Why Your Rate is Higher than the Advertised Rate

If the Sunday paper advertises a 5% 30 year fixed loan, the radio says I can get a 1% fixed payment 30 year loan, and the junk mail letter says it can lower my payments by 50%, how come I wind up paying more? These are good questions, and it is wise to know the answers before embarking on hazardous financing.

In general, 30 year mortgages come in three distinct categories:

FIXED, REALLY FIXED, "FRM" Fixed Rate Mortgage: rate and payments are fixed for 30 YEARS. These come in two sizes, Conforming and Non-Conforming/Jumbo. Fannie Mae (Federal National Mortgage Association) sets certain underwriting guidelines nationwide, and if your loan conforms to all these guidelines, you get the best possible rate.

ADJUSTABLE: rate and/or payment change every month or twice or once a year. Option ARMS (which adjust every month), 6 month ARMs or 1/1 ARMs, are quoted to you assuming a 3 year prepayment penalty. Every ARM has an "Index", like COFI (Cost of Funds Index for the Savings and Loan companies in the 11th district of the Federal Home Loan Bank), or LIBOR (London Interbank Overnight Rate) or TBILL (based on US Treasury Bonds). On top this index you will pay a margin (like a profit margin) usually 2.75%, the two added together comprise your "fully indexed" rate. For example, LIBOR is around 4.25%, your margin is 2.75%, and you owe the bank interest at 6.75%, until the next rate adjustment.

INTERMEDIATE ARMS: – Rate is fixed for 3 or 5 or 7 or 10 years, and then adjusts twice or once a year for the remaining term.

Advertised rates are for the IDEAL BORROWER buying the IDEAL PROPERTY. Think of the billboard rate as an "off the rack" price for a suit that fits nobody. Here are all of the underlying assumptions:

- Ideal Borrower (we'll call this fictional character "Norm") has 20% of the purchase price available IN CASH.
- Norm wants to pay a point out of his own pocket. A point is one percent of the loan amount, paid up front. However, those thousands of dollars (sometimes called "origination fees") are non-refundable, and it takes about 4 to 5 years for the lower payments to add up (pay back period).
- Norm has had the exact same job, at the exact same employer, being paid ever increasing salary amounts for the last 24 months, and has the W-2's and current paystubs to back it up.
- Norm has a 10 year long credit history with at least 5 tradelines showing nothing but on-time payments, i.e. perfect credit, with FICO's (Fair Isaacs Company invented the credit scoring formula) in excess of 740.
- The projected housing payments (known as PITI for Principal Interest Taxes and Insurance) are no more than 33% of IB's stable salaried income, and all other debt payments total no more than 7% of the gross income.
- After Norm buys his house, he will still have 6 months worth of PITI left in reserve.
- Norm doesn't mind a 3 or 5 year prepayment penalty.
- Norm is buying a Single Family Residence (SFR). This could be a condo, a PUD, a townhouse or a detached or semi detached home with no more than 5 acres of land, no duplexes, no in-laws, and no yurts, no older or newer or fancier than all the other houses on the block.

Deviate from these predetermined norms, and the rate you pay will be higher than the Ideal Borrower. That's OK, Norm isn't real. You are, and a good mortgage broker will get a real loan for real people, you may be pleasantly surprised at close of escrow.

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