Spring 2015

TMI About PMI: A Basic Guide to Private Mortgage Insurance

Marie Sarantakis
Purchasing a home for the first time can be an intimidating and overwhelming experience for the average consumer. In an economic downturn, Private Mortgage Insurance (PMI) is a commonly utilized mechanism that affords homebuyers the ability to purchase a residence with a minimal down payment while insulating the lender as the beneficiary of the policy. PMI is an often dreaded and misunderstood expense. This basic guide provides a rudimentary understanding of PMI for a real estate novice.

Introduction

At the beginning of 2014, the average price of a home sold in the United States was $189,000.¹ According to the US Census Bureau approximately 65% of Americans are homeowners.² Meanwhile, the median average American family’s saving account contains around $3,800 and 25% of American families have no savings whatsoever.³ These facts suggest that the average homebuyer only has a very small fraction of the purchase money needed to buy a home. While this sounds problematic, and in fact many times it is, most people are able to own real estate by obtaining a home loan from a financial institution called a mortgage.

Since the amount of the loan is typically sizable, the purchaser acquires the financing from the lender by using the property being purchased as collateral (security) for the loan. If the buyer defaults on the loan, then the property reverts back to the lender. Mortgages generally last for a period of fifteen to thirty years and the monthly payments often consist of the premium, interest, taxes, and insurance (often referred to as PITI). Our focus will be on the insurance aspect of PITI.

---


² In 2012 and 2013, homeownership rates in the United States fluctuated between 65.0% and 65.5% with a standard rate of error around 0.3%. To view homeownership rates in the United States from 1965 to present, view Table 14 on the Census Bureau’s official website which can be downloaded an Excel spreadsheet at http://www.census.gov/housing/hvs/data/histtabs.html.

What is mortgage insurance?

A lender (mortgagor) requires mortgage insurance when a homebuyer (mortgagee) is unable to put down at least 20% of the home’s price at the time of purchase. This policy protects the lender in the event of default. The mortgagee provides a financial guarantee to the mortgagor in order to secure the debt and offset the lender’s risk in providing a loan with little down payment. The lender’s assumption is that if the borrower cannot afford to provide a sizable down payment they are at greater risk to default on the debt they incur. Mortgage insurance takes the place of equity in the home and protects the lender. In the event that the borrower defaults on the mortgage, and the bank suffers a loss in foreclosure, the mortgage insurance kicks in and compensates the lender.

Since the lender is guaranteed to be made whole, regardless of foreclosure, banks are often less willing to refinance. They simply lack the incentive to ensure that the consumer is able to repay. The lender is secured their investment regardless of who writes out the check.

Who needs private mortgage insurance?

- A new homeowner who is putting down a down payment of less than 20% of the purchase price.
- Someone refinancing their home for more than 80% of the home’s value will typically be required to invest in PMI.4

What types of mortgage insurance are there?

There are two types of mortgage insurances: those backed by (1) private insurance companies or (2) the government, usually through the Federal Housing Administration (FHA).5 From here forward we will discuss private mortgage insurance (PMI) policies that are underwritten by corporations and purchased through the private sector.6

Who arranges the policy?

4 PMI is typically not required in the case of home equity loans.

5 Veterans are able to obtain housing loans (often called VA Loans) from the Department of Veteran Affairs without paying for mortgage insurance, regardless of the amount of their down payment.

6 All references to mortgage insurance hereafter, unless explicitly stated otherwise, refer to private mortgage insurance.
The lender typically arranges the mortgage insurance, since they are the beneficiary of the policy. Every month the mortgagor pays a mortgage insurance premium (MIP) to the lender, who then pays the insurer.

**Why learn about PMI?**

According to Richard J. Roll, President of the American Homeowners Association (AHA) “Millions of homeowners are being required to continue these [Mortgage Insurance] payments after they may be eligible to cancel them, resulting in overcharges amounting to hundreds of millions of dollars.” Since Mr. Roll’s statement in 1997, many significant changes have occurred in the private mortgage industry favoring the consumer. Regardless, it is crucial to be educated on what rights and duties a mortgagee has when it comes to such a hefty, reoccurring, and common expense.

**Who needs it?**

Those who put down less than a 20% down payment on their home will typically have to purchase PMI to offset the risk to the lender. Due to the rising cost of real estate combined with an economic downturn, a great number of Americans will inevitably be required to possess mortgage insurance.

