Season 1 Episode 4 – Managing Mortgages: Be PREPARED

March 17, 2023

Speaker 1:

It's time for Alabama Money with Cynthia White and Portia Johnson. We'll have financial tips from financial experts from across the state, an extension specialist at Auburn University.

Portia Johnson:

Hello and welcome to Alabama Money where we talk finance facts, fun and fast. We are your host, Portia Johnson, assistant professor and extension specialist, and Cynthia White, extension agent, both at Auburn University. Today we are discussing monthly mortgage payments. Today we're going to talk about being prepared.

Cynthia White:

Last episode, we talked about the need for this series. A lot of consumers don't read their mortgage documents or they don't know what they should do if something goes wrong. Reading and understanding the document is the first step. Paying on time is the second step, but being prepared when the loan or your financial picture changes is the next step.

Portia Johnson:

Yes, consumers need to be informed about their mortgage so they are prepared when the unexpected strikes and proactive to mitigate any bad outcomes.

Cynthia White:

This episode covers being prepared for those life or mortgage changes. One possible change is a change in the interest rate. If you have a fixed rate mortgage, this won't apply to you as much, but if you have an adjustable rate mortgage, an ARM, this absolutely applies to you.

Portia Johnson:

Fixed rate mortgages, like the name implies, they do not change. They are fixed. There's a certain rate for the life of the loan. There's no surprises there. With an ARM, there is an initial period of time where the rate doesn't change. That period can be anywhere from six months to 10 years depending on the loan term, although there are literally thousands of different loan types and term combinations. So no two fixed or ARMs are exactly the same.

Cynthia White:

For example, if a person has a three-one ARM, the interest rate stays unchanged for the first three years. After that, the rates can adjust every year, hence three and one. Similar is true for a five and one or seven and one ARM. Rate stays the same for the first five or seven years, then the rate changes yearly from then on out.

Portia Johnson:

And that applies to a few common ARM types. There's the three one, like you just mentioned, the five one, like you said, the seven one, and then lastly a ten-one.

Cynthia White:

Some arms have limits on how much the rate can change or go up and down. That limit is called a cap. For example, say you have a seven-one ARM and you have a 525 cap. That means that a rate can adjust five percentage points above the initial rate in year eight. Then every year after year eight, the rate can adjust a maximum of two percentage points. That's the two in the 525. The last five in the 525 cap means that the interest rate can never increase more than five percentage points over the life of the loan.

Portia Johnson:

And if that isn't confusing enough, ARMs can also be hybrid. They can be interest only or payment option and rate change based on the index and the margin. So an index is a benchmark. It's used by banks to set the rate based on what's happening in the economy. Then they add a little buffer. They call that the margin, and that's the cliff note version. ARMs are extremely complex and they're unpredictable. You can easily see why ARMs are often not the ideal choice for many home buyers, especially for first-time home buyer. ARMs are best for those who don't plan to stay in a home for more than a few short years or know their income will increase considerably in the future. Otherwise, it's probably best to avoid an ARM and stick with a fixed loan.

Cynthia White:

But if you have a mortgage you've already selected into a fixed or ARM. If you have a fixed rate, check the mortgage statement to ensure that rate listed is the one you agreed to when you signed the loan documents at closing. If you have an ARM, check the monthly mortgage statement even more closely to see if the rate has changed and by how much.

Portia Johnson:

The interest rate change in an ARM is also called an adjustment. Your lender are required by law to send you a letter to inform you of the new payment adjustment seven to eight months in advance of when the rate will change for the very first time. After that first-rate change, the lender is only required to send that notice two to three months in advance on each subsequent rate change.

So when you get the notice, there's a few things you need to do. First, check the percentage point change to make sure it's within the terms of the loan. Remember, we discussed a 525 for example. Make sure that the first increase isn't higher than five percentage points. That was that first five in that number. Make sure any subsequent increases isn't over two percentage points. That's that second number and that's 525 number.

Since you have had notice about the adjustment in advance, now you can plan and prepare for it. Adjust your monthly mortgage budget to account for this new higher or lower payment amount. If the new amount is too taxing on your budget, consider your options to refinance or recast that loan or even sell the home.

Cynthia White:

To properly consider all your options, it's a good idea to periodically use the monthly mortgage statement to calculate your estimated equity. Your equity is the difference between what you owe on the mortgage principle and what the home is currently worth.

Portia Johnson:

I know I am constantly checking my home's estimated value on a home estimator website, and I'm purposely using those words because I don't want to name any particular websites. I would caution you though, be careful not to endorse any other platforms. But if you Google Home "value estimator website," you will get a list of at least 10 of them. Some of them, you'll know them by name.

Cynthia White:

Me too, Portia, I do the same. So if your mortgage statement says your principal balance is 140,500 and the home value estimator says your home is worth 305,000, then your equity is likely around 164,500. Just keep in mind that estimators are just as the name suggest, so those are just estimates. The conditions in your local housing market will dictate its true worth. So it's just an educated guess so make sure you're careful about that.

Portia Johnson:

That is so true. I hear all the time where people look online, they find what they think their house is worth, and then they tell their real estate agent that they must list it for that amount. That's not really how housing markets work, but we digress.

