Homeowners Should Try To Unload PMI

By Benny L. Kass, Washington Post, April 2005

Q Several years ago, we paid $200,000 for our house. We barely were able to scrape up $20,000 and took out a 90 percent loan for $180,000. Because we did not have enough for a 20 percent down payment, we had to obtain private mortgage insurance, called PMI. Since then, in addition to our regular mortgage, we have been paying about $75 a month for PMI. Because of this wonderful real estate appreciation, our house is now worth almost $300,000. Is there any way, other than refinancing our loan, to get rid of this PMI obligation?

A The answer depends on the current amount of your loan and not on the current value of your property. You should talk with your mortgage lender about this. In my opinion, PMI is not insurance you really want. To the extent possible, you should try to avoid it if you are purchasing a new home, or you should try to have it removed from your current mortgage.

In 1998, Congress enacted the Homeowners Protection Act, which became effective in 1999. This law covers your rights in regard to PMI.

First, let's understand PMI. It should not be confused with homeowners insurance, often called hazard insurance. Homeowners insurance protects the homeowner in the event of a problem, such as fire or theft. PMI protects the lender against financial loss if the homeowner defaults and the house has to be sold at a foreclosure sale. If, for example, your house has a loan balance of $175,000, but at foreclosure sells for only $150,000, PMI will pay the lender the difference.

Unfortunately, you, as the homeowner, pay these premiums. Until recently, you would have had no choice -- you had to take the insurance -- and the premiums are not cheap. As you know from your own experience, if you put 10 percent down on a $200,000 house bought with a 30-year fixed rate mortgage, you would pay about $75 per month in mortgage premiums. If you had put only 5 percent down, the PMI premiums would have been $120 per month.

Keep in mind that you should not be required to obtain PMI if you put at least 20 percent down when you purchase your home. Lenders have learned that if you have less than 20 percent equity in your house, you are more likely to default on your mortgage loan. That is why the magic mark is 20 percent down.

The private mortgage industry makes the argument that if you do not have enough cash to make a 20 percent down payment -- and if you really want to buy a house -- PMI is the only way to go. But in recent years, lenders have come up with alternatives.

One such approach is known as the "80-10-10" loan. Under this arrangement, the borrower must have a minimum of 10 percent cash to put down. The lender makes you

two loans: one for 80 percent, and the other (a second trust) for 10 percent. Because the first deed of trust (mortgage) is just 80 percent of the purchase price, it is considered a conventional loan and no PMI is required. The second trust carries a higher rate of interest, but is clearly tax deductible. More important, you can pay off the second trust; removing PMI is often difficult, notwithstanding the Homeowners Protection Act.

Some lenders have created a program whereby they pay the mortgage insurance but pass those premiums on to the borrower in the form of a higher mortgage interest.

There are two important questions frequently asked about PMI: Can I cancel the insurance? Are the payments tax-deductible?

Borrowers have long had difficulty ridding themselves of monthly PMI payments. During the hearings when Congress was considering the PMI legislation, numerous horror stories were recounted. Among them:

* A woman and her now-deceased husband bought their home for $20,700. The couple financed $18,700 and were required by their lender to obtain PMI. At no time were they told that they were entitled to cancel this insurance. The last payment on the loan was 20 years later, and included a mortgage insurance payment of $13.99. According to her testimony before the House Banking Committee, this widow paid PMI premiums for the life of her loan.

* A member of Congress bought a small condominium in Virginia, and put down less than 20 percent. He was required to pay $20 per month for PMI. When he inquired how he could stop this monthly payment, he was told to obtain an appraisal to demonstrate that the loan-to-value ratio (LTV) was less than 80 percent. However, after he obtained that appraisal, the lender kept adding requirements. Finally, after four years of "wrangling" with his mortgage lender, he was able to cancel the insurance.

After these hearings, the Homeowners Protection Act was enacted. Under this law, PMI on most loans originated after July 29, 1999, will automatically terminate once the mortgage has amortized to 78 percent of the original purchase price of the house. Lenders are required to advise their borrowers at closing when the mortgage will reach that 78 percent mark.

Thus, in your example, your original loan was $180,000. If your loan balance is now $140,400 or less (for example, 78 percent of the original loan amount), and if your loan was originated after July 29, 1999, your lender must remove PMI payment from your loan.

On the other hand, if your mortgage loan was placed before that date, you will still have to discuss your specific situation with your lender. If the lender refuses to allow you to drop PMI, you might want to consider refinancing. Keep in mind that even if your LTV is more than 80 percent, but less than 90 percent, the 80-10-10 loan may be worth investigating. In fact, some lenders will do an 80-15-5 loan, which requires you to put

down just 5 percent of the purchase price. Do the numbers and compare the costs of refinancing.

Unfortunately, it may make no difference how much your house has appreciated. The lender and the law look only at the ratio between the current loan balance and the original amount of the loan.

Some lenders, however, will take the appreciated value of the house into account, if only to keep you from switching your loan to another lender when you refinance. You need to talk to your lender to determine your situation.

The law also requires lenders to advise borrowers who are covered under the law about PMI termination and cancellation. This disclosure must be made at the time the loan originally closes, and also once a year thereafter.

As with many areas of tax law, there is no easy, clear answer as to whether PMI is deductible. Many lenders will tell you that the premiums are not deductible, because the taxpayer can deduct only interest and real estate tax payments. The Internal Revenue Service supports that position. Congress has on several occasions attempted to enact legislation to specifically allow these PMI payments to be deductible, but to date, that legislation has not been enacted.

Some tax lawyers have concluded, however, that PMI payments are deductible. In an issue of Tax Notes, tax specialist Paul Housey wrote: "PMI premium payments made by a borrower to a lender are not paid to acquire the PMI policy because the lender is the beneficiary of the policy. Such premiums also are not paid for specific services rendered. Rather, PMI premiums are paid solely for the 'use or forbearance of money,' the same as the stated rate of interest. Thus, such payments should be characterized as interest for federal income tax purposes."

If you pay PMI premiums, and you are willing to gamble, it might be worth declaring these payments as interest deductions when you file your next tax return.