While PMI typically attracts first-time homebuyers, with little savings, people from all economic backgrounds utilize these loans. Low-income individuals, wanting to switch from renting to owning, will be able to make the transition possible by not being required to have a great deal of money saved on the front end. Freshly graduated doctors and lawyers, who have incurred high levels of debt yet have a high earning potential, will be able to more quickly purchase their homes after professional school. Even affluent individuals sometimes take advantage of PMI, not wanting to tie up much of their money on the front end. In fact, the demand for a high-end PMI market is rising.

**Who does PMI benefit?**

PMI protects the lender. It does not benefit the homebuyer or their family. Borrowers cringe at the thought of PMI because they are paying a premium where the financial institution is the beneficiary. People generally hate paying for insurance. They hate it even more when the policy is protecting someone else.

While it seems fundamentally unfair for borrowers to pay an insurance premium that is solely for benefit of the finance company, there is an inherent

---

benefit passed on to borrowers on a larger scale. By offsetting the risk to the lender, the lender is able to provide a greater number of homebuyers with the opportunity to purchase a home with less down. Traditionally, people had to have 20% of the purchase price of the home saved upfront, now with private mortgage insurance individuals can become homeowners with little down.

Homebuyers today are able to purchase a home with as minimal as a 3% down payment. Since a lender would not reasonably want to take a chance on someone only able to secure 3% of the total investment prior to purchase, they mitigate the assumed risk, and make loans available to such buyers by requiring mortgage insurance that will take effect in the event of foreclosure.

Furthermore, lessening the down payment required on a home, borrowers are able to afford a more expensive home on the front end. However, borrowers should be cautioned that just because they CAN afford something does not necessarily mean that they SHOULD take on the greater liability. Home ownership can be very costly and there are always unforeseen costs to be made in repairs (whether immediately or in the future). Therefore even if borrowers are tempted to buy a bigger house with a smaller down payment, they would be wise to still keep money set aside, and not purchase the largest home feasible in their budget, so that they can be prepared for unforeseen expenditures in the future.

What does mortgage insurance NOT do?

Mortgage insurance does not protect the borrower and/or his/her family. It does not protect the property from any damages related to fire, weather, or any other casualty. Nor does it pay off the mortgage upon the mortgagor’s death for the benefit of the mortgagor’s heirs and assigns. Because of the similarity in the name, Mortgage Insurance is often confused with Mortgage Life Insurance. The latter is a separate policy that in the event of the death of the borrower, the mortgage will be paid off by the insurance provider and that the borrower’s heirs and assigns will then inherit the home mortgage-free.

How do you pay for mortgage insurance?

PMI premiums are generally spread out over the course of the loan paid in monthly installments along with the mortgage until 20% - 22% equity is achieved in the home. Lenders may otherwise allow borrowers to pay for mortgage insurance as a lump sum in cash at closing.  

How much is it?

8 This is not a very common method of paying for PMI.
The most obvious, and yet unsatisfying, answer is, it depends. The most important variables are the amount of the loan and the amount of equity. Here are some of the factors that are taken into consideration:

**Loan-to-Value (LTV) Ratio** – This calculation is performed by dividing the amount paid towards the property against what the property is worth. As expected, the greater the LTV ratio the higher the mortgage insurance premium.

*Example:* Say that you purchased a $100,000 home and that you placed 15% down on the home. In this instance, 85% is still outstanding on the loan and therefore your LTV ratio is 85%.

**Purchasing Points** – A buy down is a mortgage subsidy that allows the buyer to qualify for a lower mortgage.

**Type of Loan** – Adjustable rate loans are typically accompanied by a higher mortgage insurance premium than fixed rate loans.

**Credit Score** – Consumers with a higher credit score pose less risk to the lender. Therefore those with better credit ratings typically pay lower insurance premiums.

With variance based on these factors the loan amount will vary anywhere between 0.03% and 1.15% of the original loan amount per year. According to estimates by Zillow.com, premiums typically cost $30 to $70 per every $100,000 borrowed per month.⁹

Fortunately, calculating your mortgage insurance premium is not altogether difficult. All you need to know is basic addition, multiplication, and division to figure out how much you will have to pay on a monthly basis.