The principal amount on the statement is also an estimate. That is because you are making monthly payments and your interest is also changing too. So as you're making monthly payments, you're paying down the loan, but your interest is also calculating upward overtime so those numbers are fluctuating. To get the actual payoff amount, just call your loan servicer and ask them what that amount is. But knowing that equity estimate at any given time can help you understand your options should your loan rate change or if your finances or your life situation might change. Say you get a job offer in another state, knowing that estimate equity can help you determine whether you want to rent out that place or whether you want to sell it.

Cynthia White:

Consider when your equity seems to be decreasing steadily month after month, you may consider if now is the time to sell and exit that housing market. Or say you want to put a child through college, or invest in your business, or your family size is changing and you need to downsize or upgrade your home, tracking your equity can help you time a home sale or a home equity line of credit.

Portia Johnson:

So know your home value in the current housing market. Got it.

You also want to periodically look at the current interest rates in the mortgage market. Interest rates literally change daily. Why is this important? Say you bought your home with a fixed rate mortgage on your home that was 6.5% when you purchased, but you looked at rates today and they are now 4%. You might consider that it's a good time to refinance your home because current rates are lower than the 6.5 that you got before.

Cynthia White:

Now, refinance or refi is when you take out a new loan to pay off and replace your old loan. So in this example of the 6.5%, if you refi, you get the lower 4% interest rate. You can easily save yourself tens of thousands to hundreds of thousands of dollars simply by refinancing at the right time. The amount of money you will save by refinancing will really depend on a few factors, how much longer you have to pay on the loan, the principal amount that will be left to pay, the current interest rate of course, and the length and the amount of the new loan.

Portia Johnson:

And refinancing has several steps involved. So we're going to quickly review some of those steps. There are about 10 of them. One, know your current interest rate. Two, do a simple interest rate search on the internet to find today's mortgage rates. Three, compare that current interest rate that you have now with the rate that you found online for today. Four, if that current rate is lower than the rate that you have, it might be time to consider a refi. Five, shop around and compare the refinance offers that you get from several different mortgage lenders. This is very important. Always shop around. Don't go with the first company you contact. You will likely have to pay closing cost just like you did on that first original loan.

So six, find out if you have a prepayment penalty on your current loan. Then seven, calculate the total closing cost and the prepayment penalty that you'd have to pay on that loan if you were to refinance. Next eight, find out the remaining balance on your new loan you would pay if you stayed in your current original loan. Then nine, compare your new loan, which includes that closing cost and that penalty for repayment, compare that to your current loan and its remaining balance. If the new loan option is better and it saves you money than your current loan, then it is time to refinance.

Cynthia White:

Now let's dig into this prepayment penalty a little more. A prepayment penalty is a fee that a loan servicer charges you if you pay your mortgage loan off early. You agree to a prepayment penalty when you originate or first sign your loan at closing. Now, the penalty allows the loan servicer to recoup some of the interests that you would've paid over time. So if you have a prepayment penalty, you really need to know because it impacts the total cost of your refi and ultimately the total amount that you're going to end up paying.

Portia Johnson:

Then there are the refinance fees. The servicer will likely charge you somewhere around 1.5% of the cost of the loan as a origination fee. Then you might also need to pay for things like a home inspection, an appraisal, title search or recording fees.

Cynthia White:

That can be more than $2,000 in just fees. Now, there is an alternative to refinancing. It's called recasting. A mortgage recast is when you make a big lump sum payment on your principle balance.

Portia Johnson:

Then the servicer will use that lump sum to re-amortize the mortgage. It results in lower mortgage payments, but the interest rate and the term, which is the length of your payment, all of that will remain the same. Basically, it's a way to lower your monthly bill, but this option may not be available for everyone.

Cynthia White:

Now, yes, you could be using the money toward another investment instead, you can't use it for a government-backed loan like FHA, USDA or a VA loan. You have to have a lump sum of at least $5,000 or maybe higher. You have to have a certain percentage of equity in the home, and you cannot be behind on your payments. You must have paid on time for a certain period of time, and that servicer will charge closing fees.

Portia Johnson:

Some pros though are that recasting is typically less expensive than it is to refinance. Recast fees are usually only a few hundred dollars versus thousands with a refi. There's no credit approval, no appraisal needed. You keep your current interest rate. The lump sum goes only to the principle, so you aren't paying on interest and lower payments of course.

Cynthia White:

Now to get an idea if a mortgage recast would be good for you, search the internet for mortgage recast calculators. It's fairly simple. Enter your remaining principle balance, your interest rate, and your current monthly payment. Then enter the amount you would put toward a lump sum recast payment and any service or recast fee.

Portia Johnson:

So there's a lot to consider, but we hope this gives the listener just a little start when you're thinking about a refinance and a recast. Next time we'll talk about being proactive when you think you can't pay that mortgage on time. But today, to recap, we covered ARMs and interest rate changes, knowing your equity estimate, refinancing and recast options and repayment penalties.

Cynthia White:

I'm Cynthia White.

Portia Johnson:

And I'm Portia Johnson.

Cynthia White:

And this is Alabama Money where we talk finance facts, fun and fast.

Speaker 1:

This has been a production of Alabama Extension at Auburn University.