#)

How might one go about correcting repository error, and changing one's scores?

16. [We Don't Care, Anymore](#)

One would tear one's hair out trying.

17. [So You Want to Add On](#)

The first method, "quick-scoring", is brand new in 2000 and is being tested by consumer trial-and-error right now. You present unambiguous evidence of error - a confession by the creditor filing the erroneous report -- pay thirty bucks to the local bureau, and they will get you re-scored within three days, and within thirty days remove all trace of the error from all three repositories.

18. [A Credit to Humanity\(?\)](#)

Pretty good, actually. Though, by the time you collect the unimpeachable evidence and get re-scored, the house you wanted is long gone. And, only two of the repositories allow quick-scoring, though surely Equifax will be forced to behave soon.

The quick-scorer's clean-up at the repository level may be the best benefit of the new approach. Stories told by hundreds of clients lead me to believe that direct consumer correspondence with the repositories is a waste of time: they don't have to respond in accordance with existing statute until (1) you have ordered a consumer report directly from them and (2) sent certified mail. It takes time for the additional report, and the published addresses for the repositories are post office boxes which won't accept certified mail. I believe these POBs are connected directly to chutes leading to local landfills.

It is productive to have a creditor confess its error directly to the repositories, which clearly open and respond to mail from creditors. However, even a creditor confession can take a month to clear an error -- bye-bye new house. (Nightmare

scenario: the original creditor is out of business, but before it went banko, it sold an imaginary defaulted account under your social security number to a collection agent which will try to collect until doomsday. No original creditor to confess... a permanent error.)

How much will your scores improve after an error is removed, whether by quick-score or confession?

We don't know. The scoring formulae are secret. However, if you have only one or two isolated errors in an otherwise clean report, they should not peril a home purchase, even if uncorrected. If you have lots of authentic derogatory entries, removing a stray error won't help your scores. If the error is a collection account showing as unpaid which was paid... correcting that "error" won't help at all -- a collection is a collection, paid or not.

The correction that helps, and sometimes a lot, is correcting a recent error: the more recent a derogatory report, the more damage it does to your scores.

Given the irresponsible behavior by the repositories, prudent, continuous monitoring of one's own credit record is impossible. Consumers can find their FICO scores only by asking a lender to run a report -- though I can't imagine Congress will allow the repositories to maintain secrecy much longer. The only reason the repositories won't disclose scores to consumers now is to prevent calls from all of us

-- trying find out who screwed up our credit scores.

One action item (besides writing to your Congressperson): at the slightest sign of a creditor confused about a payment, let alone a threat to make a negative report or to refer your account to a collection agency -- REACT!

Don't hang up on 'em, don't throw the letter away, don't let an error or an argument make it to your electronic record. Once embedded there... it's too late.

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Teaser Turnabout is Fair Play



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The unnecessary pain inflicted by computers is not the fault of the machines, but rather that of the eagerwireheads who think computers are so neat that they should be used for everything. Enthusiastic nerds havestruck again, and may the gods of silicon save your credit report.

Credit information has been "computerized" ever since the punch card and vacuum tube, and saving and sortingmasses of data are ideal computer applications. However, near-infinite storage capacity has enlarged theopportunity for electronic black magic- the imaginary entry, and the intractable error.

Problems with cybercredit fall into two categories- old ones, and a brand new one known as "credit scoring."

When you apply for a mortgage, your lender must hire a local credit bureau to interpret the electronic entrailsspread under your social security number at all three giant databases- Equifax, TRW, and TransUnion. A weekinto your application, the local bureau calls- "We show a 90-day late payment on your ChargeMax, and you willhave to explain it to your lender."

Several thoughts come to your mind. I've never had an account with ChargeMax. For that matter, who the hell isChargeMax? How do I explain a late payment on an account I've never had? I checked my TRW, and it wasclean. How did it get on my record? How do I get it off?

9. [The Name Is The Game](#)

Here is some blanket advice for dealing with mortgage lenders on credit issues. (You won't like it, but don't argue. Wrestling in the internet just makes it worse.)

10. [Sources of Closing Funds](#)

Your credit history is not real, it is virtual- it is whatever the electrons happen to say at any given moment. Deal with it as it appears, not how it may "really" be.

11. [Score Trap](#)

If the local bureau can't quickly remove an obvious

12. **Teaser Turnabout is Fair Play**

error, write an "explanation" to your lender. "I was out of town/married/car accident/surgery/forgot" are all acceptable. Workable, but risky- "This is a mistake, and you are all a pack of fools!"