There are countless online resources to assist in calculating mortgage insurance premiums with greater precision.¹⁰ For exact figures it is always best to contact the lender directly. It is important to keep in mind that the lender, not the PMI provider, is the one who will be drafting the specific terms of your mortgage.

**Am I better off paying a one-time premium or making monthly payments?**

---


For those planning on holding onto their mortgage for a relatively short period of time, then a monthly premium is ideal. However, for those that plan on paying on a mortgage over the course of many years, then a one-time premium will likely be a better bargain in the long term.

**How long should you expect to pay for PMI?**

According to the Mortgage Insurance Companies of America, 90% of homeowners paying for PMI are able to cancel PMI within five years.\(^1\)

**Can you obtain a refund if it is discovered that you overpaid for PMI after reaching the 20% equity threshold?**

Absolutely. It is a relatively common occurrence for a borrower to be reimbursed for excess MIP payment(s). This scenario occurs because the borrower pays the lender on a monthly-basis, but the lender pays the insurer on an annual-basis. In the event of overpayment, the borrower should notify the lender.

If the lender refuses to cooperate, and you believe that you have a viable claim, you should file an action in small claims court where the dispute can be settled.

**What is the borrower entitled to?**

During the closing on the property, the lender must provide the borrower with an amortization schedule along with the lender’s specific PMI termination terms. Specifically the lender’s paperwork to the borrower must state that the borrower has the right to request the cancelation of PMI occur when the LTV reaches 80% and that PMI will necessarily terminate at 78%.\(^2\) Furthermore, the servicer of the PMI must annually provide the borrower with the address and phone number where the homeowner may contact the servicer to initiate the cancelation process.

**Is PMI deductible?**

---


\(^2\) Loans that are particularly high risk may be subject to different rules.
It used to be. PMI used to be deductible for loans made after January 1, 2007.\footnote{This included properties refinanced on or after January 1, 2007 until December 31, 2013 for the amount up to the original loan value, excluding any additional cash that accompanied the loan.} This deduction was not limited to primary residences, but was also applicable to second homes and vacation properties so long as they were for personal use and not income-generating rental properties.

Married couples were eligible to claim a deduction if filing together they earn an adjusted gross income of less than $110,000 per year (or if filing separately less than $55,000 each). For couples making less than $100,000 per year, they would receive the maximum deduction amount. For those making over $100,000 per year, the deduction was reduced by 10% per every additional $1000 in income. At $110,000 per year and higher, PMI was no longer deductible.\footnote{See IRC Section 163(h)(3)(E)(ii).}

Qualified MIPs used to be treated as Home Mortgage Interest and therefore tax deductible. This Mortgage Insurance Tax Deduction expired as of December 31, 2013.\footnote{Thomson Reuters, Thomson Reuters Checkpoint Tax Provisions Expiring 12/31/13 (date of publication unknown) https://tax.thomsonreuters.com/wp-content/pdf/checkpoint/NTA-expiring%20tax%20laws2.pdf.} Unless Section 163(h)(3)(E) of the Internal Revenue Code is extended, MIP will no longer be deductible in 2014. Ask your accountant or visit the IRS website for the most current status on deductibility.\footnote{For the most current information on the deduction eligibility of mortgage insurance premiums for 2014, visit the IRS website: http://www.irs.gov/publications/p530/ar02.html#en_US_2013_publink100011895}

While it does not appear that the tax deduction will be renewed, it is a possibility since it was one of the most common tax deductions. Ironically, it was also one of the most overlooked deductions. Unless this deduction is reinstated a borrower’s best bet for savings is to reach the 20% equity threshold as quickly as possible.

**Why do you want to avoid Private Mortgage Insurance?**

Mortgage insurance is a great expense, with no return to the person who pays the premium. Over the course of the loan, the borrower can expect to pay anywhere from .50% to 1.00% of the original loan amount in premiums annually. It could take a great number of years until the equity in a home reaches 20% - 22%
and therefore the borrower will be stuck making expensive monthly payments until that occurs.

If the average price of a home being sold in the United States is approximately $189,000\textsuperscript{17}, and the borrower takes out mortgage insurance, and pays back 1\% of the loan amount annually, that means that the borrower will be paying $1890 per year. That is $157.50 per month.\textsuperscript{18} While the losses incurred paying these premiums used to at least be tax deductible, this is no longer the case.

