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Cover story: Clearing home-value hurdle to a refi

Michele Lerner SPECIAL TO THE WASHINGTON TIMES

Tightened lending standards and dropping home values may have made it harder to refinance a home mortgage, yet hundreds of Washington-area homeowners manage to take advantage of low mortgage interest rates each month.

Despite the barrage of media reports that banks have not been lending to consumers, plenty of homeowners are finding that refinancing is not only possible, but also is an advantageous way to improve their household finances.

"By far the biggest challenge for homeowners interested in refinancing over the past 12 months has been the home-value hurdle," says David Skaff, regional manager for residential mortgages in the Mid-Atlantic region for M&T Bank. "Typically, homeowners can borrow up to 90 [percent] or sometimes 95 percent of the home value, depending on the mortgage program. But of course many owners now find that they owe more than their home is worth."

Nationally, real estate industry analysts estimate that one in four households is "underwater," owing more on the mortgage than the property value. But even these homeowners may be able to refinance through a federal government initiative.

"The Home Affordable Refinance Program [HARP], introduced last year, allows borrowers with a mortgage owned by Freddie Mac or Fannie Mae to refinance up to 125 percent of the value of their home," Mr. Skaff says. "Before that, there was really nothing to offer people who owed too much on their home."

To find out if they can take advantage of the HARP program, also known as "Refi Plus," buyers should begin by looking up their current loan at Fannie Mae (http://loanlookup.fanniemae.com/loanlookup/) and Freddie Mac (https://ww3.freddiemac.com/corporate/) to see if the loan is eligible for the program.

"Although the HARP program says they will refinance up to 125 percent of the home value, most lenders are really only willing to go to 100 percent or 105 percent," says Brian Martucci, a mortgage broker in the District with GetLoans.com. "Homeowners should start by calling their current lender to ask about refinancing, then get some quotes from other banks or mortgage brokers to see what is available."

The Refi Plus program requires that a second loan must be subordinated to the first, which most second-loan lenders will not accept. Borrowers with a first and second loan will find refinancing more challenging, but they may be able to work with a lender to combine the loans or to find a way to pay off the second loan, depending on the equity in the home.

Aside from the Refi Plus program, Mr. Martucci says most borrowers generally need 20 percent equity in their home to refinance, unless they are willing to pay private mortgage insurance (PMI), which lenders require for loans of more than 80 percent of the value of the home. Some homeowners may want to refinance into an FHA-insured mortgage, which is available to homeowners with as little as 3 percent equity in the property. FHA loans also require mortgage insurance.

"If you are already paying PMI, this may not matter, but some homeowners have lost value in their homes and will not be expecting to pay the insurance," Mr. Martucci says. "It may still make sense to refinance even if you have to add $100 or so per month to your mortgage payment for PMI. It just depends on your current mortgage program."

An option many lenders offer is a program called "lender-paid mortgage insurance," which includes the cost of the PMI in the interest rate rather than as part of the monthly mortgage payment.

Homeowners with an FHA mortgage pay mortgage-insurance premiums as part of their monthly housing payments and may be eligible for a "Streamline Refinance."

Paul Defngin, a mortgage consultant with the Parsons Mortgage Group of Nationwide Home Mortgage Inc. in Rockville, Md., says the FHA tightened its qualification rules for refinancing in 2009.

"In the past, you could roll in all your closing costs and refinance without an appraisal when you had an FHA loan, but now FHA refinances are limited to a maximum loan-to-value of 97.5 percent of the appraised value of the home or a formula based on the current principal balance, less the mortgage-insurance premium refund plus the new mortgage-insurance premium, whichever is less," Mr. Defngin says.

Current FHA Streamline Refinance rules require borrowers to provide employment and income verification and meet minimum credit-score standards established by the lender, standards that were not required prior to November 2009.

The decision to refinance requires some number crunching, which homeowners can do themselves or ask a lender to do for them. A refinance will require closing costs, which can sometimes be wrapped into the loan, but even then, borrowers need to estimate how long it will take to recoup the expenses of refinancing before their lower monthly payment represents pure savings.

Qualifying for loan

Borrowers may find that lender qualifications are more strict than the last time they applied for a mortgage. Mr. Defngin says most banks require a minimum credit score of 640 to 660 in order to approve a mortgage, although FHA-insured loans sometimes can be approved for customers with a score of approximately 620.

Mr. Martucci says borrowers with some equity in their homes but a low credit score - less than 640 - may not be able to refinance. He says conventional loans typically require a credit score of 720 or above.