14. [Blink and Miss](#)

Don't bother to try to remove ChargeMax from your record. If the loan closes, you've won. Don't let pride interfere with good sense- you can correspond with the big bureaus until doomsday as they happily cross-report the error (and new ones) back and forth to each other.

15. [Service? Hah!](#)

Don't bother to "check your TRW." If you want to check your history, order a full, three-bureau report including their versions of public records under your name (IRS horrors, remnants of a divorce, mis-identified lien...).

16. [We Don't Care, Anymore](#)

Don't be misled by the easy time you had last month with Toyota Credit, or getting a new Visa. Houses are harder to repossess than cars.

17. [So You Want to Add On](#)

Those were the old problems. The new one, "credit scoring," is an attempt to reduce your entire credit history to a three-digit number. Higher than 670, you're in; lower, and you're out. The model for computing the score, charitably, has a way to go in development.

18. [A Credit to Humanity\(?\)](#)

Example- you get a bad mark in the scoring equation whenever a lender checks your credit (an "inquiry") --whether you take the loan or not. Shop among five car dealers, or open four charge accounts when moving to a new town, and the equation assumes you will soon be overwhelmed in debt. An effort to check your credit may actually reduce your score by creating an "inquiry."

More- you may fix the ChargeMax fantasy in 48 hours, but the low credit score you got because of the error can't be repaired for four to six weeks.

Another- the bureaus don't have to disclose your score to you, even if you ask, and you won't know if there is a land mine in your file until you step on it. Further, since each bureau has a different version of your history, each has computed a different credit score.

A pack of fools, indeed. Fortunately, most mortgage lenders still use the old, subjective system, and if we are lucky, lawsuits will soon smother credit scoring

in its crib.



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Blink and Miss



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The refinancing opportunity of a lifetime has gone by like a semi on a dirt road blasting past some poor fellow trying to change a tire. Why, the slipstream alone was enough to knock a car off a jack.

There's a thing or two worth studying while the gravel settles.

Next to buying the house in the first place, getting a mortgage is the largest single financial decision to face most families. During the long search for a home, consumers can bone up on mortgages; however, no civilian can keep all the weird vocabulary and theory of mortgages in memory for long.

It's not fair, but the decision to refinance often must be made fast, without a reasonable opportunity for study; and sometimes -- in a V-shaped interest rate bottom -- no time at all.

So, here follows a simple, five-step guide, designed to help you make the refinance decision under pressure.

Of course, it's not simple at all, but the outline will help with the heart of the matter- do it?... or not. Clip this column, drop it into a folder labeled "Refinance", and haul it out to take with you to your next refinance application. Any able banker can help you review the steps and concepts below, and then to reach a quick, confident decision.

9. [The Name Is The Game](#)
 10. [Sources of Closing Funds](#)
 11. [Score Trap](#)
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 17. [So You Want to Add On](#)
 18. [A Credit to Humanity\(?\)](#)
1. Subtract the rate you can get with no points and no origination fee from the rate you have.
 2. Multiply the resulting rate (1%, .75%, 1.5%...) times your current loan balance, and the result is your approximate annual interest savings in the first several years of your new loan.
 3. Mortgage interest savings are deductible, so multiply the interest savings by .67 to convert them to after tax dollars (assumes 28% IRS plus 5% Colorado brackets).
 4. Assume closing costs are 1600 non-deductible dollars, and divide the after-tax interest savings into 1600. If you get a result of "1.0", you will recover closing costs in exactly one year. If you get a fractional answer, you will recover your closing costs in that fraction of a year. If you get a number larger than "1.0", it will take you that number of years to recover costs, and you must consider how long you will live in the house, or how long it may be until the next refinancing opportunity.
 5. If you got a result of "1.0" or less, commit quickly to refinance. Do not ask Bill Clinton for further interpretation. Proceed. Do it. Do not wait for markets to improve further. Ever. Lock your rate now.
- For most consumers, this abbreviated guide to pulling the trigger begs as many questions as it answers; and so, here follow the most important answers.

-- Don't evaluate a refinance based on changes in your monthly payment. If you have paid on a loan for a year, and refi back out to 30 years, re-amortization creates the illusion of saving money when the lower payment is really just stretched-out principal.

-- Don't ever ever ever pay an origination fee or discount point on a refi to "buy down" the rate. Such fees are deductible, but over the remaining life of the loan, not in the year paid. Even when instantly deductible on a purchase loan, fee recapture takes five to six years; on refis, a decade.

