Private Mortgage Insurance (PMI) Explained

What is PMI?

To put it in basic terms, PMI is private mortgage insurance on a home loan. Lenders require it to protect themselves in cases where the buyer has less than 20 percent equity in the home.

Note: We are only discussing the type of PMI that is required on **conventional loans.** Other types of mortgage insurance may be required for borrowers who get a different type of loan. For example, someone getting an FHA loan may need to pay a mortgage insurance premium, or MIP. It's a similar concept to PMI but goes by a different name and works slightly differently.

For simplicity's sake, we're going to stick to talking about PMI on conventional loans, since that's the most common. Just be aware that mortgage insurance may be required on other types of loans, but the details of it may differ.

Why Do I Have to Pay PMI?

You may find it strange that you have to pay PMI; after all, it's insurance that you pay for, but it doesn't really protect you. That's true; PMI protects the lender and the investor, not the homeowner.

The lender and investor are taking the risk that you will actually make your loan payments, and so the lender and investor need protection in case you fail to pay. When a failure to pay occurs, the PMI policy steps in and compensates the lender for the costs associated with delinquency and foreclosure. Essentially, the lender is willing to take a risk on you, so you have to be willing to pay the fee.

How Much Does PMI Cost?

The easiest way to answer this is by thinking about down payments. Let's say you want to buy a house for $275,000 with a conventional loan. To avoid paying PMI, you must put down at least 20 percent, or $55,000. That is a huge amount of cash for most people, and it's why saving for a down payment is so hard for many people.

If you can't afford the 20 percent down payment, PMI is required.

The cost of PMI, in most cases, gets factored into the monthly payment along with principal, interest and the other costs that go along with any mortgage. PMI premiums vary but are usually between 0.5 percent and 2.25 percent of value of a home each year. For example, if a home costs $275,000 and PMI is 1 percent, then PMI would cost $2,750 a year, or about $228 per month. This amount is added into your monthly payment.

The Good and the Bad of PMI

The obvious thing about PMI that causes people to dislike it is the simple fact that it is another expense that makes home ownership more expensive. It can be hundreds of dollars per month, and that's hard to swallow sometimes.

The bright side of PMI is that it allows more people to purchase homes. Many first-time buyers wouldn't be able to purchase a home because of how hard it is to come up with a 20 percent down payment. Many buyers can afford a monthly payment with PMI included; it's coming up with the down payment that keeps people from buying.

How Do I Get Rid of PMI?

Let's stay focused on our basic, most common scenario where a person has a conventional loan with PMI. You can have PMI removed once you reach 20 percent home equity.

You hit 20 percent equity by:

1. Making a 20 percent down payment; or
2. Over time by making your mortgage payments; or
3. A rise in your home's value; or
4. Refinancing.

Option 3 is particularly interesting. You can be proactive about removing PMI, especially in an environment where home values are rising. You can request an appraisal from the lender, and if the appraisal shows 20 percent or more home equity, PMI can be removed. Keep the following in mind regarding appraisals:

- If you've owned the home for **at least five years**, and your remaining mortgage balance is no more than 80 percent of the new valuation, you can ask for PMI to be canceled.
- If you've owned the home for **at least two years but less than five**, your remaining mortgage balance must be no greater than 75 percent of the new valuation.

Option 3 and Option 4 often occur together, as an appraisal is frequently done as part of a refinance. A refinance is a new loan which allows homeowners to get a better interest rate, a shorter term or take cash out for a project or other purpose. And because of recent rises in home values in many markets, many homeowners can reap the additional benefit of ditching PMI because they'll have more than 20 percent equity in their homes.
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Keep in mind, refinancing isn't always an option for newer homeowners. Many loans have a "seasoning requirement" that requires you to wait at least two years before you can refinance to get rid of PMI. So if your loan is less than two years old, it won't hurt to ask about a PMI-canceling refi, but just know that you might not be eligible yet.

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