**How do you avoid PMI?**

While PMI is commonplace, borrowers are certainly better off without it. It does nothing for the borrower besides strain their bank account. PMI is a necessary evil that should be avoided if at all possible. Here are some ways that one can avoid paying for PMI:

- Put down at least 20\% of the loan amount as a down payment.
- Some lending institutions do not require PMI for individuals in certain professions.

  *For Example: Some lenders exempt doctors or teachers from having to add PMI to their mortgage.*

- Sometimes banks allow borrowers to pay a higher interest rate throughout the life of the loan. On one hand, that higher interest rate is tax deductible, but on the other, it will last for the life of the loan (whereas PMI will expire). It is best to discuss this option with an accountant, as it will only be beneficial in a limited, fact-specific scenario. This is typically referred to as **Lender Paid Mortgage Insurance**.

- If you are a veteran you may be able to qualify for a VA Loan.

- Obtain a HomePath Mortgage by FannieMae on select FM bank-owned homes.


\textsuperscript{18} This calculation is performed by taking the loan amount ($189,000) and multiplying it by the annual percentage (1\%) and then dividing that amount by 12 to determine monthly payments.
• Finance a **Piggyback Loan**. Here, the initial home mortgage could be for 80% of the purchase price, and then a subsequent loan could cover the rest of the financing after down payment. The advantage in this method is that the second loan can usually be paid off fairly quickly and is tax deductible. By locking into a low mortgage rate, this approach *may* be cheaper than paying for PMI.

*For Example: If you want to buy a home for $100,000 and you have $10,000 for a down payment, you would take out a mortgage for $80,000 and $10,000 on a subsequent loan from your home equity line of credit.*

**What is a Piggyback Loan?**

Home purchasers who do not have 20% of the loan amount to put down at the time of closing can opt to avoid PMI by taking out an additional second loan. Essentially they take out a home equity loan to cover the remainder of the 20% down payment.

These types of loans are also commonly referred to as 80/10/10 or 80/15/5 loans because the bank grants a mortgage for 80% of the purchase price and then subsequently grants a second mortgage for another 10% or 15%. The borrower then pays out of pocket the remaining 10% of 5% down payment for the loan respectively.

By taking out a piggyback loan, the borrower is able to circumvent paying for mortgage insurance. Moreover, the interest on the second loan is tax deductible whereas mortgage insurance premiums are not. Individuals can choose to aggressively pay down their piggyback loan, which will go towards building equity in the home.

The Piggyback Loan approach is best suited for someone with excellent credit, yet little working capital. Immediate second mortgages are becoming increasingly more difficult to obtain. They are less common because they pose a greater risk to banks. Another reason is that in 2007 a tax provision rendered Mortgage Insurance premiums tax deductible through 2013. It remains to be seen whether these types of loans will experience a resurgence upon the expiration of the mortgage insurance premium tax deduction.

---

19 This is a second mortgage on the property taken immediately at the time of purchase.

20 The deduction for Mortgage Insurance Premiums expired on December 31, 2013. It does not appear that this will be renewed for the 2014 tax year, but this is subject to change. Check with your accountant/mortgage broker/attorney for the most recent filing information.
A downside of Piggyback Loans is that the interest rates of secondary loans are often higher than the cost of an initial loan. It is therefore critical that the borrower determine, based on the percentage rate of the second loan compared to the cost of mortgage insurance, which is a better debt to incur. It is also important to remember that it could take many years to pay off the second loan, whereas the natural appreciation of a home's value could mean that an 80% equity rate could be achieved in as little as a couple of years.

**Who are the major PMI Providers?**

Here are some of the major players in the PMI provider industry: AIG United Guaranty, Essent Guarantee Incorporated, Genworth Mortgage Insurance Corporation, Mortgage Guarantee Insurance Corporation (MGIC), PMI Mortgage Insurance Company, Old Republic International Corporation, Triad Guaranty Insurance Corporation, and United Guarantee Corporation.  

**How popular is private mortgage insurance?**

Very. Many of the people who desire to become homeowners do not have surplus savings and expendable income to contribute towards a substantial down payment on the purchase of their home. According to the Chief Executive of MGIC, Curt Culver, PMI accounts for 1/3 of the mortgage share market whereas FHA controls the remaining 2/3s. This is expected to shift, with a rise in the private sector, as FHA loans are adjusting to higher premiums. Culver would go so far to suggest that the numbers might completely flip, with PMI being the norm for 2/3s of the market.

