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Do You Need a Piggyback Loan?

If you are going to be buying a home with less than a 20 percent down payment, you are going to have to pay private mortgage insurance (PMI.) This is an insurance policy protects your lender against loss, even though you pay the premium for it. You can cancel the policy as soon as your equity in the home reaches about 20 percent. Until that time though, you are stuck with an extra fee each year. Unless, that is, you decide to side step paying PMI by getting a ‘piggyback loan.’

A piggyback loan, or an 80/15/5 loan as it is also called, is really two loans – one to cover 80 percent of the purchase price and one to cover 15 percent of the remaining purchase total. You then supply 5 percent as a down payment. This loan set up allows you to avoid making private mortgage insurance payments. Many buyers prefer this option because they can get this type of loan in many formats, fixed rate and adjustable rate, and even interest-only options. Plus with this loan format they do not have to make that PMI payment each year that could be as much as several hundred or several thousand dollars.

Another reason many home buyers like this piggyback loan option is that in the past mortgage insurance premiums were not tax-deductible, but all interest paid on 80/15/5 mortgages is deductible. For 2007 however, a new tax break is being tested, allowing homeowners within a certain income bracket to deduct their PMI fees from their taxes this year. There are many people lobbying to make this deduction a permanent part of the tax code, but an 80/15/5 loan still remains a safe bet for those trying to reduce their tax bill.

There are a few drawbacks and dangers to these piggybacks loan though. First, your total interest rate on such a loan will probably be higher than you would get on a more traditional loan. You will likely get a good rate on the 80 percent loan, but the second loan is a riskier loan and will consequently carry a higher interest rate. So while you may escape PMI with 80/15/5 loans, you may end up paying more in interest charges over the long run.

Another reason to be cautious with piggyback loans is that the second loan often requires a balloon payment at the end of the loan term. This means that you will either have to come up with that lump sum of cash yourself to repay the lender or you will have to refinance into a new loan.

Finally, because a piggyback loan is really two mortgages – a first mortgage, and a second mortgage or home equity loan – you have two claims on your property and if you have difficulty paying off either loan, you risk losing your home.

So the benefits of a 80/15/5 loan for your situation will depend on how much your PMI payments would be and how low of a combined interest rate you can get on the piggyback loan. Be sure to discuss the various costs and savings with your mortgage professional or financial advisor!