-- Refi closing costs are fixed costs changing with the reissue rates on title insurance and hardly at all with the loan amount or the price of the home. \$1600 is a good Colorado guess, unless you try to fold costs into the interest rate.

-- The most extreme form of cost-folding, the so-called "no cost" refi, is an excellent idea so long as you get one half percent of your loan amount in cost

relief for each one eighth of a percent rise in the interest rate (repeatafter me...). That equation is a crucial test, as the cost relief is often a diminishing return versus higher rate.

-- Get an explanation, but do not worry about all the money flying around in interest pro-rations, skippedmonthly payments, and re-built escrow accounts -- a total due at settlement (add it to your loan!) often doublethe real cost of the refinance. Both your old loan servicer and your new one are heavily regulated and examined,and cannot keep or take money to which they are not entitled.

-- Remember that mortgage rates move real time with the bond market, intra-day; and almost anything you hearor see in the news is out of date.

-- Be careful shopping during a refi frenzy. Indecision, or trying to conduct a rate auction among lenders, or appearing reluctant to close if rates fall further will tend to drive away the best bankers and firms. "Best" in a refifrenzy means those who will give you a fair deal whether you press or not, and who will be sure to close youbefore your rate commitment expires.

Last, an apology on behalf of the mortgage industry. All firms -- the industry itself -- are limited by the numberof files they can process in a given time frame; and at the rates prevailing in a four-day stretch in early Octobereveryone in the US should have refinanced. At our firm, we could not even return calls from many pastcustomers to tell them we couldn't make room, and I'm sorry for that.



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Service? Hah!



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Back in the old days (when the Boomers were worried about turning 40), if you got a loan to buy a house, you sent the monthly payment to the people downtown who held your mortgage in their vault.

Not any more. While many consumers have detected the disembodied nature of modern "lenders", very few have figured out that the people to whom they send their house payments don't own the mortgage.

Since the 1980's, after closing, your retail lender transfers your loan to a wholesaler (which may be a captive of the retailer, or vice versa, or independent). Then, at the wholesaler or at an investment bank (the next level up-Merrill, Goldman...) your loan will be transformed- glommed with thousands of others into a "mortgage-backed security", then sliced and diced into zillions of easily traded pieces ("derivatives"), and sold all over the world.

There are exceptions- the occasional surviving S&L making special purpose adjustable rate loans; and the bankmarket for home equity lines of credit and second mortgages.

In the case of the most common mortgages -- Fannie/Freddie 30- and 15-year, most ARMs, FHA, VA, -- the loan and the payment are usually pre-disconnected, weeks before closing, when the interest rate is locked and the path from retail to Wall Street determined.

The outfit that sends you the coupon book is only a conduit for your money,

9. [The Name Is The Game](#)

forwarding it to the millions of holders of the zillions of pieces of loans. This forwarding is done for a fee- .25-.50% of the outstanding balance on your loan each year. It's a small percentage, but real dough- on a \$200,000 loan, maybe \$5,000 during the loan's six-year average life.

10. [Sources of Closing Funds](#)

To earn that kind of money, the forwarders have duties beyond forwarding- make sure your taxes and insurance are paid, collect late payments, and

11. [Score Trap](#)

foreclose on you if you quit paying altogether. The industry name for a collector/forwarder is loan "servicer". They provide service all right, but only to the people who pay them- the holders of the zillions of pieces of loans. (By the way, mortgage servicers are indistinguishable from the servicers of student loans, which go into Sallie Maes, serviced -- badly -- by Unipac, et.al.)

14. [Blink and Miss](#)

A mortgage servicer's idea of service to you includes hatfulls of mail offering bad insurance; weird deals where you pay them \$300 to take your payments twice as often; and, above all else, no human beings to answer the telephone. Servicers are the HMOs of the financial world- if you stay on hold long enough, you'll stop worrying about your problem, or forget why you called.

15. **Service? Hah!**

16. [We Don't Care, Anymore](#)

The servicer's role in the who's-doing-what-to-whom of modern mortgages can be downright insidious. For example, the worst credit problem to have on your record today is a late mortgage payment. One in the last year, and you're dead at most A-quality lenders. Why? Your loan could be a pain to service.

17. [So You Want to Add On](#)

18. [A Credit to Humanity\(?\)](#)

Servicing economics drive the whole, non-Wall Street, consumer and wholesale end of the mortgage business. For example, mortgage retailers don't make money by making loans; retailers make their living by selling servicing rights to wholesalers for lump sum fees.

