

# Taking the bite out of closing costs

## Roll fees into loan through seller or lender contribution

BY JACK GUTTENTAG

Upfront cash requirements are the single most important impediment to homeownership. First and foremost, cash is required for the down payment, which lenders insist on to protect themselves from liability.

The down payment is a buffer against loss in the event the borrower defaults. It is also a rough indicator of the borrower's financial discipline, in the sense that those able to save enough for a down payment will default less frequently than those who can't.

But cash is also required to meet settlement costs. This is a range of upfront charges, some by lenders and some by third parties such as title insurers, appraisers and local governments.

Unlike the down payment, these charges do not make the loan any safer for the lender, and therefore lenders tend to be indulgent of devices for reducing or eliminating them. These devices convert settlement costs into higher monthly payments.

There are two ways to do this, which arise at different stages of the home buying process. One way is for the home seller to pay the buyer's settlement costs and to recover it in the price of the home.

For example, Jones has agreed to purchase a home from Smith for \$200,000 and can meet the minimum down payment required of \$7,000 plus \$2,549 in lender fees but not the \$6,356 needed for third-party settlement costs. The parties agree that the price of the house will be set at \$206,356 and the seller will pay the third-party costs.

Jones now has to borrow \$199,134 instead of \$193,000, which raises his mortgage payment on a 30-year fixed-rate mortgage at 4 percent from \$921.41 to \$950.70. The point is that Jones can afford the \$950.70 payment but does not have the \$6,356 in cash.

This procedure does not always work, however, because the appraiser has to agree that the house is worth \$206,356. A ratification of the price by the appraiser was fairly easy to obtain when home prices were rising because appraisers tended to err on the upside.

It is more difficult in today's market because appraisers are now super-cautious and tend to err on the down side. Lenders also limit the size of seller contributions to 3 percent of the sale price on low-down payment loans as a way of capping any over appraisals.

The second way Jones can relieve his cash shortage is to obtain a cash-contribution from the lender in exchange for a higher interest rate. On the day Jones could have borrowed \$200,000 at 4 percent, he could have obtained a cash rebate of \$6,356 from the lender in exchange for a rate of 4.875 percent, increasing the payment to \$1,021.37.

Most lenders offer a range of rate/point combinations with the lowest rate requiring the largest payment by the borrower to the lender, and the highest rate requiring the largest payment from the lender to the borrower. Where seller contributions increase the borrower's mortgage payment by increasing the loan amount, lender contributions increase the payment by increasing the interest rate.

An advantage of lender contributions is that, unlike seller contributions, they are not subject to the uncertainties of the appraisal process.

I was persuaded of the need to view the two options together by Ernie and Wade Lester, who have been developing an analytical framework covering both. The idea for this article came from them.

With Chuck Freedenberg, I designed a simple calculator for determining the option that was least costly to the borrower. It is [number 14a](#) on my website.

The calculator indicates that although the lender contribution in my example above increased the payment by more than the equivalent seller contribution, it was not necessarily the less costly option because account must be taken of differences in the loan balance and in tax savings.

In general, a lender contribution is the better option for a borrower with a short time horizon and in a high tax bracket. With a lender contribution, the break-even period for a borrower in the 25 percent tax bracket is about five years, rising to six years if he is in the 40 percent bracket.

Borrowers who expect to have the mortgage longer do better with a seller contribution. But don't rely on these generalizations. The calculator allows you to tailor the answer to the specifics of your situation.

I realized after drafting this article that I have never been asked by a borrower whether one option is less costly than the other if both are available, which they often are. I think the reason is that they don't confront the options at the same time.

Borrowers confront the possibility of seller contributions when they are in purchase mode and advised by Realtors, who focus on the seller contribution option if one is available. Borrowers confront the possibility of lender contributions when they are in borrower mode and advised by loan officers or mortgage brokers, who focus on the lender contribution option.

Cash-constrained borrowers who want to select the least-costly option should make the decision themselves.

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14a

On the “Next page” you’ll find a sample of:

**Mortgage Insurance Calculator**

**Mortgage Insurance versus Higher Rate**

**Who This Calculator is For:** *Borrowers trying to decide whether they should elect to pay mortgage insurance on a fixed-rate mortgage, or avoid mortgage insurance by paying a higher interest rate.*

**What This Calculator Does:** *This calculator compares the after-tax interest cost of a fixed-rate mortgage on which the borrower pays for mortgage insurance with that of a higher interest rate mortgage on which mortgage insurance is avoided.*

Enter the Following Information: **DO NOT USE DOLLAR SIGNS (\$), COMMAS (,) PLUS OR MINUS SIGNS (+ / - ) OR PERCENTAGE SIGNS (%) IN ANY INPUT BOXES**

**SAMPLE BELOW**

☰ Is This Loan for the Purchase of a Property or a Refinance?		Purchase ▾
Loan Term (in years)		30 years ▾
☰ Income Tax Bracket ( e.g. 27 )		30
☰ Expected Years in House, Cannot Exceed Term		10
☰ Optional: Expected Rate of Property Value Appreciation		5
☰ What Do You Expect Your Down Payment to Be?		10% ▾
☰ Will Mortgage Insurance be Deductible for You?		<input checked="" type="checkbox"/> Yes <input type="checkbox"/> No
	<b>Mortgage Insurance</b>	<b>Higher Interest Rate</b>
☰ Mortgage Insurance (Monthly Premium Plan)	0.96	0
Interest Rate (e.g. 7.50)	5	6
Points (e.g. 1.5)	1	1

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Display Interest Costs

**To use this calculator, go to:**

<http://www.mtgprofessor.com/Calculators/Calculator14a.html>