Removing the Mystery from Your Prepaids and Payoff Amount

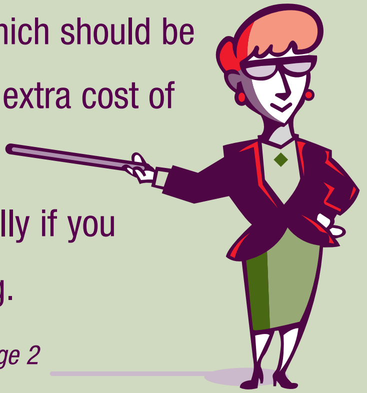
APPLE STREET MORTGAGE

Prepaids and Payoff Amount – What are They?

Q: Why am I required to bring $4,000 to the closing table when my lender said that my closing costs would only be $2,000?

A: The answer is "prepaids" and, in the case of a refinance, "payoff amount". **Your prepaids and payoff amount are not closing costs.** Closing costs are your costs to get the loan. Prepaids and payoff, for the most part, are not. Let's explain, starting with prepaids.

Prepaids generally include two things – neither of which should be considered an extra cost of getting a new loan – especially if you are refinancing.



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Prepaids:

❶ The first prepaid is **prepaid interest** which is the interest paid in advance to your new lender from the funding date to the end of the month. This is just the first of many interest payments that you will make to your new lender over the life of the loan except that this is the only interest payment that you will pay in advance.

❷ The second prepaid is your **escrow deposit**. This is the money required to set up your escrow account with your new lender so that they can pay your home insurance and property taxes when they come due. The good news is that, if you are retiring an old loan, your prepaid escrow funds often come right back to you in the form of a refund from your old lender – these prepaids "come out in the wash".

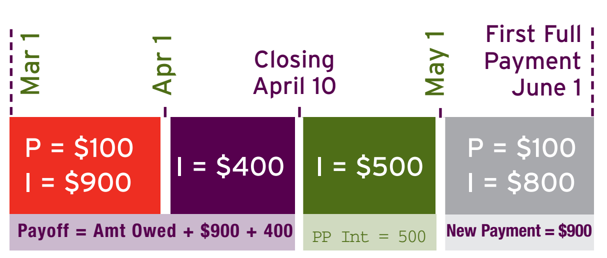
Q: *What does that mean – my escrow prepaids will "come out in the wash"?*

A: In the case of a refinance, the escrow funds required to start your new escrow account with your new lender will often be roughly equal to the refund that you will get of excess escrow funds remaining with your old lender. Granted, you will have to bring funds to the closing table to establish your new escrow account, but you will get a check back from your old lender within 30 days or so – you will not be double-billed! The dollar amount required to establish your new escrow account will vary depending on the date that your home insurance and property taxes come due. Although sometimes difficult to estimate accurately until your closing date is established, your lender should be able to give you a pretty good idea of how much this will be.

Of course, with a new purchase, you may not get an escrow refund but your new escrow deposit should not be considered as an extra fee. Escrow is just a convenience that the lender offers to help you budget your finances. Again, it's money that you need at closing, but it is not a finance cost.

Q: *How is prepaid interest calculated?*

A: Please refer to the last two squares in the colored bar, which represent money paid to your new lender. Let's say that you close your loan on April 10. At the closing table, you must pay the new lender in advance for the interest that will accrue from closing until the end of the month (green box). This is the only time that you will pay interest in advance. The good news here is that your next payment won't be due until June 1 because interest payments from here on out are made "in arrears" which means that you don't pay your interest until after it has accrued. So your June 1 payment includes the interest that accrued in May ($800 in gray box) along with your first principal payment ($100 in gray box). Guess what! You get to skip your May 1 payment!



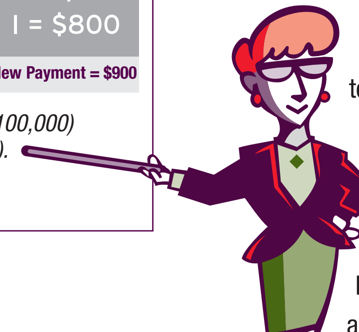
Payoff amount to old lender = amount owed (100,000) + March interest ($900) + April interest ($400). Prepaid interest to new lender = Interest from closing date to end of April ($500).

Q: *When I refinanced, the amount remaining on my old loan was $100,000, but the so-called "payoff amount" was $101,300. Am I getting squeezed here?*

A: No. Please refer now to the two left-most boxes which are included in the **"payoff"** amount paid to your old lender. At the closing table on April 10, you must pay for the principal that you owe to the old lender to pay off the old loan and, in addition, you must pay (in arrears) for any interest that accrued since your last monthly payment. This will definitely include the interest that accrued in the first part of April ($400 in the purple box) – but it may also include interest that accrued in March ($900 in red box) – depending on whether or not your April 1 payment was made and processed in time for your new closing.

Q: *What happens if I made my April 1 payment but it was not recorded? Am I getting double-billed?*

A: No. The old lender will refund your April 1 payment within 30 days or so. This is why your new lender may suggest that you *not* make your April 1 payment if you are closing in early April. You can skip the payment! Again, it will all "come out in the wash".



But there is no magic here. You will pay interest to somebody on every day that a loan exists – whether it is the old loan or the new loan. You won't normally pay twice for the same day, (paying off an FHA loan is an exception) but you won't get any free days either! Expenses for your prepaids and payoff amount all come out in the wash!