The wholesalers are in the mortgage business solely to acquire servicing rights- as the loan screams through the wholesaler on its way to Wall Street (together with any points and "origination fee"), the wholesaler scrapes off and retains the servicing right and future income.

The mortgage department at many banks exists only to help the mother bank acquire servicing a little cheaper than the bank could buy it from independent retailers. When a bank says "We don't sell our loans", they mean the servicing; the loan disappears into a zillion pieces along with all the rest.

Servicing has its own post-closing secondary market. If you think your loan got sold two years after you got it, it wasn't the loan- the servicing right got sold to another servicer. The loan was long gone.

Though terrible about phone calls, most servicers do a much better job now than

at the end of the 1980's, whentens of millions of loans from defunct S&Ls were dumped into the system. However, If you ever havetrouble with your servicer, call the retailer where you got the original loan. Retailers speak servicing jive, andhave a trick or two around the phone trees to humans.



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We Don't Care, Anymore



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The mortgage industry used to care.

We cared about all sorts of things... your landlord, your rent, where you got your down payment, your old W-2s, how long you had been on your job, how many jobs, what kind of jobs....

We don't care about a lot of that stuff any more. The brave new world of underwriting by artificial intelligence, neural network, and website has dispensed with many, many things that human bankers used to think had something to do with your willingness and ability to pay back a loan.

Bankers were (yes, past tense) human, and in their incarnation as underwriters susceptible to asking for documents, evidence, proof of this or that which ought to be important in a credit decision. Like, how reliable a rent-payer you were before you wanted a home loan, what your job title is, or the continuity of your career path. Many, many boxes to fill in.

Humans being human, those vested with the authority to approve or deny a loan too often found it comfortable to say, "Because it's the rule" -- and that line was far too often a thinly-veiled version of "Because I say so."

A common exchange under the old system began with an exasperated client: "I have a quarter of a million dollars in my Merrill Lynch account, and you want me to prove that my down payment has come out of that account?" Yes; and I won't accept a copy of a check drawn on your money market account -- wire or certified check only. "Even though you can't possibly lose any money on my

9. [The Name Is The Game](#) loan?" Yes; it's the rule.
Enter the computer-as-underwriter.
10. [Sources of Closing Funds](#) There is a set of rules inside the computer, for sure, but it's a very, very different set. This new rule book is secret, as the inventors at Fannie and Freddie fear that mortgage bankers like me will try to figure out how to "game" the new system. We are, of course, gaming the bejabbers out of it, one file at a time all day long every day, learning more about what it wants, what it will do and won't do.
11. [Score Trap](#)
12. [Teaser Turnabout is Fair Play](#) The new rule book is a vast improvement: when the factors crucial to repayment are present -- large down payment and good credit -- the computer dismisses the trivial. The computer gets no enjoyment from inflicting a bureaucratic insult, and so doesn't bother.
14. [Blink and Miss](#)
15. [Service? Hah!](#) There are exceptions: the FHA now underwrites by computer along with everyone else, but the FHA is engaged in a Great Leap Backwards, intensifying its demands for irrelevant information; and the Veterans Administration continues to transform the wonderful, old "G.I. Loan" into an impenetrable morass no longer worth the trouble.
16. **We Don't Care, Anymore**
17. [So You Want to Add On](#) If you have a large down payment, say 20% or more, and high credit scores, in or above the 680-720 range, here is a short list of the things we no longer care about:
18. [A Credit to Humanity\(?\)](#)
- * Your job title, job description, or line of work; where you worked before your current job, how long you worked there, or if you worked at all.
 - * Old W-2 forms: usually none; sometimes we don't even need a current pay stub; we verify employment with a phone call, and take your word for your salary.
 - * If self-employed, or if total income includes a high percentage of incentive payments, one year's tax return is sufficient... a big down payment, 30% or more, and we don't even need that. (Exception, probably temporary: Jumbo "lenders" still want the whole tree-killing pile of 1040's.)
 - * We no longer need proof that your down payment left the account where you have it; and the old 90-day account statement history is reduced to a single month.
 - * Your rent-payment history. We do not investigate your performance as a tenant at all.
 - * A residence history: we don't care where you lived last month, or last year, or ever.
 - * The appraiser doesn't need to go inside the house you're going to buy: save

\$75. With 25% or more down, the appraiser doesn't need to establish the value of the house, just drive by and report that there is a house: save \$175.

* You no longer have to write us those dopey letters explaining why you made a late payment to Sears in August, 1995.

* We don't need your divorce decree(s) unless you are obligated to make payments to an ex -- and then only the page describing the payment.