**Is PMI a new invention?**

Surprisingly, history shows evidence of mortgage insurance rooted all the way back to the late 1800s. In 1904, legislation was drafted to facilitate mortgage

---


insurance and by 1911 title insurance companies were recognized to buy and sell mortgages enabling the mortgage insurance market to grow dramatically. With very little regulation in place, combined the profitability of the industry in the 1920s, the industry exploded. However, the boom was short-lived as everything came to a screeching halt in The Depression of the 1930s. In 1934, the Federal Government entered the mortgage insurance scene and began to back mortgages with FHA loans. Ten years later, the VA began backing loans for veterans. FHA and VA mortgages reinstated some confidence in the market and the viability of a successful private-sector mortgage insurance industry regenerated.

In 1957, an attorney from Milwaukee, Max Karl created The Mortgage Guaranty Insurance Corporation, which resembles the companies that offer PMI today. Throughout the 1960s and 1970s these modern PMI companies flourished. In the 1980s and 1990s private mortgage insurance became an even more pivotal part of the home buying process. In the housing market collapse of 2007, these insurers incurred great losses. Be that as it may, the insurers survived, in part due to the reserve regulations. PMI providers must maintain contingency, loss, and unearned premium reserves. Mortgage insurers today play an essential role in preventing a devastating market collapse from reoccurring by distributing risk and overseeing the legitimacy and quality of loans between borrowers and lenders. As middlemen, the insurance providers add another layer to help protect against imprudent practices.

**Glossary**

**Amortization**: To gradually satisfy the payment of a debt in installments. The PITI of a mortgage is paid monthly.

**Appreciation**: An increase in value.

**Collateral**: Pledging an item as security for a loan. In the context of a mortgage, the property itself serves as collateral on the loan.

**Default**: Failure of the mortgagor to repay his/her loan obligations to the mortgagee.

---

24 Up until recent history, PMI was exclusively referred to as a ‘mortgage guaranty’.

**Down Payment**: The amount of cash paid down on the property at the time of purchase. The amount of the down payment will affect whether or not one will be required to purchase home mortgage insurance and/or the rate of the premiums.

**Equity**: This is the value that accrues in a property. Taking the current market value and subtracting the remaining mortgage balance determine the amount of equity in a property.

**Interest**: A percentage fee that is paid regularly to the lender with the mortgage principal. This is the cost of the loan.

**HPA**: Acronym for The Homeowner’s Protection Act of 1998.

**Guarantor**: The party giving a guaranty.

**Guaranty**: A security that a guarantor will repay their debts.

**Lender Paid Mortgage Insurance**: This is an option to circumvent PMI, where the lender will alternatively charge a higher interest rate.

**LTV**: Acronym for loan-to-value ratio. This calculation is performed by taking the amount of money borrowed and dividing it by the value of the property.

**MIP**: Acronym for Mortgage Insurance Premium. These are the monthly payments devoted to mortgage insurance out of PITI payments.

**Mortgage**: A loan that is used to purchase a property, where the property serves as collateral.

**Mortgagee**: The lender.

**Mortgage Indemnity Guarantee**: This is another term for ‘Mortgage Insurance’ commonly used in the United Kingdom.

**Mortgage Life Insurance**: An insurance policy that in the event of the death of the borrower, the mortgage will be paid off by the insurance provider and that the borrower’s heirs and assigns will then inherit the home mortgage-free.

**Mortgagor**: The borrower.

**Piggyback Loan**: An additional loan taken out at the time of the initial mortgage so that the borrower can avoid paying PMI. These types of loans are also commonly referred to as 80/10/10 or 80/15/5 loans because the bank grants a mortgage for 80% of the purchase price and then subsequently grants a second mortgage for another 10% or 15%. The borrower then pays out of pocket the remaining 10% of 5% down payment for the loan respectively.
**PITI:** Acronym for Principal, Interest, Taxes, and Insurance. A mortgage payment consists of these four main costs.

**Principal:** The sum of money borrowed.

**Purchasing Points:** This is fee paid to the lender, at the time of the closing, to reduce the interest rate on the mortgage thereafter.

**Term:** The length of the mortgage. Terms of 15 or 30 years are most common.