"Pricing on loans varies for people with a credit score of 620 versus someone with a score of

720 or higher, so that it may be possible to refinance, just at a higher interest rate than other borrowers or maybe by paying additional discount points," Mr. Skaff says. "People who have credit challenges should go to their own bank or a local lender for a face-to-face meeting, because loan officers are trained to help people correct credit issues. Paying on time for six to nine months can make a big difference, and loan officers can also suggest which debts to pay to have the biggest impact on the credit score."

In addition to reviewing the home equity and the credit score, lenders will review the debt-to-income ratio in the homeowner's budget. Mr. Defngin says loans owned by Fannie Mae and Freddie Mac are capped at an overall debt-to-income ratio of 45 percent of the gross monthly income needed to make the minimum payments on all outstanding debt, including all housing payments.

"It used to be that lenders wanted to see a maximum of 28 percent of the monthly gross income spent on housing costs and 36 percent on overall debt, but that has gone up to about 33 percent on housing and 41 percent on overall debt," Mr. Martucci says.

Lenders can work with borrowers to evaluate their debt-to-income ratio, credit score, income, assets and home equity in order to determine if a mortgage-loan refinance is possible. In many cases, such as a borrower with a high income or a good credit score, an exception can be made and a loan approved.

In housing markets with climbing prices, many homeowners opted to refinance to a higher loan amount to take cash out of the home to make home improvements, pay college tuition or pay off other debts.

"Cash-out refinances are very rare these days, mostly because of a lack of home equity and concerns about home values," Mr. Martucci says. "It used to be that owners could borrow up to 90 percent of the value and take out cash, but now the limits are set to about 75 percent because the lenders want to make sure there is a sufficient cushion of equity in the property."

FHA loans allow a cash-out refinance at up to 85 percent of the property value.

Closing costs

Borrowers will also need equity in the home if they want to wrap closing costs into their new loan.

"Most people choose to roll the closing costs into their loan if they have enough equity, but sometimes people will pay a few thousand dollars out of pocket if they don't have enough value in the home or they don't want to add to the size of their mortgage," Mr. Skaff says. "A lot of lenders advertise a 'no-cost' refinance, but that really means that the borrowers will pay for it with a slightly higher interest rate. Basically, the lender just makes a loan with a 5 percent interest rate into one with 5.5 percent interest and then pays the costs from the extra money they receive."

Even at the slightly higher interest rate of a no-cost refinance, many borrowers will be better off refinancing than staying with a risky adjustable-rate mortgage or one with a high fixed interest rate, Mr. Skaff says.

"We're finding that a lot of people are so motivated to refinance that they are willing to bring cash to the table to qualify for a new loan," Mr. Skaff says. "People want to feel secure with their house and the mortgage payments, and are realistic about what it might cost to get into a low-interest loan."

Mr. Defngin says that on a typical loan of $240,000, closing costs are about $2,800 to $3,000. He says borrowers can pay 5 percent interest and roll in the costs with the loan or pay 5.25 percent interest and have the bank pay the closing costs. A no-cost refinance adds from a quarter percent to a half percent to the interest rate, depending on the program offered by the lender and the size of the loan.

"Generally, people who opt for the no-cost plan don't plan to hold onto their loan for the long-term, while someone who opts for paying closing costs usually plans to keep the loan for a longer period," Mr. Defngin says. "It's best for borrowers to ask for both options and compare them to make an informed decision."

Mr. Martucci says about 95 percent of borrowers wrap the costs into the mortgage, by far the preferred method of paying closing costs, as long as they have enough equity in the property.

Type of loan

While the majority of homeowners opt for a fixed-rate mortgage because interest rates are so low, an adjustable-rate loan can be the right option for some borrowers.

Mr. Skaff suggests adjustable-rate loans make sense only for homeowners who are completely certain they will be moving before the loan adjusts, for example because of retirement or a military deployment.

"If someone knows they will move within five years, and they have at least 20 percent equity, which gives them a cushion in case home values drop a little more, then it makes sense for them to save money on their monthly payments with an adjustable-rate loan," Mr. Defngin says. "The key is being certain you will sell the house before the loan adjusts to a higher rate."

The complications of refinancing can quickly be offset when homeowners compare their current monthly payments with the lower payments possible at a lower interest rate.

"The bottom line is that anyone interested in refinancing should talk to a trusted mortgage professional who can explain the challenges of refinancing and knows the ins and outs of getting a loan in this ever-changing industry," Mr. Defngin says.