Astounding. A machine -- a calculating device -- knows what too many human bankers never figured out.

If the deal is so strong that the bank can't possibly lose money, why inflict bureaucracy on a good customer? Just say "yes," ask how you can help, and ask how quickly the customer would like to close.

If artificial intelligence is capable of a breakthrough like this, it doesn't bode well for the original model.



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So You Want to Add On



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If you are contemplating a home addition, small or large, renovation or full-scale pop-top, to a home you already own or are about to buy, there are two overriding financial objectives.

First, to navigate the maze of carts and horses littering the mortgage horizon. How do I finance an addition I haven't yet built? I can't build it without the money, but I can't mortgage it until it's built.

Second, try to accomplish the financing with the fewest possible trips through the mortgage turnstile. Up-front fees for construction loans are expensive, and even a garden-variety mortgage refinance costs a couple of grand.

Successful paths to these objectives are different for a home you already own as opposed to an addition project on a home you're about to buy.

If it's a home you own now, begin by asking your architect, builder, or brother-in-law to ballpark the cost of your idea. There is no other way to start: until you have an approximate cost, you can't make sense of financing -- or feasibility, or economics. Many a kitchen or master bedroom has died in the initial cost phase, and even more master bathrooms ("Honey, at a hundred grand, I'll live with your shaving elbow in my ear").

Once you know how much money you need, the review of financing options begins with examining the loan you already have. If you plan a small project, and your mortgage interest rate is close to the current market, the simplest way

9. [The Name Is The Game](#)

to proceed is to refinance your mortgage on a house-as-is basis, and extract enough cash to do the work.

10. [Sources of Closing Funds](#)

However, if you refinanced a \$200,000 mortgage down to 6.50% in 1998, and only need \$50,000 for a project, do anything you can to protect an interest rate two points below current market: raise the new money by second mortgage, home equity line of credit, margin loan, 401K loan, liquidate an investment, or any combination of the above. There is good, "weighted-average rate" arithmetic to guide the new-money, preserve-old-rate decision.

11. [Score Trap](#)

12. [Teaser Turnabout is Fair Play](#)

If you're planning a big project, say \$200,000 in new cost, and your current mortgage is only \$100,000 at 6.50%, the higher cost for a big second mortgage or line of credit will demolish the advantage of your current rate. When your project is done, you'll have to refinance in one \$300,000 clunk no matter where interest rates happen to be at the time.

14. [Blink and Miss](#)

15. [Service? Hah!](#)

But, how to get the money to do the construction to get to that refinance clunk? Unless you have the cash you're going to need a construction loan. Construction money is expensive, usually floating at least one percent over prime, and costing at least a one-percent loan fee.

16. [We Don't Care, Anymore](#)

17. **So You Want to Add On**

It's an odd sequence of events, but generally, as soon as you know you're going to need a construction loan and a refinance at the end of the project, go to a mortgage lender for guidance through the whole construction process, and then to a construction lender.

18. [A Credit to Humanity\(?\)](#)

The reasons to see a mortgage lender before shopping for construction money: you need to know the ultimate refinance loan is feasible; the mortgage lender will need more financial information from you than the construction lender, and can forward such stuff to the construction lender; you can save a little money and a lot of hassle by using the mortgage lender's appraiser for both the construction and permanent loans; and the mortgage lender will be current on the price versus quality trade-off among local construction lenders.

Construction loans are best found at banks, the source of any short term, high risk, high rate loan (construction loans are high risk because a semi-finished house is lousy collateral). Most mortgage lenders offer construction money, and most banks offer mortgage money (long term, low risk, low cost); however, the products are best bought "un-bundled", as pitches for "one-stop" shopping are usually better salesmanship than finance. Construction and mortgage lending are two completely different worlds, even at the same institution.

Your conig adjustment at the end. Bythen you will probably have refinanced

anyway. The high caps allow the lender to make up for a big mistake in the first five years; in return, the lender gives you a cheaper first five than tight caps would allow.

Trade away the periodic cap for a low life cap. You can still find ARMs with a life cap in the elevens if you'll shoot craps from year to year.

It is very desirable and very expensive to buy down the margin. Margin is a big deal because it's a fixed cost in each adjustment. Breakeven for buydown tends to be three and a half years -- when it's allowed.

Keep your intentions clear about how long you will own the house, how long it may be until the next refinancing window, and what the Fed is up to. Don't ever be tempted into an ARM at a bottom in rates, or frightened away at the best time -- at a high in rates, or rising into one.



