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Are No-Cost Mortgages Always the Best Deal?

credit.com By Scott Sheldon | Credit.com – 11 hours ago

A program made popular in the height of the subprime lending environment was the no-cost mortgage. No-cost mortgages have gotten quite a bit of exposure lately, as consumers seek to better understand loan terms, interest rates and how to qualify for mortgages in an ever-tightening credit market. And then there's the low-cost mortgage. No-cost mortgages, low-cost mortgages — two distinct differences. Here's how they differ.

Some Lending Lingo

Annual Percentage Rate (APR) is a function of blending the closing costs with the loan amount and re-amortizing that figure over the term of the loan. On traditional loan financing, the APR is usually within .125% of the actual note rate tied to the amount borrowed.

What to know: APR is a comparative tool enforced by the Truth In Lending Act to quickly assess cost differences between loan choices. The APR has no bearing on your principal and interest payment amount nor the note rate. APR is a barometer of loan cost solely. The interest rate, rather than note rate, determines the monthly mortgage payment.

No-Cost Mortgage is truly a "no-cost" loan — no appraisal fee, no lender fees and no closing costs. These fees are assessed by virtue of taking out the loan. The mortgage lender provides a credit at the close of escrow equal to the amount of the closing costs, thereby creating a "no fees" loan. APR is equal to the interest rate, but disclosure will have a higher APR just as a traditional mortgage would, as lenders are required to disclose APR whether there is a lender credit or not.

What to Know: No-cost mortgages will contain a *higher* interest rate and APR, so you're in essence amortizing the closing costs over the life of the loan (i.e. 360 months representing a 30-year fixed rate mortgage). The higher interest rate allows the lender to generate "overage" for the benefit of the consumer taking out the no-cost mortgage.

Low-Cost Mortgage is a traditional mortgage all lenders offer that is considered the norm, taking out a loan while paying any applicable fees associated with doing so, excluding discount points, which are usually optional. (In some cases paying discount points may very well make sense, but for our purposes a low-cost mortgage is under the assumption of no discount points.)

What to Know: Low-cost mortgages will contain lower rates than their no-cost mortgage counterparts. Because the lender does not have to inflate the rate for generating overage to pay the borrower's closing costs, the lender can offer the consumer premium pricing when it comes to the interest rate and terms. Not always, but in most cases.the interest rate and APR are lower on low-cost mortgages than on no-cost mortgages.

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Which Is Better for You?

The benefits you would gain from either type of loan depends on how long you plan to hold the loan and your financial goals. For example, because the future for many is unknown in terms of how long the loan will be held for and/or how long the property will be held for, a low-cost mortgage is a more appropriate long-term strategy as the realized benefits of the lower cost mortgage materialize over time — i.e., lower interest savings over the life of the loan. Conversely, if the property hold time or the loan payoff is going to be dramatically shorter, such as within the next 12 months, a no-cost mortgage is more appropriate despite the higher interest rate.

Here is a typical no-cost versus low-cost mortgage scenario to see how the numbers change over time…

SUMMARY

Program	No-Cost Mortgage	Low-Cost Mortgage
Loan Amount	$300,000	$300,000
Interest Rate	4.13%	3.63%
P & I Term (months)	360	360
Financed Loan Amount	$300,000	$300,000
Monthly Payment	$1,453	$1,368
Net Savings		$85
Closing Fees	None	$2,500
	COST OVER 30 YEARS	
Program Details	A	B
Principal Paid	$300,000	$317,000
Interest Paid	$223,422	$192,535
Total Loan Cost (P&I)	$523,422	$509,535

- Assumptions based on primary residence, with excellent credit and 65% loan to value.
- No-cost mortgage rate: 4.125%/APR 4.26%
- Low-cost mortgage rate: 3.625%/3.76% APR

Based on the figures, after backing out the $2,500 in closing costs, the low-cost mortgage is $28,387 lower in mortgage interest for the life of 360 months. Looking at the monthly figures, $78.85 per month is the monthly interest benefit attainable on the low-cost loan. Adding the interest savings and payment savings provided a total benefit.

How to Crunch the Numbers on Low-Cost and No-Cost Loans

1. Subtract the total interest of the low-cost mortgage from the no-cost mortgage.
2. Take this figure and divide it by the term of the loan — 360 months for a 30-year fixed-rate mortgage — and then subtract the one-time closing costs from this figure (title fees, loan origination fee, recording fees, etc.).
3. If you do this correctly it will give you a monthly figure representing the monthly interest savings between the two loans.
4. Next add in the payment savings generated by the lower interest rate and you'll have the total monthly loan benefit of a low cost mortgage

Don't be fooled by a no-cost mortgage, because there's no such thing as a free lunch, and no matter how good the advertisement is, you'll pay the closing costs over the life of the loan term. A low-cost mortgage will always net a better interest rate and payment.

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