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A Credit To Humanity(?)

By Louis S. Barnes

As anyone who has recently applied for a mortgage has discovered, credit reports are no longer evaluated by humans, and instead are numerically scored by computer software (the most common: "FICO" scores). Similar systems are used to underwrite all other consumer loans, though not as comprehensively as in the mortgage business, where the larger sums get special attention.

Using computers to do the work makes good sense: the native hard-headedness of the machines is more than offset by their supernatural capacity to recognize patterns in complex masses of data.

However, new technology has a way of... morphing... spreading.

I don't mean to make anyone uneasy, but it's time you knew that the cost and availability of your auto and home insurance policies are soon to be (or already are) determined in large part by your credit record.

Insurance companies are not studying your credit to see if you will make the premium payments on time. No, the companies -- or rather, their computers -- are studying your credit to see what kind of insurance risk you will be. George Orwell or Aldous Huxley or Robert Heinlein would get some dark satisfaction from the following sentence: The worse your credit, the more likely you are to generate an insurance loss; the better your credit, the better the insurance risk you are.

Your credit record is an extraordinarily accurate predictor of the probability that your home will burn down, or that you will have a car accident -- in fact, a better

9. [The Name Is The Game](#) predictor of the chance you will have an automobile accident than is your driving record!
10. [Sources of Closing Funds](#) The best monograph in the public domain on this subject ("The Impact of Personal Credit History on Loss Performance in Personal Lines", James Monaghan; the Casualty Actuarial Society www.casact.org/pubs/forum/00wforum) should be read in daylight. You will feel as though someone or something is not just looking over your shoulder, but looking into you... through you... measuring something in you that you don't understand.
11. [Score Trap](#)
12. [Teaser Turnabout is Fair Play](#) The correlation mathematics are as clear as can be: whether measured by "Amounts Past Due" (credit jargon for the total number of all late payments in your record), "Derogatory Public Records" (judgments, liens, bankruptcies, foreclosures), "Collection Records" (past or present accounts in collection), "Status of Trade Lines" (late payments outstanding), "Age of Oldest Trade Line" (your credit is judged better the longer you have had accounts open -- don't close idle accounts), "Non-Promotional Inquiry Count" (if you ask a lender to check your credit, it hurts; if a credit card company scans you before sending a promotional mailing to you, no harm done), "Leverage Ratio on Revolving Accounts" (balance outstanding at any moment versus credit limit -- keep your balances below 50% of limit, even transient, intra-month balances!), or "Revolving Account Limits" (get your limits raised any time you can)... if you have poor credit by any ONE of these standards, you are a higher insurance risk.
14. [Blink and Miss](#)
15. [Service? Hah!](#)
16. [We Don't Care, Anymore](#)
17. [So You Want to Add On](#)
18. **A Credit to Humanity(?)** This list of credit criteria, with slightly different weighting, is used to compute your FICO credit score. You can assume that your FICO score is a reasonable proxy for your attractiveness as an insurance risk: above 680 (into the 800's), a good risk; below 620 (into the 400's), a poor risk.
- What, exactly, are the insurance machines measuring here? As Mr. Monaghan says near the end of his analysis, "An outstanding issue that will likely remain outstanding is causality."
- Causality. The credit vs. insurance risk correlation is clear and unambiguous, but nobody knows why. Monaghan recites the leading theories, but all fail rigorous tests of cause and effect. One might suspect that those with poor credit rely more on insurance, and are quicker to file claims, or are more likely to file fraudulent claims; but these hypotheses do not prove out. Some suggest that insurance risk may be the result of low income, or some differentiation by age, or residence (urban, rural, or suburban), but none of these correlate with insurance loss as well as predicted by credit rating. Only two groups present some evidence for cause of both poor credit and high insurance risk: those under stress, and those who are self-employed.

You may have been amused to discover that Amazon.com could quickly predict from your buying habits which books you would next like to buy. Perhaps you felt a little uneasy at the ability of "data-mining" software to identify nearly anything you want to buy or do.

Orwell, Huxley, Heinlein... under the scrutiny of sophisticated pattern-recognition, our credit and insurance ratings may be aspects of a larger quotient, some measure of relative caution in the way we live our lives, or competence at it, or responsibility for it, or... we may not be able to comprehend the cypher in us at all, no matter how transparent our behavior is to the machines.

You do have options: the data show that if you set out to improve your credit, and do so, you will have less chance of a car accident or burglary in the future.

Why, we don't know. But you will, predictably.

Inhumanly.



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